

FOCUS · Is the drop in earnings in the US heralding another economic recession?

The earnings season starting in mid-April for S&P 500 companies pointed to a decline in earnings per share of around 9% for the first quarter of 2016. Should this scenario be accurate, it would confirm that the United States, which had already seen three negative quarters in 2015, is currently in an earnings «recession». In the past, such a large decline in earnings has almost always occurred at the same time as an economic recession. However, several elements point to the current episode potentially being one of the few exceptions to this pattern.

Since the early 1970s six of the eight episodes of declining corporate earnings for S&P 500 firms have coincided with the start of a recession in the US economy. The most recent exception took place in 1998 when earnings fell by more than 7% without the US economy showing any signs of weakness (in fact it grew at a rate of about 5%). At that time a strong dollar, which in just over a year had appreciated by almost 17% compared with the euro and 15% on average compared with a basket of currencies, and the drop in the price of oil below 10 dollars per barrel had a considerable effect on the earnings of energy and exporting companies. The previous exception was in 1985. On that occasion the dollar's strong appreciation prior to the Plaza Accord and a slump in oil prices were also largely responsible for the drop in earnings. GDP growth remained firm, just the same.

It is tempting to compare the current situation with the episodes in the 1980s and 1990s. The strength of the dollar, which appreciated close to 27% compared with the euro between June 2014 and the end of 2015, is similar to the rise seen in the aforementioned episodes while the current drop in the price of crude oil is also clearly responsible for a considerable proportion of the poor earnings reported by S&P companies. In fact, if we exclude companies from the energy sector, earnings remained relatively stable in the last few quarters.

In any case the fact that an earnings recession is limited almost exclusively to one sector in particular does not seem to be a sufficiently solid argument to rule out a possible link between an earnings recession and an economic recession. We only need to remember that the decline in earnings in 2000 was «only hi tech» and in 2007 it was «only financial», although the presence of a bubble at the beginning of the millennium and the systemic nature of the financial sector were decisive factors in the occurrence of their subsequent recessions. On the other hand, the decline in earnings is also

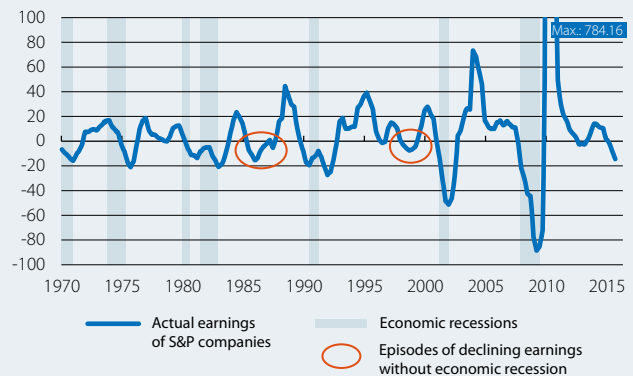
affecting many firms that do not belong to the energy sector. According to the earnings data from the National Accounts system, which provide a broader picture of US companies, nine of the 16 non-energy sectors saw a drop in earnings in 2015 Q4. Be it partly a result of the impact of lower demand in the energy sector compared with other sectors, be it partly due to the dollar's appreciation, what is certain is that a considerable segment of the US economy is suffering from a decline in earnings.

Apart from historical comparisons, other considerations also point to the disappointing corporate earnings reported recently not being an omen of economic recession. Firstly, although the relative weight of the energy sector has increased after the shale boom in recent years, the net impact of the slump in oil prices should be positive for the US economy. Moreover, the high level currently enjoyed by profit margins, still above the historical average in spite of the recent decline, ensures firms still have room to manoeuvre. On the other hand the main factors behind the decline in earnings are now showing signs of recovery, or at least of stabilisation, given the upswing in oil prices since the beginning of the year and the pause in the dollar's appreciation brought about by the Federal Reserve's accommodative tone in the last few weeks. Lastly, and perhaps most importantly, the solidity of the figures recently published for the labour market and private consumption are in line with continued expansion in economic activity.

In short, the current recession in earnings is a phenomenon that warrants close scrutiny. However, the evidence seems to suggest that we are witnessing an exception to the pattern and not a precursor of an economic recession in the US.

Actual earnings of S&P companies and economic recessions

Year-on-year change (%)



Source: CaixaBank Research, based on data from Robert J. Shiller and the National Bureau of Economic Research.