Forget Recession - Here's How A Second-Surge Recovery Might Happen

Mar. 6, 2017 6:00 PM ET | 7 comments | Includes: BXUB, BXUC, CAPX, DDM, DHVW, DIA, DOG, DXD, EPS, FTA, IVE, IVV, IVW, LLSP, OTPIX, PSQ, QID, QLD, QQEW, QQQ, QQQE, QQXT, RPG, RPV, RSP, RWL, RYARX, SDOW, SDS, SFLA, SH, SPDN, SPLX, SPUU, SPVU, SPXE, SPXL, SPXN, SPXS, SPXT, SPXU, SPXV, SPY, SPYG, SPYV, SQQQ, SSO, TALL, TQQQ, UDOW, UDPIX, UPRO, VFINX, VOO, VOOG, VOOV

James Hickman
Long/short equity, newsletter provider, macro, value

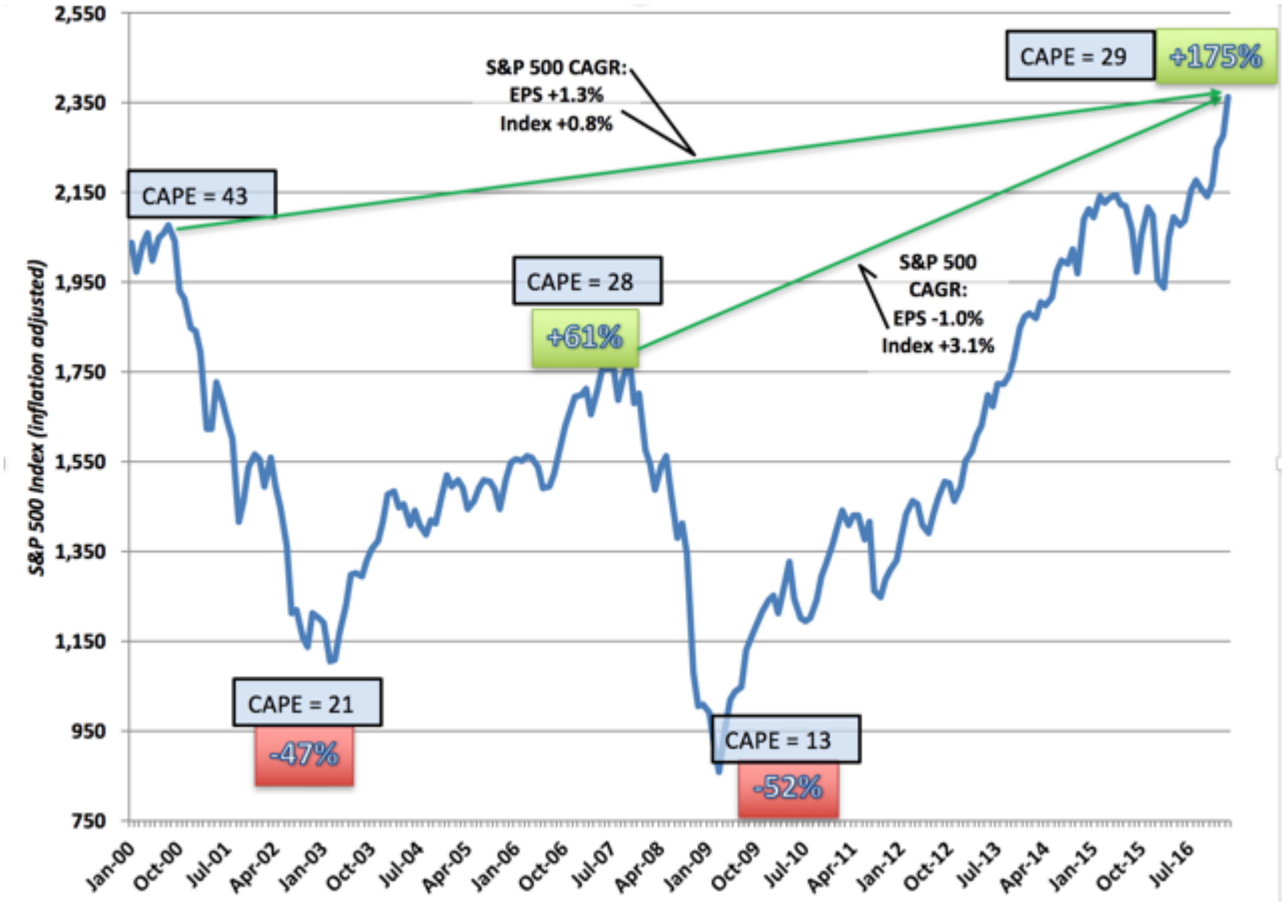
Summary

- Warren Buffett says the stock market is cheap but contradicts his prescient reasoning when calling tech bubble collapse.
- Corporate profits as a percentage of GDP are falling but remain well above historical averages - bearish.
- Interest rates are being pushed up but remain far below historical averages - bearish.
- The stock market ha only been dearer prior to crashes of 1929 and 2002 - bearish.
- But a capital spending resurgence could trigger a second surge for the economy, earnings and market.

Is the stock market in bubble territory? Warren Buffett says no. But unless Buffett changed his mind on what drives equity markets over time, he contradicts his own reasoning when he accurately argued the non-consensus case that an inflated stock market in 1999 portended below-average future returns as interest rates and corporate profit margins normalized. Profit margins have fallen but are currently 40% above long-term averages. The US 10-year is around 2.3% compared to a long-term average of 5% and the Fed is signaling imminent rate increases. Only one thing can propel this market meaningfully and sustainably higher -- a spike in capital spending across sectors, and there is a formula to make it happen.

The major stock market indices are at or near historical highs and the cyclically adjusted (trailing ten-year average S&P 500 real earnings) price-to-earnings ratio (CAPE) is at 29.3X, a peak for the current cycle. Current CAPE is the third highest in history (distinct episodes - see chart below). CAPE has never been useful as a trading signal, but it provides a pretty good barometer for future market returns from prevailing price levels. The two higher episodes preceded the stock market crashes of 1929 (~85% drop) and 2002 (~50% drop).

Historical S&P 500 Index and CAPE

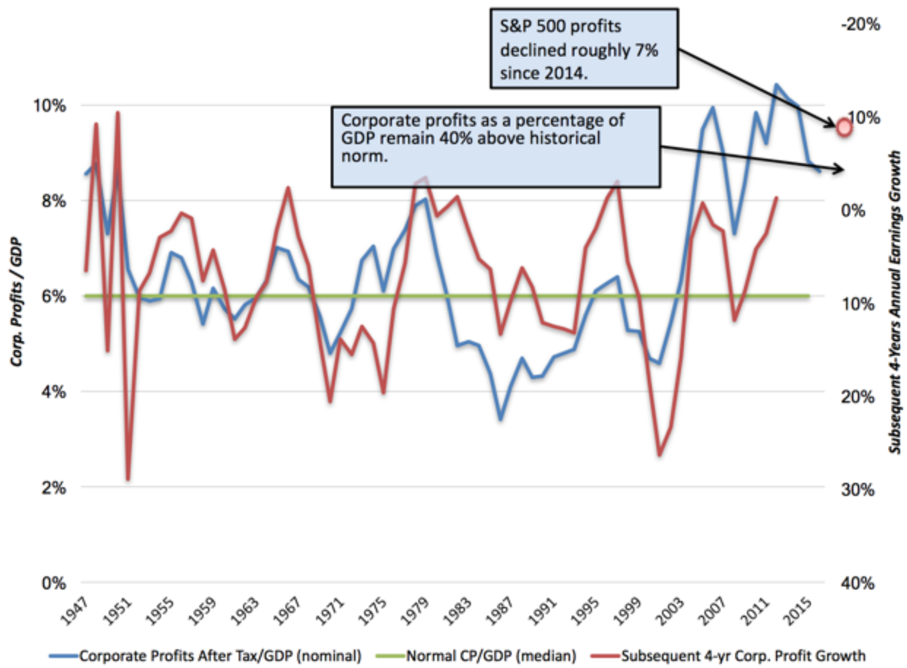


Sources: Standard & Poor's; Robert Shiller and his book Irrational Exuberance for historic S&P 500 prices, and historic CPIs.

CAPE is valuable because it eliminates the risk of cyclically high or low earnings creating false PE ratio signals of cheapness or dearness, respectively. But it falls down as a buy or sell signal for the same reason, as it does not contemplate the earnings trend.

So, where are earnings currently, relative to normal, and what is the trend? Could an acceleration in earnings make it okay for the CAPE to be historically high, normally a signal of inferior medium and long-term stock market returns?

US Corporate Profit Margins and Subsequent 4-Year Earnings Growth



Source: US Bureau of Economic Analysis - Dept. of Commerce

The chart above shows US corporate profits as a percentage of GDP - profit margins - aligned with the growth rate of earnings in the subsequent four-year period (latter scale is inverted). When margins get meaningfully above the long-term average, as they are currently, earnings declines have normally followed.

The green line represents the long-term average of 6%, a proxy for the level at which growth spending is triggered in the overall US economy. As profit margins expand, more capacity is drawn into the market - capital spending rises. As new plants, machinery and equipment, higher headcounts and higher production capacity enter the market, margins are competed back down, discouraging further capacity expansion and driving out higher cost players. Margins have been significantly above the long-term average since 2003, peaking above 10% in 2012, signaling earnings declines. Margins declined but remain 40% above normal, and S&P 500 earnings did not actually fall until 2015 and recovered modestly in 2016.

The explanation for sustained high margins? Corporate capital allocators lost confidence in the investment appeal of their businesses. Besides profit margins, reinvestment economics depend on capital turnover, cost of capital, tax rates and the overall perception of risk. Capital allocators have been more pessimistic about one or more of these factors, evidenced by historically anemic investment spending growth since 2000.

Historical Growth Rates of US Investment Spending and GDP

	Real Gross Private Domestic Investment, Chained 2009 Dollars	Real Gross Domestic Product, Chained 2009 Dollars	Ratio of Investment to GDP Growth
1950-2000	4.9%	3.7%	1.3
1980-2000	4.4%	3.2%	1.4
2000-2016	1.1%	1.8%	0.6

Source: Federal Reserve Bank of St. Louis

Frugal capital spending explains the weakest post-recession recovery since World War II (particularly top-line growth), persistently high profit margins and the protracted absence of another recession. For all its weakness, the recovery is virtually tied as the third longest (91 months) since the Depression. Capital spending is the fulcrum of employment, real wages and the overall economy (see here and here).

From 1950 to 2000, private domestic investment in the US grew at 4.9%/year, driving GDP growth of 3.7% (see table above). From 1980 to 2000, private domestic investment grew at 4.4% while GDP expanded at 3.2%. Since 2000, investment has grown at the annual rate of 1.1%, and GDP growth fell to 1.8%.

Interest rates should remain lower longer, despite further increases by the Fed that will flatten the yield curve but still leave long-term rates well below historical norms for years, not quarters, as we have argued for the last four years.

Anemic growth spending for 16 years could well mean the trigger of economic downturn, excess capacity, is not a near-term risk, despite the protracted recovery and Fed tightening. This conclusion is further supported by the severe, ongoing labor overhang. An acceleration in capital spending could accelerate top-line growth by igniting economic dynamism and a recovery in money velocity. The S&P 500 companies are collectively holding a record $1.54 trillion in cash at the end of Q3 (excluding financials), despite staggering and historic levels of distributions to shareholders over the last two years, including roughly $800 billion in the twelve months ended in Q3 according to FactSet. Capital spending among the S&P 500 was reportedly down almost 9% for the twelve months ending in September 2016, to $600 billion, versus the same period ending in 2015.

If the recovery ended today, it would rank as the 8th weakest out of 10 recoveries in terms of cumulative, real economic growth between recessions measured peak-to-peak, and the 7th weakest out of 10 measured trough-to-peak. Seven and a half years of anemic capital spending and production growth, during which job growth has been weak relative to pre-recession levels, real wages have been stagnant and capacity growth has been sluggish, point to the potential for a second-surge recovery sparked by a dramatic turnaround in private sector capital spending. The catalyst for an opening of the reinvestment floodgates would have to begin with relief on corporate tax rates and regulatory growth disincentives. At 0.6% compounded annual growth since 2000, S&P 500 sales have grown at only 37% of the rate of earnings. Economic production, earnings and the stock market could explode to the upside if policy changes successfully restored capital spending optimism after nearly a generation of under-investment.