"Successful investing is anticipating the anticipations of others."

- John Maynard Keynes

Overview

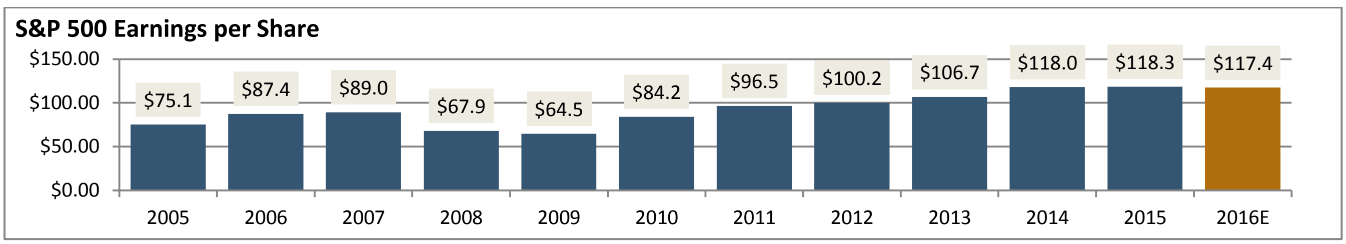
Over time, corporate profits are the primary driver of the stock market. The observed correlation between stock prices and corporate earnings serves as the basis for a fundamental research-based approach to investing in equities. At Aureus, we use our own internal research and understanding of companies as the primary method of choosing stocks.

Recently, this effort has been complicated by two factors exerting influence on corporate profits. The collapse in profits for the energy sector and the strength of the US dollar have led to a "profits recession", which began in the second half of 2015 and could continue for at least the next few quarters. The short-term and longer-term impact of these two factors on the stock market is explored in this paper.

S&P 500 Earnings

Earnings growth for the S&P 500 has been generally strong since 2009, rising to $118 per share in 2014, as shown in Chart 1 below. However, 2015 was flat over 2014 and we expect this to continue for 2016.

Chart 1

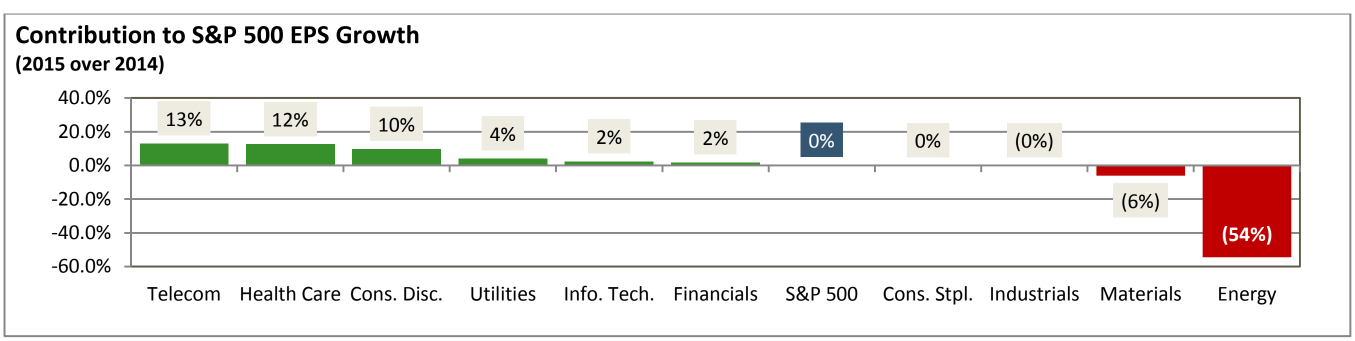


Impact of Energy Sector Earnings

We commented about the expected shortfall in sales and earnings across the energy industry, in our *April 2015 Investment Perspectives*, as well as the resulting winners and losers in other sectors. A closer look reveals the extent of the damage inflicted by this sector on overall earnings growth.

Chart 2 details the earnings contribution from each of the ten primary sectors of the S&P 500 in 2015. In a year of modest growth (aggregate earnings improved only +0.2% in 2015 versus 2014), six sectors exhibited earnings growth, two had no growth, and two had negative growth. Energy was the clear standout with earnings down over 50% for the year. Despite representing only 8.5% of the total S&P 500 at the start of 2015, the earnings drop in the energy sector was enough to nearly offset the gains by all the other sectors combined.

Chart 2



Impact of Dollar Strength

The US dollar has been gradually strengthening against other currencies since 2011. The primary reason is the strength of the US economy compared with many international regions. Despite relative economic prosperity, the impact of the strong dollar on corporate revenue and profits is negative because sales and profits generated in foreign currencies translate into fewer dollars.

Starting in late 2014, the US dollar moved sharply higher versus our trading partners, causing many multi-national companies to mark down their overseas sales by more than 10% during 2015. The dramatic move has produced a string of materially negative year over year comparisons since the 4th quarter of 2014 (Chart 3). With roughly one third of S&P 500 revenues generated overseas, the drag on quarterly growth has been as much as 4% during this period - about the same as the negative impact from the energy sector collapse. The good news is that the worst year over year hit from foreign currency was in the third quarter of 2015, with the potential for positive comparisons by the fourth quarter of 2016.

Chart 3

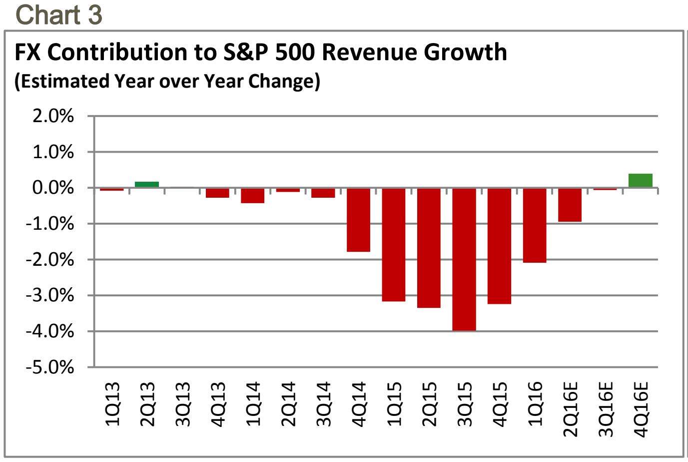
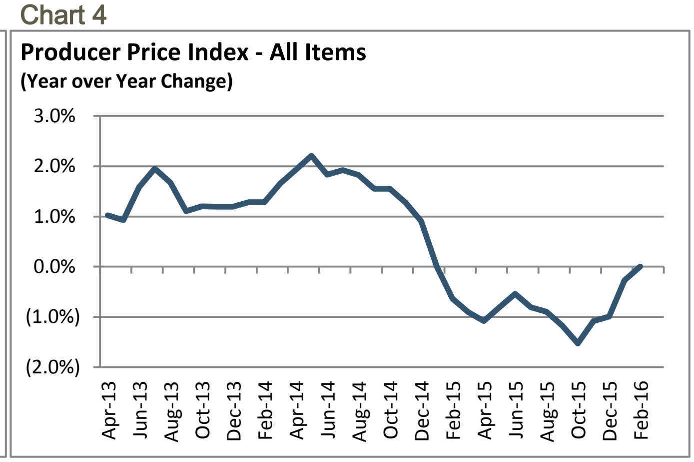


Chart 4



With the huge drop in oil prices, we might assume that many corporations would have grown margins and earnings from lower commodity prices. However, a combination of slower organic revenue growth and pressure on manufacturers to pass on commodity savings to customers, have offset much of this benefit.

Conclusion

As outlined above, S&P 500 earnings growth has been pressured by significant headwinds, which we expect will continue for much of 2016. However, recent data suggests the impact may be moderating: Oil prices appear to be recovering, purchasing prices are trending upward (Chart 4 above), and the dollar has been gradually falling versus other currencies. Barring a downturn in economic momentum, this sets the table for renewed earnings growth in 2017. Because the stock market is forward looking, we would expect prices to react in anticipation of this improvement as we progress through the year and investors gain confidence in the earnings outlook.