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TIME TO TAKE A STEP BACK?

As a disappointing first-quarter earnings season rolls on, I am beginning to feel more cautious about the markets in the months ahead. We're in the midst of a third consecutive quarter of poor profits and cash flows, and what's most troubling is the weakness that's spreading beyond energy and exporters to a broader swath of companies in the S&P 500 Index. To me, this is a signal to reduce risk in many portfolios.

Why the increasing level of concern? The three previous earnings recessions of the last 50 years that were caused by a combination of tumbling oil prices and a strong dollar tended to last two quarters. But this pronounced downturn in earnings has now stretched into a third quarter. By now, I would have expected sales and profits to have rebounded, with consumers responding to the "energy dividend" that has accompanied the tumble in oil prices. And the pass-through from lower input costs should have driven an increase in overall economic activity, fueled by higher real consumer incomes. That has not yet happened. I find it both discouraging and an ominous sign for risk assets.

Reevaluate your asset mix

With new money, investors may want to contemplate standing aside for now. An appropriate response for existing diversified portfolios could be to reevaluate their quality mix and to consider favoring a tilt toward shares in companies with sustainable dividend yields and toward high-quality bonds, perhaps US corporate credits.

Although I don't believe the present backdrop signals the beginning of a US recession, it does mean that we are now experiencing a protracted earnings recession. To resume favoring risk, I'd need to see the following:

- A recovery in capital expenditures
- An improved revenue line for US-based multinationals
- A sustained improvement in emerging markets
- Improved pricing power on the back of an increase in global inflation

Additional concerns

Aside from the concerns expressed above, there are a number of other issues that the market needs to confront. In particular, because of the growing weakness in earnings, the current price-earnings ratio for the S&P 500 is too high, at 16.3x.

Seasonal trends are not particularly favorable in the months ahead. The May–October period is historically characterized by sideways market movements, delivering indifferent returns to investors when viewed over many decades. As the popular saying goes, "Sell in May and go away." This year, in particular, investors can afford to wait for more clarity from the data flow.

Generally, market participants tend to be cautious in the months leading up to major elections. And with this year's US election likely to be contentious, that caution may be justified. Further risks that may warrant caution are the Brexit referendum on 23 June and a Spanish general election days after, as well as concerns about Greece's ability to meet its financial obligations over the coming months.

The macroeconomic environment has proven less dynamic than expected in recent months. US government income tax receipts have slowed despite still-robust employment data. New single family home sales, though solid, have not met my expectations. Auto sales are losing momentum after a very strong 2015. And most importantly, the profit share of gross domestic product, one of the most important forward indicators I follow, has started to slide.

While the current US business cycle remains strong by many measures, like job and wage growth and corporate profit margins, the equity markets are laboring to produce the earnings and margins that we've come to expect in recent years.

Our job will be to follow the shifts in the markets and the economy, and it's our hope that our current concerns will be temporary.

But for now, it might make sense to take a step back.

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