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EXPECT THE UNEXPECTED!

Don't Ever Underestimate What Central Bankers & Government Will Do.

ANALYTIC INSIGHTS

Gordon T Long
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EXPECT THE UNEXPECTED!

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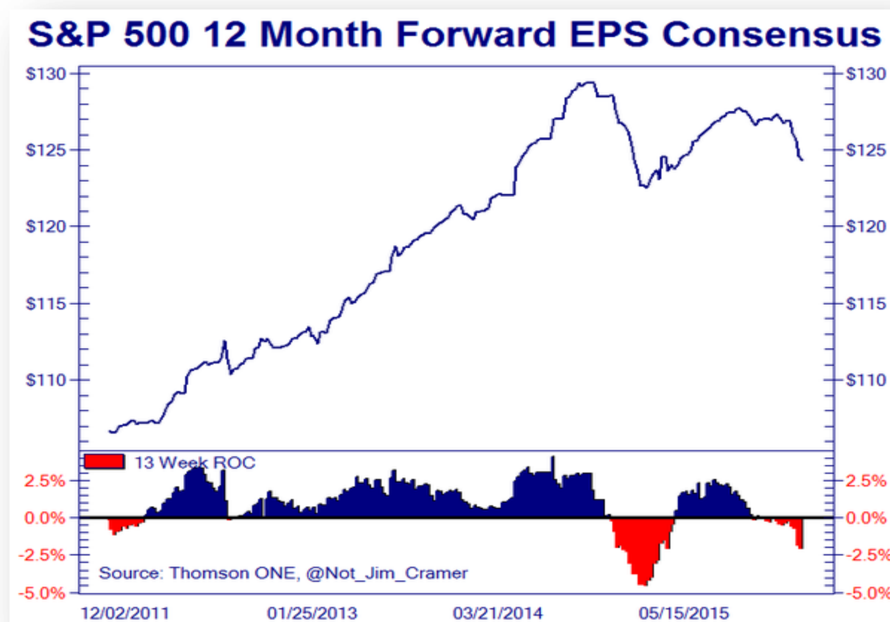
FALLING PROFITS – Weakening Markets

We talked throughout 2015 about the falling top line revenue growth. Then in Q3 and Q4 2015 we began talking about falling profit growth. We pointed out continuously how buybacks were hiding reality, as EPS growth was actually based mostly on a shrinking denominator.

We additionally began pointing out that margins were showing noticeable weakness and cash flow / EBITDA was falling, rather rapidly.

We now witness 12 month forward Earning per Share (which factors in expected buybacks) is being taken down – quickly and significantly.



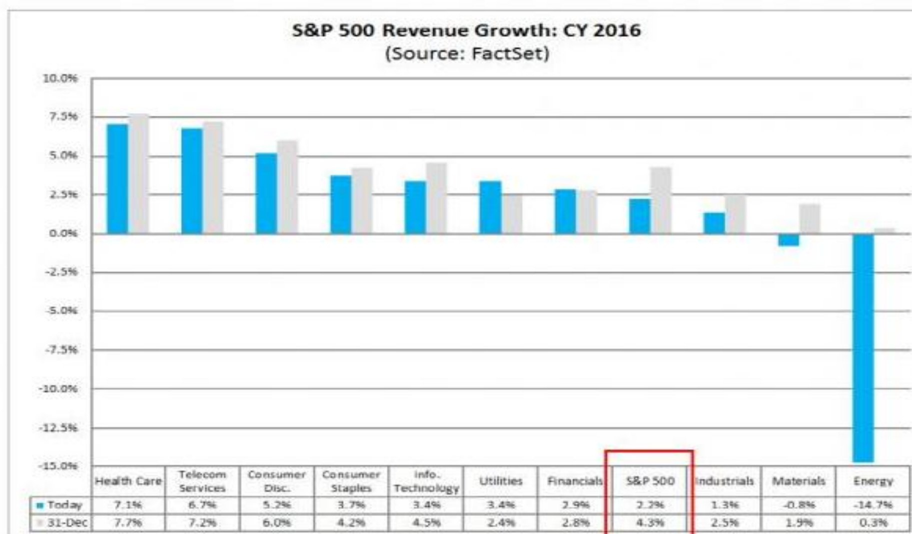
If previous forecast reductions are any indication, then the current rate of reduction is truly alarming. As I will show in a moment, 2016 EPS growth estimates have been slashed by 50%, just one month into the year.

The fundamentals also suggest falling earnings are in the cards and should be expected.

Chart 1: Global earnings estimates trending downwards

Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, MSCI Datastream, IBES

CY 2016: Growth



	Health Care	Telecom Services	Consumer Disc.	Consumer Staples	Info. Technology	Utilities	Financials	S&P 500	Industrials	Materials	Energy
Today	7.1%	6.7%	5.2%	3.7%	3.4%	3.4%	2.9%	2.2%	1.3%	-0.8%	-14.7%
31-Dec	7.7%	7.2%	6.0%	4.2%	4.5%	2.4%	2.8%	4.3%	2.5%	1.9%	0.3%

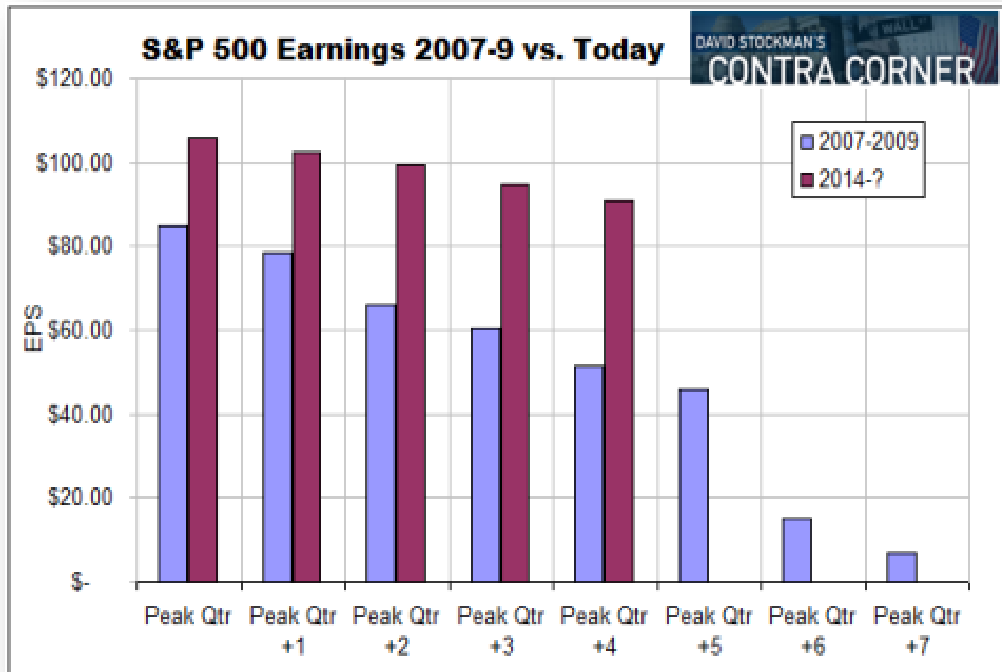
Factset notes, that it is usually the case that analysts predict significant increases in earnings and revenue growth in the 2nd half of the year. In terms of earnings, the estimated declines for Q1 2016 and Q2 2016 are -5.3% and -0.4%, **while the estimated growth rates for Q3 2016 and Q4 2016 are 5.5% and 10.7%.**

In terms of revenues, the estimated declines for Q1 2016 and Q2 2016 are -0.1% and -0.1%, while the estimated growth rates for Q3 2016 and Q4 2016 are 2.3% and 4.5%.

These are ridiculous “hockey stick” predictions that only the very naïve and novice could possibly believe?

The hard reality is that these forecasts will never materialize, which can be seen in the full year EPS forecast and is highlighted in the box shown here, in a single month, full year EPS has declined from 4.3% to 2.2%.

The comments from CEOs during the latest earnings conference calls are truly alarming. Every indication is that the fall in earnings may be more pronounced than the period which kicked off the 2007 financial crisis.



Here are some typical comments:

Industrial companies have been in recession for four quarters now

"We are now basically in our fourth quarter of the recession…I see at least one more quarter, maybe another quarter." —Emerson CEO David Farr (Industrial Components)

"Industry demand for medium and heavy duty trucks in China decreased by 24% for the full year as the industrial economy slowed." —Cummins CEO Thomas Linebarger (Truck Engines)

Sysco mentioned "deflation" 40 times on their conference call

"We currently believe that deflation headwinds will persist for at least the remainder of the fiscal year…deflation impacts the P&L…the reality is, it's not a great environment because you end up with fewer dollars to pay your expenses with." —Sysco CEO William DeLaney (Food Distributor)

The Chinese are looking to shut down steel capacity equal to US output

> "Clearly, you have a situation of excess capacity across most infrastructure supporting industries, like steel, glass and cement…the Premier recently here announced their goal to take out about 100 million to 150 million ton a year capacity. And just to put that in perspective, that's like the entire capacity of the United States." —Praxair CFO Matt White (Industrial Gasses)

At best, it's a slow growth environment

> "There's no doubt, it's a slow growth environment." –Honeywell CEO David Cote (Conglomerate)
>
> "We do think that we are in this frustratingly slow environment that can often cause people to use the recession word, but I think that's almost a more of a kind of an emotional issues than it is a the factual basis" —Eaton CEO Sandy Cutler (Diversified Industrial)

Eaton said that people have got their hatches buttoned down tight

> "I think people have got their hatches buttoned down tight and they too are trying to live through a period of time when growth is less than they'd hoped it might be a couple of years ago" —Eaton CEO Sandy Cutler (Diversified Industrial)

The market is only beginning to reflect the realities of what the CEO's are reporting and saying. The financial markets are now being forced to listen as the momentum players exit.

I have written a number of articles in the last 60 days on the precarious nature of the markets and the startling lack of breadth.

These articles shown here can be found in the commentary section of our web site or in the public addition of the Trigger$ webzine.

Basically about ten stocks have been holding up the US equity markets. Market breadth deteriorated in Q4 2015, but not the indexes! Index weakness began January 1st as these 10 stocks began to see selling pressures.

What is important for investors to understand is that the rise of index ETFs and mutual funds, which all depend on these 10 stocks, has never accounted for this much of the global market before.

The rapid emergence of Index ETFs accounted for nearly 30 percent of the trading in the U.S. equities market last summer. Weakness in these stocks will magnify, or even potentially cause flash crashes if they break critical support levels.

This is an untested $1 trillion stock bubble problem!

LIQUIDTY AGAIN A PROBLEM – Falling Flows and Private Credit Growth

LIQUIDTY AGAIN A PROBLEM

The rolling 3 month asset purchases by the global central banks give us insight into another development going on below the surface.

Having become addicted to liquidity injections by the central banks in the post financial crisis period, the liquidity growth decline (since the US TAPER program was implemented) is clearly being felt globally.

Particularly so in the Emerging Markets.

The forced selling by the Emerging Markets due to negative current account balances and currency pressures has significantly aggravating a tenuous situation.

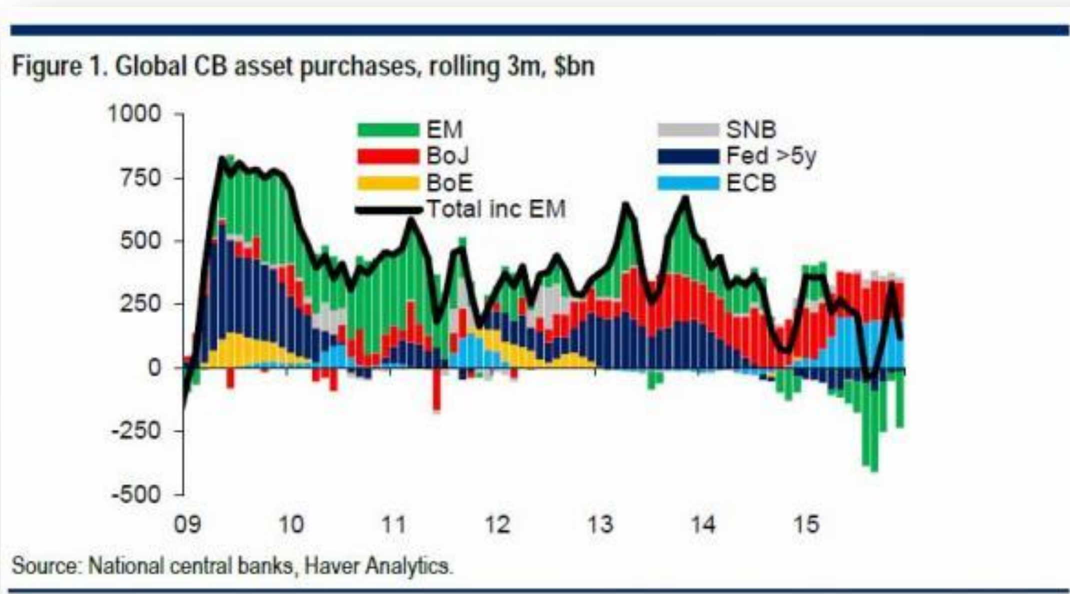
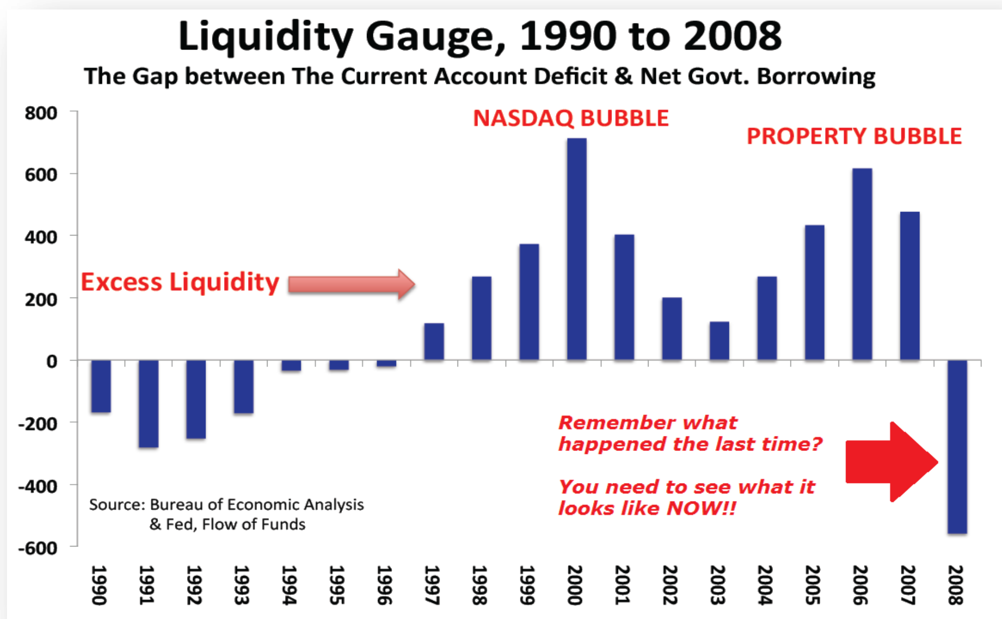


Figure 1. Global CB asset purchases, rolling 3m, $bn

Source: National central banks, Haver Analytics.

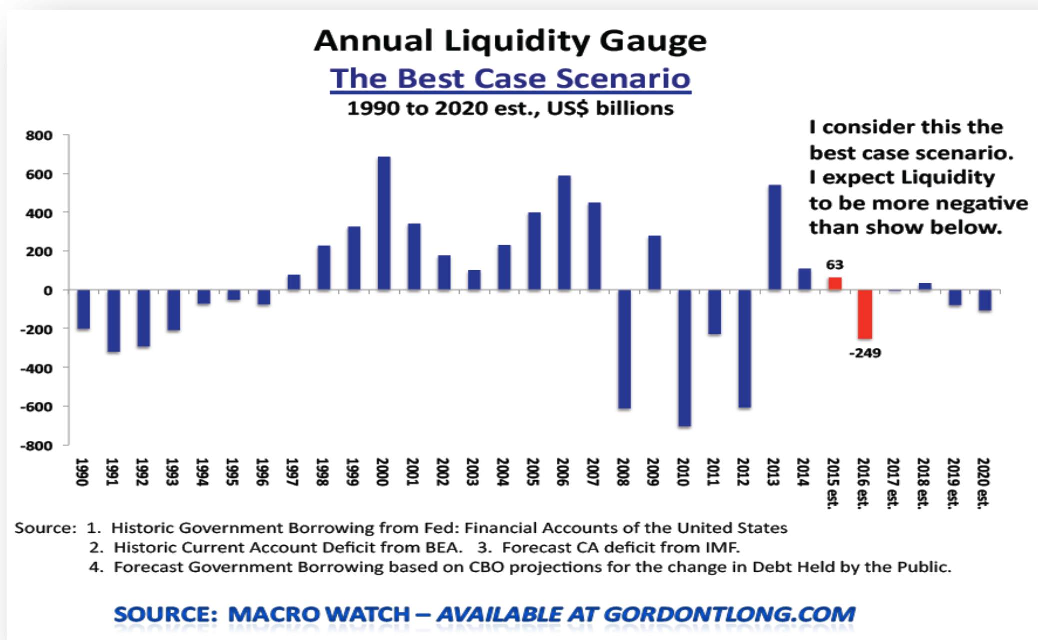
Richard Duncan at Macro Watch does a stellar and unique job of analyzing global liquidity pressures. His proprietary Liquidity Gauge showed what we should have expected in 2007 and 2008 if we had been following it.

The question is, If we knew the liquidly levels today what would we do?



Well here it is – thanks to Richard. This is his BEST CASE projection.

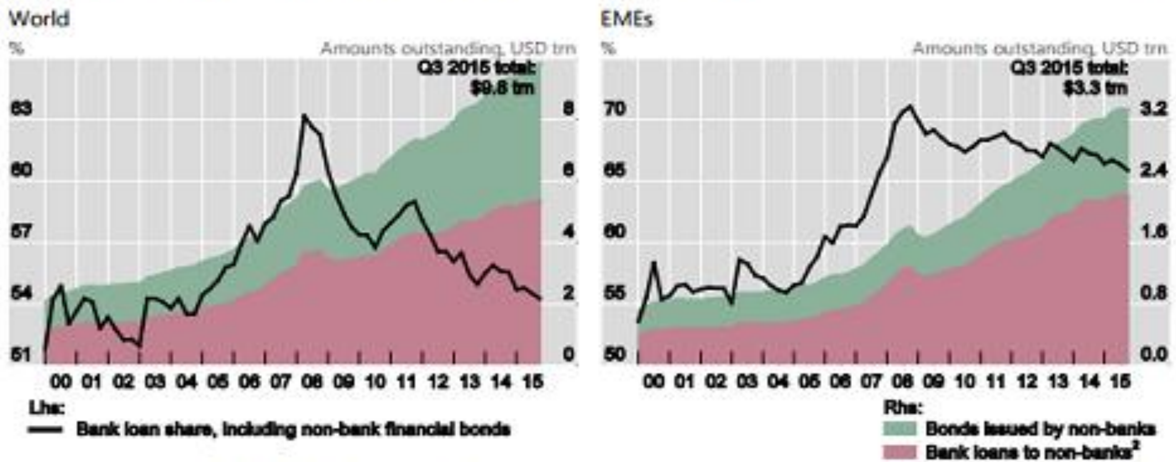
He strongly believes that unless the US Federal Reserve immediately takes policy action the USA will be in a recession in 2016 *(that is if it isn't already).*



A big part of the problem of what is a cascading situation is the amount of US dollar denominated credit to non-banks outside the US and particular to the Emerging Market nations.

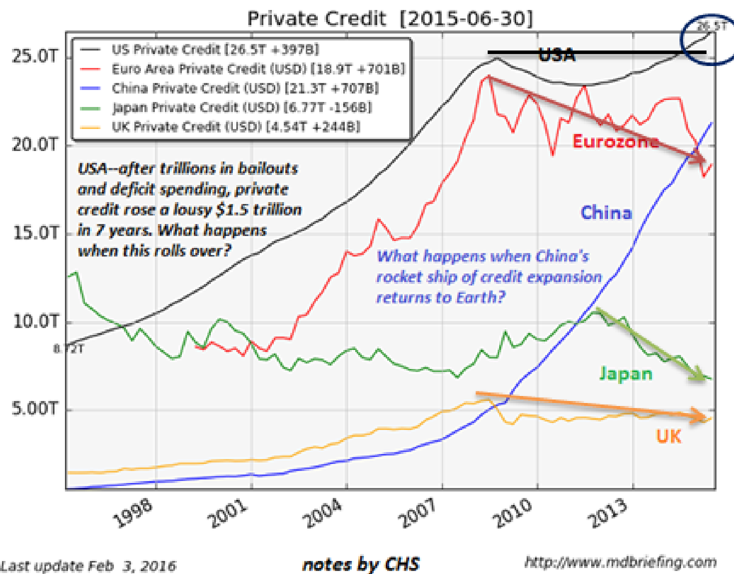
An unprecedented strengthening US dollar is making debt payments a major burden for debt holders of weakening Emerging Market sovereign currencies.

This situation is effectively an unexpected "sucking sound" of liquidity being taken out of the system due to the strengthening US dollar. Leverage and margin is being forced out due to these payments.



Additionally, Private credit is contracting in the major economic regions of Japan and the Euro Zone, while stagnant in the UK.

After trillions of dollars in bank bailouts, historic central bank liquidity injections and $8 Trillion in deficit spending, private credit in the US has only managed a paltry $1.5 Trillion increase in the seven years since the financial crisis meltdown.



Private credit is contracting in Japan and the Eurozone and stagnant in the U.K.

.. As for the U.S., after trillions of dollars in bank bailouts and additional liquidity, and $8 trillion in deficit spending, private credit in the U.S. managed a paltry $1.5 trillion increase in the seven years since the financial crisis meltdown .

We have a global problem in the growth of Private Credit!

CREDIT CYCLE HAS TURNED

CREDIT CYCLE HAS TURNED

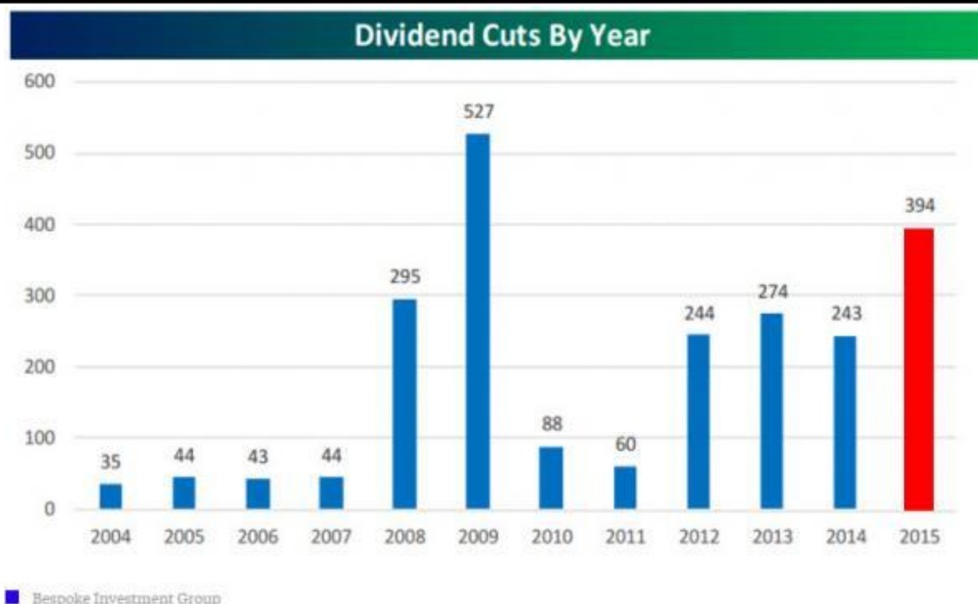
I have discussed previously with you how falling Cash Flows and EBITDA, coupled with high corporate debt levels, are a central reason for the recent credit cycle reversal.

This trend reversal is not about to be reversed as credit cycle reversals are normally infrequent and can be expected to take years to reverse again. It is a process that is about resetting debt to manageable and serviceable levels.

It normally forces out the malinvestment created by easy credit. It is extremely worrisome in this particular credit cycle reversal because of the size of debt & malinvestment, leverage outstanding and the degree of collateral impairment underpinning the debt pyramid.

Reduced corporate dividend payouts are a sure sign that the credit cycle has reversed which we are now witnessing.

The number of dividend reductions has now far surpassed 2008. It is almost 100 more than at the outset of the Great Recession, a time when the implosion of Lehman caused equity markets to plummet in the later stages of the third quarter.



[As Bloomberg reports,](#) on this fall in dividends:

> Because of the stigma associated with cutting dividends, management is loath to go down that path unless the need is dire**.** The trend toward trimmed payouts hasn't let up so far in 2016, especially among companies under stress from soft commodity prices. In recent days, ConocoPhillips slashed its dividend by 66 percent and Potash Corp. of Saskatchewan Inc. reduced its payout by 34 percent.
>
> The ratcheting down of payouts to shareholders is a function of weak commodity prices, sluggish growth dampening corporate profits, and a tightening of credit conditions. This combination—and in particular the stingier lending—could exacerbate the carnage already seen this year in financial markets, further dampening economic activity.

As credit markets shut off the source for economically rational shareholder-friendliness, the situation is only going to get worse.

We can now expect the market ”buybacks” elixir to finally start slowing!

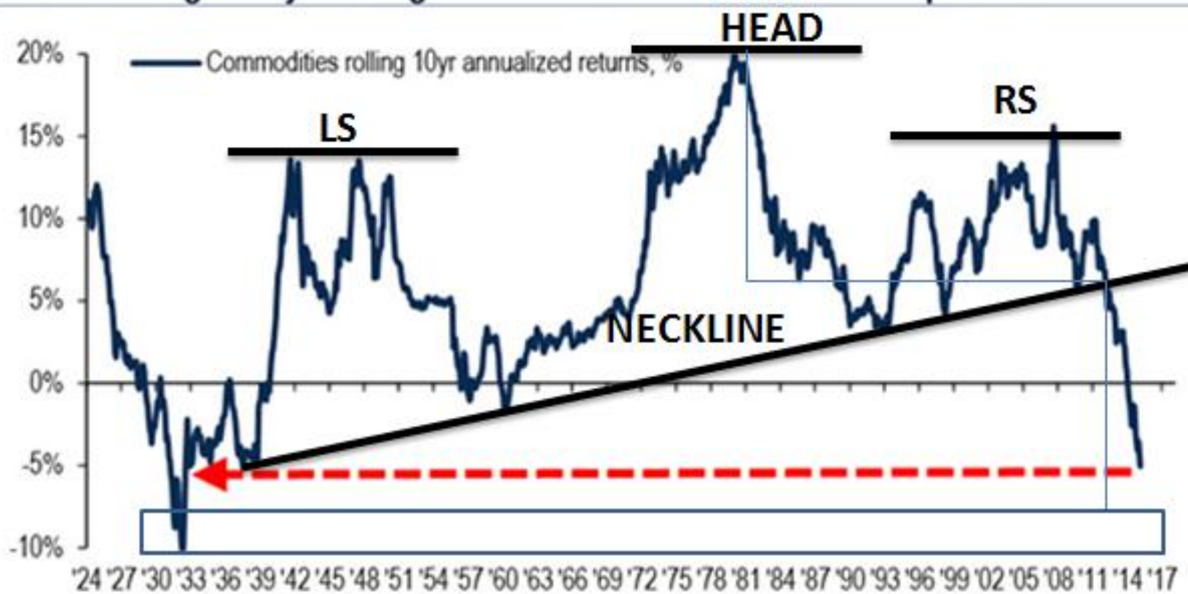
We should expect the unexpected throughout 2016.

I thought this nearly 100 year commodity chart of the rolling 10 year annualized percentage returns quite enlightening.

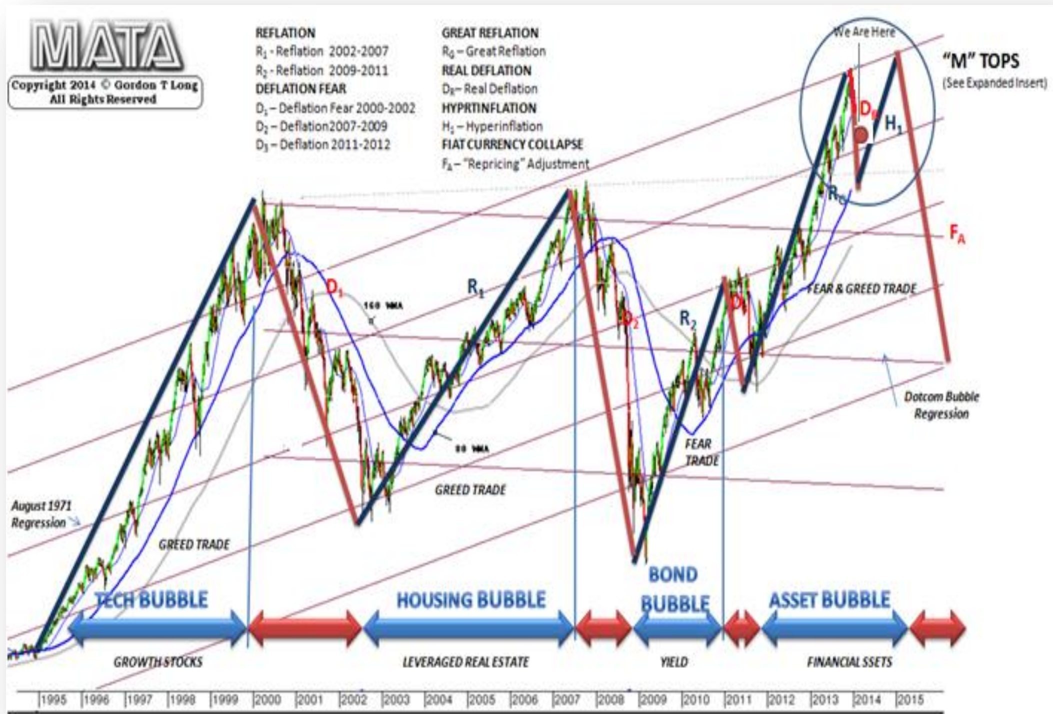
I marked it up to show a very clear technical “Head & Shoulders” pattern.

Though we are near completion of this classic pattern, there is still more to go and maybe more importantly, it suggests low commodity prices are likely to be with us over the next decade. That is if a Head and Shoulders pattern is applicable to a century long period of data.

It does tell us we are in the midst of a major economic event. Maybe an unprecedented resetting of economic growth associated with the 19th - 20th century Industrial Revolution.



We are all well aware we have had three major financial market waves over the last 15 years. What we often refer to as the Dotcom Bubble, the Housing Bubble and what I will term as the most recent “Central Banker Bubble”. Actually, all three were a direct result of Central Bank policies.

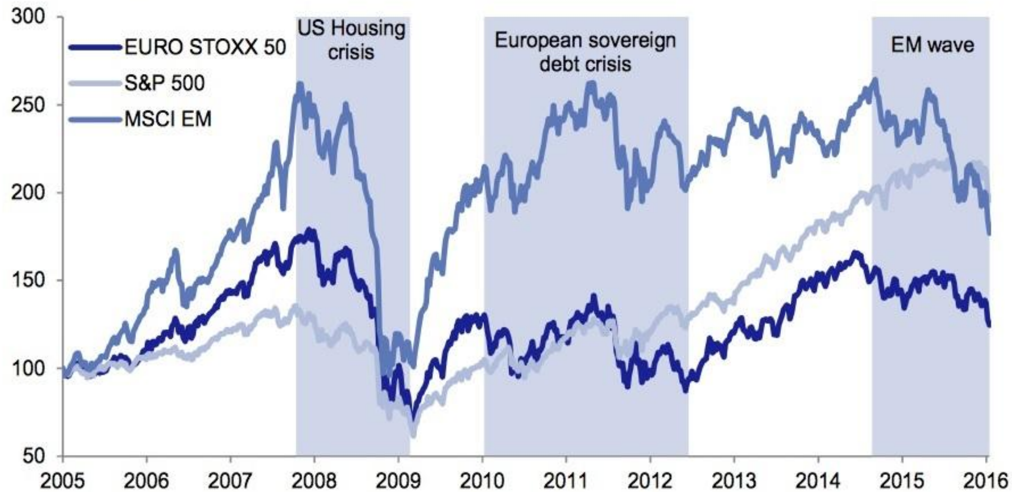


Each of these peaks approximates 7.4 years.

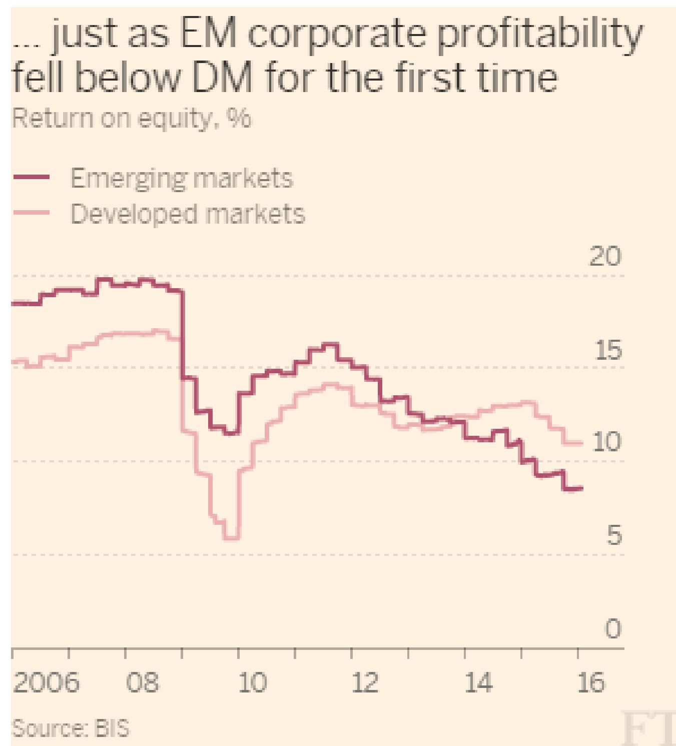
The third wave might itself be considered of consisting of three waves as shown here.

What is important to see here is that once again the Emerging Markets are central to the problem?

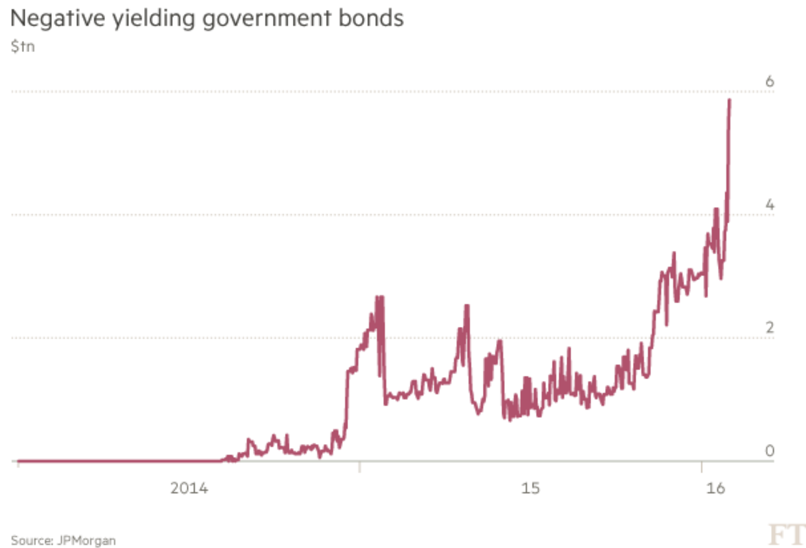
Debt levels, over expansion, foreign denominated debt all are major issues that are and will have a profound impact to global markets over the next 5 to 8 years.



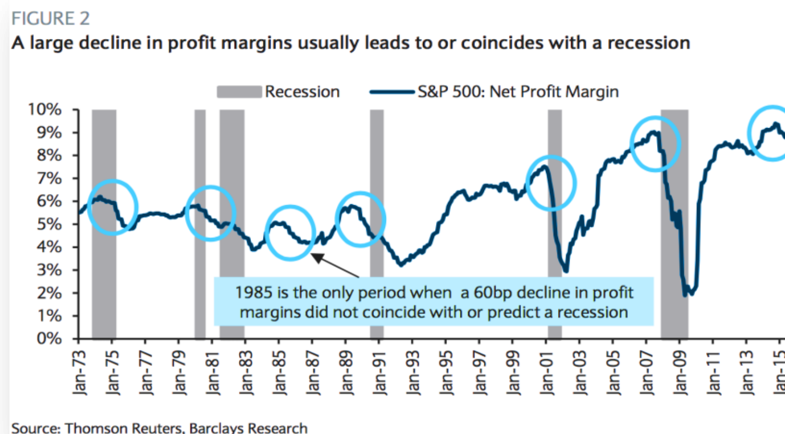
We see the pronounced decay trend in Corporate Profitability in the Emerging markets. It may get worse with $9T in debt outstanding, needing to be serviced and rolled over. This is a problem!



With over $7 Trillion of bonds now trading at negative nominal yields, it is telling us that something is seriously wrong and needs correcting.



Recessions and depressions are usually the outcome required to do the "dirty work" of resetting the stage, which political leaders will avoid at all cost.



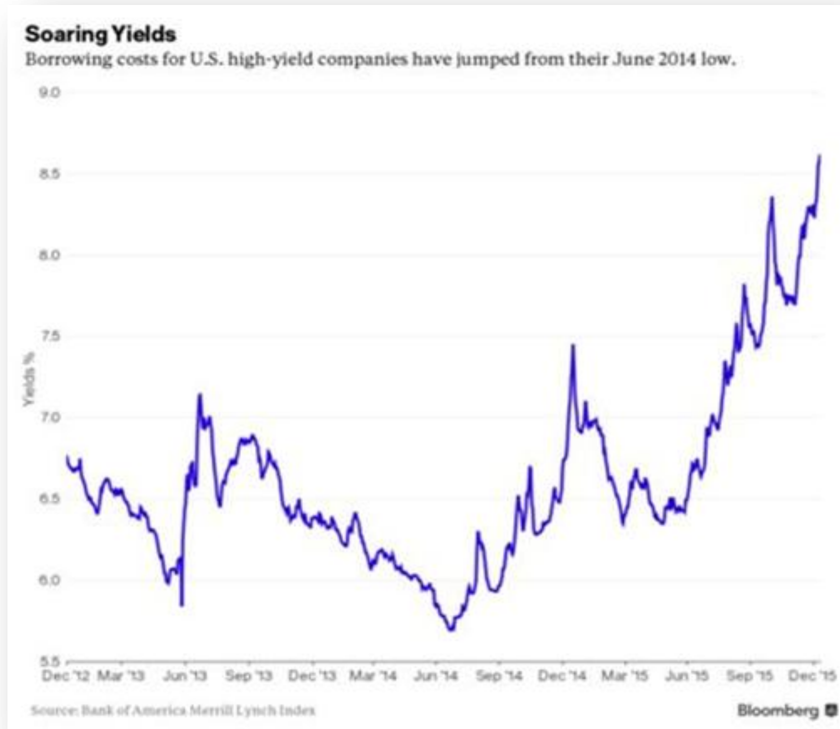
22nd SLIDE

A flat and Inverted Yield Curves are historically the most prevalent and consist indicator of coming recessions and process of realignment and adjustment.

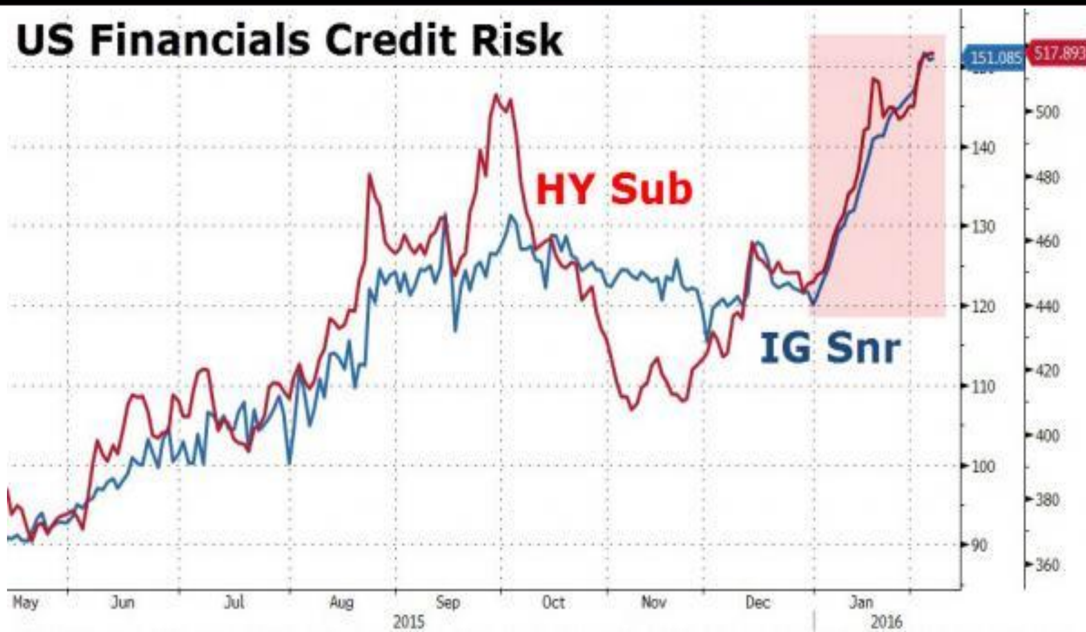
We have been watching very closely the triple bottom in the 2-10 UST Yield Curve since Q4. You have seen this particular chart a number of times. The yield curve has been as flat as it has been since the last recession.

As we prepared the slides for this discussion we see that the triple bottom has now been decisively broken. We are moving to an inverted yield curve.

Borrowing costs for High Yield companies which we have also shown previously, CONTINUES to rise dramatically from 2014 lows



Global risk measures are also now breaking out – quickly!



The bottom line from the reversal in the Credit Cycle is that we are getting signals that it could get very ugly in 2016!

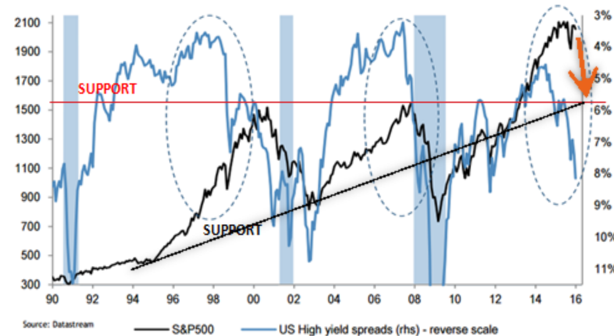
IT COULD GET UGLY IN 2016 – S&P 500 AT 1550?

Credit typically leads equities

- The best leading indicators for recession were: credit spreads, shape of the yield curve and profit margins.
- Credit spreads are not giving a positive signal.

J.P.Morgan CAZENOVE

S&P500 and US HY spreads and recessions



DRIVER$

SOURCE: JP Morgan

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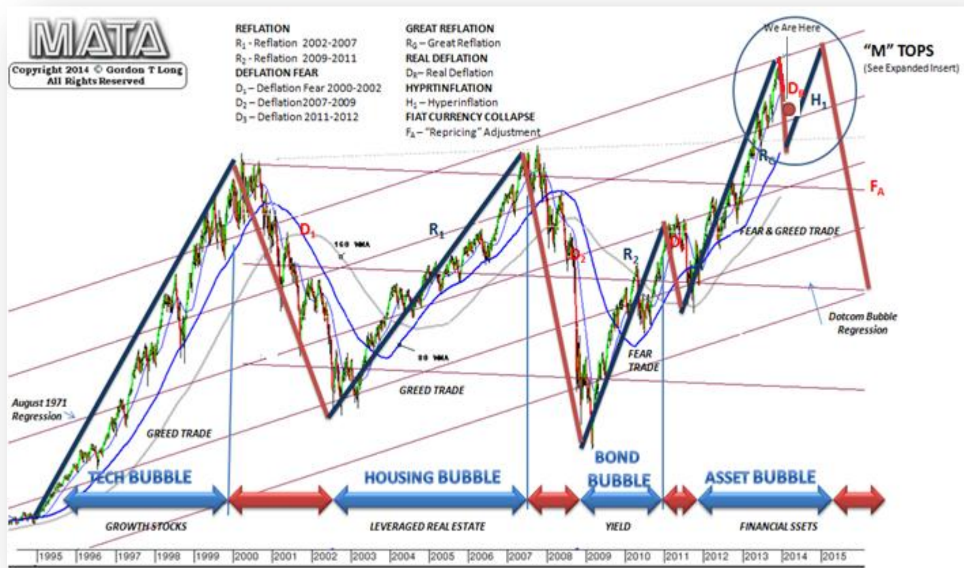
CRACKS IN THE DIKE – A 1929 Type Trap

We believe our "M" top which we fashioned a few years ago is playing out extremely well. We likely have more downside to go before we see a violent counter rally based on coordinated and surprising central bank actions. Of course these actions will fail, but not before wrecking havoc on the bears. We may not get a new higher high. We may not get a double top. We may instead see a standard Fibonacci 61.8% retracement. Time will tell.



Our 200 DMA and 400 DMA boundary conditions served us well during the 2007-2008 financial crisis. They appear to be serving us well again.

Bad things happen when the 200 DMA crosses the 400 DMA. It is rare and is almost always followed by a protracted period within the new directional trend direction it establishes. We aren't quite there yet but we are extremely close.

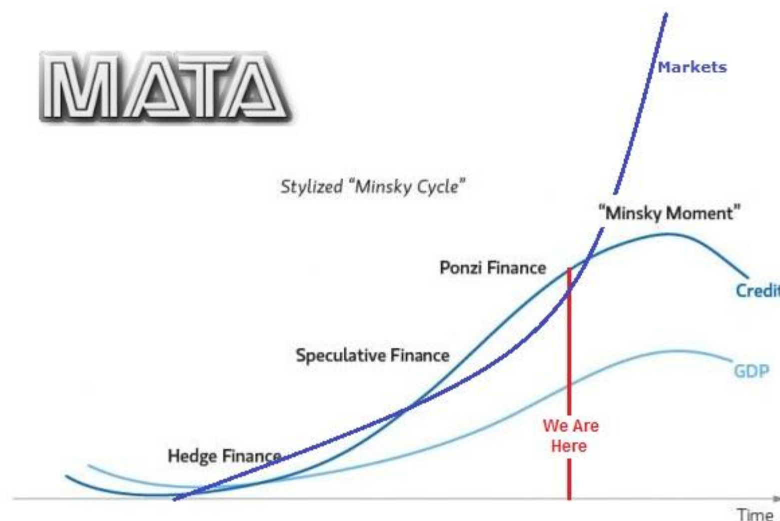
We would expect prices to minimally test the underside of the 400 DMA as overhead resistance before the Long Term top is finally in. Likely in Q2-Q3 2016.

CRACKS IN THE DIKE – A 1929 Type Trap

In conclusion, let me reiterate, I continue to fully expect a Minsky Melt-up before all this ends very badly in 2016 - possibly 2017?

Eventually, it will be clear to all that central bank policies have been an abject failure.

The government's policy of Financial Repression are becoming too heavy handed as productivity falls, high paying jobs disappear and tapped out consumer demand steadily erodes.



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Market Research & Analytics

www.GordonTLong.com

Gordon T Long
Publisher & Editor
general@GordonTLong.com

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