Quantum Capital

# The Four Seasons of Recovery

By Mat Johnson

## What Does an Economic Recovery Look Like?

The renewed volatility of the financial markets in recent weeks surely has many doubting the economic recovery. With rising concerns over government debt defaults in Europe, speculation surrounding the long-term viability of the Euro currency, and state and local deficits in the U.S., it is little wonder that recovery doubts have re-surfaced in recent months.

Despite these concerns and the market's renewed volatility, we continue to see the U.S. economic recovery being firmly in place, and improving in a way that is increasingly favorable to promoting U.S. company earnings growth.

The stock market's strong advance since last spring led many investors to conclude that economic conditions were on the mend. The debate then quickly became one of defining whether the recovery would be a 'U, V or L-shaped' economic recovery; describing the anticipated strength of consumer spending and business investment. In our view, that debate was far too premature. The real question to be asked was whether the market's earlier sharp decline was an accurate reflection of the financial and economic condition of most U.S. companies?

The correct answer to this question…

Our view is that stock prices were over-discounted; based on the perceived ill health of the economy – and most companies – a year ago. As a consequence, the strength of the stock market advance better reflected past investor errors, than future investor expectations. In the end, it just wasn't as bad as feared and consequently, reduced investor fears have been re-priced more appropriately. This still leaves the question though, 'what will the future economic path look like?'

A good proxy to measure the health and potential strength of companies is by looking at their inventories. On one hand inventories represent the anticipated strength of future sales, and on the other, sales that failed to materialize. As the U.S. entered the recent recession, inventories were actually remarkably low, and were a key reason that economic activity recovered as well as it did.

Despite low existing inventories entering the recession, companies continued to pare them aggressively. Consequently, as economic activity has slowly recovered, businesses have been 'forced' to respond by increasing production. Should end market conditions continue to improve, businesses will ultimately be required to respond with new investments and hiring.

In order to appropriately invest during this transition period, it is important to recognize that companies take an evolutionary approach to changing business conditions. There is no miraculous point at which businesses or consumers suddenly change their behavior, rather their behavior evolves, slowly but surely as seasons come and go.

Today companies are increasingly resuming business as usual, where 'usual' means having to produce their goods and services as opposed to selling previously unsold items from excess inventory. Meanwhile, across most markets demand remains soft and limited in scope. This latter fact appears to still be given the

majority of weight with investors. However, to focus on this now is the equivalent of forecasting tomorrow's weather by looking out the window today.

The proper perspective should be to better grasp what the outlook will be, by appreciating the business environment that companies will be operating in. Forecasting what lies ahead, particularly when it comes to the economy, is substantially more difficult around economic turning points. In more normal times, changes in a given variable such as interest rates, consumer attitudes, energy prices or tax rates, have a well understood economic effect as they pass through to companies. Such changes produce an accelerating or decelerating effect on the trend in place, but seldom significantly change the slope outright.

Around economic turning points, however, changes in investor expectations can be orders of magnitude different than what is visibly evident, as investors attempt to discount the other side of the 'turn.' This clearly happened in the spring of 2009, as expectations increased in the belief that easy money and fiscal stimulus would produce a sharp economic rebound. More recently however, there has been a groundswell of concern about the sustainability of the U.S. recovery resulting from continuing financial sector woes around the globe.

While both views have some merit, one discounts that the future will be better than the past; the other simply discounts the news of the present. In the apparent absence of an obvious catalyst for future economic acceleration, this tension between past and present tends to manifest itself in the markets as a rise in volatility. However, with renewed pessimism being priced into the present, it may well be time to redouble our focus on the future path of the economy.

In an effort to better highlight our outlook, a suggestion would be to view the economic recovery as a four-part process, or the 'four seasons' of recovery. The goal is to better represent where we are in this process, so that appreciating the future becomes clearer with each hurdle passed and more readily discernable as it continues to evolve in the months ahead.

**Realignment and Rationalization**

Generally speaking, periods of transition from economic growth to slow down, or outright contraction, force companies to reevaluate their current business, most directly with respect to scale. This is where the recent business downturn has been one of the worst in history; the sheer magnitude of the slowdown in economic activity has been one of the steepest, rendering past investments grossly misaligned with current opportunities.

The result is the oft-cited inventory overhang, which leaves companies with substantial excess inventory and only compounds the already evident excess capacity that had been built during the earlier boom years – particularly true in housing and housing related industries. On a broader scale, the impact is to render most businesses out of sync with slower demand and results in sharply lower profitability. The final result being deep cuts in business investment, payrolls and the shuttering of excess capacity.

**Stabilization and Business as 'Usual'**

Following realignment to current business conditions, companies tend to experience a nice jump in profitability, though this shouldn't be confused with actual growth of profits. The change in profitability is merely the result of the realignment process itself; lower costs of doing business resulting from reduced investment and payroll expenses. Despite the increase in profitability, there is likely little expectation within companies that profit growth is on the immediate horizon.

It is in this period however, that the primary catalyst for economic recovery begins to develop. As companies begin to see demand fall more squarely on their operations, they begin to shift to current production rather than simply selling from their excesses, i.e., inventory. Since current production activity has linkage effects to other companies and industries, whereas selling out of inventory has few, if any; the magnifying effect on the volume of economic activity can be meaningful and durable.

With companies having undertaken the bulk of the measures to realign their businesses at this stage of the recovery, any uptick in business should also be associated with early increases in operating activity and profitability. This is true even if the meaningful growth in sales has yet to materialize.

**Turn in Pricing**

Utilization, not sales levels, is the proxy to measure by. This distinction has to be made in order to appreciate that since companies have scaled down their operations, or have even seen competition scaled down through merger or bankruptcy, the potential level of supply has been effectively reduced. In turn, pricing firms at lower levels of demand than seen in the recent past.

As the volume of business activity begins to first translate into increased utilization, higher operating leverage and a sharp upturn in productivity, each successive rung that business activity surpasses will begin to create an improved balance between supply and demand – and ultimately pricing. This improvement in pricing, combined with increased utilization of operating assets, is the primary driver for not only the growth in profits, but also the reasonable expectation by companies of continued profit growth as it becomes increasingly associated with stable to rising sales to customers.

**Increased Business Investment**

'As go profits, so goes business investment.' For the most part true. The key distinction we would make is that yes, it takes profits to fund new investment (including payrolls), but more importantly it takes need for investment to affect the expenditure. This can come from two sources: a reasonable expectation that the new investment will enhance profits at present sales levels (better technology for example), or future demand will begin to 'tax' existing resources, leading to new investments in order to expand the scale of a business.

## So Where Are We Now?

**Season One – Realignment & Rationalization**

Following the massive inventory liquidation and paring of inventory levels over the past year, it is relatively safe to say that we have long since passed the depth of the business realignment and rationalization phase. Underscoring the extent of the cutbacks, profitability has risen dramatically, with a significant number of companies having reported their largest quarterly profits ever, despite the continued softness of sales.

Given the tepid increase in sales to date, management guidance regarding their business outlooks is unlikely to change in the near-term. Equally unlikely is management optimism toward investing in their businesses, allowing neither inventories nor payrolls to begin expanding freely. However, other measures of broader economic activity have begun to turn higher, and the longer the divergence between increased business activity and business investment, the larger the degree the pent-up demand for investment is likely to be.

### Season Two – Stabilization & Business as "Usual"

Though we are still nearer the depths of the realignment process than the end, we have already seen some hopeful signs that the period of stabilization and a more 'usual' business environment is underway. The first sign is that while growth in sales remains subdued, growth in activity has resumed, specifically within the manufacturing sector.

By August of 2009, manufacturing activity reported its first increase in activity in 18 months, as measured by the Institute for Supply Management's Manufacturers Survey. It has continued to expand, even seeing a robust upturn in the past six months, with the average index level being 58 (over 50 indicating expansion) versus 37 one year ago. The primary driver of the expansion has been new orders and production, much as would be expected with inventories being as low as they currently are.

Further validating that current demand is falling more squarely on company resources, is the marked increase in industrial production figures. Over the past 12 months, ending in May, industrial production is up 8%, versus being down -12% this time last year.

While sustained private sector employment growth has remained elusive, a frequently overlooked number in the monthly payrolls release indicates that even the job market is feeling the effects of strengthening business activity. Alongside the monthly jobs report, is a measure of aggregate hours worked. Despite aggregate hours being affected by jobs lost, this measure has been steadily moving higher since last November.

The importance of this measure is twofold. One, it suggests that current employees are experiencing increasing demands placed on them. This not only provides for growth in income, particularly among hourly workers, but firms consumer confidence through a sense of greater job security.

Second, while companies may be slow to develop enough conviction to expand their payrolls, consequently leading payroll figures to lag the actual increase in economic activity, hours worked coincides with increased business strength; consequently becoming a leading indicator to future jobs growth.

A final and significant sign that we have at least entered the second 'season' of recovery is that profits appear to be trending higher. In fact, if all goes as anticipated this upcoming earnings season, U.S. corporate profitability will remain at, or even surpass, its recent all-time record high of 11.2%, up from 8.7% a year ago, while earnings growth will surpass 40% over the past 12months, in contrast to a 19% decline in the second quarter of 2009.

Much of this improvement in profitability has not been accompanied by a marked increase in sales, suggesting that companies have merely brought their businesses back into alignment with the current level of demand and largely without the benefit of strengthening sales.

### Season Three – Turn in Pricing Power

While the absolute upturn in pricing power is not yet glaringly evident and may not be for a while longer, the volume of activity and increased utilization of current operations does appear to be trending higher.

Importantly, when we speak of pricing 'power' we are not alluding to a business' ability to raise prices, but rather its ability to sustain pricing above the cost of goods and services sold. In 'season one' or the period of realignment, most companies unable to sell their unwanted inventories are required to discount the price of their products to 'clear the market'; a clear sign of loss of pricing power. As businesses stabilize,

the terms of pricing begin to improve, particularly relative to the cost of inputs, e.g., raw materials, labor, etc.

Two metrics that clearly highlight this are business inventory 'turns' (sales divided by inventories) and business productivity, both of which have improved considerably since the middle of 2009 and are expected to continue doing so as business activity broadens throughout the economy.

Productivity has risen more than 6% versus a year-ago, well in excess of the long-term average of roughly 2% a year. Not only is this a significant indicator for increased total business utilization (investments and labor force) and a hopeful return to improved pricing power, but such a large increase also suggests that companies' realignment may have been overly aggressive. The result of the latter being potentially greater, and more durable, operating leverage; leading to a more pronounced rise in profits ahead.

A clear indicator of underlying productivity is the number of time business turnover their current investments. Again, using inventories as a proxy, companies are now turning over their inventories about ten times per year, up from just eight at the beginning of 2009.

However, until we see pricing power turn higher in absolute terms, i.e., a firming of pricing in finished goods markets *and* supplier input markets, it seems slightly premature to claim that a sustainable trend in pricing power has been established. At this point, it seems more accurate to say that the economic recovery has stabilized, though it has just entered the early stages of improved, but tentative, pricing power.

**Season Four – Increased Business Investment**

At this point of the recovery, there are few signs that increased investment by businesses will amount to much more than a marginal uptick; consistent with maintaining existing equipment relating to current operations. There are however, a few industries indicating they are operating at utilization levels that, if sustained, will result in future investment outlays, though at this point in time it is still short of a widespread phenomenon.

Importantly, there are several industries going through some major shifts in their investment behavior. A notable one is the telecom industry, where the rapid adoption of data intensive smartphones is quickly antiquating the existing infrastructure. However, even here, the major carriers will likely cannibalize their existing investments (disinvest) while making new investments to keep up with the new demands. The net result would likely be only a modest aggregate increase in investment.

Longer term however, there are still more developments occurring within the industry that could have a large impact on future investment. Over the past year, there has been increasing talk about raising the speed of the Internet by 100x to 1000x. While the overhaul of the network itself would represent a massive long-term investment, the resulting increase in speed would likely also serve as an enabler for a host of new product and services.

Likewise, in the energy industry there is a nascent investment trend toward alternative energy production, i.e., wind, solar and the application of nanotechnology. To the extent that emerging technologies can bring production costs closer to those in the legacy energy production industries, this too would represent a long-term and enabling investment opportunity for many businesses.

Examples like these are the truest representation of secular investment opportunities, as they represent potentially far-reaching and sustained long-term investment paths; bringing a large number of industries into the fold as they adopt new technologies and enhance long-term economic productivity.

## Bottom Line

After a nice stretch of encouraging economic data late in 2009 and early this year, current reports are leaving much to be desired. Nevertheless, there are encouraging signs for those willing to look for them, and those wanting to understand what the 'weather' will be tomorrow.

One thing is generally true of all economic downturns – they are necessary adjustments to past errors. For the economy, the adjustments now underway are being felt by virtually everyone as businesses scaled back their operations. Companies became acutely aware that past spending by consumers was artificially high, owing to their taking on ever more debt to finance spending beyond their income. With consumers now more focused on shoring up their finances, this has forced businesses to scale back to the new economic realities.

For an improvement in economic and market conditions to materialize, the immediate challenge will be in restoring confidence among businesses, consumers, and investors. This is clearly important from an economic standpoint, but probably equally so from an investment point of view given the current volatile state of the markets and investor sentiment.

## Parting Shot

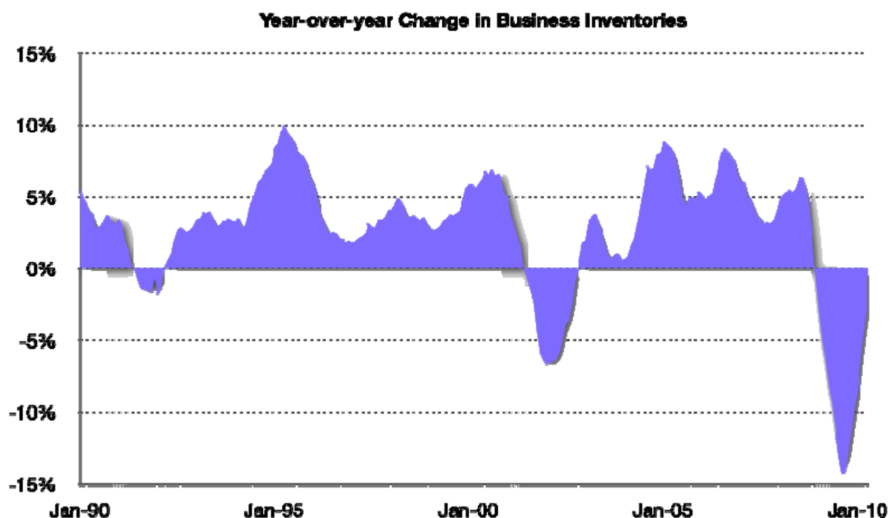
The macroeconomic outlook that our view is built upon has a parallel in the world of microeconomics – return on invested capital.

At its core, our outlook is merely an extension of the corrections that need to take place to remedy the current problems resulting from the recent sharp economic downturn; specifically, that too much capital was invested for today's current low rate of growth, rendering companies over-scaled for sustained profitability and at the micro-level, resulting in companies poor returns on invested capital.

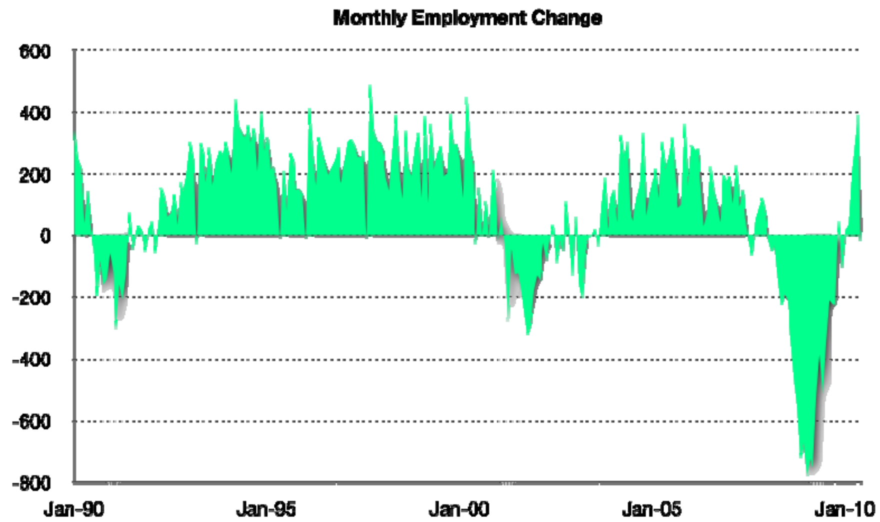
The reason we want to underscore the real world phenomenon underlying the macro view is that as the recovery likely unfolds, we believe that company returns on investment will arguably be the best and earliest metrics for determining companies poised to deliver investment returns to company shareholders.

Clearly our outlook suggests that investors need to be focused on quality companies 'in the flow' of potentially higher levels of activity. We believe that with the majority of companies having sufficiently realigned their business for the current slow growth economic environment, though a continued difficult pricing environment, it will be the healthiest and most consistent businesses that are best poised to realize the rewards of investing earlier rather than later.

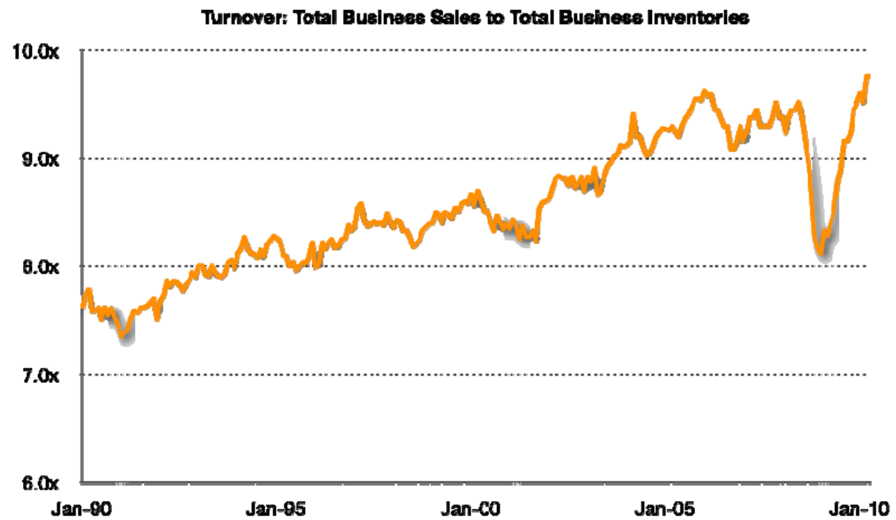
*The inventory workdowns that have taken place for more than a year now have dramatically improved the health of businesses; effectively realigning companies with the current economic environment.*



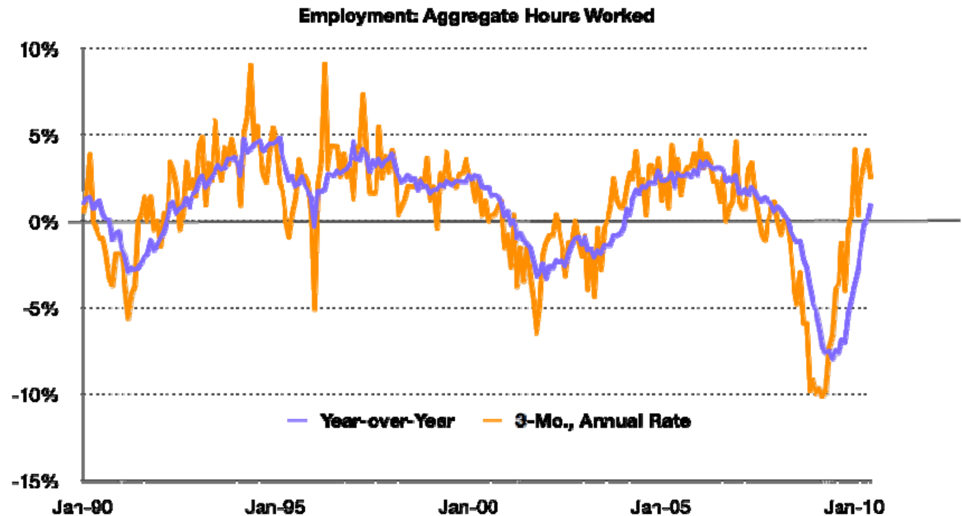
*Similarly, the sharp contraction in payrolls has helped to realign costs with the recent soft demand environment, though with inventories playing less of a role with respect to meeting current demand, labor utilization is poised to*



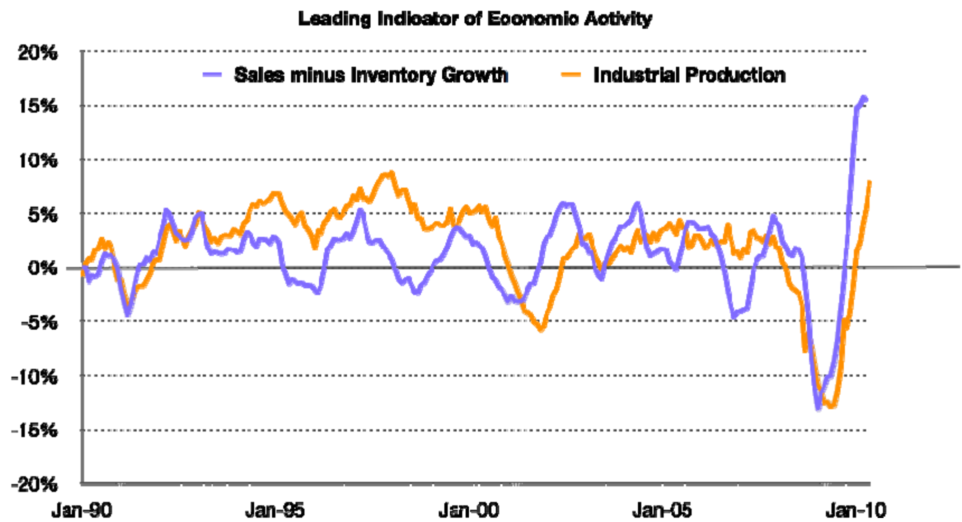

*Turnover represents an implicit measure of productivity, which has increased markedly since a year ago. Such a large increase also hints that companies' realignment may have been overly aggressive and could possibly result in a*



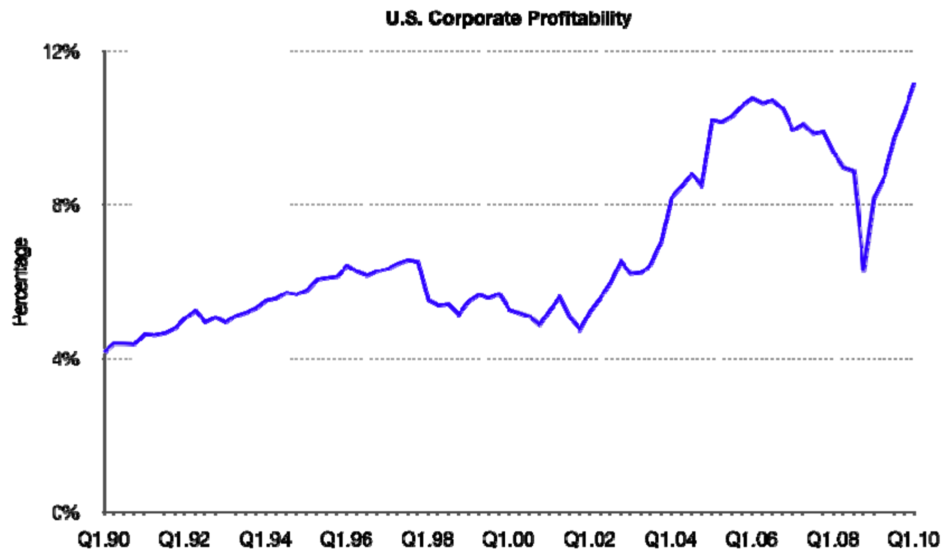

*One of the early indicators of changes in business activity, aggregate hours worked by employees, has begun to trend higher. This is precisely what would be expected once businesses have right-sized their operations and current demand becomes*



*With businesses being aggressively downsized, as measured here by inventory investment, even small increases in end market demand will result in large increases in new orders, production activity and ultimately growth in*




*To date, the improvement in cost cutting has come as the result of sizable cost cutting efforts by companies. Importantly however, as business activity improves, new 'production' will leverage the increased profitability, likely leading to*

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