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Synthesis

A composition that pulls together the primary themes, analysis and portfolio views from Portside Investment Advisors

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May 3, 2018
It's All about (Future) Earnings

Earnings in the first quarter were impressive. Maybe great by some standards. Growth in net profits will have exceeded 20% for the overall market and will finish higher than expectations. That's the good news - yesterday's news – but the US equity market is negative in 2018 because it is all about future earnings, not last quarter.

Investing would be easy if we only had to use good news that is already known. Markets operate by having to look into the future, using the past as context.

In the outlook for earnings, the market has already absorbed a surge in global growth that occurred in the second half of 2017 and the tax cuts that were especially helpful to corporations. These previously positive factors are now causing some uncertainty about continued profit growth.

It is socially positive that unemployment is low and wages are now rising. The demand for labor is good for the American worker but means that companies must cut into profits to sustain production and price levels. The manufacturing sector has been very strong, this has meant an increase in demand for energy and materials. This demand increase leads to inflation which also means lower profits unless the cost can be passed to the consumer (which would hurt disposable income).

The consumer is confident but is already stretched financially. The personal savings rate has fallen from 6% just two years ago to 3% today. This has been good for corporate sales, but implies a lot less room for revenue growth going forward. Interest payments by individuals have also been rising, in part due to consumption and part higher interest rates. Aggregate personal interest paid is up 33% in five years and is now back to the peak level from 2007. This appears to be pressuring consumption as the contribution from personal consumption to GDP growth in the first quarter was the lowest since 2013.

Then there are the taxes saved. The hope has been that long delayed capital spending by companies would be accelerated. Evidence is showing that large companies were already flush with cash from issuing debt at record low yields. The tax savings are just more cash sloshing around the balance sheets without a productive place to go.

Apple is a perfect example of this phenomenon. Apple announced it would be buying another $100 billion of its own stock. That's a really big number. There's no question it will create some price support for the stock. It should be noted, though, that Apple bought $25 billion of its stock in the first quarter and it still had a (slightly) negative return. Ultimately, this use of cash is a sign that R&D spending and new growth opportunities are limited.

Considering the forward looking profit pressures, at this later stage in the market cycle, it is always important to keep a perspective on potential exuberance in valuations. Take Amazon as an example. Amazon was expected to earn about $1 per share this quarter and they reported earning about $3 per share. On a percentage basis above expectation, that's really big. But, keeping in mind you have to pay over $1500 per share in order to earn those $3, it doesn't feel all that great. That's a simplistic perspective but sometimes the market gets lost in the weeds.

The bottom line is that investing going forward is going to take patience and foresight. Not many assets are cheap right now and the future environment will not likely be similar to the current. There will be opportunities, though, as there always have been.

We will certainly keep looking for the attractive value in the current and future markets. Have a wonderful start to spring!