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An Earnings Season in the "Expansionless Recovery"

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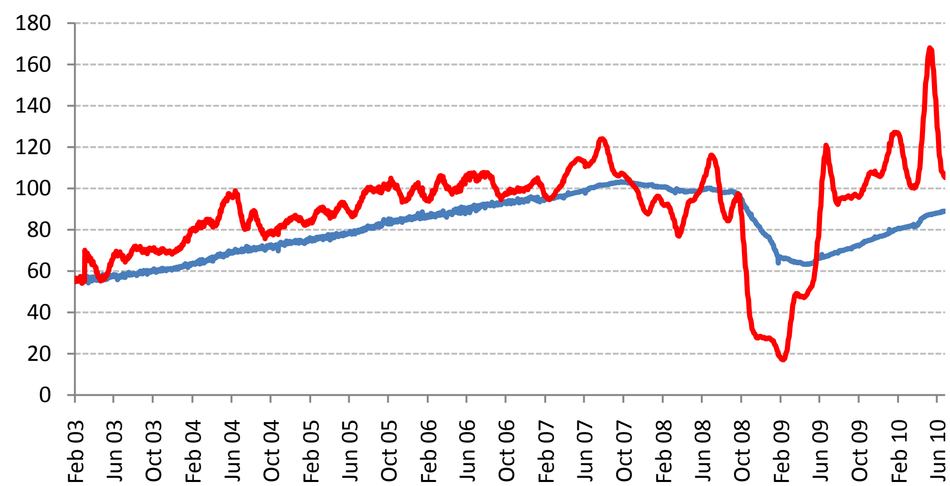
Intel's sales are back above trend -- but that leaves the economy still far below.

The first murmurs of earnings season, and the latest macro data, ought to be as confounding to those who thought a "double dip" recession was underway as to those who hoped several months ago for a "v-shaped" recovery. It's what we've been saying throughout: an "expansionless recovery." It confirms our twin beliefs that the correction in stocks from the April highs is just a correction, not a new bear market -- but that attaining the April highs and beyond will be challenging.

As of yesterday's close, all six reporting S&P 500 companies with June quarter-ends have beaten the street on earnings, but not spectacularly. The best has been Intel, by 19%, with the unweighted average at 10.2% -- down markedly from last earnings season's 26.7%. These good-not-great beats occurred against a backdrop of decelerating expectations -- Alcoa's $0.13/share beat expectations of $0.12, but that's a miss versus the $0.14 that was expected two weeks ago. More significant strategically, year-ahead estimates are rising, but decelerating (please see the chart below).

S&P 500 consensus forward earnings **Extrapolated monthly trend**
Index points, operating; bottom-up, cap-weighted



Source: Zacks, TrendMacro calculations

Update to strategic view

US STOCKS: Against decelerating but not falling expectations, so far this earnings season has been a consistent but unspectacular winner. This affirms our expectation that the current correction is just a correction, but that reclaiming and exceeding the April highs will be slow and difficult.

US MACRO: The deceleration of forward earnings expectations, as well as incoming macro data such as retail sales and business inventories, supports our expectation for no "double-dip," but rather an "expansionless recovery."

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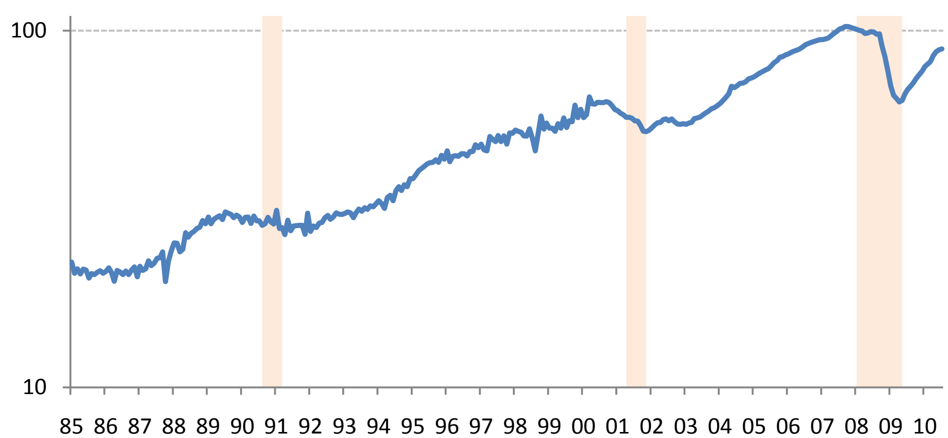
Presently at 88.9, forward earnings have been growing at an annualized month-on-month rate of 15.8%, which if extrapolated, would put them at 105.2 a year out (think of that as "forward-forward" earnings), and would surpass the all-time high of 103.2 in October 2007. But the deceleration has been sharp. By the end of May, at the last gasp of "v-shaped" recovery hopes, forwards were being upgraded at an unprecedented 92.2% annual rate, which if miraculously sustained, would have put them at 168.0 one year out. The intensification of the correction in stocks has corresponded with the abandonment of these absurd hopes.

But earnings expectations have not turned outright negative as we believe they would if we were really in for a "double dip." That is, forward earnings expectations are decelerating, but they are not falling. That's not just because Wall Street analysts as a breed are optimists. They are fully capable of outright cutting forwards on a sustained basis, as indeed they did with great prescience in advance of the last three recessions (please see the chart below). There was even one false downside alarm from these supposed perma-bulls -- in the jobless recovery of 2002-2003.

S&P 500 consensus forward earnings **Recession**
Log scale, in index points



Source: Thompson, Zacks, NBER, TrendMacro calculations

Incoming macro data tells the same ambivalent story of an "expansionless recovery." This morning June retail sales were reported lower -- not the stuff of "v-shaped" recoveries. At the same time, the losses were concentrated in autos, gas and building materials -- not the stuff of "double dip" recessions, when autos and building have already been so depressed for so long. "Core retail sales" actually grew by 2.6% on an annual basis in June, following back-to-back drops in April and May.

But contrary to the dominant narrative, the consumer has never really been the problem in this cycle (see, among many others, "The Consumer: QED" April 16, 2010). The problem has been capital investment. Intel's "best quarter ever," led by strong growth in servers, is being touted as indicating a renaissance in business spending. Let's hope so, because such growth

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Brian Riedl
The Wall Street Journal
July 13, 2010

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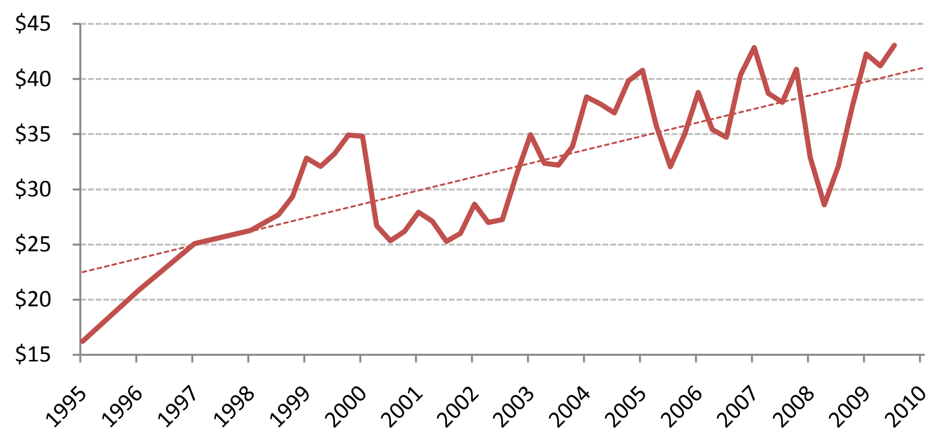
is the only hope for a "v-shaped" recovery, because that's the part of the economy where there is the most slack -- fixed investment (capital goods, housing, and commercial real estate) is at an all-time low as a fraction of GDP, at 11.8%. If Intel were the whole story, it would be very encouraging. Intel's sales are both at all-time highs *and* back above trend, having recovered from a sharp drop in the recession much more rapidly than they did after the 2000-2002 dotcom bust (please see the chart below).

Intel sales - - - **Linear trend**
USD billions, annualized



Source: Reuters, TrendMacro calculations

But Intel isn't the whole story -- investment in computers and peripherals accounts for less than 1% of GDP. When 2010-Q2 GDP is reported, we have no doubt that it, like Intel's revenues, will be at an all-time high. But GDP will be far below trend -- and with trend getting away from us at about a 3% real annual rate, the sluggish growth likely to be reported won't have narrowed the gap. Business investment overall -- not just computer investment -- is only about 6.5% of GDP. It would have to double immediately to make a serious down-payment on closing the gap to trend.

Don't hold your breath on that one, but neither get discouraged that investment is likely to fall back much from here. New orders for non-defense capital goods ex-aircraft have been growing at double-digit annual rates since March. And this morning's inventory data was encouraging, too. With overall sales *falling* about 1%, business inventories nevertheless *expanded* slightly. Thus the inventory-to-sales ratio rose from last month's all-time historic lows. We don't cite this as evidence of strong recovery, but rather as an argument that the economy is likely to be resilient against a "double dip." With fixed investment and the business inventory-to-sales ratio at or near historic lows, there just isn't much room on the downside without an outright catastrophe such as we experienced in mid-2008. The risk of a systemic rupture in Europe's banking sector is diminishing (see "Europe Gropes toward Stress-Tests" July 12, 2010). And with the *Wall Street Journal's* lead story today confirming our forecast that the Fed is preparing further easing (see "How to Ease, Not When to Tighten" June

23, 2010), and today's June FOMC minutes downgrading the Fed's growth outlook, funds rate expectations in the futures market are making new all-time lows (please see the chart below). So we just don't see a catastrophe -- and we see the rescuers very well geared up, just in case. There's no "double-dip" materializing, nor a "v-shaped" recovery. Embrace the boredom: it's an "expansionless recovery."

Expected year-ahead funds rate **Current actual** **Correct prediction**
Implied from futures

Source: CBOT, Federal Reserve, TrendMacro calculations

Bottom line

Against decelerating but not falling expectations, so far this earnings season has been a consistent but unspectacular winner. This affirms our expectation that the current correction is just a correction, but that reclaiming and exceeding the April highs will be slow and difficult. The deceleration of forward earnings expectations, as well as incoming macro data such as retail sales and business inventories, supports our expectation for no "double-dip," but rather an "expansionless recovery."