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THE WORLD IS DROWNING IN OVERSUPPLY

Take a step back to see the big picture

With the first quarter of 2016 earnings season half way through, let's take a look at the profit reports around the world. In the Eurozone earnings are down -7%, for the broader EU Stoxx600 earnings plummeted -18%, for the US S&P 500 earnings fell by -7%, Japan's Broad Market sees earnings down -11% and China's Mainland earnings tumbled -11%. Moreover, these are all non-GAAP and non-IFRS earnings; they are the adjusted, made-up, fantasy earnings that we described here. The real numbers are much lower and we will present them at the end of the earnings season.

That earnings around the world are down again for a fourth consecutive quarter is hardly surprising. What we find interesting are the reasons for the earnings slump most often cited by companies. Those justifications are mostly uniform around the globe. By far the most popular explanations this quarter are the "detrimentally strong local currency" and the "weak international demand." Honestly, even if you listened to a single conference call, chances are you heard those two as the top excuses for weak profits.

On every earnings conference call Japanese companies are complaining that the strong yen is weighing on their international sales, the European firms are finding fault with a strong euro making exports uncompetitive, the US companies are attributing lower earnings to the strong dollar while Chinese corporations are claiming the yuan should come down to boost profitability. The main trading partners of each of the above-cited regions are the other three. Altogether they account for 74% of the world's consumption. Their four currencies combined account for 81% of the global currency supply. They simply cannot be all expensive at the same time relative to each other. And, by the way, on average the dollar in the first quarter was little changed from Q1 of 2015. Yet companies and the sell-side still use it as a justification for weak earnings.

The second unifying theme is the all too often cited "weak international demand." This was even peddled by the central bankers, who hold that their respective economies are doing well while the international economy is faltering. Yellen said that although the US is doing great, she is concerned about disturbing global macro developments. Draghi stated that the EU's recovery is fine, but that it is vulnerable to shocks from the worsening international economy. Kuroda believes that Japan is on track, save for that pesky international demand weakness, which perfectly mirrors China's position on that issue.

All of this is exceedingly amusing, since these four regions combined account for 74% of the world's consumption and investment. Blaming the weak international economy means they are basically blaming themselves. Then what could be the reason for the falling sales and sinking profitability around the world?

Just like previous cycles at the end of the expansion stage, economies suffer from ubiquitous oversupply. However this time it is worse – in the current cycle we never had monetary tightening and kept the zero rates and money printing for a full 8 years. It is a textbook example of oversupply due to overextension of credit.

Commodities were the first to experience the glut – from oil, iron, copper, wheat, corn and soy to cotton and steel. A few days ago Bloomberg reported that even excessive amounts of cheese are bursting warehouses since the price of milk is plummeting.[1] Commodities were the first to fall prey to oversupply, since they were also the first to receive vast and fast capital inflows. Would we have had the oil fracking 'revolution' without access to cheap credit and zero interest rates?

The growing concern is that this surplus is no longer confined to the commodities sector. With the earnings season unfolding around the world it is becoming clear that the times of low competition and high margins are over. The oversupply is now evident in every business segment.

Let's say that you are a budding entrepreneur looking to start a new business. If you want to open a new computer components factory, good luck. Giants like Intel and Micron already feel the pain of increased competition in an already crowded space, leading to falling capacity utilization and increased employee layoffs. From flat screens to solar panels manufacturing, from smartphones to gadgets, oversupply is king.

As the number of factories rose significantly over the last few years, everything from plastics to clothing is seeing capacity utilizations dropping. Shipbuilding in Korea and China is dwindling with plunging utilizations. Bloomberg reported that shipyards are being turned into parking lots.[2] Even for airplanes "the market is oversupplied" as Pierre-Francois Riolacci, Chief Financial Officer of KLM-Air France stated during their conference call. He further added that it is getting much worse as "we see capacity coming in."[3]

Let's take a look at retail. As indicated by the New York grocery chain Fairway in its bankruptcy filings just a week ago there are too many supermarkets. The big retailers like Walmart, Macy's and JC Penney are hurting as their margins are thinning. They are thinking of closing down stores to contain costs. There is an excess of malls and shopping centers worldwide. Three years ago Lululemon used to be alone in its category of athleisure yoga pants, now it competes with Athleta, Sweaty Betty, Tory Sport, Oiselle, Outdoor Voices, Nike, Lucy Activewear, Under Armor, Tracksmith, Lorna James, Phat Buddha and Zara Terez.

What about software or phone/gadget apps? There are 1.5 million apps now in the Apple Store while people only use about 500 of them. Competition is fierce. The software-as-a-service (SaaS) concept came into existence a few years ago and by now all of the verticals like healthcare, accounting, financial services, fleet management, etc., have been filled up. Promotions are intensifying due to the high marginal benefit and low marginal cost of every additional client, which inevitably hurts profitability.

Perhaps you would like to try your luck in other services? Restaurant chains like McDonalds, Chipotle and Domino's Pizza have added more than 19,000 new restaurants worldwide in the past few years. As for financial services there is not a single bulge-bracket bank that is not laying off at least 10% of its personnel, with Goldman Sachs being the latest with a fresh announcement last week. We can continue with virtually every business segment but for the sake of brevity let's stop here.

With intensifying competition across the board, it is easy to understand why decreasing profits put pressure on prices. Despite the fact that central banks printed $13 trillion in the past 8 years, inflation around the world hasn't really picked up. The US, EU and Japan's inflation rates have all been running sub-1% for a while now. It's hard to raise prices when strong competition is luring your clients away.

Cheap and abundant credit for 8 years nitro boosted competition. It reduced factory capacity utilizations, which left machines and workers idle. This explains why we see a slump in productivity in large economies. It also explains why companies are increasingly reluctant to invest in capital expenditures and prefer buybacks and M&A.

1 http://www.bloomberg.com/news/articles/2016-04-29/u-s-cheese-inventories-soar-to-highest-since-1984
2 http://www.bloomberg.com/news/articles/2016-04-14/this-shipyard-is-so-unprofitable-it-s-turning-into-a-parking-lot
3 http://www.bloomberg.com/news/articles/2016-05-04/air-france-klm-narrows-loss-warns-of-tough-fare-environment

Central bankers kept the pedal to the metal for too long and that's what they got – an oversupply of everything. That is why the 20th century central bankers did not keep rates at 0% for too long; they never had negative rates or quantitative easing. Not because they did not wish to stimulate the economy, and not because they had not discovered the miracles of money printing. Rather, because they were prudent and did not want to overheat the economy by creating the wrong incentives.

One chief economist at a central bank recently exclaimed: "How can the economy be overheating with a low sub-1% real GDP growth and a low employment participation rate?" That is why you do not always measure the 'temperature' of the economy by GDP growth and unemployment. Instead, the right gauge this time would be the abundance of credit and cheap money. Add to that the lack of productive uses for superfluous credit, and the questionable outlets corporations funnel debt into and you would capture a clearer picture of the state of the economy.

How will the debt-fueled oversupply be resolved? Oversupply has always been resolved the exact same way – via bankruptcies. In fact, the default cycle has already started. In the first 4 months of 2016 a total of 57 corporate issuers have already defaulted. In comparison, for the same 4 months of 2009, in the wake of the global financial crisis, total defaults were 67 or just 10 more than this year. Exactly 43 of the 57 defaults are in the US. If you believe that most of this is due to the lower oil prices, let's clarify that only 20 of the 57 defaults are in the oil and gas industry.[4]

The number of defaults is accelerating. Investors and institutions are largely unprepared for the forthcoming tidal wave of bankruptcies worldwide. Introductory textbooks on economics say that everything is based on supply in demand. With supply surging, there is no other way to resolve the imbalance but to have the most inefficient companies throw in the towel. There cannot be a boom, without a bust. We cannot see profit margins expand again, without quite a few companies going belly-up before that. That is why the forthcoming recession is unpreventable, especially by printing even more money and having the interest rates lower for longer, which would only exacerbate the imbalances.

[4] http://now.eloqua.com/es.asp?s=302554905&e=322670&elq=c2cd74cab41547bf9782d7ed970304e9