The first sign of weakness in corporate America

Richard Bernstein

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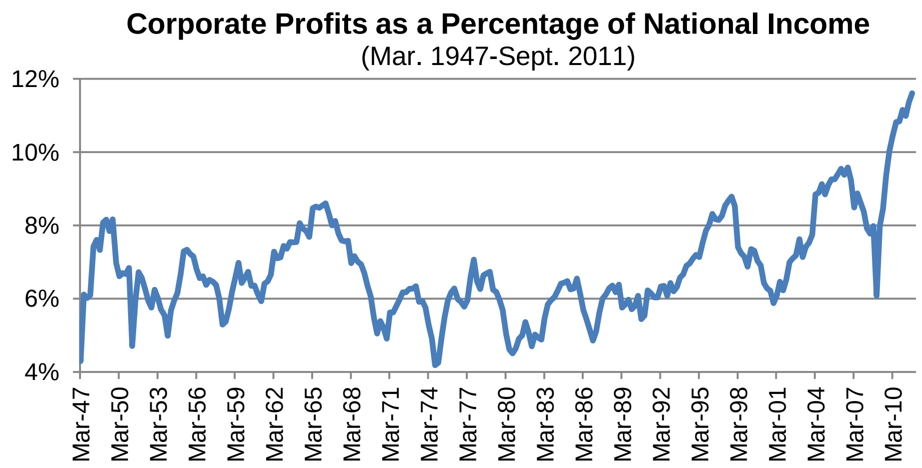
Our bullishness over the past several years regarding US equities has been primarily based on the strength in US corporate profits. Whereas the overall economy had a rather tepid recovery, the US corporate sector had one of its strongest recoveries in history. Corporate profits now comprise the largest proportion of national income in post-war history (see chart 1).

Our research over the past twenty-five years has consistently suggested that profit cycles, rather than economic cycles, drive equity markets. This cycle's stock market bears, we felt, were focusing too much on the meager growth in the overall economy, and not enough on the robust growth in corporate profits.

Chart 1:



Source: Richard Bernstein Advisors LLC, BEA

*Computed after-tax, with IVA and CCA adjustments. For IVA and CCA descriptors, see "Index Descriptions" at end of document.

The US corporate sector remains the strongest corporate sector in the world. Just as the weakness in the US economic cycle might have incorrectly influenced US stock market bears, the strength in emerging market economies may have incorrectly influenced investors' bullish attitudes toward emerging market stocks. Corporate profits in the emerging markets continue to show distressing signs. An example that we have used before is Chinese companies have actually been increasing their leverage despite an economy that is growing quite rapidly, whereas US corporations have been reducing leverage despite slow US growth (see charts 2 & 3). US corporations have been able to produce superior earnings growth without increasing leverage.

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Chart 2:

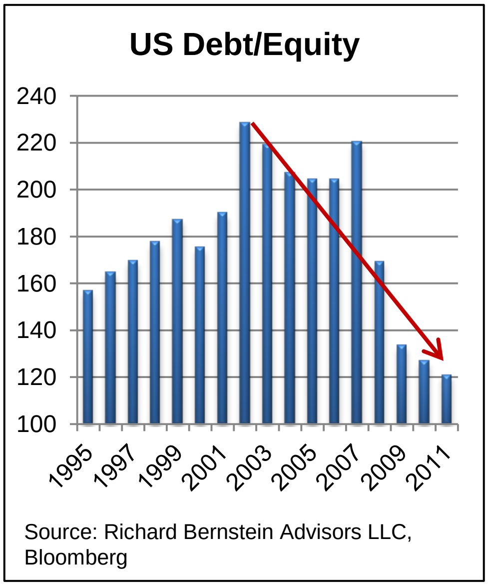
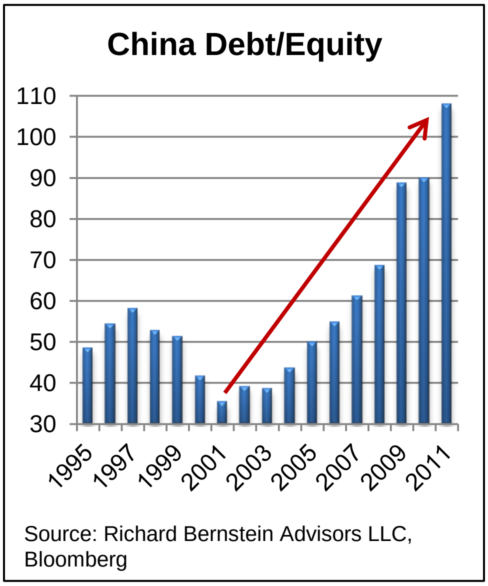


Chart 3:



Negative EPS surprises increase

The US corporate profits story, however, is showing the first chink in the armor. The proportion of US companies reporting negative earnings surprises has jumped significantly so far in the current reporting period. With over half of the S&P 500 companies reported, 30% of the companies have reported negative earnings surprises. If reports continued in the same pattern for the remainder of the reporting season, the current reporting period would be the worst since 2008 (see Chart 4).

Chart 4:

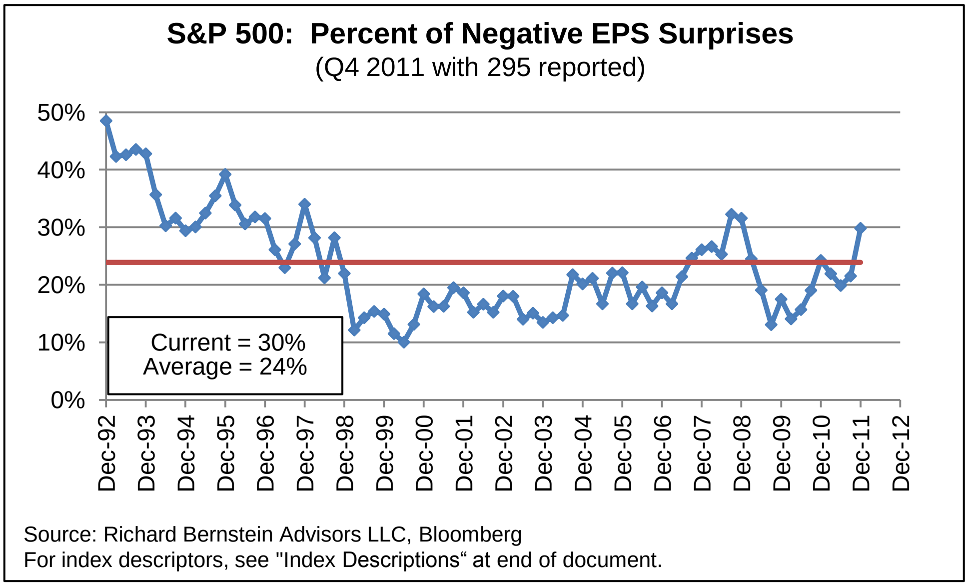


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Chart 5 shows the proportion of S&P 500 companies that are reporting negative earnings growth (year/year). The proportion has recently increased to 31% of the universe, which is the highest proportion since December 2009.

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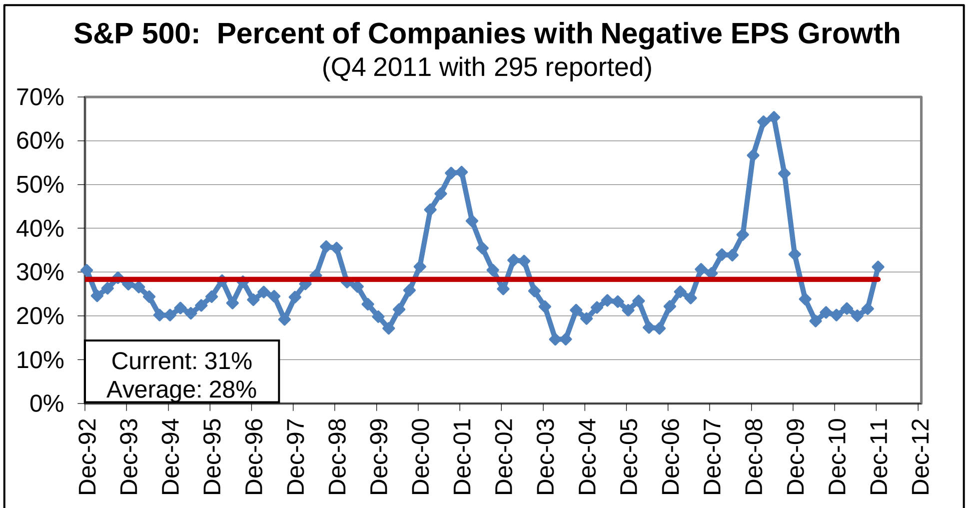

Source: Richard Bernstein Advisors LLC, Bloomberg
For index descriptors, see "Index Descriptions" at end of document.

It seems increasingly clear that the profits cycle is slowing enough so that one should again consider the probability, albeit still reasonably low, of a profits recession. We are not suggesting that a profits recession is imminent. Rather, we are simply saying that the profits data appears for the first time in this cycle to be weakening enough to warrant consideration of such an outcome.

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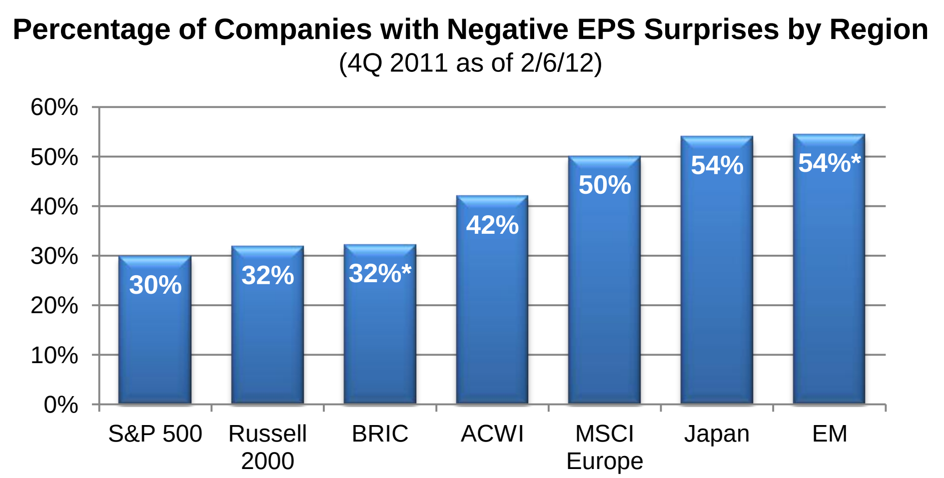
US corporate sector still the strongest

The US corporate sector, despite this first chink in the armor, still appears to be the strongest corporate sector in the world. US earnings data are definitely weakening, but these data are still superior to that outside the US.

Negative earnings surprises continue to dominate reports outside the US. Chart 6 shows the proportion of companies reporting negative earnings surprises so far during this reporting period. Although the sample of companies varies by regional reporting dates, the volume of negative surprises seems increasingly disconcerting.

30% of S&P 500 companies have reported negative earnings surprises, and on the surface that does seem worrisome. However, that proportion seems quite good when compared to the emerging markets, where 54% of reports have resulted in negative surprises. In fact, the emerging markets continue to lead the world in negative earnings surprises.

Chart 6:



Source: Richard Bernstein Advisors LLC, MSCI, Bloomberg
* Low proportion of companies reported for this quarter
For index descriptors, see "Index Descriptions"at end of document.

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A revival of the US household sector?

The combination of an increase in US's companies negative earnings surprises from non-US effects (the dollar and slowing non-US growth) and the definitive improvement in US employment statistics (such as jobless claims, payroll employment, hours worked, and the unemployment rate) seems to argue that the US household sector might be starting some sort of revival. We are not suggesting that the household sector will return to its heady buying patterns of the 2000s because it is unlikely that credit will be available enough to again spur such a spree.

However, the probability seems to be increasing that the household sector will begin to garner the majority of the improvement in national income.

Our strategies continue to focus primarily on the US. The US corporate sector may be showing the first signs of global fatigue, but the domestic household sector seems to be benefitting. We expect the secular outperformance of US assets to continue.

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INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

ACWI: MSCI All Country World Index (ACWI®) The MSCI ACWI® Index is a widely recognized, free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of developed markets.

S&P 500®: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Russell 2000: Russell 2000 Index. The Russell 2000 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

BRICs: MSCI BRIC Index. The MSCI BRIC Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of the following four emerging-market country indices: Brazil, Russia, India and China.

EM: MSCI Emerging Markets (EM) Index. The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

Europe: MSCI Europe Index. The MSCI Europe Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of developed European markets.

China: MSCI China Index. The MSCI China Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of China.

Japan: MSCI Japan Index. The MSCI Japan Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of Japan.

IVA: Inventory Valuation Adjustment. The inventory valuation adjustment (IVA) is an adjustment made in the national income and product accounts (NIPAs) to corporate profits and proprietors' income in order to remove inventory "profits", which are more like capital gains than profits from current production.

CCA: Capital Consumption Adjustment. The capital consumption adjustment (CCA) is used to adjust gross domestic product for the wear and tear of capital during the course of production. The result of this adjustment is net domestic product. The CCA is also the difference between gross private domestic investment (*i.e.*, the total amount of investment expenditures for capital goods) and net private domestic investment.

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