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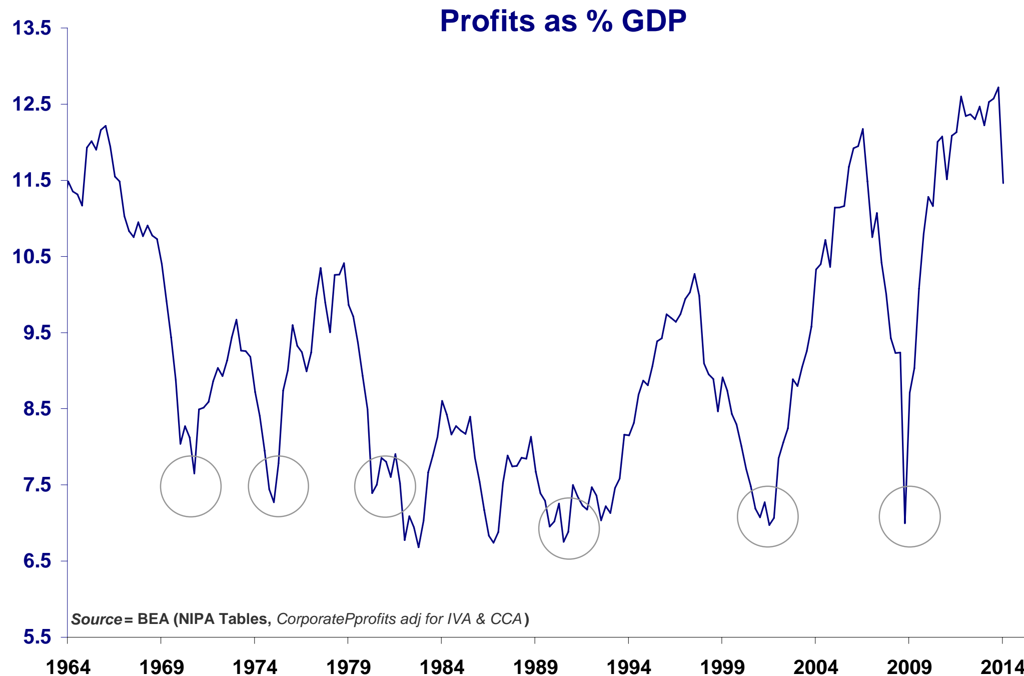
Stephanie Pomboy
212.989.3311



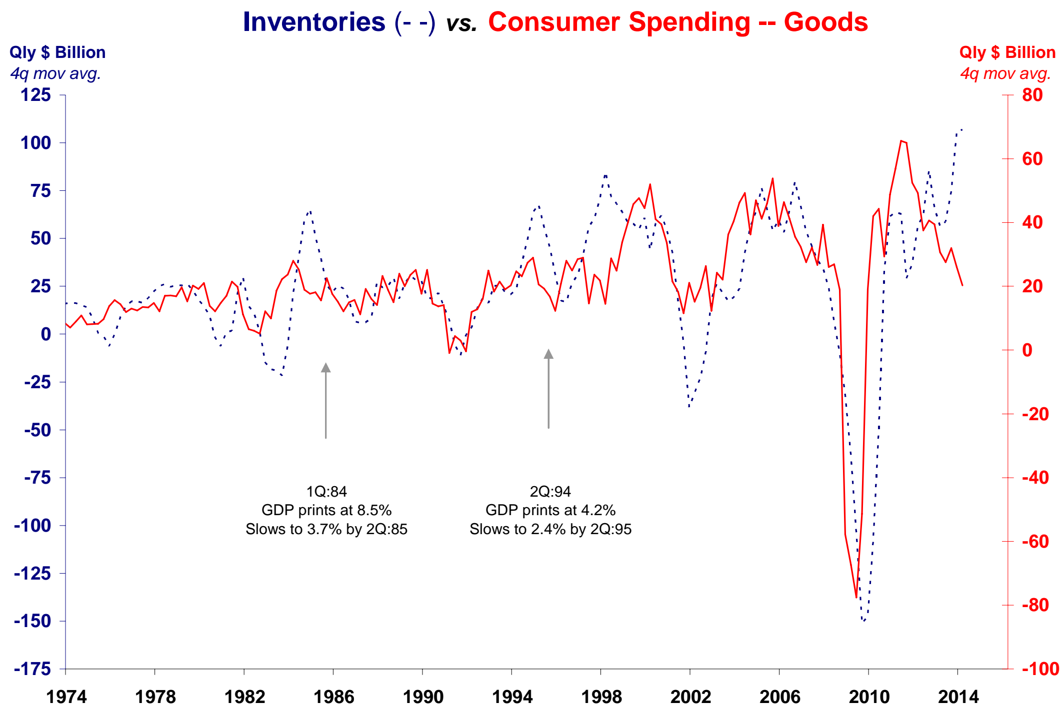
That Giant "Hissing" Sound…

Shhh… *Did you hear that???* If you stay very quiet… *There!* **You hear that hissing sound? I first noticed it a while back. But it really got loud with the release of GDP last week.** While the focus was on the government's second swipe at 1st quarter growth, it was their initial take on profits that really deserved note. In the 1st quarter, **total corporate profits posted a -10% decline quarter-on-quarter and -3% year-on-year.** These represent the largest declines since 4q:08 and 2q:09, respectively.

And so the bubble begins to deflate. As long admonished by yours truly, **the boom in profits fits the very definition of a bubble, having had precious little to do with the economy and virtually everything to do with QE**. Punctured by Taper, that reality is at last coming into focus. Even for those who take issue with the bubble characterization, **the chart above doesn't afford much comfort that the 1st quarter decline will swiftly be reversed.** Quite the contrary, **profits appear poised to zoom toward 6.5-7% of GDP** - levels associated with recession (denoted in the circles) -- **in a matter of quarters.** If we graciously assume 4% nominal GDP growth (higher than our current 3.4%) that would imply ZERO growth in profits over the next year.

Powerful as the tendency of 'mean reversion' depicted above may be, sellside analysts emphatically reject it. According to Factset, these analysts see 2q S&P 500 eps rebounding to 5.7% from 2.7% in the 1st quarter and building momentum into the 3rd and 4th (with gains of 9.6% and 10.1%, respectively). **Their chipper forecasts not only stand against the weight of history illustrated above, but the guidance being offered by companies themselves.** Again, per Factset, of the 108 companies that have offered forward guidance, 81 have lowered and only 27 have raised. And that's atop quarter after quarter of overwhelmingly negative forward guidance. In other words, companies see things going from bad to worse—or less good to less "gooder", if you prefer. ☺

Against this backdrop **it seems certain that analysts will maintain their track record of overestimating 3q earnings by an average of 43% and 4q by 48% during the post-crisis period.**



What's that you say? ***First quarter weakness was a function of the expiration of accelerated depreciation measures??*** While that surely contributed to the severity of the decline, it in no way changes the outlook. Quite the contrary, it **only illustrates my point that the boom in profits has been due to one-time (or multiple-time ☺) factors now exhausted. Hence the urgent hope that GDP is about to miraculously rebound and deliver top line growth sufficient to push air into the profit bubble faster than it is hissing out the Taper hole.**

Alas, that prospect, too, seems unlikely. **The odds of a material increase in top line took a major hit with the Personal Income and Spending report last week.** It revealed the Payroll lie. Despite the addition of 288k jobs, income growth languished in April . Proof positive that folks -- finding their hours cut courtesy of Obamacare -- are being forced to take on 2nd jobs to sustain the same income. Not surprisingly, this is acting as a harness on **spending, which posted a -$10b decline in the month. That figure would have been far worse had it not been for healthcare outlays, which soared $7b**. Once again, the footprint of Obamacare looms large. To get a sense as to how large—**check out the degree to which higher healthcare costs are now crowding out spending on goods.** In fact, consumer outlays for goods are posting their weakest growth since the Great Recession… *and the recessions that preceded it.* In other words, if I may, **the rate at which consumers are buying stuff suggests we are actually in recession.**

This slowdown in spending on goods is only exacerbating our already-ponderous inventory overhang. While inventory was accumulated at a slower rate in the 1st quarter, as you can see above, over the last four quarters we've built inventory at a record pace. Juxtaposed against consumer spending on *goods*, which is the most apples-to-apples comparison since we don't inventory *services*—you can see, we still have a lot of work to do. **Absent a spontaneous increase in personal income or borrowing that boosts the demand for goods, one presumes this inventory will be unloaded at substantially lower price.**

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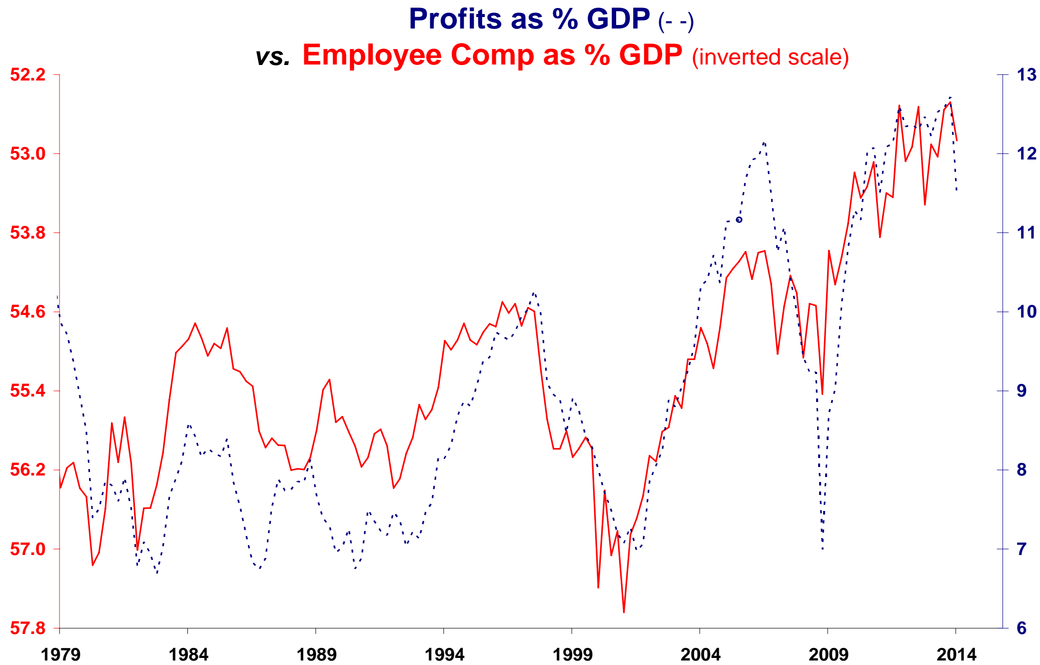
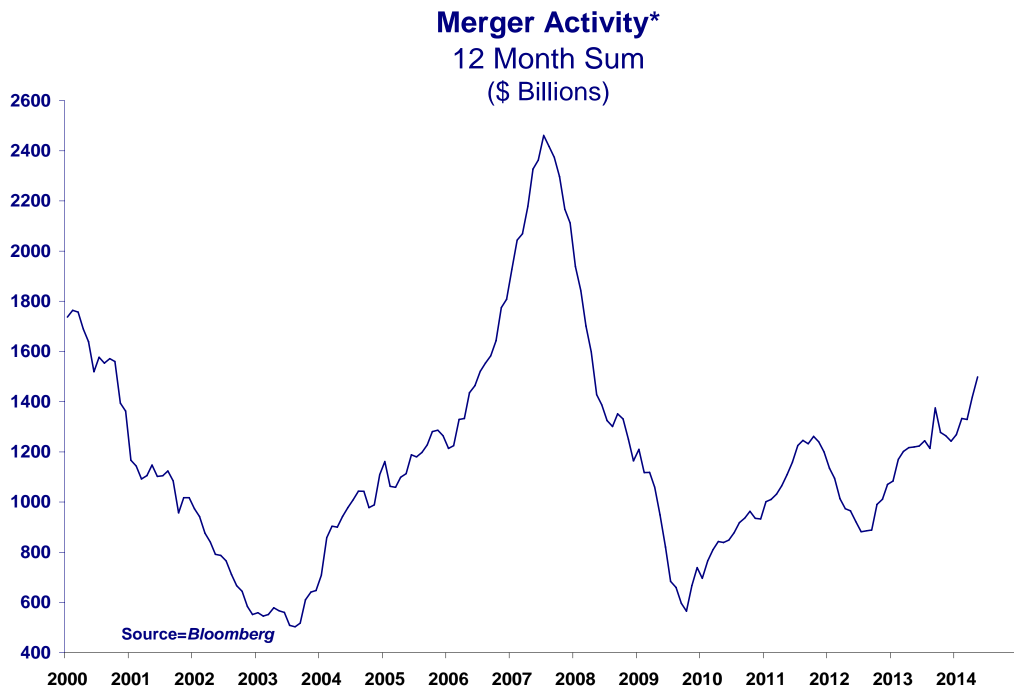
That will squeeze margins precisely as the largest expense for business is also starting to pinch. This was the other shiny nugget unearthed in 1q profit report. With the 1st quarter, the post-crisis downtrend in labor's share of GDP (inverted in the chart immediately below) came to end. Thank you, Obamacare! As it predictably would, the legislation is both squeezing consumer spending and corporate profits.



It's not for nuttin' that we are seeing a resurgence in M&A activity. Over the last 12 months, merger activity has soared to $1.5t—a level we last whizzed by on the nosedive down from the financial crisis in 2008. This is the obvious last hope for companies to offset the inexorable hit to margins as all the aforementioned drags come home to roost. To the extent that companies can wring *any* additional excess out of labor (or other) costs through horizontal mergers, or broaden their audience via acquisitions, **now's the time to do it!** After all, **the window of opportunity to finance this activity on the cheap is starting to close.** Credit issuance peaked around Ben's T-Bomb last May and has slowed steadily since (see addenda) while rates have stopped declining and spreads have edged up.



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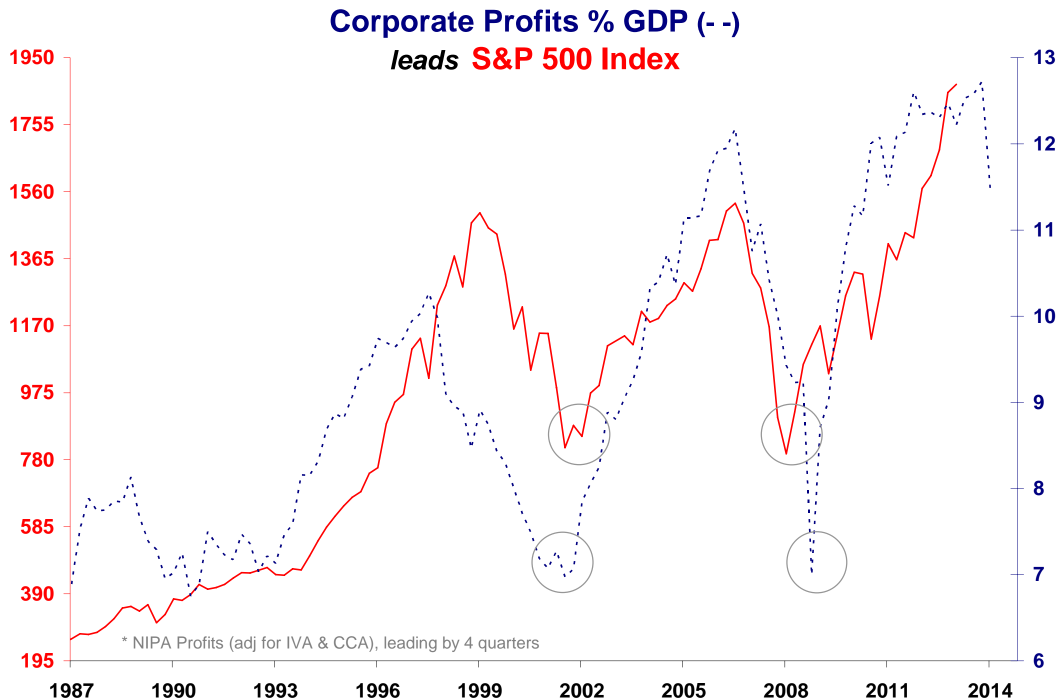

That same development, it bears note, conspires to stem the tide of shareholder goodies that have provided cheerful distraction from disappointing revenue growth.

All of which only bolsters my expectation that the Fed will taper the Taper, or come up with a new way to continue to provide stimulus. When that happens, **count on sell side analysts to proffer assurances that surfeit Fed liquidity will provide support for equities where the fundamentals do not.** Meanwhile, **the chart above offers slightly different portents.** The Fed can huff and puff but it can't put the air back in the profit bubble.

Even if it re-ups QE, the benefits that might accrue to profits have already been exhausted. With corporate borrowing costs already at record lows (see junk yields) the likelihood of a further reduction in interest expense seems low --lower still, considering that companies are ramping-up debt issuance. Likewise, the improvement in credit quality, which was achieved largely on the back of the housing recovery, has peaked and started to reverse course – see HELOC. Thus ends the reserve release bonanza for financials. And, now, the benefit of accelerated depreciation is over as well.

As all of these artificial supports fall away at a time when top-line growth is still flagging, profits will inexorably revert to the mean. And, judging by the chart above, stocks will follow suit. Indeed, if profits tread the trail laid out before them, the market will test the lows of 2003 and 2009.

Extreme as that sounds it really shouldn't come as any surprise. **In an economy whose growth is entirely a function of trickle down effects from asset inflation, a reduction in stimulus and *tightening* are one and the same**. Thus, **what QE inflated, Taper will deflate.** Judging by the latest profits data, the hissing has already begun.

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