

Global Strategy Weekly

****Alert****Economic and equity market meltdown imminent****Alert****

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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 Equity Research

Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont. Europe
Underweight	Japan Emerging mkts
Very Underweight	

Source: SG Equity Research

Last week saw the publication of Q2 US whole economy profits data. They were shockingly bad. Core measures of profitability are in free-fall and have now reached a tipping point, where corporate activity could easily implode. We have also reached the point where companies give up 'manipulating' their profits higher and admit they are actually in free-fall. A combination of economic and reported profits slumping will catalyse the next equity downleg.

■ We see whole economy profits as a major driver of the economic cycle. Unlike most commentators we believe that profits lead, not lag, the economic cycle. They also tend to lead stock-market measures of profits (see chart below).

■ US Q2 whole economy profits were shockingly poor. The headline data (post-tax) were down 6% yoy - bad but not a disaster. But our preferred measure of *underlying* profits (domestic non-financial economic profits – full explanation later) is down a surprisingly sharp 17½% yoy. The last 4 quarters' average is down 12% yoy (see chart below). Typically we have now reached the point in the cycle where companies reach the end of the road on earnings manipulation and have to admit to their shareholders how bad things *really* are, sending reported profits diving. James Montier's recent piece "[Cooking the Books](#)" suggests that some companies may indeed be doing what the title implies. But analysts currently see no prospect of a non-financial profits slowdown, let alone recession (see table below). Why? Because companies have not yet owned up to the mess they are in and *told* the analysts to downgrade their numbers!

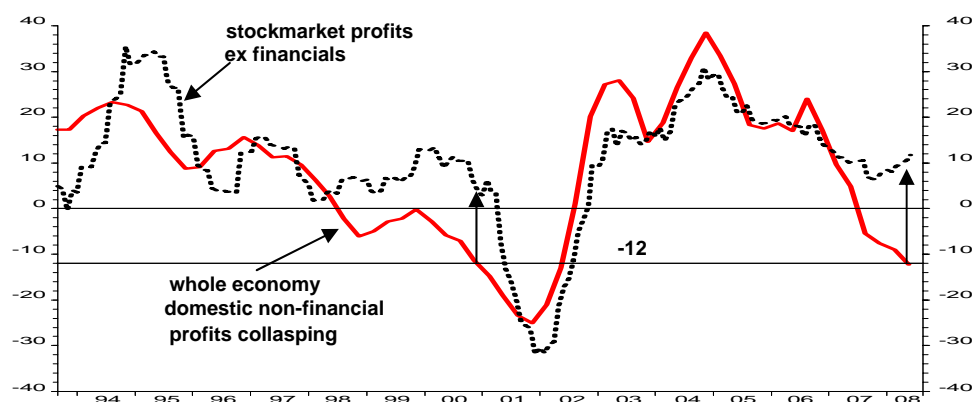
Global Equity consensus profit growth profile

	2007	2008	2009
Global	5.8	5.1	16.8
Global ex Financials	13.2	12.5	13.5

Source: SG Quantitative Research, IBES

■ We are at a very similar point to the end of 2000, just before corporate capitulation sent reported profits and the economy diving and the equity market collapsed (see chart below).

US whole economy non-financial profits leads stock-market measure (4q mav, yoy%)

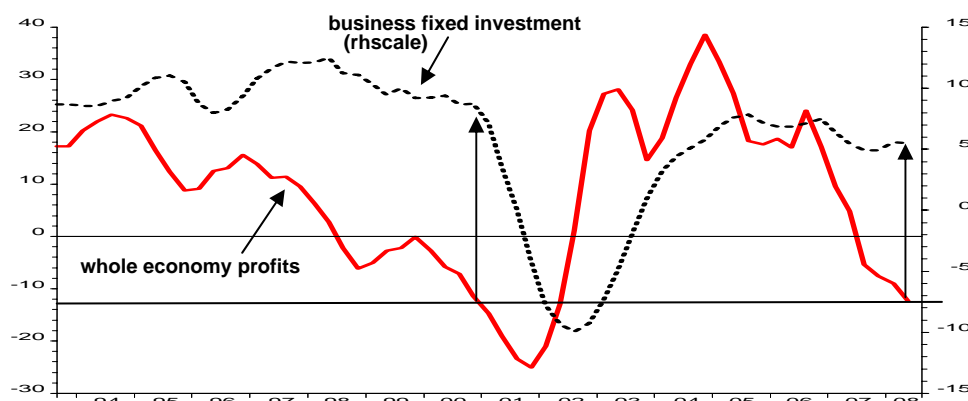


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Economists typically model corporate profits as a residual, with it dropping out of their economic models as a *function* of what is happening to the economy overall. We have always believed though that corporate profits are a key *driver* of the economic cycle, rather than just the result of it. Historically, recessions are 'caused' (in an accounting sense) by the corporate sector. As profits decline, after a point companies finally bite the bullet and business investment slumps (see chart below). Historically, the evolution of pre-tax domestic non-financial profits proves to be the best explanation for company's *domestic* spending activity.

The chart below shows that the recent surprising resilience in investment spending, in the face of the profits recession, is not untypical at this stage of the cycle. But the moment of truth has arrived. With profits slumping, Fed Flow of Funds data shows that corporate investment spending now exceeds cashflow by almost the same extreme as it did at the height of the 2000 bubble! If profits continue to suffer, companies will be forced to slash and burn.

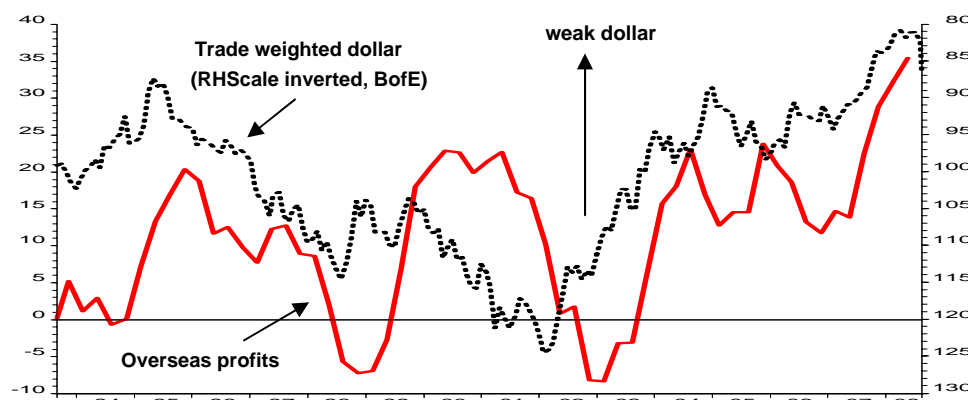
US business investment lags domestic whole economy profits (both 4 qtr mav)



Source: Datastream

The bulls might admit the clear link between domestic profits driving the domestic US economy, but point out that a weak dollar has propped up exports and overseas earnings (see chart below). This has ameliorated the impact on the overall economy and overall profits. The chart shows though that a weak dollar similarly inflated profits in 1999, the subsequent rally hurt overseas profits growth and revealed the underlying profits weakness for all to see.

US company profits from abroad (yoy%) and US dollar trade weighted exchange rate



Source: Datastream

Many commentators are now coming around to our view that the dollar has bottomed out. Regular readers will know that we see the key driver for this as the ongoing slump in the US trade deficit rather than relative growth disappointments outside of the US. In our world then, the dollar carries on rallying even when US growth data disappoints on the downside. Now, although many fundamental analysts deride technical analysis, we do not. Hence we note that the euro is sitting on a major support level against the dollar around \$/€1.44 (also a key Fibonacci retracement level, see chart below). Breach this and we head straight to next key support levels at 1.38 and 1.33! This will *seriously* damage S&P reported profits during 2009.



Source: Reuters

Now the obvious conclusion for an asset allocator from all of the above is that one should go overweight European equities as the dollar rallies, for in the same way that US profits will be hurt, European profits will be helped. And with most agreeing (including us) that European equity market is cheaper than the US, the draw to overweight European equities is compelling. We believe this is a Logic Trap. For if the US equity market slumps through next year, the high beta markets of Europe will decline even faster, *even if* their profits outperform the US *and* even if they are cheaper. My Quant colleague Andrew Lapthorne confirms this thesis, pointing out in a [recent note](#) that when the US ISM is in recession territory it is difficult for Europe to outperform (see chart below). This will be the case even when the dollar is rallying. Avoid the Logic Trap and do not be tempted to overweight Europe as the dollar rallies.

Ranked ISM levels and performance of Europe v US (local currency)



Source: SG Quantitative Research

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