Spring 2016

Thought experiment. Which of the following two bits concerns you more?

a. After a long run of gradual earnings increases, corporate profits have decreased for two consecutive quarters.

b. There's a rising risk of an earnings recession.

How about between these two?

a. Pfizer is merging with Allergan, headquartered in Ireland, to save money on taxes.

b. Pfizer, in the largest tax inversion move to date, is abandoning the US.

In both examples, a and b are reporting the same thing. But the language is dramatically different. And it matters. And needs to be unpacked.

A "recession" is, simply, when economic activity declines for two or more quarters in a row. This can be individual countries' economies, in regions such as Europe, or the entire global economy. Combining the term recession with earnings is a relatively new phrase, thus "earnings recession", and masterfully wordsmithed if the goal is to raise concern, but market "experts" are glomming onto it in a potentially harmful way. The current notion is this--while the economy may not be headed for a recession, the truly worrisome kind, companies nonetheless are entering something similar, where profits have been shrinking. Keep in mind, few go so far as to say a global recession is imminent. It would be foolish since none of the classic signs of such an occurrence are there. Employment is stable and improving, wage inflation is almost non-existent, commodity scarcity or inflation is nowhere to be found, and interest rates are low and positively sloped.

Those arguing that the market is heading for more problems because of this "earnings recession" assert that if companies' earnings are shrinking, equity markets are not reflecting proper valuations. So, they'll need to adjust, downward, to the "proper value." On a macro basis, this may be true. But let's get a little more micro. We'll start by focusing on the US and Canadian markets (the same holds true in the other global markets as well). The S&P 500 Index in the United States and the S&P/TSX Composite Index in Canada, show earnings for the respective markets did, indeed, drop 2.0% and 16.5% from their year-end totals in 2014 to 2015. But the 2016 forecast indicates the earnings for the composite totals are expected to resume their historic growth patterns. Still, you're going to hear, in language similar to the b choices in our thought experiment, that these estimates are too high and companies will again make less this year than last.

Not true, says us. Here's why. The biggest driver of last year's and possibly this year's drop in these composite earnings totals comes from one major sector. Energy. That energy companies' earnings are down significantly from 2014, when crude oil prices averaged $84 a barrel (as measured WTI Crude Futures) compared to $54 in 2015, is no surprise. (For reference, 2016 has started out with an average price of $36 a barrel.) In a major way, that contributes to composite earnings for the S&P 500 and S&P/TSX Composite. The S&P 500 Energy Sector makes up almost 7% of the entire S&P 500 Index and the sectors earnings shrank by more than 58% in 2015. And are expected to shrink another 64% this year. In Canada, it's even more impactful. The S&P/TSX Energy Sector makes up more than 19% of the S&P/TSX Composite, where 2015 earnings from the energy sector were negative, meaning they actually lost money. Even with an expected rebound in 2016, earnings will be down over 92% from 2014. And we're not even considering closely related sectors such as materials and industrials.

All this to say, some areas of the market aren't thriving...but all the fuss over earnings slowdowns is hyperbole. The woes of energy-related companies is a big reason why, but higher wages and a slowdown in worker productivity (defined as unit of output per worker) are also contributing.

The second trending bogeyman...tax inversions, which is legal, but sounds an awful lot like what put Al Capone and Martha Stewart behind bars. Let's use the second example of our thought experiment, Pfizer's attempted merger with Allergan PLC, which the US Treasury recently squashed. There were strategic fits between the two companies, but the major benefit was the tax savings. The "target company" (in this case Pfizer) would have been headquartered in Ireland (the country Allergan, who would have purchased Pfizer, calls home) where tax rates are 20%, as opposed to the US, where they've been paying 39%. These types of mergers, "tax inversions," help the target company realize huge tax savings by being purchased by a company residing in a lower tax country. In 2015 Pfizer, paid over $2 billion in income tax, down from over $2.7 billion in 2014. If we agree that a company's core purpose is to increase profits, Pfizer's decision to merge with Allergan makes good sense.

Just as millions of American and Canadian families sit around the kitchen table trying to figure out legal ways to minimize taxes, corporations are bound to do the same, more likely in boardrooms. One Capital Management works diligently to minimize each client's tax burden where and when we see opportunities. In the US we buy municipal bonds, where appropriate, to earn interest free of taxes for our clients. We realize losses through our "tax trading strategies" to offset future gains, and minimize short-term gains to avoid the higher tax rates. Long-term gains are favorably taxed in the US. In Canada, it's a bit more complicated, but equates to approximately half of the rate on income or earnings. In the US, the maximum is 20%, plus the excise tax imposed by the Affordable Care Act, as opposed to the 39.6% maximum tax on short-term gains or ordinary income. (This does not take into account state taxes.) Just as it's our duty to keep these figures in mind and work to save clients' as much money as is legally possible, the same holds true for companies. Is Pfizer, and the scads of other companies trying to take advantage of "tax inversion," if we must use the phrase, a "corporate deserter" or "unpatriotic," as critics (largely politicians) contend? That's open for debate. But condemning companies for this legal practice is equivalent to condemning a Canadian family for taking advantage of an income split, or an American family for taking a home-office deduction. Don't hate the player, hate the game.

We recognize the current challenges and those that lay ahead for investors. The next few months will bring new wrinkles and concerns, and more scary language. But more than ever before, people are working. And affluent. Goods and services continue to be consumed at a very healthy rate. In other words, our 2016 forecast is not partly cloudy. It's mostly sunny.