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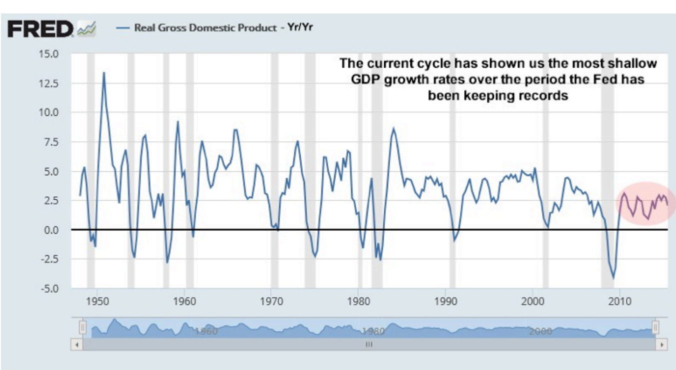
ARE WE HEADED TOWARD RECESSION?

Are we headed for a recession ahead? Importantly, the answer to that question depends on which type of recession is in debate. The word "recession" usually invokes thoughts about US Gross Domestic Product ("GDP"), the scorecard against which we measure the progress of the macro US economy. In this installment of Capital Insights, we will discuss a "corporate profits recession" as well and what a corporate profits recession could mean to investors and their investments.

Personally, we are not wildly enamored with the thinking regarding the "macro" economy in the current cycle. Why? If we step back for a minute, we need to remember that results for the macro US economy are derived from many individual micro economies that make up the whole. In terms of geography, we have seen incredible growth and vibrancy in places like the San Francisco Bay Area and New York, but not so much in many other major metropolitan locations. As we look across industries, health care and technology continue to produce nice gains. However, if we isolate an industry sector such as energy, we are witnessing a serious recession. Likewise, many industrial companies are feeling marked slowing, especially companies with significant foreign revenue dependency. It is very important for investors to always remember that there exist many subsets and "micro economies" that contribute to and define the aggregate GDP numbers we see every quarter.

Having said this, as of the initial report, the US economy registered a 1.5% gain in the third quarter. This is completely in character with the current 2009 - present cycle of historically slow growth.



During the third quarter, business investment was relatively weak, which again was not surprising given the makeup of the current cycle. Inflationary pressures remain subdued. Inventory reductions weighed on growth, but in prior quarters this year, inventories supported GDP, all part of the normal course of inventory cycles. Lastly, although real final sales were acceptable, consumption peaked in July and slowed in August and September.

You may remember our discussion of the Atlanta Fed GDPNow model as being an indicator worthy of observation. It has come closer to predicting actual GDP than the Blue Chip economist survey since its inception early this year. In early November after manufacturing data was reported, the model's estimate for fourth quarter US GDP dropped from 2.5% to 1.9%. This was not surprising and completely fitting with the continuing character of the current cycle. For now, we don't see a US GDP recession on the near term horizon, but in like manner, there does not appear to be any acceleration toward historical 3-5% growth rates that have been considered average in prior cycles.

As we mentioned at the outset, there are two types of recessions that are very important to the investment community. In addition to actual headline macroeconomic "GDP recessions," a "corporate profits recession" is equally, if not more important, to investors. Important not only to investment outcomes, but to forward macroeconomic outcomes as well. What is a corporate profits recession? Simplistically, two consecutive quarters of lower corporate earnings. So why consider this now? Because we are on the cusp of such an event.

One key issue in the current 2009 - present cycle is that central banks keeping short term interest rates at zero has allowed corporations a once in a lifetime opportunity to borrow extremely cheaply and use that capital to buy back their stock, supporting "earnings per share." In fact, even companies facing declining revenues have been able to show positive earnings per share gains via very meaningful stock buybacks. How meaningful has this been? Let's use a comparative. According to a recent Bloomberg article (quoting Bank of America's

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chief investment strategist), for every job created in the US this decade, companies have spent $296,000 buying back their stocks. The corporate investment of choice in the current cycle has not been in people, plant or equipment, but in stock buybacks. From 2009 through 2014, aggregate corporate revenues increased 22%, yet related earnings per share advanced a whopping 87%.

Because the buyback anomaly is supporting earnings per share growth, it is very important to look at the top line – revenues. And the picture is not sanguine. Here is the history of the last year of aggregate corporate revenue results:

Q4 2014	- 1.6%
Q1 2015	- 2.8%
Q2 2015	- 3.3%
Q3 2015 Est	- 4.6%

Based on the chart above, it is fair to say we are in the middle of a "corporate revenue recession" right now. In addition to the poor corporate revenue numbers, corporate earnings growth turned negative for the first time since 2009 in the second quarter of this year. With approximately three-quarters of the S&P 500 having reported third quarter earnings thus far, profits were down 3.1% on a share weighted-basis. Therefore, it appears likely that Q3 earnings growth will be negative for the quarter, which would mean that we would be in a corporate profits recession.

Again, why is this important? Stock buybacks can support earnings per share growth for a time, but not forever. This is especially true in a demand constrained environment that is witnessing actual revenue declines. It is very important to watch the actions of management teams within this environment, and what we have seen in the third quarter earnings reporting season is a bit of a change. At the margin, we are seeing companies continue to report satisfactory earnings results, but this is being accompanied by increasing layoff announcements.

Here are a few anecdotes from the current earnings season:

- Caterpillar reported their 34th consecutive month of declining global sales and will lay off 10,000 over the next three years.
- Biogen reported a well in excess of estimated earnings gain accompanied by the news of a 10% total workforce reduction.
- Microsoft reported very good earnings and will lay off 1,000.
- After a yearlong meaningful headcount reduction, Chevron reported another 7,000 will be let go.
- 3M will trim their Minneapolis workforce by 1,500.
- Deutsche Bank (the largest European bank) reported 35,000 will be let go and a contraction in their global geographic footprint.
- Conagra (one of the largest food/ag companies in the US) will reduce their workforce by 1,500.
- Maersk (the world's largest shipping company) will reduce their workforce by 4,000.
- Kraft-Heinz announced they will be laying off 10% of its total workforce, including shutting their San Leandro, CA plant completely.

These are not small companies, nor insignificant cost cutting measures.

In the recent market correction, it was clear that investor emotions were running high. Investor memories of 2007-2009 are still fresh, as are the memories of corporate management decisions during that time. Investors remember full well the downsizing and cost cutting necessary to restore profitability during and after the Great Recession. It is clear to us that the decline in corporate revenues we have been seeing over the last year is translating into management action now, action they apparently deem necessary to get ahead of potential contracting profit margins.

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Can these current actions in corporate corner offices ultimately precipitate a decline in GDP? It remains to be seen. Yes, higher unemployment is highly correlated with declining economic growth, but it is also importantly correlated with what you see below, financial market downturns. The black line in the chart is the historical US headline unemployment rate set against the history of the S&P 500 over the last two decades. The chart speaks for itself.

At the moment, the most important "recession" possibility in our eyes is not a GDP defined recession, but rather a corporate revenue and profits recession and what that type of event may mean to the financial markets and broader economy.

Post the October lows, the US stock market has rebounded smartly, driven in very large part by comments from global central bankers. The European Central Bank, now printing $60 billion monthly, will consider upping the number in December as industrial production fell hard in Europe's strongest economy, Germany. They will also consider dropping negative interest rates into even deeper negative territory. The Bank of Japan, currently printing $100 billion monthly, will also consider increasing the amount in December. Apparently $1.2 trillion annually just is not enough. China cut their interest rates and their banking system reserve requirement as their economy has displayed signs of further slowing. This has been music to the ears of the investment markets. It's just a shame these central bankers cannot print up what corporate America is increasingly parting with in the third quarter earnings announcements – jobs. Stay tuned and keep your eyes focused on corporate revenue and earnings growth.

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