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MACROCOSM

We Love Our New iPhone, But…

Wednesday, March 21, 2012

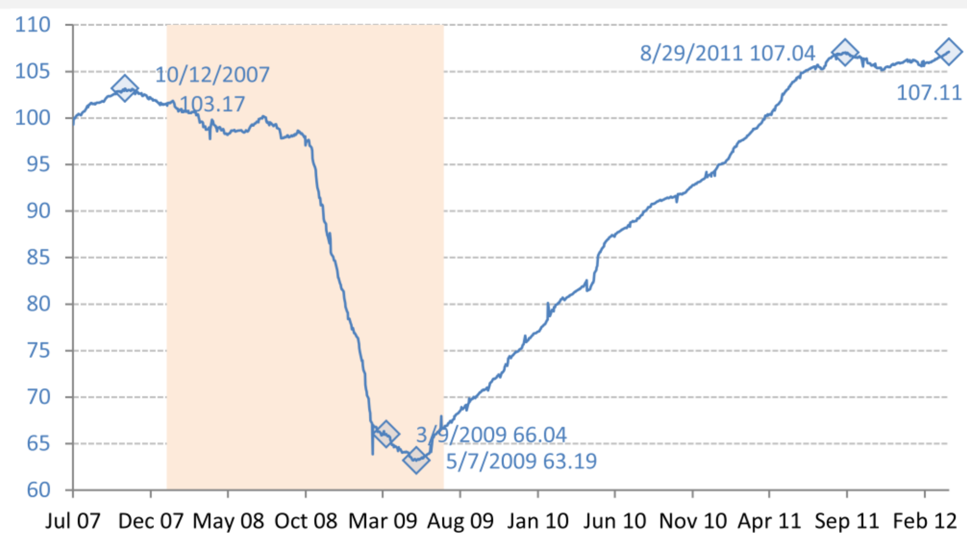
Donald Luskin

…without Apple, S&P 500 forward earnings wouldn't be at new highs -- they'd be off 2.4%.

Yesterday S&P 500 earnings per share made new all-time highs, having been flat-lining since August 29 (please see the chart below). We believe that in a healthy economy this inherently forward-looking gauge of broad economic vigor ought to rise a little bit almost every day. We've learned over many years of observation that when it doesn't, a recession is brewing. So we've often cited the last six-plus months of stagnation as a main reason for our caution on the US economy in 2012, even as we've correctly argued that stocks would undergo a durable slow-motion melt-up (see, most recently, "When Bernanke Talks, People Sell" March 1, 2012).

- A digression about that slow-motion melt-up. Over 67 weekdays since the December 19 correction bottom, the S&P 500 has not had so much as a 3% correction. We're challenging the 69-day record for an uncorrected up-move set in last year's similar slow-motion melt-up. It's high time for a correction -- especially, as we discuss in this report, as the environment is not as good as many seem to think.

S&P 500 forward EPS **Recession**



Source: Zacks, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: S&P 500 forward earnings, our favorite business cycle indicator, have pulled out of a six-plus month slump and moved to new all-time highs. But it's more than completely explained by a single company: Apple. Without Apple, S&P 500 forward earnings are off 2.4% since their August 29 peak. By removing a single stock, this seeming good news is more a recession warning. At the same time, the slow-motion melt-up in stocks is approaching the record duration of the one a year ago. Surely it's time for at least a small correction.

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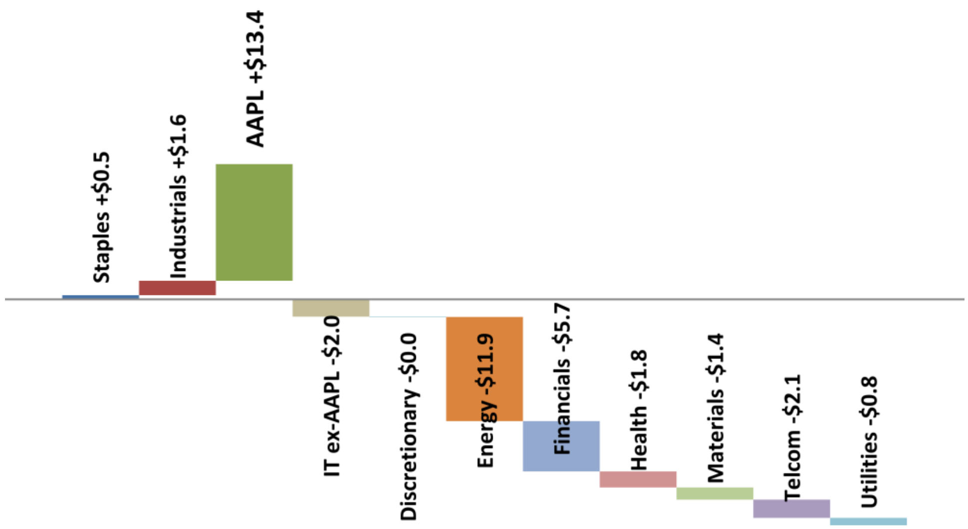
Now back to forward earnings. We hate to second-guess an indicator as trustworthy as this one. And having perhaps something of an optimistic bias, it's an unnatural act for us to find fault with good news like this. Nevertheless we must -- as we did with this month's jobs report, hailed by many as proof positive that the economy is strongly accelerating (see "On the February Jobs Report" March 9, 2012).

- We think there is no hiding from the implications of the fact that *just a single company -- Apple -- is responsible for forward EPS making new all-time highs*.
- When S&P 500 forward EPS peaked on August 29, Apple's forward earnings stood at $29.5 billion. Today they are $42.8 billion, an astonishing gain of $13.4 billion (or 45.4% -- please see the chart below).

Change in consensus forward earnings from August 29 2011 peak
USD billions



Source: Zacks, TrendMacro calculations

- At the same time, forward earnings for the other 499 stocks in the index have *fallen* $23.7 billion (or 2.4%).
- A drop in forward earnings of that magnitude and longevity, by all historical precedent, is a recession indicator.
- Making matters worse, note also that while forward earnings *per share* are at new highs thanks to Apple, the *dollar value* of forward earnings is lower (with Apple higher by $13.4 billion, and the other 499 down by $23.7 billion). The difference is because S&P 500 companies have bought back shares, on net, since August 29. For valuation purposes, EPS is the most important metric -- but the dollar earnings power of companies tells you more about the overall economy.

We recognize that Apple is an inseparable component of the economy -- indeed an outstanding example of the creativity and tenacity that makes

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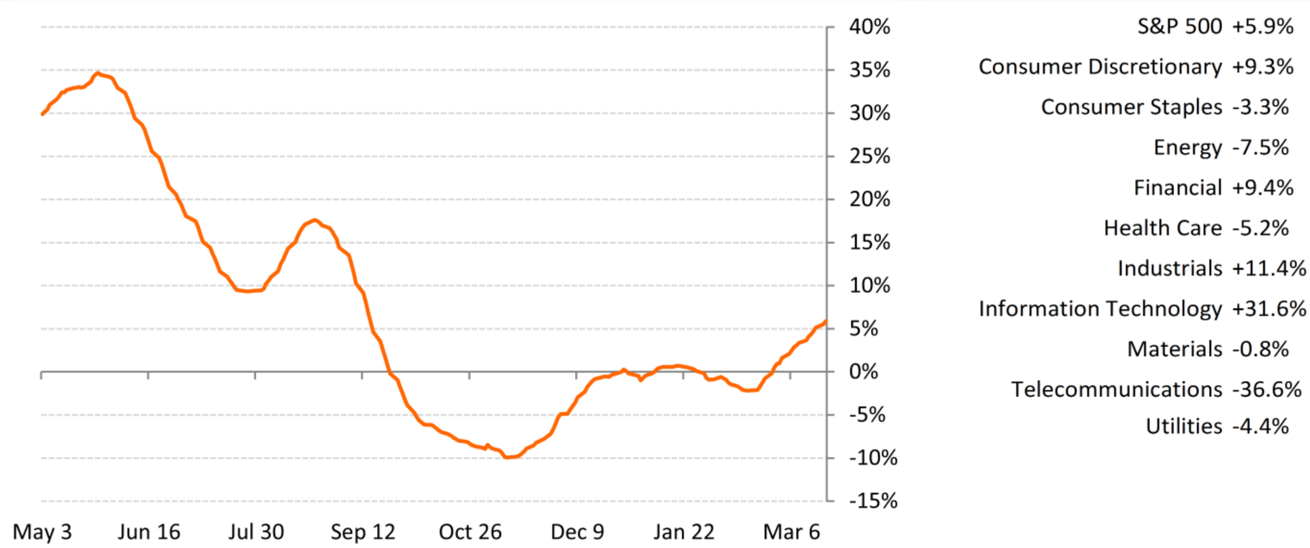
[About us]

American business so powerful and resilient. Perhaps it shouldn't be arbitrarily removed from S&P 500 forward earnings for this analysis in order to make them look worse, any more than we should remove the *worst* performer -- Exxon Mobil, whose forward earnings are off $5.3 billion -- to make them look *better*.

- Certainly overlooking a whole sector would be dangerous. Removing the financial sector in 2007 and 2008 when forward earnings began to decline ahead of the Great Recession -- it was, after all, the only sector to suffer a significant forward earnings decline *before* the Lehman and AIG failures plunged the world into panic -- turned out to have been a terrible analytic error.
- But now, only three sectors have forward earnings higher than they were on August 29. Two are consumer staples, by $0.5 billion (or 0.5%) and industrials, by $1.6 billion (or 1.6%). The third is information technology, up $11.4 billion (or 5.9%). But *that* is more than explained by Apple -- the IT sector ex-Apple is off $2.0 billion (or 1.1%).
- The other seven sectors are outright losers versus the August 29 high-water mark for the overall index.
- On a more contemporaneous basis it's the same. The monthly upgrade rate for the S&P 500 overall has turned positive. But six out of ten sectors are negative -- that is, earnings are being downgraded, not upgraded. It's seven if we remove Apple from the IT sector (please see the chart and table below).

Monthly forward earnings upgrade rate
Change of current 30-day MA of forward earnings versus month-ago, annualized



Source: TrendMacro calculations

We're trying to say curb your enthusiasm -- we're not trying to make a bear case. We simply don't see enough high-quality evidence to convince us of the phase-shift to higher growth that many clients are talking about now. Our base case is for continued growth at about the trend level seen in Q4

2011 -- when it would take multiples of that to really undo the damage of the Great Recession. In fact, with S&P 500 forward earnings off 2.4% (ex-Apple), we have to think there is a much greater chance of a recession than anyone now believes.

Yes, virtuous cycles have to start somewhere. Maybe it will turn out that Apple singlehandedly pushing forward earnings to new all-times highs was just what we needed now. But we still see major trouble for markets as the year-end triple-threat of Washington brinksmanship -- over extending the Bush-era tax rates, repealing the investment tax surcharge in Obamacare, and raising the debt ceiling -- comes closer by the day, with the post-election political environment still murky at best (see "What Could Possibly Go Worng?" March 8, 2012). Enjoy the slow-motion melt-up -- but this is not the time to get over-committed.

Bottom line

S&P 500 forward earnings, our favorite business cycle indicator, have pulled out of a six-plus month slump and moved to new all-time highs. But it's more than completely explained by a single company: Apple. Without Apple, S&P 500 forward earnings are off 2.4% since their August 29 peak. By removing a single stock, this seeming good news is more a recession warning. At the same time, the slow-motion melt-up in stocks is approaching the record duration of the one a year ago. Surely it's time for at least a small correction.