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EARNINGS & CASH FLOW FALLING AT UNPRECEDENTED RATES

An Acceleration in the Credit Cycle Reversal

ANALYTIC INSIGHTS

Gordon T Long
2/15/2016

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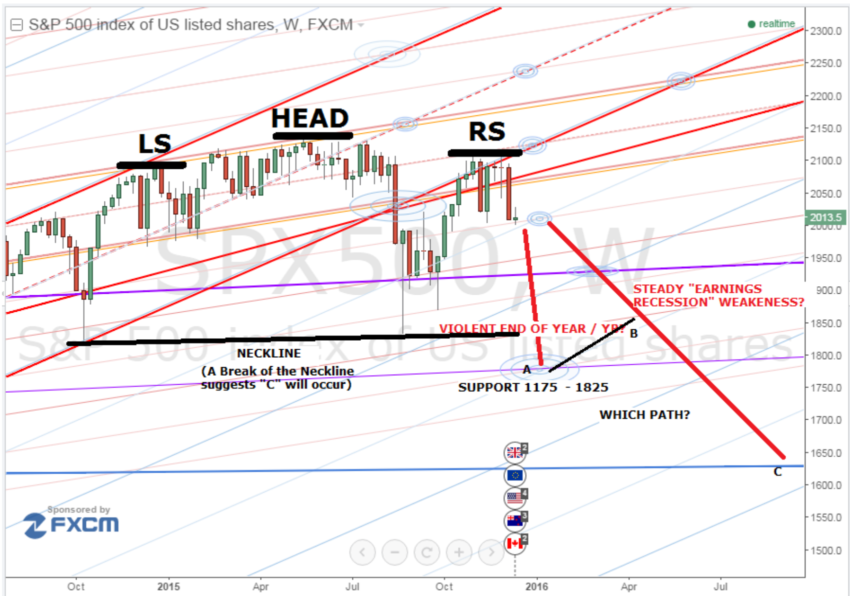
An Acceleration in the Credit Cycle Reversal

WE WARNED – *Expect a 'Violent Reaction'*

PREVIOUS REPORT WE SHOWED THIS CHART – We Predicted "Violent YE"



LATEST CHART – It Was a "Violent YB"

We were off slightly! It didn't happen on December 31st but instead on January 1st… and it was violent!

It was only a matter of time … and patience.

FEAR BUILDING – *Cracks Showing Everywhere You Look!*

With Q4 earnings season drawing to a close, here is a quick recap of the key issues facing corporate CEOs and CFOs based on their conference calls as summarized by Goldman's David Kostin:

> (1) Company managements forecast positive US GDP growth in 2016, in contrast with investor concerns of a potential recession. However, global growth prospects appear grim, particularly within commodity-exposed nations.
>
> (2) Strong domestic consumer demand persists amid industrial weakness.
>
> (3) Several firms announced large or accelerated share repurchase programs in 2016. Corporates will remain the largest source of US equity demand this year.
>
> (4) Despite recent economic and currency turmoil, firms view China as an attractive market in the long term.

Oddly enough, despite consensus being on the verge of forecasting that 2016 will see another Y/Y EPS decline, which would mean 7 consecutive quarters of declining earnings growth, management teams still remain oddly upbeat and instead of conserving cash, they prefer to delude themselves that the current economic slowdown will be transitory and chose to spend said cash on stock buybacks instead, giving shareholders one last out as the company itself scrambles to buy every share outside shareholders (and management teams) have to sell. Here are the 4 key themes summarized:

- **Theme 1:** US economy appears insulated from global weakness - Managements expect stable US economic growth in 2016, dismissing concerns of a potential recession. However, global growth forecasts remain bleak.
- **Theme 2:** Strong domestic consumer demand persists - Companies benefit from positive US consumer spending. Wage and job growth, low rates, and low oil prices should keep spending power elevated.

- **Theme 3:** Managements remain devoted to share repurchases - Several firms announced large share buyback programs. S&P 500 YTD repurchase authorizations of $63 billion are at the highest level since 2007.
- **Theme 4:** Outlook for China is positive despite recent turmoil - Managements expect consumers will drive long-term economic growth in China and remain committed to expanding their businesses in the region.

Deutsche Bank sees two new worries emerging:

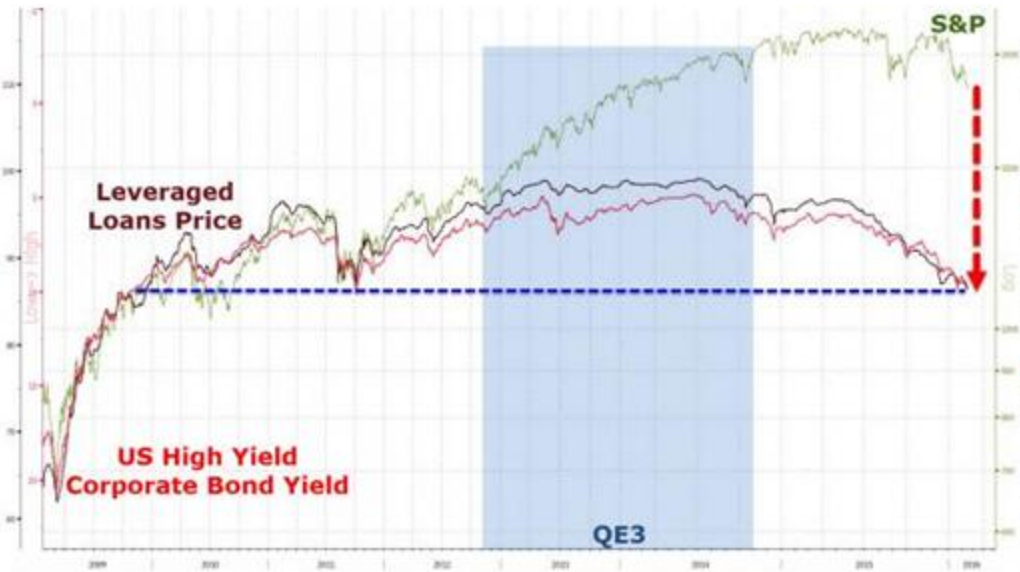
There are two new concerns weighing on risk sentiment beyond China and energy: US growth and European financial conditions

Concerns and what is needed for a sustained turn in risk sentiment

New concerns	US	Macro improvement	✗	• Macro data generally disappointing: not only have data not improved, but momentum has actually slowed further
New concerns	Financial conditions	Reversal of recent tightening	✗	• Financial conditions have tightened sharply in the US and in Europe and could weigh on growth if sustained
Original concerns	China	Policy clarity	✗	• FX has remained stable vs. the dollar, following the start of year devaluation • But overall FX policy still uncertain, risk of large one-off devaluation remains – even IMF called for more clarity
Original concerns	China	Macro stabilisation	~	• Macro data broadly in line with expectations, confirming growth is slowing gradually – not a rosy picture but far from the feared sharp slowdown
Original concerns	China	Policy easing	✗	• Monetary policy easing continues but impact diminishing • Strong fiscal stimulus would abate growth concerns but is unlikely for now
Original concerns	Oil	Stabilisation	✓	• Oil has risen $5/bbl since mid-January, reversing a large part of this year's fall • Volatility relevant for markets/inflation but increasingly less so for economy • Adjustment is progressing, though a material recovery is unlikely this year
Nice to have	Monetary policy	Support from BoJ, ECB and Fed	✓	• All three central banks took a more dovish stance at their January meetings, with unexpected easing by the BoJ, signalling of upcoming easing by the ECB and a cautious tone by the Fed

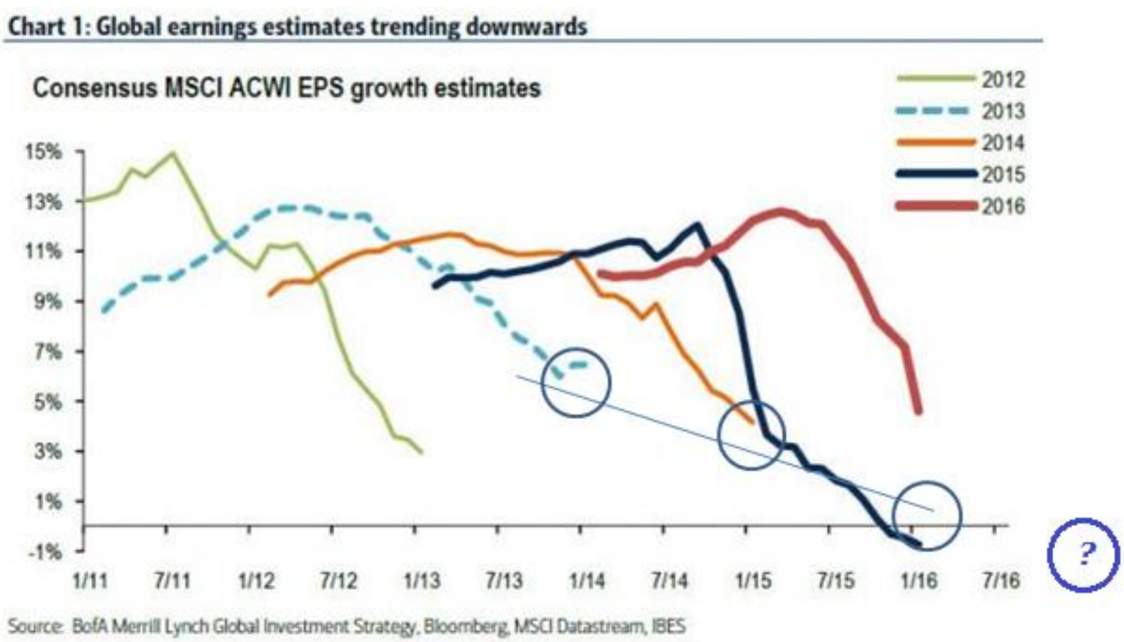
WE EXPECT BREAKING US$ "PEG"s TO SHOCK MARKETS in 2016

The gap with Leveraged Loans and HY Corporate Bonds says the market needs to find support at lower levels in Q1 2016.



EARNING FORECASTS – ***Being Taken Down Across the Board***

The rate at which earnings are being taken down is startling, even for those of us that were fully expecting this to occur. If history is any indicator, as well as the current 2016 year end "hockey stick" predictions – it is going to get much worse as the year unfolds.



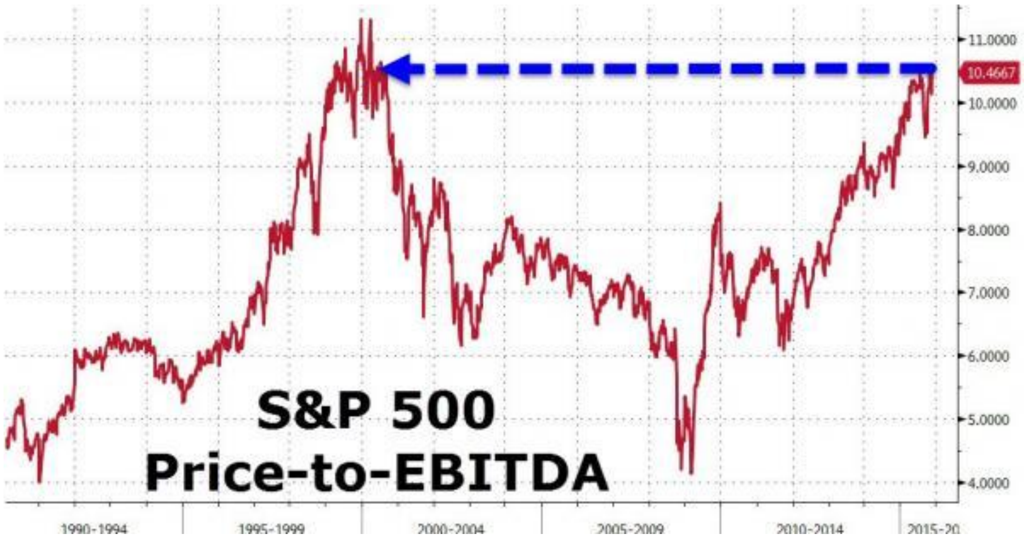
YIELD CURVE – ***Flattest Since 2008 and Now Headed Towards a "Recessionary" Inversion***

We have a flat yield curve that appears to be sending indications of a potential inversion. This would be a clear sign of a looming recession. The recent break of a triple bottom in the 2-10 10Y UST is yet another major concern.

CREDIT CYCLE HAS TURNED – ***Earnings Now Surfacing as a Problem***

In the December Triggers we outlined that the Credit Cycle had turned because Cash Flows or EBITDA was rapidly falling.

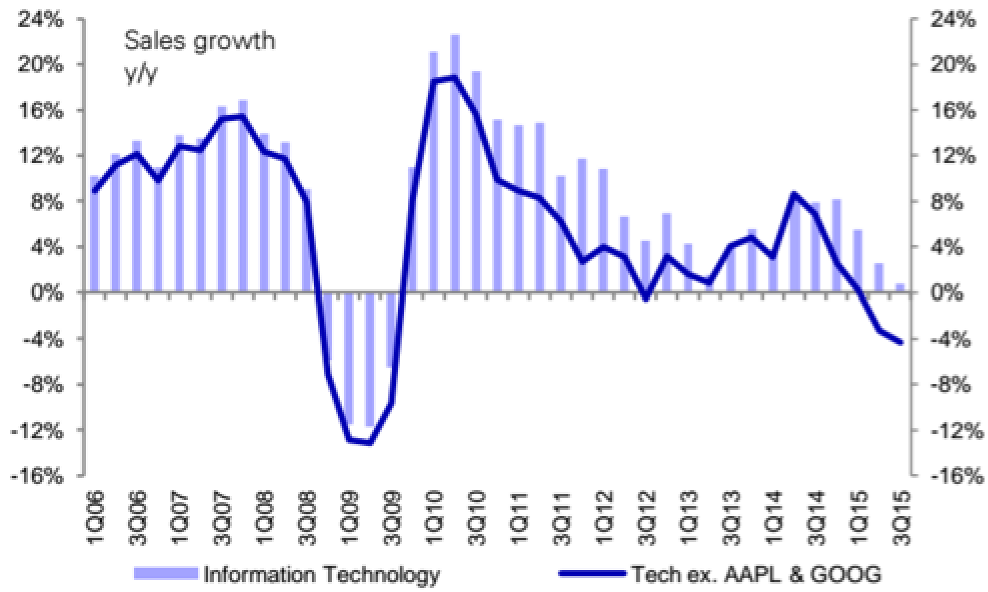
Price to EBITDA for the overall S&P 500 only continues to deteriorate and now approaches the 2000 Dotcom Bubble levels!



GOING TO GET UGLY - FAST!

US Corporate Profit Growth have turned down nearly two years ago, and now are negative.

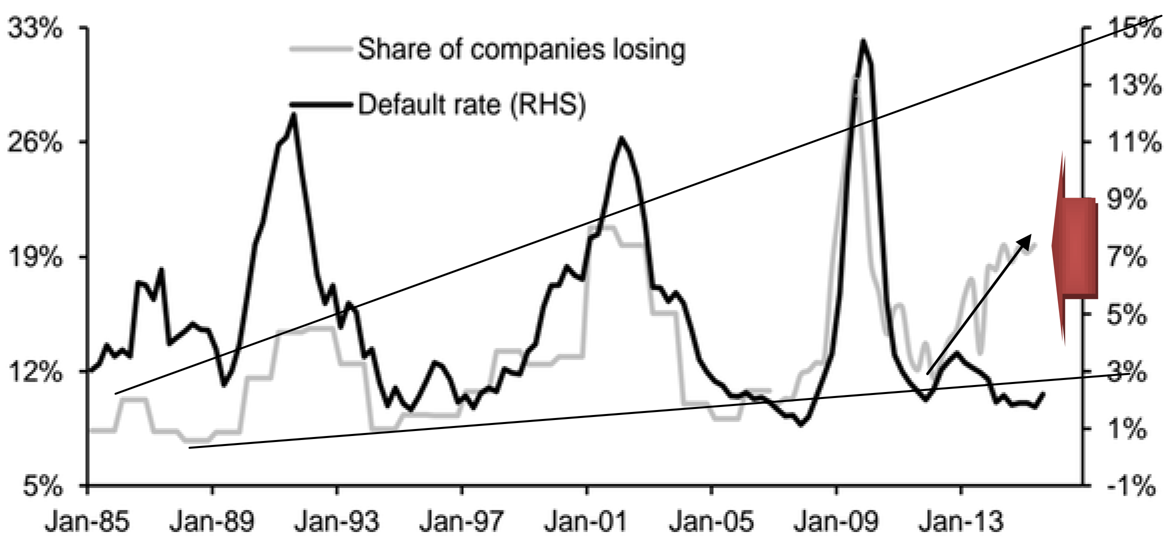
Tech ex. AAPL & GOOG sales growth



Source: IBES, Deutsche Bank

Share of companies losing money points to much higher defaults

Percentage of US companies losing money (annual 1985- 2006, quarterly last 12 months thereafter) and trailing 12-month Moody's HY default rate

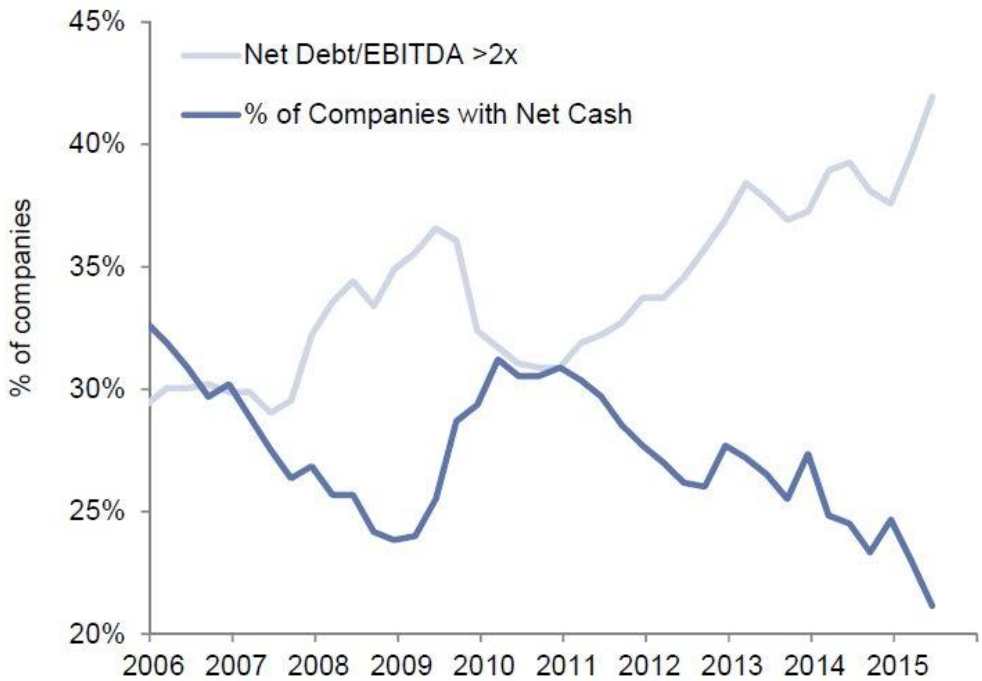


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service, Moody's Investor Services

THE "STOCK BUYBACK" GAME MAY BE ENDING – WATCH CASHFLOW VERSUS DEBT LEVELS

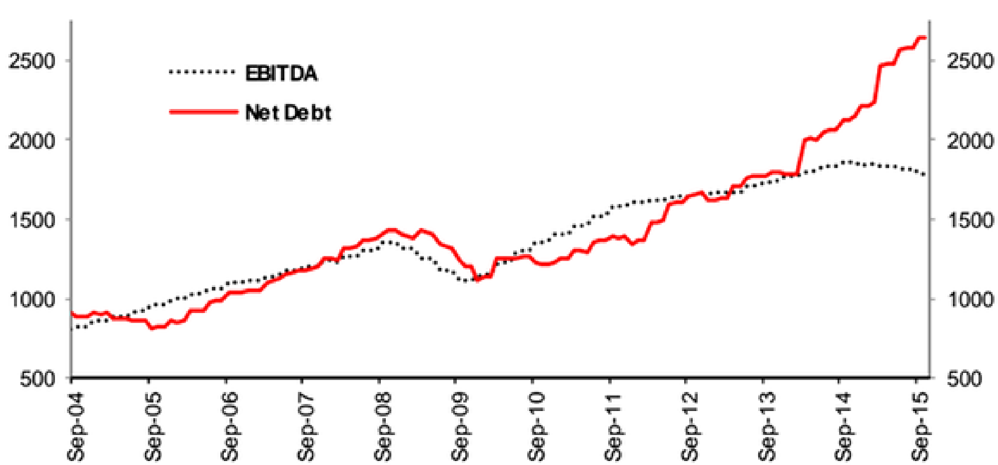
Net EBITDA 2x Highest since 2006 % of companies with net cash Lowest since 2006.

Exhibit 29: "Net Cash" companies are increasingly scarce
% companies with leverage (ND/EBITDA) above 2x vs. % net cash; GS coverage



Source: Goldman Sachs Global Investment Research.

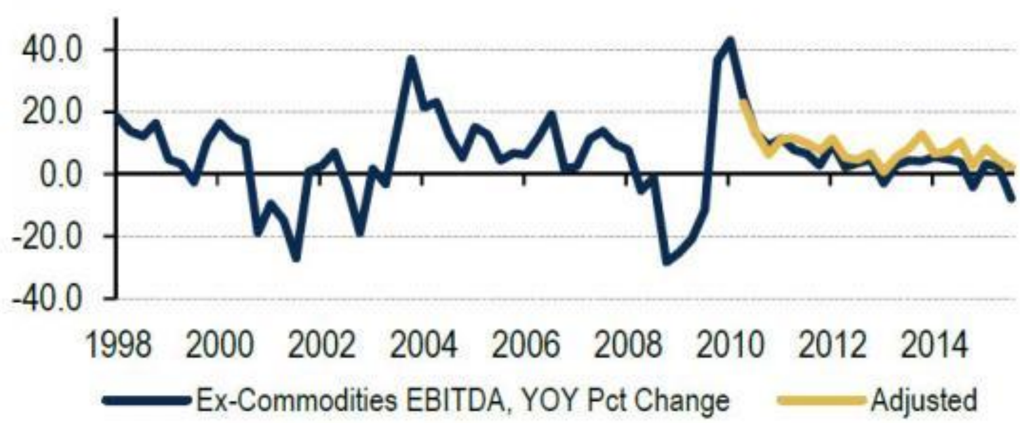
US corporate net debt has exploded and massively exceeds EBITDA ($bn, S&P 1500 ex fins)



Source: SG Cross Asset Research/Equity Quant

This has been the biggest EBITDA drop outside of a Recession since 2000!

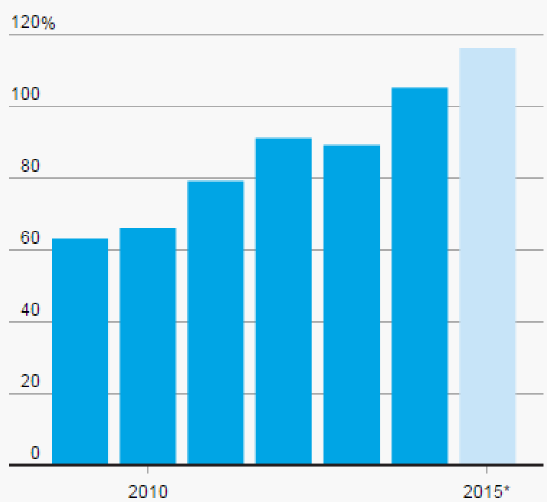
Chart 2: Non-recessionary unadjusted EBITDA growth is the worst since 2000



Source: BofA Merrill Lynch Global Research

1900 US listed corporations spent more on Buybacks and Dividends in 2015 than they earned! The difference being increased debt levels.

Buybacks and dividends as a percentage of net income

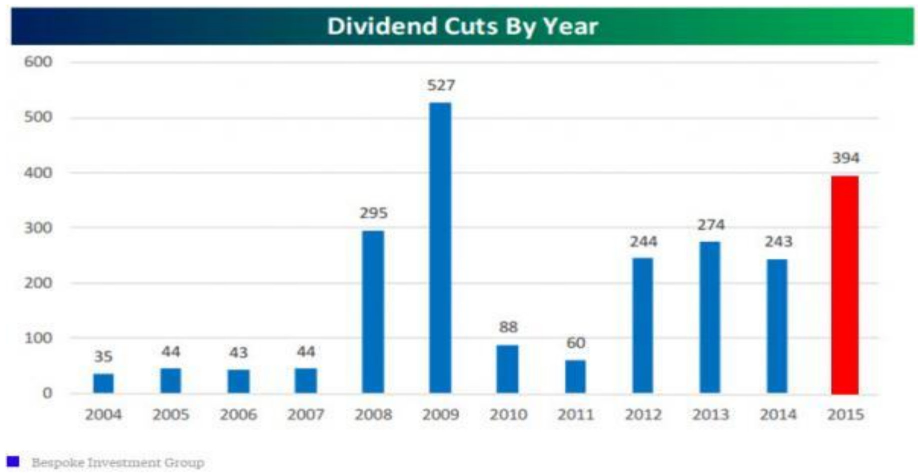


Note: Aggregate number for 3,297 publicly traded non-financial companies analyzed by Reuters
*2015 data for 613 companies that have reported

Sources: Thomson Reuters data, regulatory filings

By Matthew Weber and Karen Brettell | REUTERS GRAPHICS

A sure sign of series longer term issues is when corporations start cutting dividends. CEO and Boards are loath to do this unless they have absolutely no choice.



It is important to note that Precious Metals have tested and initially broken major overhead long term resistance. After backfilling and retests we expect 2016 to be a strong year for Precious Metals dispute every effort being made by the Bullion Bank Cartel to suppress it.

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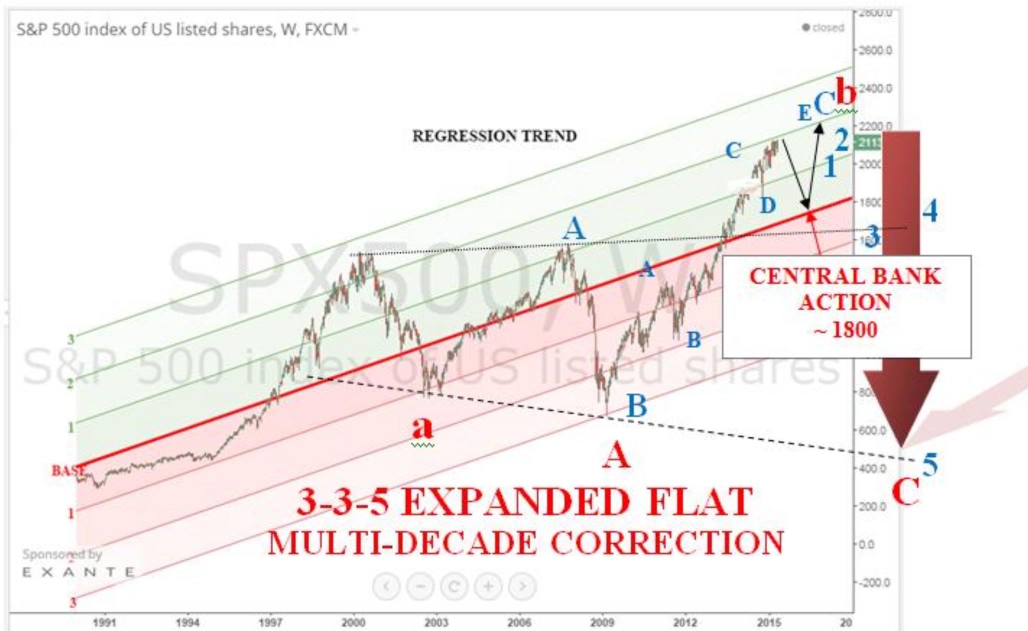
LONGER TERM VIEW

As we have laid out in previous MATA reports, we still see more increases in the equity markets later in 2016 after this consolidation / correction has run its course, but have serious concerns beginning in Q4 2016.

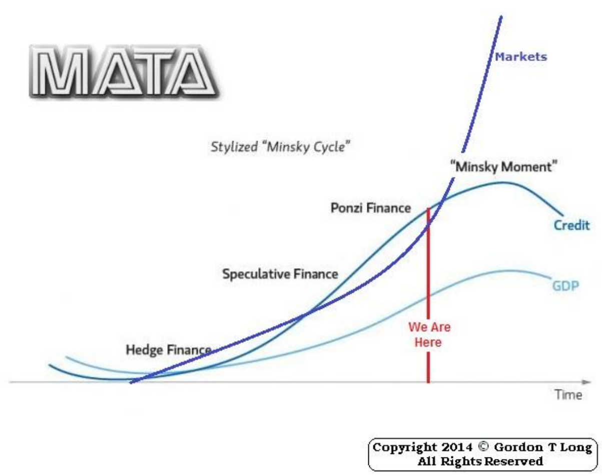
Sometime in Q4 2016, after the central bankers have had another shot at QE, helicopter money and collateral guarantees - it will end badly!



HAVEN'T CHANGED OUR POSITION

After the near term expected correction we still expect markets to head higher towards a "Minsky Moment" in 2016.

This is based on the assumption that Central Banks will react to any deterioration in the financial markets with yet another round of crisis driven liquidity pumping!



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