Earnings Fairytale Has An Unhappy Ending

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The air underneath stock prices is indeed getting very thin at these altitudes. According to none other than Goldman Sachs (NYSE:GS), median stock prices are positioned at the 97th percentile of historic valuations. Other metrics such as Median PE ratios, Market Price to Sales and Total Market Cap relative to GDP all validate the extremely overvalued condition of U.S. stocks.

In order to justify these near-record valuations, analysts are once again predicting a J-curve in earnings growth for next year. S&P 500 earnings are projected to rebound from the trailing twelve months earnings per share (EPS) of $111, to about $130 for the forward 12-month EPS.

Negative Growth

The S&P 500 has produced five consecutive quarters of negative earnings growth. According to FactSet, earnings growth for the index so far in the third quarter of 2016 has a blended increase of just 1.6%. And even if earnings manage to produce a small single digit rise in year-over-year earnings growth for the first time in the past one and one half years, it would hardly support near record market valuations.

Since 2010, economic growth in the United States has been slightly above 2%, and for the first three quarters of this year GDP growth has averaged just 1.7%. Yet despite this anemic economic growth and shaky earnings backdrop, perma-bulls are still betting on a huge earnings surge next year of 16% in order to reach that illusory target of $130 EPS.

But the news coming out of multinational conglomerates so far this quarter proves EPS won't even come close to that Wall Street earnings fantasy.

Cases In Point

Right out of the earnings gate light-weigh metals giant Alcoa (NYSE:AA) blamed, "near-term challenges in some markets" for missing its earnings estimate, as its revenue declined 6% year-over-year.

General Electric (NYSE:GE) lowered its revenue growth and narrowed its profit forecast for the year. The multi-national industrial giant noted its revenue rose less than expected, to just 1 percent in the quarter. The company also trimmed its full-year revenue forecast, now expecting revenue to be flat to 2 percent growth.

Honeywell International (NYSE:HON) cut its full-year EPS guidance for 2016, noting that its core organic sales are now expected to be down 1-2% for the year.

Manufacturer Dover (NYSE:DOV) cut its full-year sales and profit forecasts, citing a weak global economy. On their conference call they noted, "The primary factors driving this revision are generally weaker capital spending across several industrial end-markets..."

PPG Industries (NYSE:PPG), which makes paints and coatings for the construction and other markets, said it was, "disappointed with this quarter's EPS growth rate as we continue to operate in a sluggish economic environment with no clear near-term catalyst for improving global GDP growth."

Global construction and mining equipment maker Caterpillar (NYSE:CAT) reported an astounding 18% decline in its global retail sales for the three months ended Sep 2016. The company cited listless demand for heavy machinery in its core markets due to a slowdown in construction and mining activity. For the past few quarters Caterpillar has suffered from a weak mining industry, low oil prices, stronger U.S. dollar and China's economic woes. In addition to all this, its third-quarter profit was cut in half due to the global economic slowdown that the company expects to extend into next year.

3M Company (NYSE:MMM) sited challenges in its Electronics and Energy Sales Division for the reduction in profits for 2016, which saw a decrease of $1.3 billion, or down 7.5 percent in those key segments.

And finally, if you needed more proof, YRC Worldwide (NASDAQ:YRCW), a leading provider of transportation and global logistics services, saw its profit drop 9.5% YOY, blaming a "soft industrial backdrop".

There are many more examples of earnings shortfalls, and to be sure, not all companies reported bad numbers. Nevertheless, these earnings and revenue warnings regarding current and future global economic weakness from multinational industrial giants should not be ignored.

Multiple Sectors

But it is not just multinational industrial conglomerates that point to a lack of earnings growth. There are numerous examples of weakening revenue and earnings -- along with projections of further weakness -- across various enterprise sectors. For example; fast-food chain Sonic (NASDAQ:SONC) dropped 17%, Home appliance maker Whirlpool (NYSE:WHR) fell 11% and sports apparel provider Under Armour (NYSE:UA) plunged 13%, all on the same day they reported earnings.

It may have been acceptable for investors to maintain hope for a huge earnings rebound as long as the epic bond bubble was still inflating (yields falling), the dollar stopped rising, oil prices were well on their way back toward triple digits and the Fed had your back. However, this is no longer the case.

Long-term interest rates have been rising sharply across the globe due to the new central bank strategy of steepening their respective yield curves. The Trade-weighted Dollar Index has jumped 4% since August of this year and is up 20% since the summer of 2014 in anticipation of a resumption in the Fed's tightening cycle. The price of WTI Crude Oil seems to be stuck below the $50 per barrel range, despite numerous attempts by OPEC to construct a deal to freeze production at all-time highs.

And, as mentioned, the weakening multinational earnings picture has not yet dissuaded the Fed from recommencing its rate rising campaign come December 14. Indeed, the Fed's median dot plot projects short-term borrowing costs will rise close to 1¼ percent by the end of 2017.

When near record-high market valuations slam into slowing global growth, rising interest rates on both the long and short end of the yield curve and the epiphany reached by investors that there will be no robust or sustainable earnings rebound, it will lead to the end of this equity bubble. A prudent investor should listen to the message of markets not the perpetually-inane optimism of Wall Street analysts. Therefore, expect a 7-10% correction in the major averages between now and the end of this year.

This selloff in stocks should continue until our inflation-loving central bank returns to the printing press with the futile hope that a rising CPI will bail out the economy. And even though stock prices may then catch a bid, expect the chances of viable economic growth and a strengthening middle class to fall further down the cesspool.

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