Global Strategy Weekly

We'll keep trying to look beneath the surface to discover the 'truth'

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What is the real profits, jobs and income story? Or are the economic data just garbage?

- The US economy has remained surprisingly resilient, confounding economists' predictions that it would slide into recession last year. We have also seen strong upgrades to economists' 2024 GDP growth forecasts throughout this year.

- While most economists will focus on the perennial resilience of the consumer as a reason for GDP upside surprises, others such as myself and our very own US economist Stephen Gallagher, believe that surprising robust US profits hold the key to the business cycle.

- Whole economy profits tend to lead the economic cycle. Profits declines typically occur *before* a recession as they force corporate to cut back on business investment (including inventories) and job hiring. A profits decline usually precedes an economic downturn.

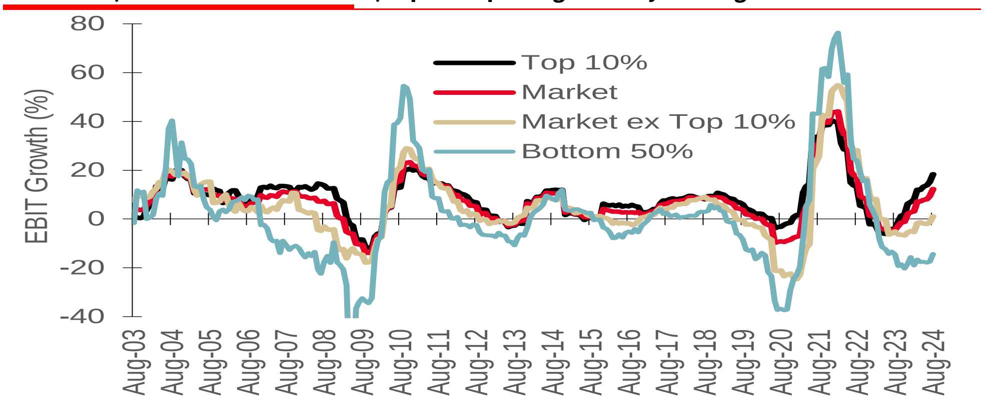
- Any downturn in profits is not immediately visible at the stockmarket level as finance directors have ample (legal) ways to 'massage' pro-forma earnings higher. My former colleague, James Montier, back in June 2008 developed the 'C-Score' to identify companies who in his words are "cooking the books" - resorting to financial jiggery-pokery to maintain the illusion of profits growth (you can read James' original SG report here or a synopsis here).

- US whole economy profits published by the BEA as part of the GDP release are derived from IRS tax data and hence tend to be a 'truer' representation of what is happening under the hood (companies might try and fool the market but not so much the IRS). So economists like Stephen Gallagher and myself tend to focus on these whole economy profits data (which also include unquoted mom and pop companies). A decline in whole economy profits typically precedes a downturn in stockmarket profits as it also precedes a recession.

- Robust US whole economy profits - with margins soaring to record highs in the wake of the pandemic - are likely one of the key reasons why a US recession did not arrive on cue.

- Yet as my colleague Andrew Lapthorne noted in this incredibly important chart below, aggregate profits data (including the whole economy profits) are being inflated higher by a small number of large and mega-cap stocks. Looking at the large cap S&P 1500 universe, if you exclude the top 10% of companies profits are barely rising - link. If you exclude the top 50%, then profits are falling sharply. This story is confirmed by the Russell 200 small cap stocks and the small unquoted companies surveyed by the NFIB – link.

The large and mega cap US companies dominate the aggregate profit growth picture: S&P 1500 (ex-financials & Oil & Gas) reported profit growth by size segment



Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

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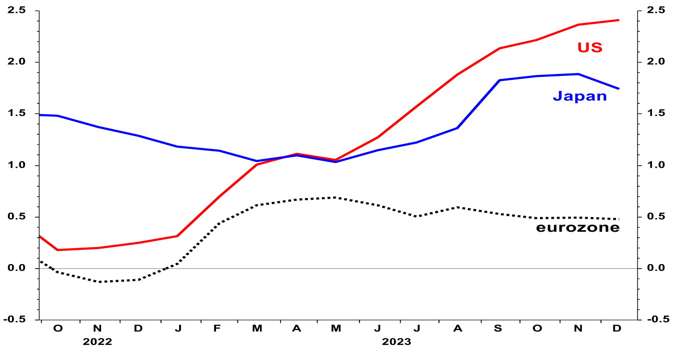
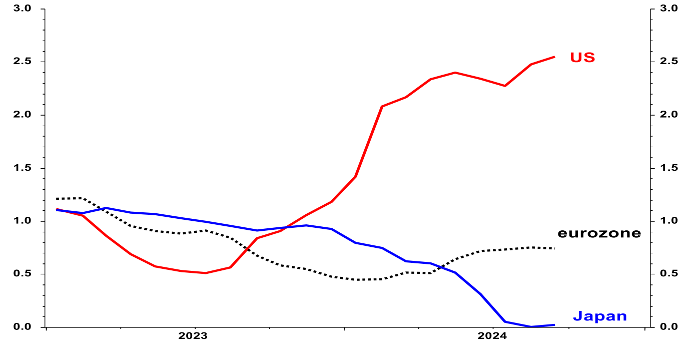
US GDP growth forecasts have been revised up sharply through both 2023 and 2024. Japan which kept pace with the US last year has capitulated in 2024. The eurozone is just meh!

The predicted 2023 US recession never arrived...



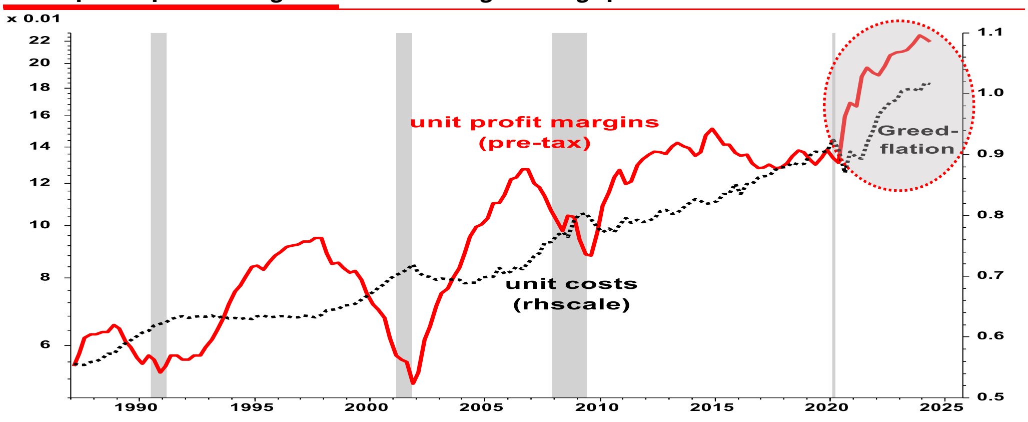
... and 2024 US GDP growth has also been revised higher



Source: Datastream, Consensus Economics

As we explained, robust US profits are a key reason why the corporate sector was able to maintain its spending on jobs and investment. Greedflation (aka price gouging) is certainly one key reason why profit margins surged higher in the wake of the pandemic, *despite* unit costs also jumping higher. This was unprecedented - rising unit costs had always previously led to *falling* margins. Call it what you like, this was a key reason why the US avoided recession.

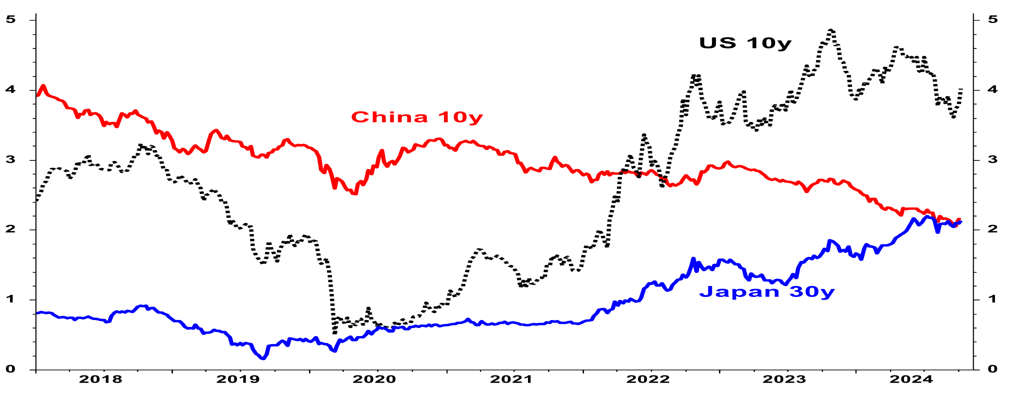
US corporate profits margins are at record highs in large part due to Greedflation



Source: Datastream

But Andrew Lapthorne's chart shows that it may be only a few large and mega-cap companies driving this rosy aggregate profit picture. And as it is small companies that drive employment growth, not the large and mega caps, the US economy could still be vulnerable to recession as *'long and variable'* monetary lags work through the system. Meanwhile the stronger than expected September US payrolls data have pushed US 10 yields back above 4%. That, for me, is not the big story, which is that Japanese 30y yields have now risen above Chinese 10y yields!

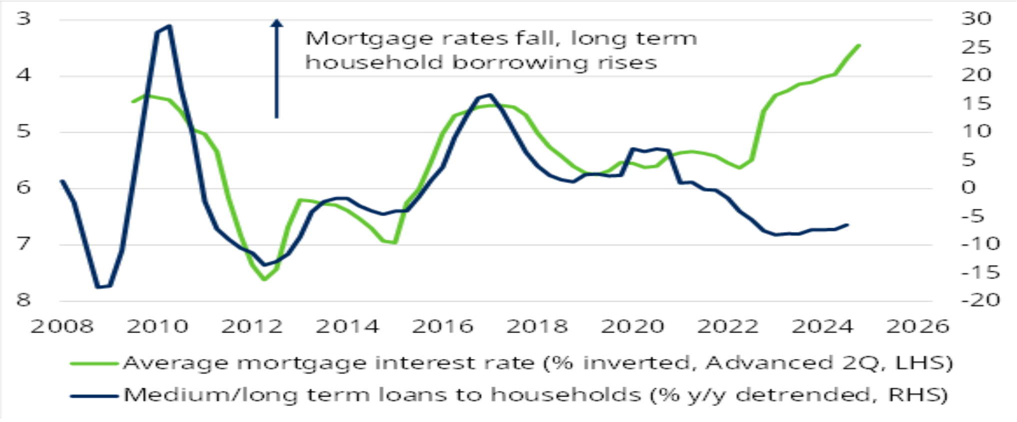
How times have changed: Japan's 30y yield has risen above China 10y



Source: Datastream

Investors have been whipsawed by the recent announcements of Chinese stimulus. But as David Rees at Schroders points out in an excellent note**,** more interest rates cuts may just be pushing on a string as a Japanese-like, balance sheet recession grips the Chinese household sector.

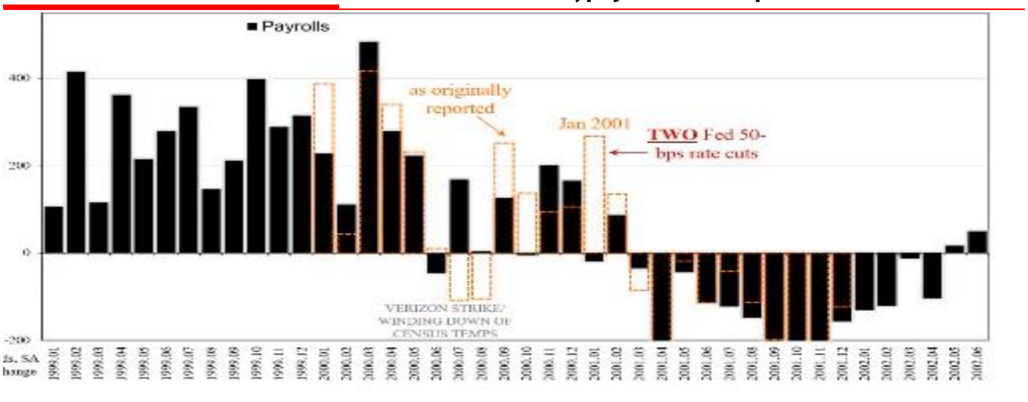
Chinese interest rates have to date totally failed to stimulate more borrowing



Source: Schroders

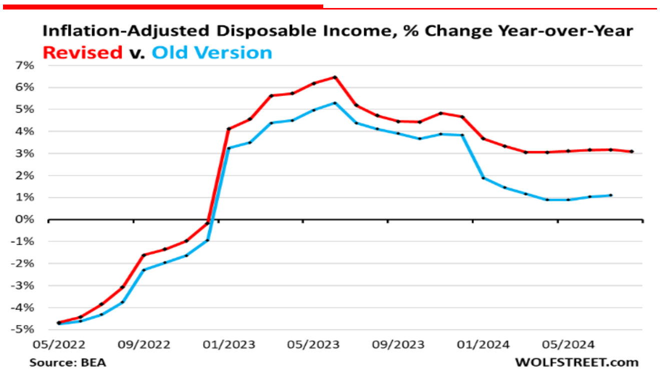
Which brings us back to that surprisingly strong 254k rise in US payrolls. There are so many odd things about this data but you would have likely already read that analysis elsewhere, so I won't repeat it. What I would highlight instead is the point that @JeffSnider_EDU made on X (formerly Twitter). He notes that in Jan 2001 the BEA reported payrolls had risen a similarly robust 268k. The equity market rejoiced as the Fed had also just cut rates for the first time that month. But just two months later a recession started and subsequently that large Jan 2001 rise was revised to a decline! (A similar thing happened with the robust 166k rise in Oct 2007 payroll data, just two months before a recession began.) The payroll data are lagging, unreliable and will be revised.

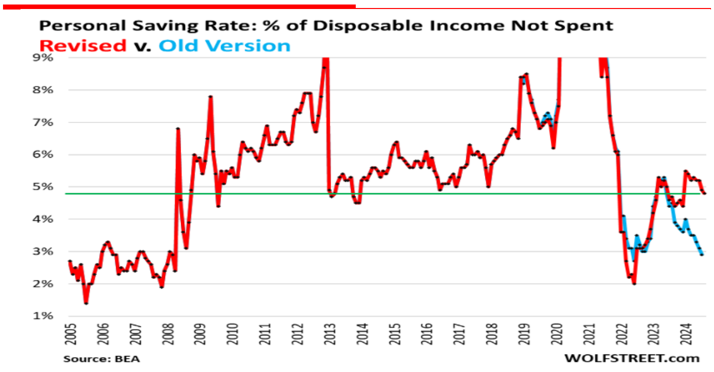
Just two months before the start of the 2001 recession, payrolls were reported to have risen 268k



Source: @JeffSnider_EDU on X (formally Twitter)

Talking about revisions, just after I wrote that the US saving ratio (SR) had worryingly fallen below 3%, the US BEA came along and revised the data! So instead of real household incomes growing at 1%, they apparently grew by 3% and the SR was in fact 5% -link. That is a HUGE revision. I *almost* feel sorry for the Fed in trying to set policy when the economic data are clearly garbage.





Source: WOLFSTEET.com

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