TrendMacro

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MARKET CALLS

Under-Seasoned

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Donald Luskin

Expectations are so elevated, this earnings season almost has to be a disappointment.

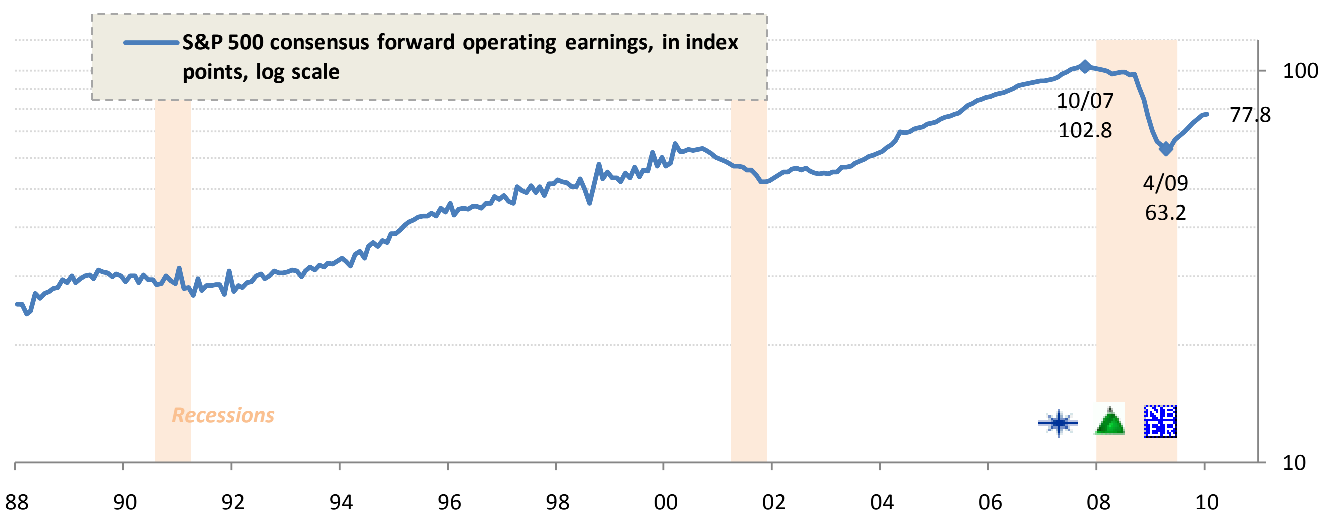
Stocks are losing momentum, now only creeping to eke out new recovery highs where once they were surging. But other than that, our expectation for a correction of the bull move from the March 2009 lows, now the fifth best rally in the recorded history of daily US stock prices, has been entirely frustrated. We are fully attuned to the very good reasons for stocks to have performed so well: the resolution of the banking crisis, the end of recession, the ongoing spew of liquidity from the Fed, and the reduction of economic policy instability. It's a fact -- stocks just don't want to go down. We *get* that. Yet we remain cautious, more than ever.

Update to strategic view

US STOCKS: Earnings upgrades have been running at a torrid pace, and the past two earnings seasons have been spectacular. That sets what may be an impossibly high bar for this earnings season. With stocks having already delivered an historic rally, and already at peak forward multiples, they are vulnerable to disappointment that seems nearly inevitable.

[see Investment Strategy Dashboard]

We can't help but think that we still don't have convincing evidence for a truly robust expansion at hand -- the move in stocks, in and of itself, isn't sufficient evidence. Be that as it may, now with consensus forward earnings having recovered 23% from their April 2009 low (see the chart below), the S&P 500 is already back to its peak forward multiple -- that is, the multiple that obtained at the top for the stock market in October 2007, which has been the top of the range of



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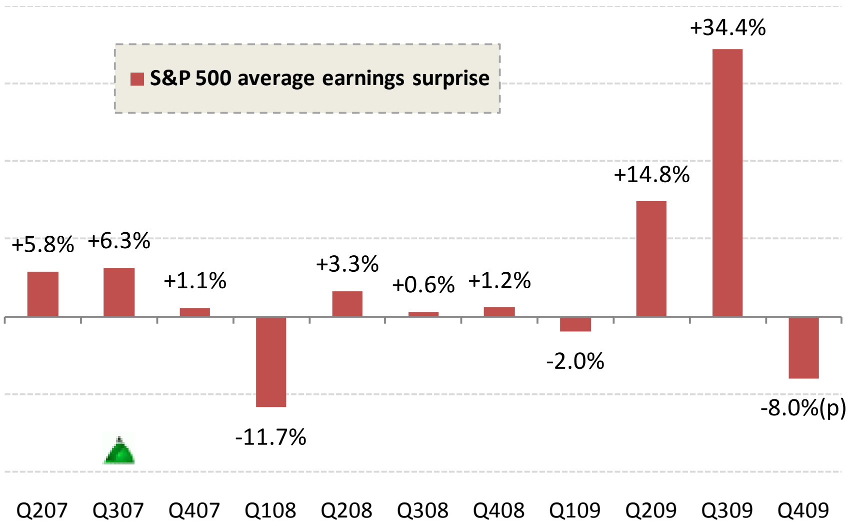
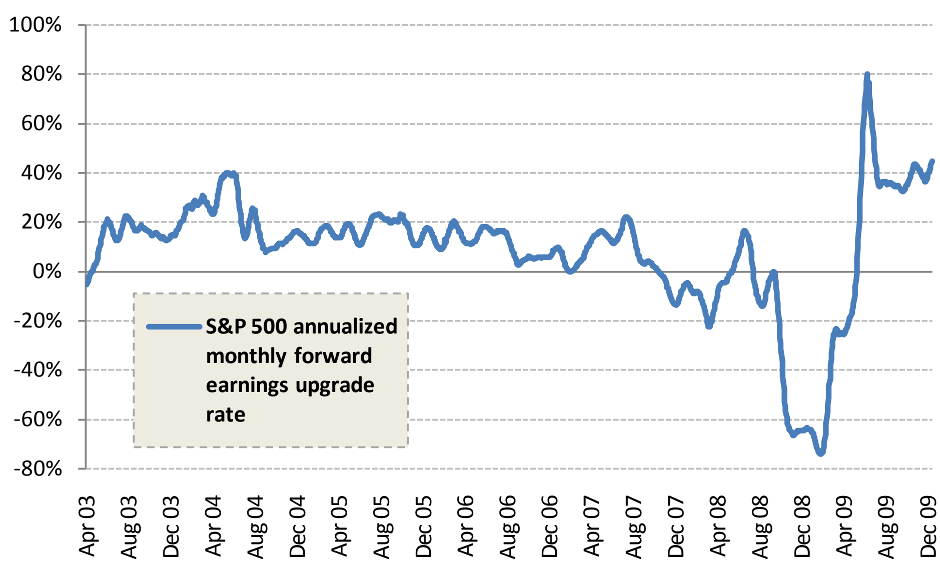


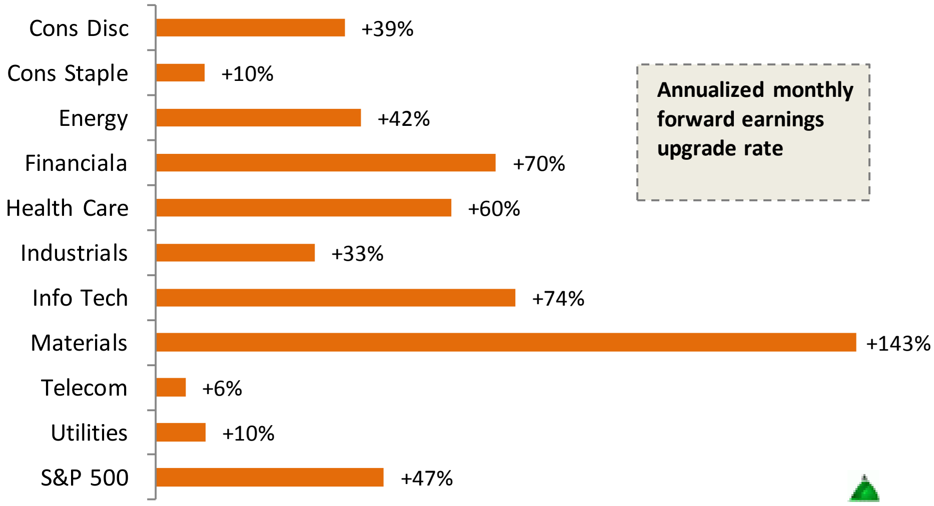
the forward multiple since 2002. There isn't much more room for sentiment improvement here. Why should there be after a 69.8% up-move in 311 days -- it's after large *down*-moves that sentiment has lots of room to improve, not after large *up*-moves. The rally from the March bottom has already been fully commensurate with the bear market decline that preceded it -- roughly proportional in percentage terms to the larger rally that occurred from the bottom of the worse bear market in the Great Depression.

If gains from sentiment will now be in short supply, then gains will have to come from more earnings upgrades. But how much more can we expect, and when? What worries us here is that the pace of upgrades is already so torrid, the earnings season now commencing will have to be an absolute barn-burner to beat very elevated expectations. The previous two earnings seasons were that strong (see the chart above). So far, with only a tiny handful of companies reporting, and those dominated by Alcoa's big miss, this one isn't. Maybe that will be the catalyst for our long-awaited correction.



The rate of consensus forward earnings upgrades has been some version of amazing ever since June, 2009. The chart at right depicts it as the daily rolling month-over-month percentage change in forward earnings, annualized. From an abysmal reading of negative 74% in February 2009 -- which, if it had persisted would have implied an earnings decline of the same magnitude as that seen over the course of the Great Depression -- the upgrade rate rebounded to a peak of *positive* 80% in July, and has been stable ever since at about 40%. Right now it's at 47%. At 77.8, today's consensus forward estimate for the S&P 500 *already* implies a 54% growth rate above actual trailing earnings of 49.8. Are we really to expect *another* 47% *next year*, as implied by the upgrade rate?

A large portion of the current implied earnings growth rate of 54% is a product of the expected rolling off of write-offs in the banking sector so large that they drag down trailing earnings for the whole S&P 500, creating an artificially low base. Stripping out the whole financial sector, the implied earnings growth rate falls to a more modest -- but still quite impressive -- 20%. But that moderating influence doesn't apply to the *upgrade* rate, as *that's* based on *forward* estimates that have already consigned the bank write-offs the rear-view mirror. Taking out the financial sector only reduces the S&P 500's upgrade rate from 47% to 43%.



The chart at left shows the upgrade rate sector by sector, and we can see that some are more vulnerable to disappointment than others. The highest expectations are for the materials and information technology sectors -- and it's probably no coincidence that these are the two best-performing sectors off the March 2009 bottom. It's also probably no coincidence that earnings season was kicked up this week not with a bang, but with a whimper, by Alcoa -- a materials sector member -- whose earnings missed by 80%. The materials sector remains our favorite, on fundamental grounds having to do with the intertwining threads of reflation and global recovery. But that doesn't mean the sector isn't vulnerable short-term to a little dose of reality. Can we really expect the sector's earnings to grow 143% after they've already rebounded 81% from the trough in May 2009, just eight months ago?

We note that Intel so far has not been lavishly rewarded for its upside surprise last night. And as of this writing, JPMorgan is lower despite its upside surprise, for its bottom-line at least. The point is that these positive surprises aren't really all that surprising. Bad surprises like Alcoa's are being punished severely, while good ones like Intel's and Morgan's aren't being appreciated. We're generally bullish, but in the intermediate term, we think it's one thing to be a bull and another to be bull-headed. It's high time that stocks took a rest, to give reality a chance to catch up with expectations, and to give expectations a chance to get back in synch with reality.

BOTTOM LINE: Earnings upgrades have been running at a torrid pace, and the past two earnings seasons have been spectacular. That sets what may be an impossibly high bar for this earnings season. With stocks having already delivered an historic rally, and already at peak forward multiples, they are vulnerable to disappointment that seems nearly inevitable. The chart at left shows the upgrade rate sector by sector.