BULL AND BEAR BULLETIN

The Economic Cycle: What Inning Are We In?

Since 1950, the average economic cycle has lasted approximately six years, while the average economic recovery and expansion phases have lasted roughly five years (Chart 1). As the present economic cycle enters its fourth year since the June 2009 bottom, investors should maintain a historical perspective on the average business cycle length and the variables that may promote further expansion and those that could end the current growth phase.

One of the biggest benefactors of continual economic growth has been corporate profitability, which has recovered much faster than previous economic cycles. U.S. corporate profits recently surpassed the previous business cycle level highs and are now approaching the highest level of profitability since 1950 (Chart 2). While corporate profits help support and sustain stock prices, the ability of corporations to improve their profitability may soon be in jeopardy. As Europe continues to slide into a deeper recession and the Chinese economy decelerates from its torrid pace, overall demand will begin to fade. With less global demand, corporations will likely have to reduce their prices to maintain the same amount of unit sales. The lower goods' prices will negatively impact corporate profit margins.

While corporate profit margins may begin to decline in the face of lower global demand, corporations are still likely to maintain positive earnings as technological advances have allowed companies to realize significant productivity gains from their employees. Corporations can use productivity gains to offset modest declines in product pricing, enabling them to generate a similar amount of profit per product.

Despite the ability of corporations to offset some of the weaker global demand, investors seem less convinced. As we have discussed in the past, the global equity markets have already discounted a sizeable amount of negativity into individual company stock prices despite no major economic disaster occurring (Chart 3). Traditionally, a healthy market will appreciate at a similar pace as the growth in corporate profits, as measured by earnings per share. Combining two significant market crashes in less than ten years, a below average economic recovery and the constant publishing of negative news headlines, investors have either been unwilling or too fearful to reward stocks for their impressive earnings growth.

With stocks currently out of favor with investors and already trading at a discount to the historical values versus earnings, there are two likely outcomes from any deceleration in corporate profitability. Under the first scenario, investors may choose to use the deceleration as further proof to support their decision to reduce their stock market exposure, driving equity prices to an even greater discount to their earnings. The second scenario would be a relative nonevent, where investors have already factored the earnings deceleration into existing stock prices and the market's upward trajectory merely adjusts to reflect the new lower earnings growth pattern.

Even with Europe acting as a parachute to the global economic growth rate, investors should also remain mindful of the saying "Don't Fight The Fed." The saying refers to the Federal Reserve's efforts to promote economic growth and its benefits to both corporate profits and stock prices. While the Federal Reserve's effort to stimulate the economy continues to have a diminishing marginal benefit, meaning that they are receiving less "bang for their buck" with each dollar they print, their effort does build some degree of support into the stock market. With the Federal Reserve constantly pumping money into the system, even if a majority of this money is being held by the banking system and targeting extremely low interest rates, it will take a greater than normal economic shock to produce a contraction of the U.S. economy and a subsequent decline in corporate earnings than if the Federal Reserve was standing by idle.

While we acknowledge that the current economic expansion phase is becoming more mature with every passing quarter, we believe that there are certain sectors and companies within the economy that will continue to experience earnings growth despite a weaker global economy. Furthermore, it is also possible that given the Federal Reserve's unprecedented policy decisions that the existing economic expansion could be longer than the historical average, allowing for a longer upward trajectory of the stock market.

As part of our overall philosophy and strategy, we will continue to monitor the various sectors and data points of the economy to assess the stability of global economic growth and will use each quarterly corporate earnings season to better evaluate our expectation for further profit growth. If our outlook changes, we will attempt to convey the details to our clients through our internal publications, phone calls and client meetings. In the meantime, please do not hesitate to contact us if you have any further questions or concerns.

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Chart 1

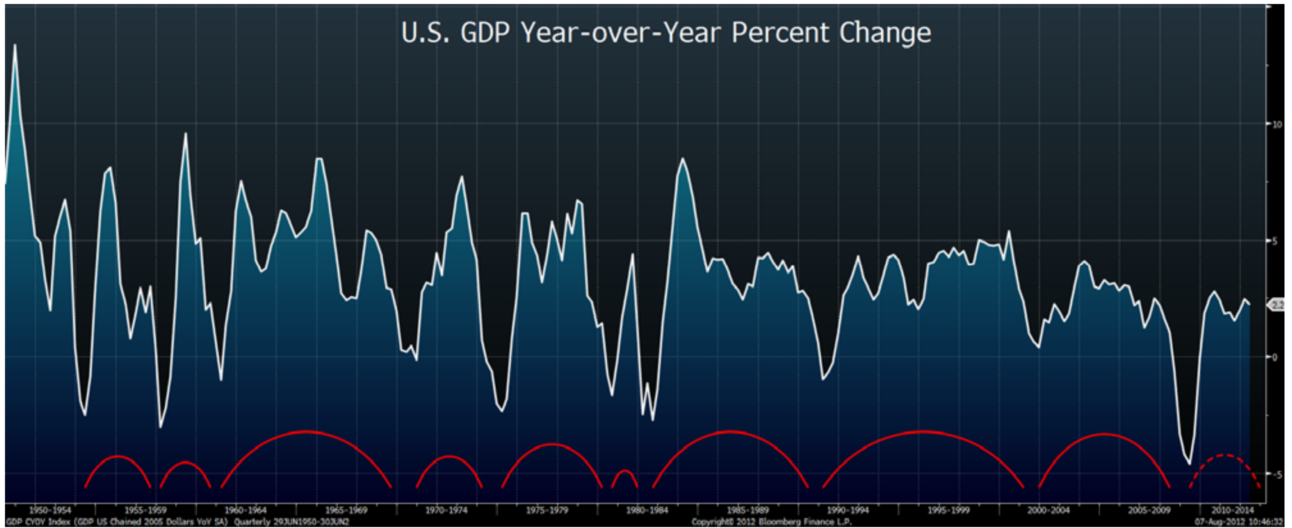

Chart 2

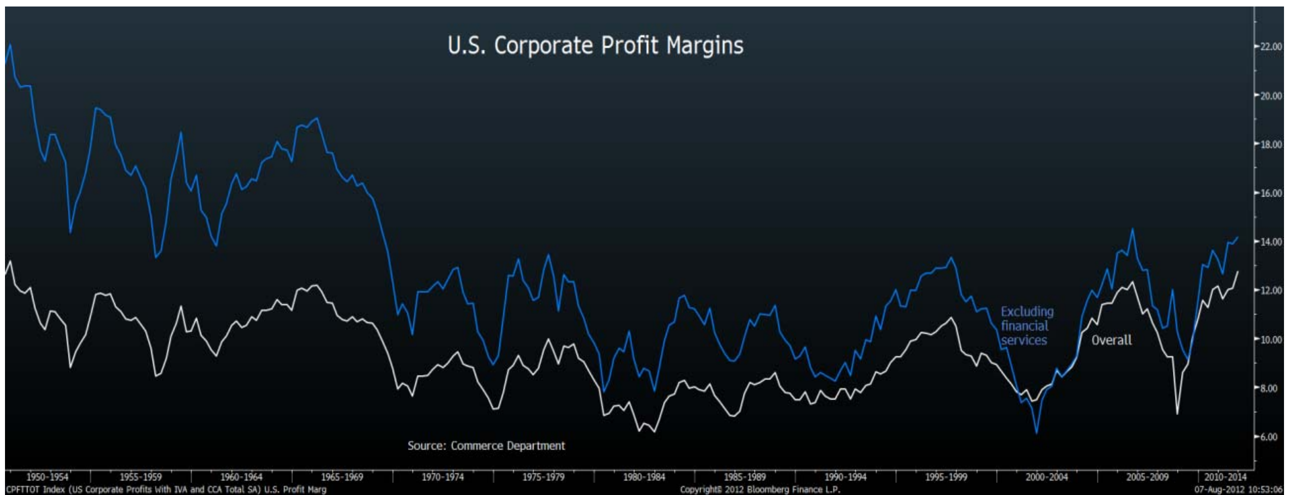

Chart 3

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