THE PROFITS AND EARNINGS LIE

CRITICAL SIGNALS REPORT

WITH MATT PIEPENBURG

Investor's Report
From: Matt Piepenburg
For: *Critical Signals Report* Members

The Profits and Earnings Lie

Dear Subscriber,

In an era when "fake news" has become the new name for "news" in general, one can understandably worry about who or what source to believe – be it left, right, or center; red, blue, or paisley; conventional or non-conventional; on-line or off-line; bull or bear.

A recent best seller, Michiko Kakutani's, ***The Death of Truth***, raised the important distinction between opinion and "objective fact."

In the fog of a 24/7 media circus (increasingly driven by sensational buzz and page clicks rather than honest fact-checking), one should read carefully between the lines.

Financial journalism, by every measure, has become less investigative and more spin-based.

And when it comes to financial news, I've seen a staggering rise of sell-side bull bias as markets get more and more overvalued, distortive, and dangerous.

Fortunately, I have no bull or bear axe to grind. Instead, I'm a veteran investor of three great market cycles with a weakness for candor and math.

In short, facts matter, for when it comes to your money and future, you don't need more rants; you need facts.

In this spirit, let's rely on numbers rather than prose.

The Two Biggest Lies

The easiest way to bring this point home is to simply look at the most important metric for security pricing on all the major U.S. exchanges: profits and earnings.

As even the most novice investor knows, profits and earnings determine whether a stock goes up or down.

When profits and earnings go up, stock prices go up; inversely, when profits and earnings go down, stock prices go down.

Fair enough.

In a record-breaking stock market that seemed to only go up since the 2008 crisis, one would assume profits and earnings were doing the same thing, right?

The financial sell-side media sure wants you to think so. Throughout the 2018 highs, they were on a tear lauding (and promoting) the "booming profits and earnings" meme in a nosebleed-high market that peaked in September (but bled a great deal from October through December)…

Let's look at the math and see for ourselves whether that "booming" was real or, well… fake?

The Al Capone Market

But before we do the math, let me remind you from my free report, 12 Ways to Protect and Grow Your Wealth Today of that little distinction between honest balance sheet reporting – namely as required by Generally Accepted Accounting Principles, or GAAP, and by the IRS – and the legalized fake balance sheet reporting (as allowed by Wall Street's sell-side spin doctors), also known as ex-items accounting.

This ex-items accounting is literally a form of legalized fraud, that is, it's…

"…a parallel little accounting universe (and an open secret in the hedge fund world) where CEO's are allowed (a bit like Al Capone's CPA) to carry two sets of books: one (GAAP) which they report to the SEC (nod to Sarbanes-Oxley) under penalty of prison, and another (non-GAAP, or Ex-Items), which they report to sell-side analysts and retail suckers (you and me)."

This is true. Really unbelievable, yet true.

And I'm guessing not one in 10,000 investors even knows this…

But in this accounting "new normal," this "second book" basically allows the vast majority of the companies in which you've invested to skip past (i.e. ignore) over-head and report mostly cash-flow.

That's a bit like a lemonade stand that reports only lemonade sales but not the cost of lemons…

What's the net result?

Earnings, by the very nature of accounting tricks, are not honestly reported, which means investors aren't seeing honest risks.

Which is why an **Associated Press** report recently concluded (and your advisors probably overlooked) that 72% of the companies they reviewed had adjusted profits that were higher than net income.

From 2010 to 2014, the S&P as a whole showed adjusted profits that came in $583 billion *higher* than net income.

Folks, pause to think about that for a second.

Profits higher than net income?

Thank clever accounting for making 2 + 2 = 6…

The "Booming Profits" Lie

But let's jump now to the current markets and see for ourselves what the *facts* rather than headlines have to say.

If you look at the pre-tax profits of corporate America for Q2 of 2018, the number came to $2.2 trillion.

And if we look at the same data for Q2 of 2017, we see that the profit numbers were essentially the same.

In fact, you can go all the way back to the pre-tax profits of Q2 2012, and guess what, profits back *then* were also around $2 trillion.

In short, corporate profits were not booming at all as the markets sailed into the December 2018 storm.

Instead, they were nearly flat, annualizing at a meager rate of 1.3%.

This doesn't even keep pace with fictional inflation.

This, by the way, is not my opinion. It's math.

However, if we look at after-tax profits, the growth rate for Q2 2018 was a much higher 6.8%.

Cue roll the "booming profits" headlines, right?

Nope.

If you think before (or even as) you read, then you'll know these headlines are completely, well fake.

That is, we are not seeing companies (or their profits) growing at all. Instead, we are simply seeing a one-time IRS paper growth – the direct result of the Trump Tax Cut, which brought corporate rates from 35% down to 21%.

But if you paid any attention to the details (rather than hype) of the recent tax cut, you'll also know that it expires this year.

Simply put: This de-contextualized profit data was 100% a tax trick, not a profit surge. Full stop.

The "Booming Earnings" Lie

Turning from profits to earnings, let's look once more at facts rather than headlines.

Currently, the Street is actually projecting ex-items earnings for year-end 2019 to be $177/share, at a "normal" PE multiple of 16 times, which means they anticipate a 22% earnings growth …

But if you leave the fake world of ex-items accounting and enter the real world of GAAP earnings, here's the real numbers: The last-twelve-month (LTM) GAAP earnings for June of 2018 came in at $122/share.

The pre-crisis peak earnings 11 years ago were $85/share, which means we've seen earnings grow by an annualized rate of only 3.4%.

Again, this is fact, not opinion; this is math, not spin.

Now I ask you: Does 3.4% growth over an 11-year cycle feel like a "boom" in earnings?

Reality Check

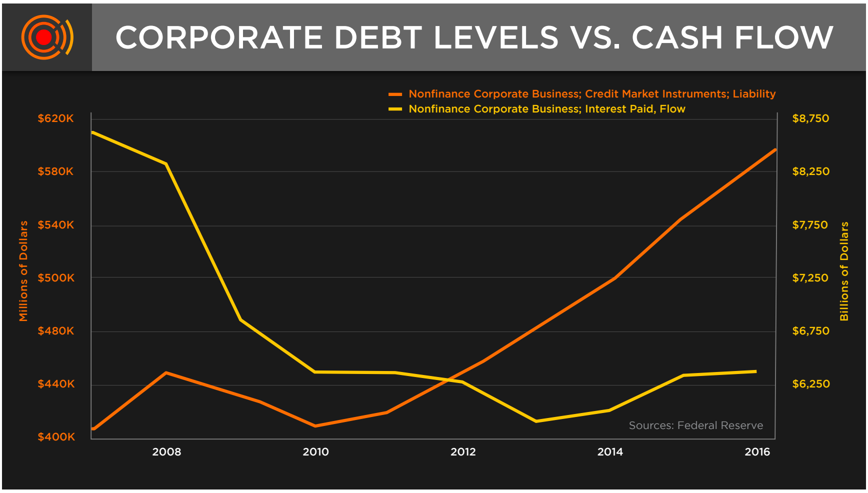
By pure math (as opposed to opinion), we can *objectively* conclude that since the last market peak in 2007, two things are happening: (1) profits are empirically flat, and (2) annualized earnings are paltry, not booming. Period.

The obvious next question is this: With earnings annualizing at just 3.4% and actual profits mathematically flat-lining, how is it that U.S. equity markets reached all-time highs in 2018 and rebounded from their December lows so quickly?

The Debt Truth – the Lying Skunk in the Financial Woodpile

If you want to know how markets can rise while such crazy "old-fashioned" indicators like profits *and* earnings are stalling, the answer is simple: cheap debt.

If you don't believe me, let's look at a colorful picture and do the math…



As you can see, the falling blue line represents the cost of borrowing.

When bad or profitless companies see a chance to cheaply borrow their way out of a hole, they always do so.

They are no different than anyone who lives off a credit card rather than a salary to get through the month.

This explains the rapidly rising red line, which represents corporate debt exposure.

It's skyrocketing.

As I've written ad nauseum, we can thank the happy idiots at the Fed for creating this addictive debt monster and 100% fake "recovery."

By cranking rates to the zero-bound in the wreckage of the Big-Bank-created fiasco of 2008, the Fed created a debt monster.

Why a monster?

Equally simple: Debt is fun when rates go down, but debt is a killer when rates go up or recessions emerge.

And guess what?

Rates are only staying low because the Fed just folded like a chair in March and ended its promised balance-sheet tightening and projected rate hikes.

This sudden Fed pivot was a screaming confession that the economy and markets are in fact too weak to handle even a modest rate hike, despite years of the Fed telling us (i.e. fibbing) we were in a full "recovery."

Now, instead of rising rates, we are seeing a flattening yield curve as investors run to bonds for safety, which in today's credit market bubble is like running into a burning house to stay warm.

Our yield curve is flattening, which means bond holders are getting less return on longer-term bonds than for shorter term bonds.

Such scenarios have preceded all seven previous recessions.

It's not a good sign.

But don't expect the sell-side financial advisory industrial complex to offer you much candor or warning, for that might lead you to pull some money out of the markets, which means they get paid less.

The Big Question

If we just look at the math, then, we see objectively that: (1) earnings are weak, (2) profits are flat, (3) corporate debt at $9 trillion is at an all-time high, and (4) the yield curve is inverting.

We also see that none of these facts are being articulated in a simple, cogent, or rational manner in the financial headlines or glossy bank brochures.

So, when will the market dam burst? When will reality trump fiction and sell-side spin?

As soon as a critical volume of investors – either by wisdom or trigger event – face reality rather than spin, base conclusions on math rather than headlines, and call out this "recovery" for what it really is – a debt-driven sham.

Folks, every market crash throughout history was preceded by a debt bubble, and you are currently sitting on top of the biggest bubble in history.

It's time to leave the herd and think for yourselves.

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