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MACROCOSM

Cupertino, We Have a Problem

Wednesday, July 25, 2012

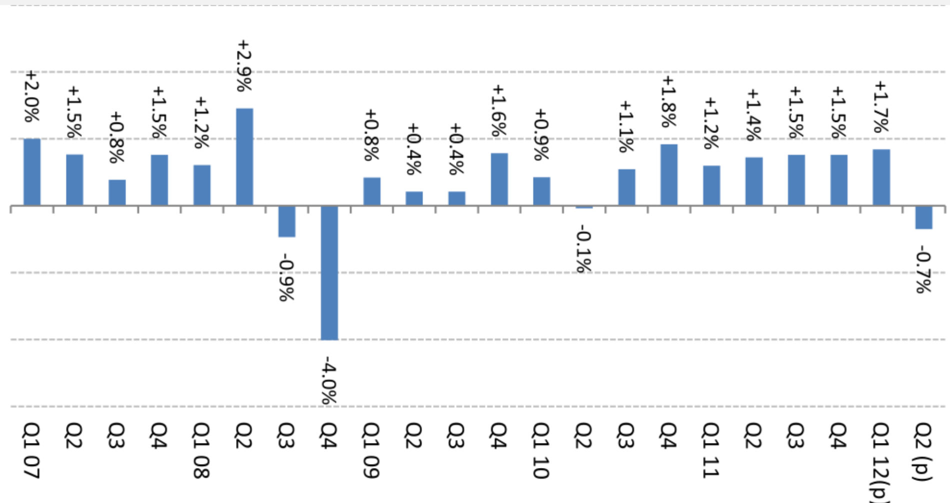
Donald Luskin

Not just Apple: sales are missing and forwards are falling amidst global political uncertainty.

Apple's big miss yesterday may have mostly to do with company-specific issues. But in some key ways it fits in perfectly with an earnings season that is shaping up as emblematic of our Not So Great Expansion.

- For us the big shock in Apple's Q3 results and Q4 guidance is the top line. It comes in an earnings season in which the weighted average *earnings* beat has been a decent but not great 3.5% (Apple's miss took it down by about 2%). But weighted average *sales* have missed by 0.7% (not perturbed very much by Apple). *This marks only the second -- and the biggest -- top line miss since the Great Recession ended.* It's bigger than the other one two years ago -- when tensions in Europe had triggered widespread expectations for a double-dip recession in the US.

S&P 500 sales versus consensus expectations Weighted average



Source: Bloomberg, TrendMacro calculations

- So it's not that US companies can't keep on growing their record margins, a fear we have heard many times from clients over the last two years. With the bottom line beating when the top line misses, evidently they can.

Update to strategic view

US STOCKS, US MACRO, US FED: Apple's miss is emblematic of a troubling earnings season in this Not So Great Expansion. Companies have missed on the top line for the first time in two years. And it's not just a one-off event: consensus forward earnings per share and sales per share have both turned lower, signaling the corrosive effect of pervasive and persistent policy uncertainty in Europe's crisis and heading into the US's year-end fiscal cliff. With the output gap already so wide and stocks so cheap, we wouldn't expect significant economic weakness or a dire downside for stocks -- but as the year plays out, those will be determined by the election and the handling of the fiscal cliff. For now, we think the weakness implied in this earnings season is enough to push the Fed to ease at next week's FOMC meeting.

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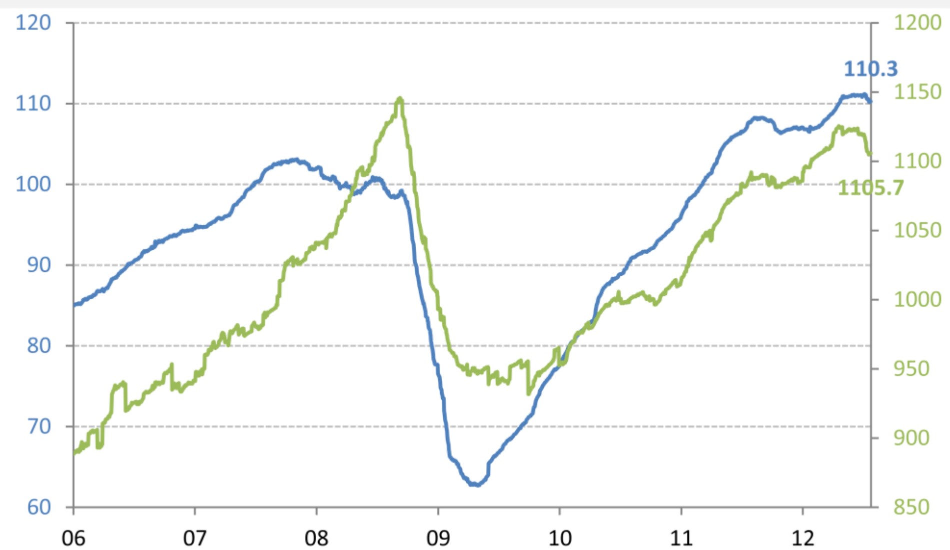
- The problem is the top line, and how difficult it is to grow it in the Not So Great Expansion -- when pervasive uncertainty about ever-changing government policy retards the risk-taking that is the prerequisite for growth (see "The Fiscal Cliff Bites" July 12, 2012 and "For Europe, It's the Politics, Stupid" June 27).
- Indeed, in its conference call, the company indicated that economic weakness in Europe -- where policy uncertainty in the face of ongoing crisis has produced a recession -- had suppressed sales.

We don't think the very latest iteration of Europe's ongoing crisis specifically explains what's ailing US stocks now -- we don't see the systemic risk potential we've seen in previous crises. But in general Europe's been a background irritant for months (see "Sell in May and Go Away -- Volume 3?" May 10, 2012). And now America's own homegrown policy crisis, the year-end "fiscal cliff," is coming into the foreground as a depressant to both sentiment and reality (see "What Could Possibly Go Worng?" March 8, 2012 and "Time Is Our Frenemy" May 24).

- The reality is that now year-ahead consensus forward estimates for both the bottom line and the top line have turned down (please see the chart below). The consensus is not treating this earnings season as a disappointing anomaly, but as a harbinger.

S&P 500 — **Forward earnings** — **Forward sales** Per share



Source: Bloomberg, TrendMacro calculations

- Forward earnings and revenues turned lower like this last year, and then recovered -- earnings made it to all-time highs (see "A Glass of Snapple, Half Full" Friday, April 20, 2012).
- It's a little known fact -- a secret hiding in plain sight -- that as forward earnings made new all-time highs in April, so did US stocks. Yes, believe it or not they did, or at least the S&P 500 did, on a total return basis.
- Forward earnings are our favorite business cycle indicator. Their similar flattening and gentle decline starting a year ago helped

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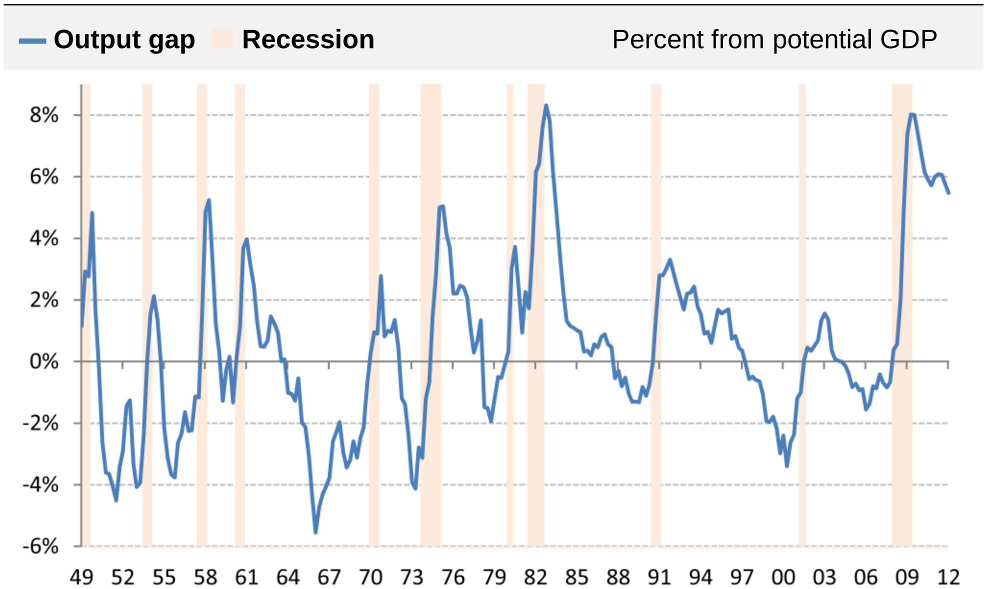
[About us]

make us appropriately cautious heading into this year (see "2011: A Lost Year" December 29, 2011). Now, here we are again.

- Our caution does not mean that a double-dip recession is in the offing. The nice thing about our L-shaped recovery is that, while we never really recover, it's also very difficult for any serious weakness to set in (see "Testing 1, 2, 3" September 7, 2011). The idea is that you may scrape your knees if you fall out of the basement window, but you won't die. More technically, the output gap remains extraordinarily wide -- absent a large-scale systemic risk event, this is where recessions end, not where they begin (please see the chart below).



Source: Congressional Budget Office, BEA, NBER, TrendMacro calculations

- In the same spirit, stocks are so undervalued that even starting from all-time highs in April, the present correction has been quite mild (at the bottom in June, the cumulative loss from the April peak was only 10.9%). We continue to think this is only a correction, not the beginning of a new bear market. Whether or not it can resolve to new highs depends entirely on arbitrary political processes -- the election, and the handling of the year-end fiscal cliff.
- Last week we wrote that a revival in home sales was a potential source of self-sustaining higher growth (see "It's Okay You Didn't Build That" July 20, 2012). But our best hope remains a turn toward pro-growth policy in the November election -- which in the near term would imply a swift and happy resolution to the fiscal cliff.
- In the shorter term, we continue to believe that the Fed is likely to either undertake further easing at next week's FOMC meeting -- or at the very least signal the certainty they will do so in September. This has been our view since the mini-easing at the June FOMC (see "On the June FOMC" June 20, 2012) -- and it seems to be coming increasingly part of the consensus, one that the Fed won't want to disappoint. Apple, and this earnings season it symbolizes, should be rationale at the margin driving the Fed to act.

Bottom line

Apple's miss is emblematic of a troubling earnings season in this Not So Great Expansion. Companies have missed on the top line for the first time in two years. And it's not just a one-off event: consensus forward earnings per share and sales per share have both turned lower, signaling the corrosive effect of pervasive and persistent policy uncertainty in Europe's crisis and heading into the US's year-end fiscal cliff. With the output gap already so wide and stocks so cheap, we wouldn't expect significant economic weakness or a dire downside for stocks -- but as the year plays out, those will be determined by the election and the handling of the fiscal cliff. For now, we think the weakness implied in this earnings season is enough to push the Fed to ease at next week's FOMC meeting.