DEVILISH DETAILS

These past few weeks we have come across very few trends—macroeconomic, capital market, geopolitical or otherwise—that warrant the sort of optimism for the New Year that would substantiate present valuations across a range of equity markets. Keeping our editorial light for the month, we selected a few top-of-mind views to support our continued cautious stance on domestic equity market exposures.

TOP AND BOTTOM LINES PRESSURED...

In Figure 1, we show that the trends in year-over-year declines in both revenue and earnings per share have not reversed since we last offered these data earlier in the year. The Energy sector, buffeted by plunges in petroleum and petroleum product prices, is not the only culprit. In Figure 2, we show year-on-year earnings growth across all ten sectors. With a few exceptions, earnings per share growth is slowing or is in outright decline.

FIGURE 1

Growth in S&P 500 Revenue and Earnings Per Share

From 01.31.90 to 11.30.15. SOURCE: Innealta Capital using data from Bloomberg

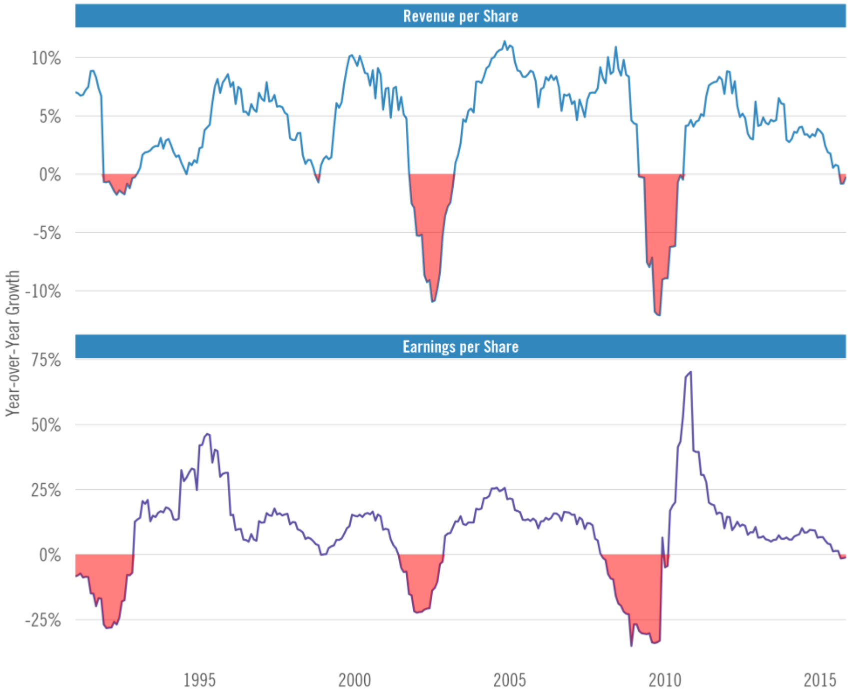
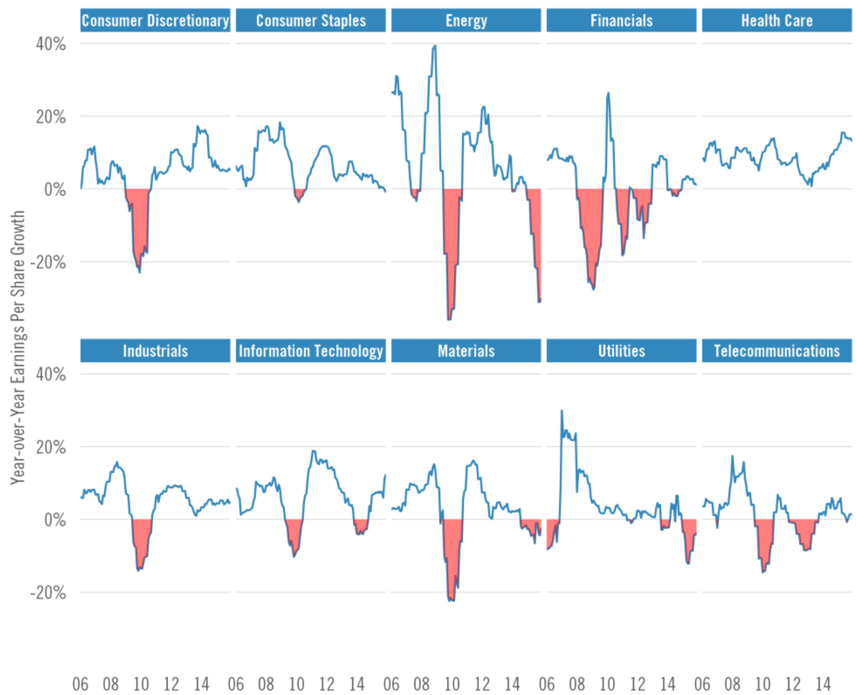


FIGURE 2

Growth in S&P 500 Sector Earnings Per Share

From 12.31.04 to 11.30.15. SOURCE: Innealta Capital using data from Bloomberg



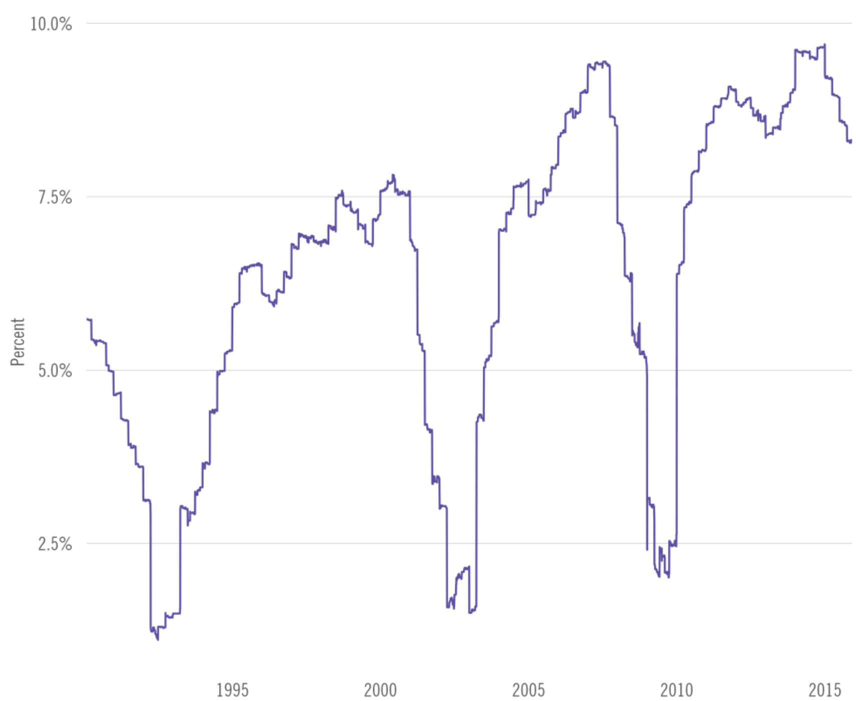
...AS MARGINS FADE...

Indeed, profits are feeling the squeeze. Charted in Figure 3, this trend should not be so surprising, really, considering the long duration of weak to declining top-line growth. American managers seem to have run out of room to pare costs. As top-line growth slows, even turning negative, competition for incremental dollars intensifies. Profits suffer more. This down-cycle might turn, but we think it'd need resurgence in revenue growth to do so. Broader macroeconomic reviews limit optimism of any such turn in the medium term.

FIGURE 3

S&P 500 Net Profit Margin

From 01.31.90 to 11.30.15. SOURCE: Bloomberg



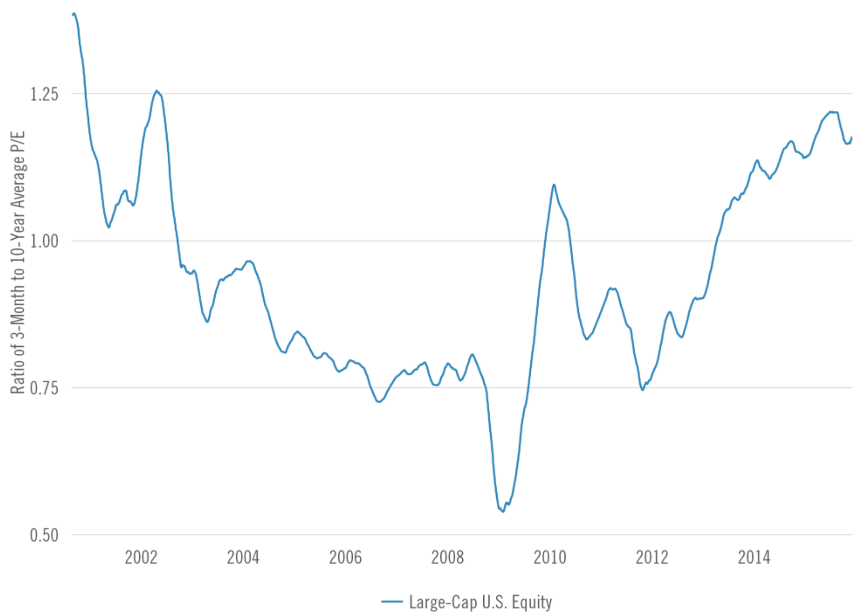
...BUT PRICES PERSEVERE

Nonetheless, even with the late summer correction, the S&P 500 has held up pretty well this year. That only can mean domestic large-cap equities are now even more expensive, decreasing the likelihood of further gains and increasing their inherent risk. Figure 4 reprises a chart we have shared in earlier commentaries that shows the near-term average price-to-earnings ratio for large-cap U.S. stocks relative to their long-term average. Elevated and still rising, the ratio can normalize only two ways: via a dramatic ramp in earnings, or as dramatic a decline in price. Leading macroeconomic indicators would suggest the path from here is heavily weighted to the latter.

FIGURE 4

Ratio of Short-Term to Long-Term P/E

Trailing data. From 08.24.00 to 11.30.15.
SOURCE: Innealta Capital using data from Thomson Reuters



COURSE CORRECTION

We remain firm in our belief that beta exposures should be chosen for a favorable risk-reward dynamic that strongly considers relative valuations, whether the tenure of those exposures are expected to be short- or long-term in nature. The equity market dynamic over the past few years seems to have spurned such a rational approach to investment management. Nevertheless, we continue to believe that our approach will be proved most reasonable in the fullness of time, despite the efforts of central banks around the world to convince investors otherwise.

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