

# MONTHLY HOUSE VIEW

MARKETS, INVESTMENT & STRUCTURING – JULY 2019



## FOCUS

PROFITS ARE NOT ALL THE SAME

## EQUITIES

THE POWER OF CENTRAL BANKS

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# EDITORIAL

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## MIND THE GAP

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Dear Reader,

Holidays are getting closer, but agreements on various issues are still distant.

Amongst them, we can list the China/USA trade dispute, the disagreement between Italy and the European Union (EU) with respect to the former's public deficit, as well as the differing stance on Brexit between the UK and the EU. Unsurprisingly, markets are forming expectations on these issues, and they have varied sharply over time.

But markets are also discounting monetary events, as too, we identify a significant gap between the US central bank's decisions to change the Federal funds rate and the current fundamentals. While the Federal funds futures' market is pricing in a flurry of cuts, we find it difficult to understand the rationale for such extreme expectations. According to the OECD, the output gap in the US economy, i.e. the amount by which its actual output exceeds its potential output, is close to 1.4% (up from 1.1%). This gap should shrink to justify a Fed funds rate cut.

That being said, the corollary of the existing disputes is the high level of uncertainty. At the end of May, the value of the Global Economic Policy Uncertainty index as computed by Baker, Bloom and Davis was more than double that of its quarterly long term average (22 years). The latter covers a period which was not light of significant and material changes e.g. the start of the EMU, end of the dotcom bubble, China entering the WTO, the Great Recession, and the European sovereign crisis to name a few. Thus, it should not surprise us if the level of the index were to recede, bringing its value closer to the average.

In other words, the size of the gaps observed on the issues listed at the beginning should shrink in the coming months. This should come as a comfort to investors.

# FOCUS

## PROFITS ARE NOT ALL THE SAME

Profits are at the core of financial markets. We review different definitions of profits, derived either from macroeconomic statistics or directly at the company level. We then perform a statistical analysis of the European and the US markets in order to assess which profit figures, macro or corporate, might provide the most explanatory power regarding market behaviour.

### USA

Looking at US corporate profits from a macroeconomic perspective, we use data provided by the US Bureau of Economic Analysis (BEA). Turning to the relationship between macro profits and stock markets in the US, we observed that since the 1990s corrections in US stock markets have tended to follow any declines in macro profits.

The BEA national income measure of corporate profits differs from profits reported by firms in accounting terms. These also diverge from profits as measured in stock market indices. The discrepancies pertain to coverage, industry representation, and accounting principles, amongst others. Despite all the differences, long-term trends are broadly similar, especially between S&P 500 operating earnings and the BEA/NIPA (national profits after tax without inventory valuation and capital consumption adjustments).

### EUROPE

In the EU, the measure used for macro profits is the “gross operating surplus and gross mixed income” (GOS) published by Eurostat. The difference between company profits shown in company accounts and GOS estimates involve the fact that only a subset of total costs are subtracted from gross output to calculate the GOS. GOS also makes no allowance for consumption of fixed capital.

The commonly used accounting standards are the International Financial Reporting Standards (IFRS). Most of the world’s more

significant capital markets now require IFRS to be used. At the conceptual level, IFRS is considered more of a principles-based accounting standard in contrast to the more rules-based GAAP standard used in the US. 585 companies out of the 600 companies included in the Stoxx Europe 600 Index reported under IFRS.

Of the many differences highlighted above between these two measures of corporate profits, perhaps the most important is that macro profits include non-listed firms while stock market indices naturally are limited to listed firms.

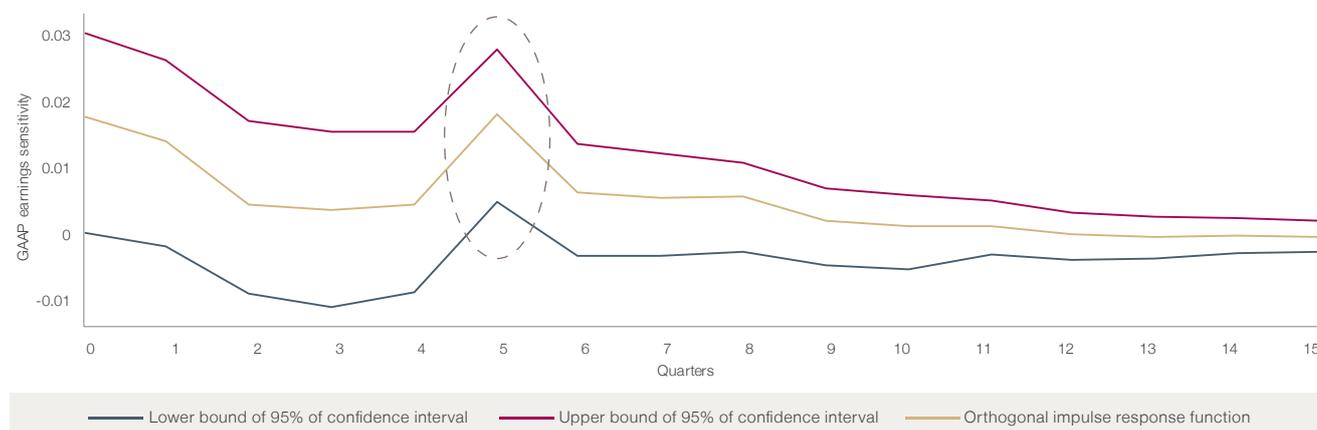
### THE EXPLANATORY POWER OF MACRO VS. CORPORATE PROFITS ON MARKET BEHAVIOR

Looking at which definition of profits that has the most explanatory power in terms of stock market behaviour, we find that for the US, the use of corporate reported earnings appears statistically more pertinent than the use of macro profits. Furthermore, if we apply a shock to the reported earnings variable, it triggers a significant spike in the fifth quarter after as can be seen in the chart below, reverting back to its level 2-4 quarters later.

Thus, a significant shock to reported earnings could have a material impact on the S&P 500 index 5 quarters after.

Focusing specifically on the US, we can also look at whether reported earnings can offer any insights in providing a recession signal. Our model output finds that all recessions since 1987 have been preceded by the estimated recession probability crossing the 28% threshold. In other words, if the model’s recession probability exceeds 28%, it signals a potential recession in the coming months. Using macro profits instead yields similar results graphically, but the statistical significance is lower than that obtained using reported earnings.

### IMPULSE RESPONSE FUNCTION FOR S&P500 AND GAAP EARNINGS SHOCK



Source: Bloomberg, Indosuez Wealth Management  
Past performance does not guarantee future performance.

# FOCUS

## PROFITS ARE NOT ALL THE SAME

Regarding Europe, we find that macroeconomic profits are the key explanatory factor in the dynamic of the stock market. We also find that a material shock to or change in macroeconomic profits can have a significant effect on returns around the second quarter following the shock, and that it tends to take some time (6-9 quarters) before the shock is absorbed, as illustrated in the chart below. If we instead look at shocking corporate profits, we find that the size of the impact is smaller than in the case of the macroeconomic profits shock. Thus, with regards to European markets, it appears that macroeconomic profits is the most pertinent variable in terms of explaining market behaviour in Europe.

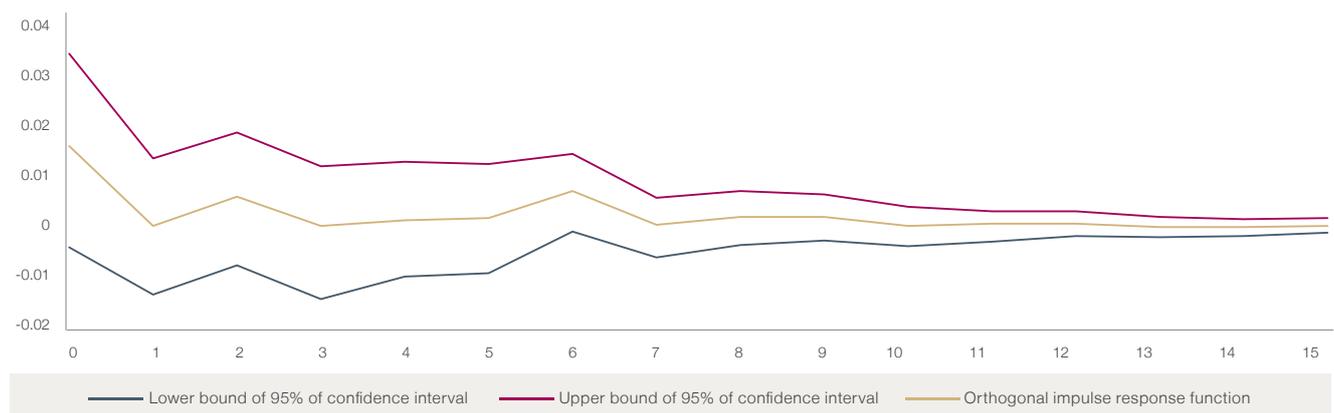
Understandably, the framework above has its limits and we do not claim that earnings is the “universal variable” to explain all movements on European markets.

### KEY TAKE-AWAY

Depending on which measure of profit is used, macro or corporate, we find different explanatory power regarding market behavior. In Europe, our analysis shows that macro profits impact markets the most, whilst in the US, corporate profits are the superior measure. Furthermore, in the US, corporate profits also provide a good indicator in terms of signaling a possible recession.

Clearly, not all profits are equal.

### IMPULSE RESPONSE FUNCTION FOR STOXX EUROPE 600 INDEX AND MACRO PROFITS SHOCK



Source: Bloomberg, Indosuez Wealth Management  
Past performance does not guarantee future performance.

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