NATIXIS ASSET MANAGEMENT

ALLOCATION PERSPECTIVE

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The Fed and the equity markets: margins of error

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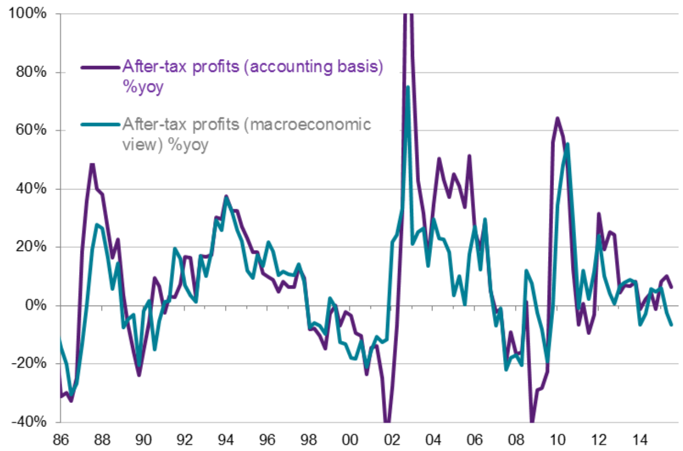
After a bumpy ride over the summer (Chart 1), the US stock market has regained its highs of the year and calmly discounted the end of 6 years of zero interest rates, which is more or less a certainty for this month. For all that, the profits position of US companies looks fragile, which, combined with high valuations, makes current index levels appear vulnerable.

Chart 1
US equity market: S&P 500 index

Source: Bloomberg

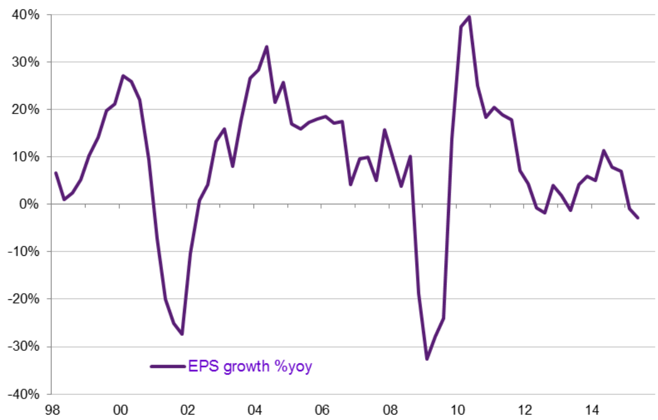
The profits of non-financial US companies rose by 6.4% in Q3, but this growth incorporates some pure accounting effects, which do not reflect the macroeconomic reality. These profits really need restating for the difference in the calculation of capital depreciation between the tax view (accounting profits) and the economic view (in the sense of the national accounts, i.e. in macroeconomic terms). This means taking into account the 'material' capital depreciation, which is slower than that allowed by the US tax authorities. This impact is currently abnormally high as a result of the investment tax incentives introduced during the great recession of 2008-2009. Companies were able to write down their new investments on an accelerated basis creating a mismatch today between abnormally low tax depreciation and 'macroeconomic' depreciation, which remains unaffected by these tax measures. Once restated for this depreciation impact and the revaluation of stocks, profits developments provide a picture of corporate profitability which is a truer reflection of the macroeconomic reality. As Chart 2 below shows, this reality is more worrying than the one shown by published financial accounts: profits are contracting, in aggregate by 6.7%. This view does not contradict profits reported by non-financial corporates listed on the S&P 500, which have shown earnings per share(EPS) contracting by 2.9% per annum in Q3 (Chart 3).

Chart 2
US: non-financial corporate profits



Source: Datastream

Chart 3
EPS of non-financial corporates listed on the S&P 500

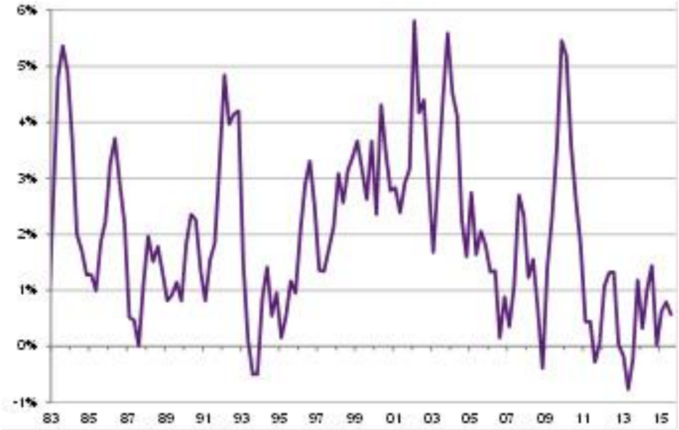


Source: Bloomberg

Increased revenue growth estimated with the aid of nominal GDP for non-financial companies was nevertheless 3%. The earnings contraction is thus the result of a margin squeeze.

As the payroll bill represents the most important cost for companies, we use unit labor costs to estimate corporate margins. This unit cost represents the ratio between the hourly wage and the hourly productivity of employees. One of the characteristics of the US economy since the end of the economic crisis has been the structural weakness of productivity gains (Chart 4). This weakness of productivity gains means that any increase in the hourly wage cost tends to have a ricochet effect for unit labor costs and therefore for margins and profits growth.

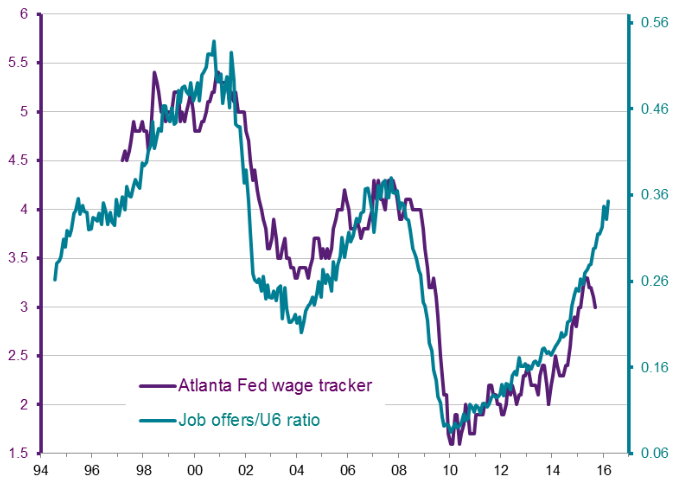
Chart 4
Non-farm business sector productivity growth (% y-o-y)



Source: Datastream

Wages actually present the greatest risk of a change in trend. The unemployment rate has fallen back to a six-year low of 5% of the labor force. We consider the best leading indicator for wage pressure to be the ratio between job offers and employment seekers in a broad sense (i.e. the U6 definition of unemployment). This ratio is at its highest level since 2008 and augurs a sharp acceleration in wages as shown in Chart 5. The fear therefore remains that a strong rise in wages will erode corporate margins in 2016.

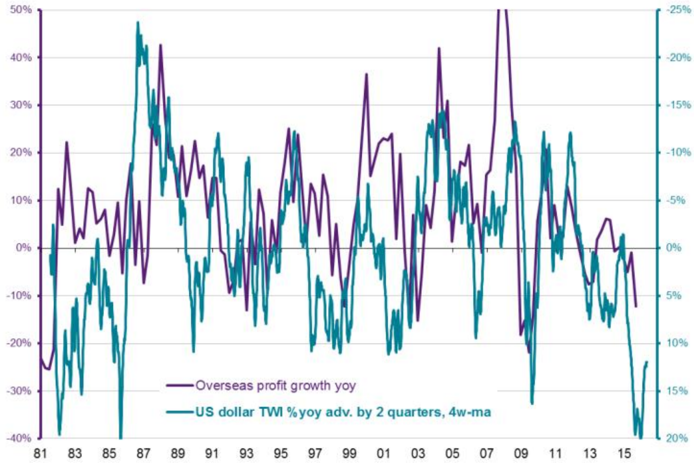
Chart 5
US: labor market and wage inflation



Source Datastream

In contrast to the previous cycle, overseas corporate profits by US companies will not be able to absorb the damage caused by the fall in domestic margins. Earnings generated abroad contracted by 12% in Q3, and recent dollar strength foreshadows an even worse contribution to total earnings from abroad in the coming months (Chart 6).

Chart 6
US: overseas corporate profits and the dollar



Source: Datastream

The analyst consensus predicts growth in earnings per share (EPS) of 8.5% in 2016 for the US market. This figure includes around 3 percentage points linked to the automatic impact of share buybacks on EPS. But even net of share buybacks, growth in the order of 5% seems difficult to achieve, given the risk of a margin squeeze. In addition, deterioration in the debt market (50 bp rise in high yield debt spreads in the past month) augurs a slowdown in share buybacks (made using debt), which will further weaken the figures for EPS growth. Faced with uncertainties in profits and confronted with the imminent prospect of monetary tightening by the Fed, the US equity market looks very vulnerable, perched on its valuation peak of 17 times earnings. The Fed should therefore assess the rate rise trajectory for 2016 with the greatest caution.

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