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Double Dippin'

This is attempt to understand the interaction between company cash flows, the macro economy, and the equity market valuation as the economy 'green shoots' out of a recession, or, more likely for now, hits bottom. Our thesis might help explain the 'double dip' phenomenon in past recessions, and offer some clue as to how to trade through it.

When the economy slows down, companies cut production in excess of the decline in their revenues. This leads to an inventory correction. In a severe shock such as this one, they have also cut labor costs quickly. As a result, even though the first quarter earnings showed revenues in the supply chain declining faster than the macro economy, to at least this observer's amazement, costs in many cases declined even faster. The combination of reduced working capital needs and costs contributed to a revival of the stock market as companies proved they could manage liquidity in the absence of access to debt markets.

At some point, production needs to bounce up to the level of revenues to maintain inventories. This will show up in the quarterly GDP data as a positive. But then what? Either consumption recovers quickly with a V shape, so that production remains stable, or, if consumption is slower to materialize, then the rebound proves to be the middle spoke of a W recession, and the numbers fall again to create the second dip. This implies that 1) this week one should go into Q2 GDP announcements with a long bias, because a production recovery might numerically translate into overall economy recovery. This may well explain the ongoing rally in the market. 2) The Q3 GDP growth is harder to guess and one is better off being neutral going into the release. If the economy holds up in Q3, then the market likely drifts up again. If not, equities will aim downwards by October, and in a hurry, because now no one will be able to tell when consumption will resume with gusto. In 2002, this relapse happened in the market despite the fact that the underlying economy really grew out of the recession quite reliably, primarily because a slow recovery in jobs left macro economic risk in place. So, one has to assume that the market does no better when the actual economy is bumpy, with double digit unemployment and ongoing deleveraging.

Without increased consumption, finished goods firms will not show revenue improvement after one or two quarters of the same magnitude as their production increases to replenish inventory; so they will likely disappoint with Q3 growth even if the economy stabilizes. The exception would be an improvement in exports so robust that companies decide to rebuild inventories and signal that to the market. Somehow that is hard to foresee at this point without additional data, although Germany's capital goods sector is experiencing something along these lines from Chinese export orders. So, Q2 GDP would not be worth celebrating too much, and if Q3 GDP is negative, it would certainly be time to short equities because by then costs would have been wrung out of the system, and revenue growth will dominate valuation. By September working capital and employment need to stabilize to support a recovery, and given the slack in productive capacity, the incentive to compete on price will remain quite high. Margins could get crushed.

While this conjecture might prove incorrect in some details, it lays out the mechanism by which to think of market exposure during the earnings and government data release seasons for the remainder of the recession.

This relationship also offers potential insight into what is happening to the US supply chain i.e. China, Asian Tigers, etc. They suffer from more volatility than the US economy as the sources of production so they faced the brunt of the inventory correction. Their decline in production was, and upcoming bounce and subsequent slowdown will be, far more pronounced than US numbers. This roller coaster is going to be magnified by the size of the Chinese stimulus, which is staggering at about a third of their GDP.

This also implies that, by late 2010 or early 2011, as the new stable rate of growth of 5% rather than 10% becomes apparent in Asia, asset values, which have recovered remarkably well in public markets and held up relatively well in property markets as a result of government stimulus, could reset lower. This pushes out a final bottom in financial center hard asset markets to 2012. The marginal buyer of London or NYC real estate came from Moscow or Bombay or Shanghai in 2007. They will be the marginal sellers of 2012. The US and Chinese stimuli may also have delayed the moment of reckoning in currency markets. South Korea and the U.K. have suffered devaluations, but China, India and Europe have held on. The potential for reigniting 8-10% growth, or in Europe's case 2-3%, will keep currencies stable until evidence turns one way or the other. At a 4-5% stable number for Asia, the current level of stimulus a.k.a. deficits cannot be financed and marginal tax rates go up, hitting equities.

This also explains why bear markets eventually bottom at high single digit multiples: A market budding towards large cap growth with oligopolistic margins and low taxes deserves a 15-20x multiple. A market with slower growth becomes full of small cap value, with fully competitive margins, which begets at a 5x multiple. Since the G7 will be dealing with individual and institutional leverage for the next decade or so, real growth will be hard to come by. If slack in the economy is truly 30% as some data indicates, then 5-10 years of investment at minimal / maintenance levels might be required to converge capacity with demand.