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ALTERNATIVE PERSPECTIVES

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Earnings—Cause for Near-term Concern?

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In the Q1 outlook I mentioned the high probability of negative earnings in the first two quarters of the year:

"There is the potential that we could see negative year over year profits growth in either Q1 or Q2 before seeing a second half resurgence in profits."

Q1 earnings are expected to be flat to slightly negative—the worst quarter since 2012. This should cause some concern, but that doesn't necessarily mean the downside risk is imminent.

I am not generally one for valuation metrics, but valuation metrics can, at times, provide insight into the state of the market's behavior. For instance, in a year like 2013 when equities rise 32% and operating earnings rise just 10.8% then we're looking at a substantial multiple expansion in the market that occurs largely due to behavior. Investors are willing to buy more of the S&P 500 today at a higher value with the expectation that future prices will be justified by future operating earnings. Of course, this is precisely how markets become increasingly risky. The point in the cycle where stocks become most risky is not when earnings are low and everything appears to be falling apart. The riskiest portion of the market cycle is when earnings are moderating and yet enthusiasm to own a smaller slice of the pie at higher prices is running rampant. Indeed, stability creates instability.

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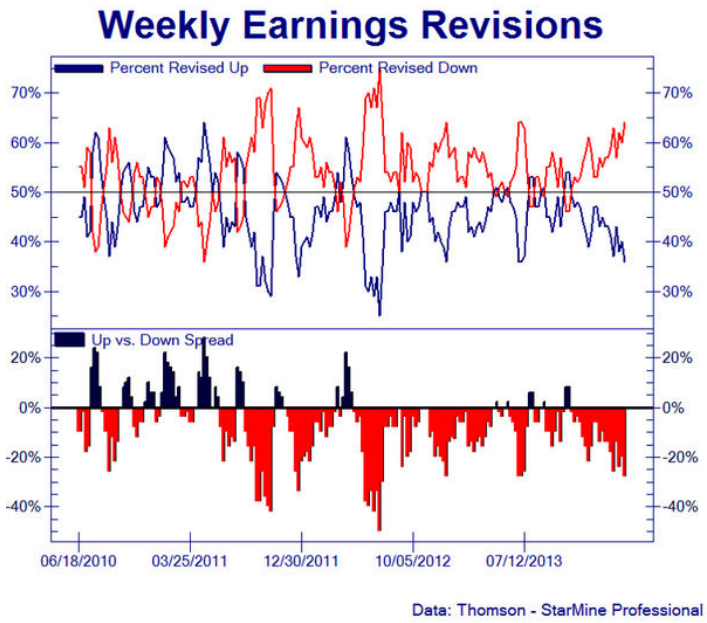
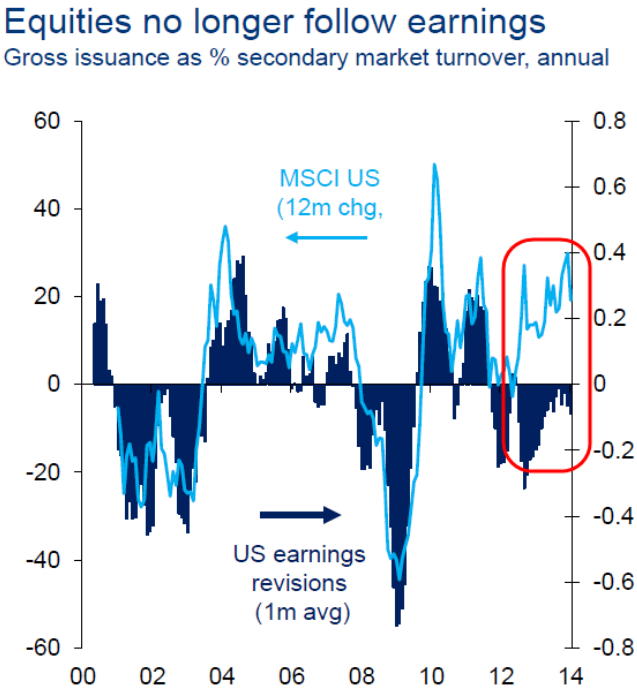
This divergence in earnings and market price action has grown increasingly obvious in the last 12 months. As you can see in figure 1 on the right we're seeing a large negative divergence in positive versus negative earnings revisions. This is occurring as companies slash forward guidance. Now, this sets the bar very low for the actual reporting season, but we should not ignore the negative long-term trend in place here. The current weakness in earnings is likely to last into Q2 based on my early analysis before picking up in H2, but the near-term behavioral risks are higher than normal given the likelihood for investors to soon recognize that there is very little earnings growth underpinning the equity markets.



We can also see this longer-term trend in stocks relative to earnings revisions. It appears as though a very tight correlation has been broken in recent years. Again, this appears to be behavioral to me and if we had to pluck one gigantic behavioral impact out of the air it would clearly be the Federal Reserve's QE policies and the incredible psychological impact this policy has on markets. But the question becomes—how long can the Federal Reserve prop up assets without very strong underlying earnings growth? My guess is that they can't do it forever and when and if the markets come around to this realization then we could see greater downside than many think is possible. That, however, likely won't occur until the underlying fundamental deteriorate substantially.



Of course, I can't predict the future, but tail risking hedging is almost always wisest when the risk of recession is high. That is, negative outliers tend to occur inside of a broader negative macroeconomic landscape. Years like 2008 and 2002 tend to occur when market participants are finally coming to grips with the reality of a weakening macro picture. I still see very

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low risk of recession in the present environment. So I think we need to continue to tow the line and/or adhere to a very basic "buy the dip mentality". That said, I am somewhat uncomfortable given the clear disequilibrium that QE appears to have created. This is why I feel very comfortable continuing to own a portfolio that has a healthy fixed income component to it.

Most importantly, we are in a continued environment of low inflation with increasingly higher risk of recession (as opposed to boom). Therefore, I see no reason why we can't remain predominantly bullish about our views, but using a fixed income piece as a pseudo-hedge. In other words, I don't feel strongly about implementing substantial non-correlated tail risk hedges at this juncture (such as shorting or buying puts), but I do think that many fixed income assets with a positive correlation to equities will be an excellent portfolio mix. As I mentioned in the Q1 outlook I think an aggregate index and medium duration government bonds are a smart way to play this. Both performed about in-line with the S&P 500 during Q1 with substantially lower variance. I would not be surprised if Q2 sees a similar trend given the low inflation environment and likelihood for continued equity market uncertainty in the face of tepid earnings growth.

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