



MORNING BRIEFING

July 2, 2019

The Rodney Dangerfield of Economic Expansions

See the [collection](#) of the individual charts linked below.

(1) Happy birthday, expansion, and many more! (2) No boom, no bust. (3) The Trauma of 2008. (4) Longest expansion is also one of the most lag-prone expansions. (5) Credit crunches cause recessions, not old age. (6) Distressed asset funds are the new shock absorber in the credit markets. (7) Not enough distressed assets for DAFs. (8) Powell's mini credit meltdown. (9) Do buybacks drive the stock market or vice-versa? (10) Joe's updated analysis still finds negligible impact of share count on stock performance.

US Economy I: Happy 10th and 243rd Birthdays! It's July, and it's official: The current US economic expansion is the longest on record. It turned 10 years old this month, a month that happens to include the 243rd birthday of the United States of America. Let's have a look at some of the underlying economic achievements of the current expansion:

(1) *For the record books.* Appendix 5.1 in my book, *Predicting the Markets* (2018), is titled "US Business Cycle Expansions and Contractions: 1854-Present." An [updated version](#) of this table shows that the current expansion has lasted 121 months so far. According to the National Bureau of Economic Analysis, it started in June 2009 and now exceeds the previous longest expansion from March 1991 through March 2001.

Debbie and I aren't surprised. As far back as 2014, we predicted that the expansion might last well into 2019 and maybe beyond. We still believe that "beyond" is likely now that we are well into 2019. Our basic thesis has been "no boom, no bust." That's one of the major lessons I learned during the first 40 years of my career on Wall Street, as I discuss in my book.

The Trauma of 2018 was extremely traumatic. The widespread fear that it could happen again anytime soon has kept a lid on speculative excesses. So there hasn't been a boom to set the stage for a bust.

The current bull market in stocks has frequently been described in the financial press as the most widely hated bull market of all time. It certainly has been hated by the bears. Similarly, in our opinion, the next recession has been the most widely anticipated of all time. That might explain why it hasn't happened so far, frustrating the pessimists. The current economic expansion has been the most hated one of all time, as the pessimists claimed that it has been associated with the most inequality in both incomes and wealth. According to the naysayers, only the rich have gotten richer, while the standard of living has been stagnating for everyone else.

In other words, this has been the Rodney Dangerfield of economic expansions—getting no respect. Yet here we are, celebrating its 10th birthday!

(2) *Longest, but among the laggards.* Reflecting the absence of a boom, the economic expansion has been among the laggards compared to previous expansion. So, for example, industrial production is up 25.8% since June 2009 through May of this year ([Fig. 1](#)). The post-WWII record increase so far was

74.9% from February 1961 to December 1969. The average increase during the previous 11 expansions since the end of WWII was 32.4%.

Real GDP is up 25.0% from Q2-2009 through Q1-2019 ([Fig. 2](#)). That's the second-weakest 10-year economic performance compared to the previous six 10-year periods that started with expansions and might have had some downturns along the way. (Keep in mind that five of the previous six expansions were shorter than 10 years old.) The same can be said about the 25.4% increase in real personal consumption expenditures ([Fig. 3](#)). On the other hand, the 65.0% increase in real capital spending so far beats two of the previous 10-year periods ([Fig. 4](#)). That demolishes the myth promoted by the naysayers that capital spending has been the worst ever.

(3) *Recoveries and expansions*. Back in 2014, Debbie and I compared the current economic expansion to the previous five using the Index of Coincident Economic Indicators (CEI). The CEI includes four components: payroll employment, real personal income (less transfer payments), real manufacturing & trade sales, and industrial production ([Fig. 5](#)).

We divided the business-cycle upturns into their recovery and expansion phases ([Fig. 6](#)). On average, the previous five recoveries, measured back to their pre-recession peaks, lasted 26.4 months. We observed that the latest recovery took 68 months from January 2008 through October 2013. We reckoned that since the recovery took so long, so might the expansion into record-high territory.

The previous five expansion phases averaged 65.4 months. Adding that average to the end date of the latest recovery phase puts the next business-cycle peak in July 2019. Here we are, though we don't believe that the current expansion is over.

US Economy II: The Secret to Old Age. The secret to the longevity of the current expansion isn't a mystery, in our opinion. In the past, booms set the stage for busts by generating lots of speculative excesses that were financed by too much debt. Those excesses caused either price inflation or asset inflation, or both, to soar.

The Fed responded by raising interest rates. Somewhere along the way, interest rates rose to levels that triggered a financial crisis when one or a few significant borrowers couldn't service, refinance, or roll over their debts. The crisis turned into a widespread credit crunch when even good borrowers couldn't get credit as their lenders struggled to stem the damage to their capital from mounting bad loans. That would quickly turn the boom into a bust.

So far, there has been no serious credit crunch during the current expansion. The yield curve has inverted, which in the past has signaled a recession. However, in the past, inversions also have coincided with credit crises ([Fig. 7](#)). So why haven't we had a credit crunch so far? Consider the following:

(1) *The doom view*. The doomsayers have been saying that there are plenty of excesses in the credit markets. They are particularly alarmed by the record amount of nonfinancial corporate debt outstanding (\$5.6 trillion during Q1-2019) as well as the record amount of leveraged loans (\$1.8 trillion) ([Fig. 8](#) and [Fig. 9](#)). The bears have been ringing the alarm bell for some time, yet here we are in the longest expansion of all time with the S&P 500 at a record high.

They've been wrong partly because record-low interest rates have fueled reach-for-yield demand for credit instruments. So it has been easy for borrowers to refinance their debts, often at lower yields.

(2) *The new shock absorber*. In addition, there is a relatively new shock absorber in the credit markets,

which we first discussed in 2016. Distressed asset funds (DAFs) have been attracting lots of investors. They have SWAT teams of professionals who are adept at restructuring broken balance sheets and income statements. They love doing so when they can buy distressed assets at a huge discount and restructure them to be sold at much higher prices.

I believe that's what happened during 2015. Back then, credit-quality spreads soared, particularly for debt held by commodity-related businesses when the price of oil collapsed ([Fig. 10](#)). Before the financial crisis among commodity-related firms could spread, the DAFs restructured all the bad stuff.

The DAFs are similar to the government's Resolution Trust Corporation (RTC), which restructured the S&L crisis from 1989-1995. The RTC became a massive property-management company, cleaning up what at the time was the largest collapse of US financial institutions since the Great Depression.

(3) *Dearth of distress*. I first got wind of the DAF shock absorber during the spring of 2016 from one of our accounts in NYC who happens to manage DAFs. He was bemoaning the dearth of distressed assets. The ones from 2015 had already been snapped up by the DAF industry, but new money was still pouring into the funds. In a meeting with the same account last week, he told me that finding distressed assets is still tough and that they are getting snapped up at lower discounts.

(4) *Powell's credit crunch*. There actually might have been a mini credit crunch in the nonfinancial commercial paper market late last year in response to the plunge in stock prices, which had been triggered by hawkish comments by Fed Chairman Jerome Powell in early October. The outstanding amount of paper dropped 29%, or \$104 billion, from a 2018 peak of \$355 billion during the 6/20 week to a \$251 billion trough during the 1/2 week of this year ([Fig. 11](#)). That might have contributed to Powell's pivot to dovish comments at the beginning of this year.

Buybacks: Negligible Impact. Joe reports that Q1-2019 stock buybacks data are now available for the S&P 500. They totaled \$206 billion, the second-highest quarter since the final quarter of 2018, when they totaled \$223 billion ([Fig. 12](#)). Previously, Joe and I have observed a high correlation between the S&P 500 stock price index and the sum of S&P 500 buybacks and dividends ([Fig. 13](#)).

We had assumed that causality ran from the cash flows to the stock market's performance. We changed our minds when preparing our May [Topical Study #84](#): "Stock Buybacks: The True Story." We wrote:

"With the benefit of hindsight and additional research, Joe and I are amending our interpretation of this chart. The bull market in stocks has been driven by solid earnings delivered by a global economy that continues to grow. The coincident relationship between the S&P 500 and buybacks reflects that compensation—with some percentage paid in stock—rises in a growing economy. If compensation rises, buybacks tend to. If the economy grows, bull markets thrive. So economic growth drives both buybacks and the stock market. That's why they move in sync. It's not that buybacks drive the stock market, as widely believed."

We concluded that the impact of buybacks on earnings per share has been greatly exaggerated. On balance, buybacks reduced the share count of the S&P 500 by only 8.0% over the period from the Q1-2011 through Q1-2019, or an average of 1.0% per year. That's because we found that roughly two-thirds of buybacks may be mostly offsetting stocks issued as labor compensation. Rather than boosting earnings per share, most buybacks are aimed at reducing the share-count dilution that results from compensating employees with stock. Limiting them or banning them by law, as suggested by a few Progressive politicians, would deprive lots of employees, not just top managements, from an equity stake in their companies and from benefitting from their companies' success.

I asked Joe to update his analysis of the relationship between the changes in the share count of the S&P 500 companies and the changes in their stock prices since Q1-2011 through Q1-2019. Plenty of these companies have had aggressive buyback programs, aimed not only at offsetting dilution from stock compensation but also at boosting earnings per share. However, as demonstrated in our *Topical Study*, the overall impact of buybacks on S&P 500 earnings per share has been relatively small.

Joe didn't find a noticeable performance difference between companies that had increased and those that had decreased their share counts. But among those companies that had share-count reductions, there was slight outperformance correlating with how much a company's share count was reduced. Here is a summary of his findings, based on the share-count data shown in [S&P 500 Share Count Update](#):

(1) Joe looked at 458 of the 505 issues in the S&P 500 with price performance data from Q1-2011 through their calendar Q1-2019. The 47 issues not included in his study went public after Q1-2011.

(2) Joe found that the stock prices of all companies rose an average of 165%. The 175 issues with increased share counts had a slightly higher gain of 170%, while the 281 issues with decreased share counts rose a slightly lower 163%. (Two companies' share counts were unchanged.)

That was a little surprising, but not unexpected. Joe surmises that companies with higher share counts after the past eight years issued additional shares primarily to finance M&A activity. These companies outperformed because the M&A activity presented them with better opportunities for cost reductions and growth of their revenues and earnings.

(3) Looking at the companies with share-count decreases and grouping them in tranches by degree of decrease, Joe noted that their average price change improved negligibly the more shares were removed. Among the 149 companies that reduced shares by more than 15%, the average price gain was 163%, slightly worse than the all-company average of 165%. The 100 firms with at least a 20% decrease in their share counts rose 174%; the 41 companies with more than a 30% drop rose 175%; and the 16 companies with at least a 35% decrease rose an average of 185%.

CALENDARS

US. Tues: Motor Vehicle Sales 17.0mu, Williams, Mester. **Wed:** ADP Employment 140k, Jobless Claims 220k, Challenger Job Cuts, Merchandise Trade -\$53/4b. Factory Orders -0.5%, ISM & IHS Markit NM-PMIs 56.0/50.7, MBA Mortgage Applications, DOE Crude Oil Inventories, Baker-Hughes Rig Count. (DailyFX estimates)

Global. Tues: Germany Retail Sales 0.5%_{m/m}/2.7%_{y/y}, RBA Cash Rate 1.00%, Lowe, Carney. **Wed:** Eurozone, Germany, France, and Italy C-PMIs 52.1/52.6/52.9/49.5, Eurozone, Germany, France, and Italy NM-PMIs 53.4/55.6/53.1/50.0, UK C-PMI & NM-PMI 51.0/51.0, China Caixin NM-PMI 52.6. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose last week for all three S&P indexes, continuing their rebounds that began during March. LargeCap's has risen during 17 of the past 20 weeks; MidCap's 12 of the past 16 weeks; and SmallCap's 11 of the past 14 weeks. LargeCap's was at a record high for a fourth week for the first time since late October, while MidCap's and SmallCap's are 1.0% and 5.5% below their mid-October highs. At their bottoms, LargeCap's forward EPS had been the

most below its record high since June 2016, and MidCap's was the lowest since May 2015. SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged down a 30-month low of 4.2% y/y from 4.3%. That's down from 23.2% in mid-September, which was the highest since January 2011. MidCap's y/y change was steady at 3.5%, which compares to a 34-month low of 3.0% in mid-June and 24.1% in mid-September (the highest since April 2011). SmallCap's -1.6% y/y is the lowest since January 2010. That compares to an eight-year high of 35.3% in early October. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 2.8%, 11.7%), MidCap (22.7, 0.8, 14.3), and SmallCap (22.4, 2.7, 18.7).

S&P 500/400/600 Valuation ([link](#)): The forward P/E ratio edged down w/w for LargeCap, but improved for MidCap and SmallCap. LargeCap's forward P/E dropped 0.1 point w/w to 16.7, a tad below its 13-month high of 16.9 in early May and up from a five-year low of 13.9 during December. That also compares to a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E rose to an eight-week high of 15.8 from 15.7. That's down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E improved to a seven-week high of 16.4 from 16.2 and is well above its seven-year low of 13.6 during December. That's still well below its 51-week high of 20.2 in December 2017 (which wasn't much below the 15-year high of 20.5 in December 2016, when Energy's earnings were depressed). SmallCap's P/E was below LargeCap's P/E for a seventh straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q2 earnings season set to begin next week, the consensus forecast has held up well despite concerns about the trade war's impact on earnings. Revisions activity remains light for the current quarter: last week saw the S&P 500's Q2-2019 EPS forecast drop two cents w/w to \$40.44. That's still in line with our forecast of \$41.00, which assumes there will be yet another earnings hook during the reporting season. The consensus' \$40.44 estimate is down 2.1% since the start of the quarter, which represents an earnings decline of 1.3% y/y. On a pro forma basis, it represents an earnings gain of 0.3% y/y, compared to 0.2% a week earlier and 2.9% at the end of Q1. If Q2 earnings growth is positive, it would be the 12th straight y/y rise, compared to 1.6% in Q1, 16.9% in Q4, and 28.4% in Q3 (which marked the peak of the current earnings cycle). Five of the 11 sectors are expected to record positive y/y earnings growth in Q2-2019, with only one rising at a double-digit percentage rate. That compares to six positive during Q1, when one also rose at a double-digit percentage rate. Five sectors are expected beat the S&P 500's Q2 growth rate, the same as during Q1. However, Communication Services and Utilities are the only sectors to post better growth on a q/q basis during Q2, just as they did during Q1. Here are the latest Q2-2019 earnings growth rates versus their Q1-2019 growth rates: Communication Services (16.4% in Q2-2019 versus -9.9% in Q1-2019), Financials (5.6, 8.0), Health Care (3.0, 10.3), Utilities (2.2, -0.5), Real Estate (1.0, 6.3), Consumer Discretionary (0.0, 8.1), Industrials (-0.2, 6.9), Energy (-1.5, -26.1), Consumer Staples (-1.3, 0.9), Information Technology (-7.9, -1.1), and Materials (-29.6, -13.4). On an ex-Energy basis, S&P 500 earnings are expected to rise 0.4% y/y in Q2, down from 3.0% in Q1 and well below the 14.2% y/y gain in Q4. Q2's forecasted gain would mark the lowest ex-Energy growth rate since Q2-2016.

S&P 500 Q2 Earnings vs Past Quarters Trend ([link](#)): Earnings estimate revisions activity for Q2-2019

returned to the usual pattern of falling just before the earnings reporting season, but the decline has not been as bad as pundits feared. With the June-quarter books closed, the current Q2-2019 EPS forecast of \$41.34 is down just 2.2% over the 13 weeks since the quarter's start. That's less than the average decline of 4.1% over the same time period in the 100 quarters dating back to 1994. It's also markedly better than the 7.0% drop for Q1-2019 and the 4.0% decline for Q4-2018. Analysts expect EPS for Q2-2019 to be down 1.4% y/y on a frozen actual basis, which would mark its first y/y decline since Q2-2016. However, we think the positive surprise bias will appear again and that y/y growth will be positive for a 14th straight quarter. Since 1994, the Q2 earnings surprise has averaged 2.8% and has been positive in 22/25 years, with the last miss occurring in 2008. Q2-2019 should mark the S&P 500's record 42nd straight quarter of positive surprises—a streak dating back to Q1-2009.

GLOBAL ECONOMIC INDICATORS

Global Manufacturing PMIs ([link](#)): Global manufacturing activity in June was the weakest since October 2012, while business optimism slumped to a series-record low. JP Morgan's M-PMI fell further below the breakeven point of 50.0 last month, after dropping below in May for the first time since February 2016—posting its first back-to-back sub-50.0 readings since H2-2012. The M-PMI sank to 49.4 in June, declining steadily from December 2017's seven-year high of 54.4—as output stopped growing and inflows of new business contracted at the fastest pace since September 2012. The emerging nation's M-PMI (to 49.9 from 50.4) deteriorated slightly for the third month, after improving the prior two months from January's 49.5 (which was the first reading below 50.0 since mid-2016) to 51.0 in March. Meanwhile, the M-PMI for developed nations fell for the second month, to 48.9, after recovering to 50.2 in April, following a brief dip below 50.0 in March (to 49.9). Of the 30 nations for which June PMI readings were available, the majority (18) contracted, with Germany (to 45.0 from 44.3), Spain (47.9 from 50.1), the UK (48.0 from 49.4), Italy (48.4 from 49.7), China (48.4 from 50.2), Japan (49.3 from 49.8), Taiwan (45.5 from 48.4), South Korea (47.5 from 48.4), and Russia (48.6 from 49.8) among those countries experiencing downturns. The US (50.6 from 50.5), France (51.9 from 50.6), the Netherlands (50.7 from 52.2), Australia (52.0 from 51.0), India (52.1 from 52.7), and Brazil (51.0 from 50.2) were some of the larger industrial nations to register an expansion.

US Manufacturing PMIs ([link](#)): Manufacturing activity in June expanded at its slowest pace since October 2016, according to ISM's M-PMI, and held close to May's near-decade low, according to IHS Markit. The ISM M-PMI (to 51.7 from 52.1) remains on a steep downtrend from its recent high of 60.8 just 10 months ago. "Comments from the panel reflect continued expanding business strength, but at soft levels; June was the third straight month with slowing PMI expansion" said Timothy R. Fiore, Chair of the Institute for Supply Management (ISM) Manufacturing Business Survey Committee. The new orders (to 50.0 from 52.7) measure dropped to the breakeven point of 50.0 last month, recording its slowest pace since December 2015, while the production (54.1 from 51.3) measure bounced off May's 33-month low. The employment gauge improved for the second month, climbing to 54.5 in June, after falling from 57.5 in March to 52.4 in April. The remaining two components that compose the M-PMI—supplier deliveries (50.7 from 52.0) and inventories (49.1 from 50.9)—continued to deteriorate, with the former nearing the 50.0 breakeven point and the latter dropping below for the first time since the end of 2017. IHS Markit's M-PMI (50.6 from 50.5) in June was little changed from May's reading, which was the weakest since September 2009; these are down from 54.9 at the start of this year. According to the report, "The survey provides accurate advance indicators of comparable official data, and paints a worrying picture of marked declines in both output and jobs. The June survey sub-index readings are consistent with manufacturing output contracting at a quarterly rate of 0.7% and factory payrolls falling by 18,000."

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