FORSTRONG GLOBAL

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HAVE CORPORATE PROFITS PEAKED?

Don't Stop Me Now*

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2018 has been all about America. And why not? It's been quite the show. Trump's rants from the Twitter pulpit (averaging 12 tweets per day). His infidelity to the post-war system. A nail-biting mid-term election. But most glaringly, a stock market — contrary to its struggling global peers — soaring on government wings.

Underpinning this recent levitation is a robust 20% plus third quarter y-o-y EPS growth rate and a record high for operating profit margins (11.5% at latest reading).

But has gravity begun to tug at this vertiginous lift-off? Worries about slowing growth abruptly hacked off 7% from the MSCI US equity index in October. More ominously, a growing consensus views corporate earnings as already at their high for this cycle. Peak profits may have arrived.

We are not so sure. Yes, earnings growth will slow materially next year. One cannot overlook the primary drivers in 2018: corporate tax cuts and the rapidly widening US government budget deficit. Crucially, these have one-time impacts. From here, earnings growth rates will come down. Investors that extrapolated this year's lofty numbers will have to adjust their narratives. And, the US stock market may struggle. But the absolute level of earnings is unlikely to peak until the macro data confirms a significant economic slowdown. We are not there yet.

Taking a wider world view of corporate profits, expectations for global ex-US earnings growth are downright sour. China is viewed as a victim of US trade brinksmanship and a rapidly slowing economy. Emerging markets are seen as vulnerable to a virulent contagion replay of 1998. And, Europe has been left for dead.

What could go right here? Actually, quite a lot. Regularly, our investment team peers into the BAML Global Fund Manager Survey**, a kind of investor voyeurism, giving us statistical snapshots of our competitor's positioning (hey, even professionals can provide contrarian signals). November's report shows widespread gloom. Most fund managers expect global profits to deteriorate over the next 12 months, their most bearish view in 6 years. Negative profit expectations also marked equity lows in 2011 and 2016.

Similarly, economic expectations have collapsed: 44% expect global growth to decelerate in 2019. This is the most negative reading since the depths of the 2008 GFC and also more depressed than equity lows in 2011 and 2016. In other words, there is plenty of room for positive earnings surprises outside the US.

Meanwhile, no one is talking about it, but emerging markets have been firm in recent months and are likely forming a solid base. Even in China, where the market is expecting an outright profit contraction, policy reflation is gaining momentum. Lower interest rates, a cheaper renminbi and easier access to credit argue for higher corporate profitability. Stock prices should begin to reflect the improvement in the earnings outlook in advance.

We reiterate our call to rotate away from the US into global exposures. Deeply depressed sentiment, reasonable valuations and early signs of corporate profit improvement in many global regions make this an asset allocator's dream setup. Don't miss it.

* With thanks to the late Freddy Mercury for borrowing this title.

**Hat tip to Urban Carmel for providing this data. fat-pitch.blogspot.com

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