INSTITUTIONAL INSIGHTS

EARNINGS RECESSION

The current economic expansion is nearing its seventh anniversary, and most indicators point to a limited chance of a recession in the near future. However, another type of recession, an earnings recession, is underway. What exactly is an earnings recession, and what does it mean for markets and the economy?

WHAT IS AN EARNINGS RECESSION?

Though the National Bureau of Economic Research makes official calls on recession dates, a common generalization used by markets is that two consecutive quarters of negative economic growth indicates an economic recession. Similarly, two quarters of negative year-over-year earnings growth is generally interpreted as an earnings recession. Specific earnings and earnings growth rates vary depending on source (Thomson, FactSet, and Bloomberg, among others) due to different methods and interpretations of operating earnings; but all of these sources indicate we are currently in an earnings recession. For this analysis, we measure earnings growth in terms of a year-over-year comparison of trailing 12-month earnings.

Overall, S&P 500 company earnings saw their first year-over-year decline since 2009 in the third quarter of 2015, the second in the fourth quarter of 2015, and now a third, as the first quarter of 2016 is tracking to a decline of 4% based on our methodology. This constitutes an earnings recession as earnings have

1 WHILE ENERGY, MATERIALS, AND THE OVERALL S&P 500 ARE IN EARNINGS RECESSIONS, SOME SECTORS ARE STILL SEEING POSITIVE GROWTH

Sector	Number of Quarters of Negative Trailing 12-Month Earnings	Latest Year-over-Year Growth Rate
S&P 500	3 (started Q3 2015)	-4.10%
Energy	6 (started Q4 2014)	-66.9%
Materials	2 (started Q4 2015)	-4.4%
Financials	1 (started Q1 2016)	-4.9%
Consumer Staples	1 (started Q1 2016)	-2.5%
Utilities	0	1.4%
Industrials	0	2.2%
Information Technology	0	2.7%
Telecommunications	0	5.5%
Healthcare	0	9.3%
Consumer Discretionary	0	12.60%

Source: LPL Research, Bloomberg 05/11/16

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declined for more than two consecutive quarters; however, a closer look reveals that the earnings recession is not very broad.

Narrow in Scope

Energy has been the key driver of this earnings recession, with negative earnings growth starting in the fourth quarter of 2014, and most recently reporting trailing 12-month earnings down nearly 67% from a year ago. However, energy only makes up a little over 7% of the S&P 500 Index. Only two sectors, energy and materials, have officially met the criteria for an earnings recession; two others, financials and consumer staples, are showing single quarter declines. The remaining six sectors are still posting positive earnings growth [Figure 1].

THE HISTORY OF EARNINGS RECESSIONS

Earnings recessions are nothing new for markets, with the S&P 500 experiencing 12 since 1954. Nine earnings recessions happened within one year before or after economic recessions, leaving three that did not accompany a recession.

The average earnings recession since 1954 lasted a little over 6 quarters, and the maximum year-over-year earnings decrease averaged 17%, but the lengths and severities vary widely. The 1990 earnings recession lasted 11 quarters (almost 3 years), and the maximum earnings decline in the 2008 financial crisis came in at more than 35%. The effect that earnings recessions have on the market can also vary. Figure 2 shows each earnings recession, along with the length, maximum drawdown in earnings, and maximum drawdown in the S&P 500.

2 EARNINGS AND PERFORMANCE DATA FOR ALL EARNINGS RECESSIONS SINCE 1955

First Quarter of Negative Earnings	Length (Quarters)	Max Year-over-Year Drawdown in Earnings	Max Drawdown in S&P 500 During Earnings Recession	Economic Recession?
12/31/56	11	-17.0%	-21.6%	Yes
09/30/60	5	-14.6%	-13.9%	Yes
12/29/67	2	-5.4%	-6.6%	No
03/31/70	5	-10.2%	-36.1%	Yes
09/30/75	4	-17.5%	-31.0%	Yes
06/30/81	2	-4.4%	-19.7%	Yes
09/30/82	6	-16.3%	-13.5%	Yes
09/30/85	7	-12.8%	-9.4%	No
03/30/90	11	-28.0%	-19.9%	Yes
06/29/01	6	-21.7%	-49.1%	Yes
12/31/07	8	-35.1%	-56.8%	Yes
09/30/15	3	-4.1%	-14.2%	No (to date)

Source: LPL Research, Bloomberg 05/11/16

Maximum drawdown is from previous all-time high. Highlighted items did not accompany an economic recession.

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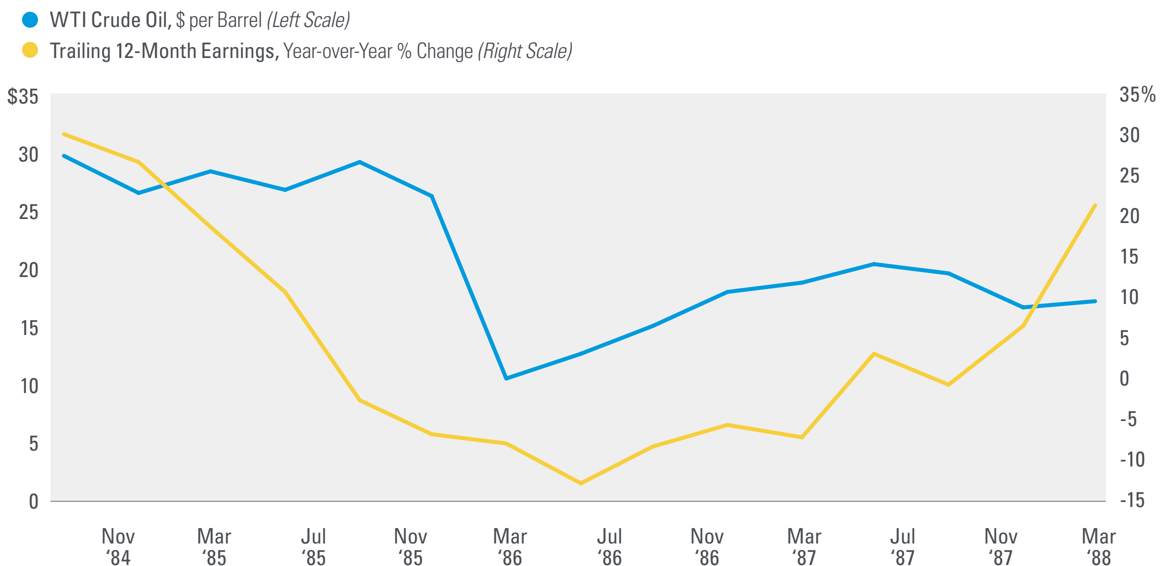
A key driver of the extent of a stock market pullback that is driven by an earnings recession is whether it is accompanied by an economic recession. When an economic recession happens within one year of an earnings recession (either before or after), the maximum decline (peak to trough) for the S&P 500 during the earnings recession has averaged nearly 30%. The two earnings recessions not accompanied by economic recessions witnessed a much lower 8% average maximum drawdown (not including today's). However, it is also important to note that both of these earnings recessions experienced large pullbacks in the stock market either a year before or after. The 1967 earnings recession saw a max drawdown in the S&P 500 of 22% in the year prior, and the 1985 earnings recession saw an even steeper pullback of 33% in the following year, though approximately 20% of that drop happened in one day (October 19, 1987, better known as Black Monday).

When an Earnings Recession Is Not Accompanied by a Recession

There are only three earnings recessions—one in 1967, one in 1985, and today's—that were not related to an economic recession. Both the 1967 and 1985 earnings recessions happened during periods in which the federal government deficit was increasing, while today the deficit is actually shrinking. Interestingly, the 1985–86 earnings recession was also accompanied by a steep and sudden drop in the price of oil, and took place during a relatively long economic expansion from 1982–1990 [Figure 3].

3 **A DROP IN OIL PRICES ACCOMPANIED THE 1985 EARNINGS RECESSION**



Sources: LPL Research, Bloomberg, FactSet 05/11/16

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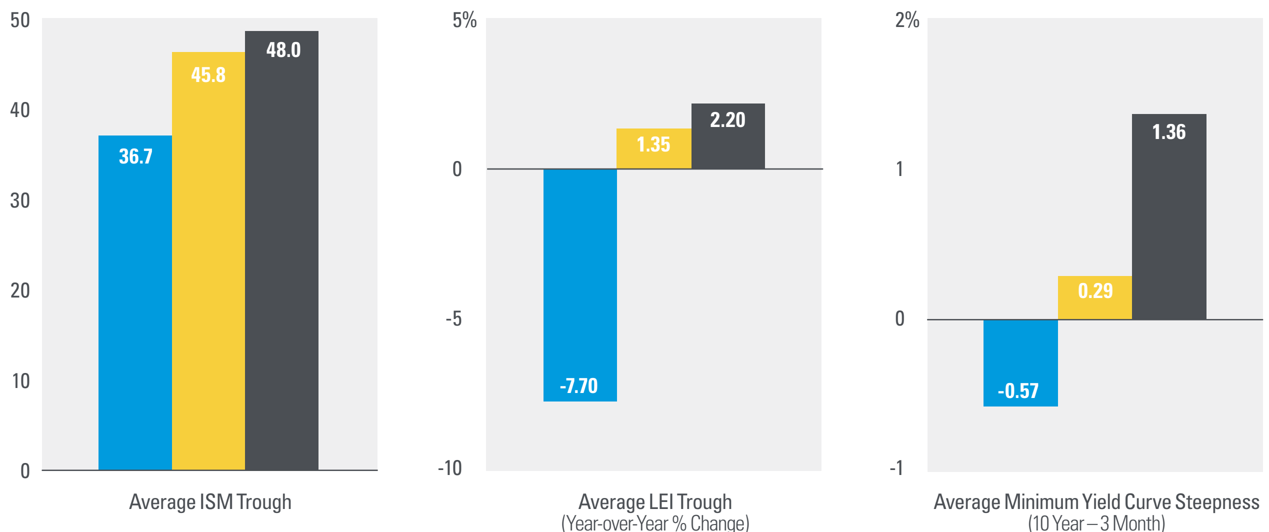
Earnings recessions that don't accompany economic recessions have historically caused less pain for the stock market; however, given that the two don't always happen simultaneously, how can investors be sure that an economic recession is not on the way? No method is perfect, and the sample size is small, but three indicators can help assess whether an earnings recession may be accompanied by an economic recession.

The degree of decline in the Institute for Supply Management's (ISM) reading on manufacturing activity, the yield curve, and the annualized change in the indicators in the Leading Economic Index (LEI) show marked differences between an isolated earnings recession and a full-blown economic recession [Figure 4]. The ISM is particularly insightful because it has historically led earnings by about six months.

The yield curve has historically inverted prior to economic recessions, and the year-over-year growth rate in the LEI also tends to turn negative. Taken together, these indicators suggest that today's earnings recession is not likely to be followed by an economic recession.

The number of sectors experiencing an earnings recession may also be an indicator, but data are only available dating back to the early 1990s. Of the three recessions since that time, two maxed out at seven sectors in earnings recession, and one (2008) maxed out at eight sectors, again pointing to the narrow nature of today's earnings recession.

4 TODAY'S EARNINGS RECESSION APPEARS MORE LIKE THOSE THAT HAVE NOT ACCOMPANIED ECONOMIC RECESSIONS IN THE PAST



Sources: LPL Research 05/11/16

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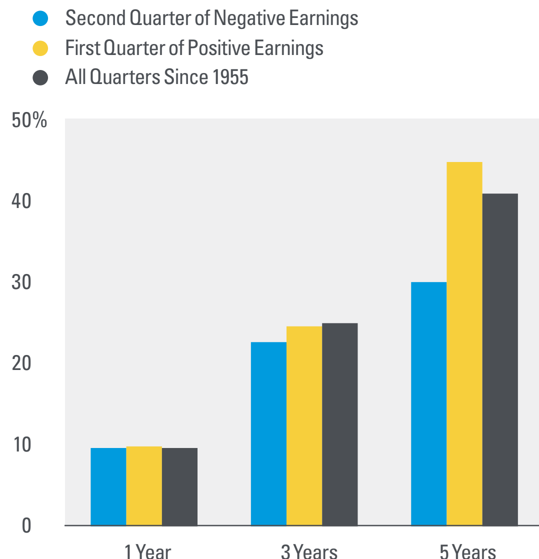
ARE EARNINGS RECESSIONS AN OPPORTUNITY?

The bigger question may be, is it better to invest during an earnings recession or outside of one? Figure 5 shows the median results of investing using two different strategies surrounding earnings recessions: investing at the end of the second quarter of negative earnings (the official start of an earnings recession), and investing at the end of the first quarter of positive earnings following an earnings recession. As a comparison, the figure also shows the median return of investing two months after the end of any given quarter since 1955. The returns for all three strategies assume investing two months after the end of the appropriate quarter, as it would be impossible to know if either event is happening until earnings are reported.

5 CUMULATIVE RETURNS OF TWO EARNINGS RECESSION INVESTMENT STRATEGIES



Sources: LPL Research, Bloomberg 05/11/2016

Cumulative price returns not including dividends.

Based on historical data back to 1955, buying during the first quarter of positive earnings is the most profitable over the one- and five-year time frames, though the five-year number is more impactful; three-year returns were also in-line with the all quarters' median. Investing after the second quarter of negative earnings was the second best over a one-year period, but was the worst of the three options over three- and five-year time horizons. Although it does appear that investing after earnings recessions has been beneficial historically, it is also important to keep in mind that these results are based on a small sample of only 11 earnings recessions (not including the current), and results will likely vary in the future. However, the chart does reinforce the long-term impact of earnings growth on stock prices.

CONCLUSION

Earnings recessions have historically led to near-term pain for the stock market. However, those not accompanied by economic recessions have resulted in more limited price declines. At this point, based on leading indicators such as the ISM, the yield curve, and the LEI, it appears to us that the current earnings recession poses little threat of tipping the overall economy into recession. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

All investing involves risk including loss of principal.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing major industries.

The Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Leading Economic Index (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

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