CFO Survey: Skepticism Could Be An Important Warning Signal

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Summary

- Duke's CFO Global Business Outlook is not discussed very often in mainstream media, but it is currently flashing a warning signal.

- The optimism index had been deteriorating rapidly for four consecutive quarters by early 2008, while the S&P 500 had yet to drop 50%.

- Given today's challenging environment, hoping for the best but preparing for the worst might be the best approach to investing.

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Indications that global economic growth deceleration is underway continue to mount. One of the most convincing of them, in my view, came from the rarely-discussed CFO Global Business Outlook, conducted by the Fuqua School of Business and recently mentioned as a potential warning sign by "The Godfather of the Yield Curve Inversion", Duke University Professor Campbell Harvey.
According to the survey of more than 500 global CFOs most recently conducted in the first week of September:

- business optimism has not been this low since September 2016
- 55% of U.S. CFOs have become more pessimistic about the business outlook in 3Q19 than they had been in the previous quarter
- capital spending expectations have reached the second-lowest growth levels since December 2009
- two-thirds of respondents predict a recession by the end of 2020

See table below summarizing some of the key metrics tracked by the study and the general trends over the past couple of quarters.
Intuitively, hearing what global finance executives have to say about the business landscape and economic growth prospects makes a lot of sense to me - after all, they are the ones ultimately making hiring and other investment decisions. Pessimism is likely to lead to caution towards spending in the foreseeable future (i.e. tighter budgets), while optimism should point in the opposite direction.

**Testing the predictive powers**

I decided to look into whether the CFO survey could be used as a guide for what to expect of the economy and the stock market in the foreseeable future, more specifically in the United States. I looked at the historical trend in the CFO Optimism index and assessed how well it anticipated the drop in economic growth and stock prices during the most recent recession (the only period of economic contraction to take place since data on the index has been available).

The graph below, particularly the blue line representing optimism towards the broad economy (perhaps the most unbiased measure, compared to the "own firm" metric tracked by the red line), suggests that the index might be worth paying close attention to.
The grey shaded area represents the six-month period between a peak in CFO confidence and the highest levels reached by the S&P 500 (SPY) in October, right before the 2007-2009 crash.

While the minor drop in the optimism index in 2Q07 could have easily been interpreted as "noise" in the data, the trend had turned decisively negative by September 2007: pessimist CFOs outnumbered optimists by roughly a four-to-one margin, the highest measure of gloominess ever. Commentary on the 3Q07 survey results seemed to be forewarning of tougher times to come:

- "Optimism about the U.S. economy plunged to a record low this quarter"
- "CFOs expect slow growth in earnings, capital spending and acquisitions and no growth in hiring"
- "They are very concerned about weak consumer demand, rising labor costs and credit markets"

By 1Q08, the optimism index had completed a sequence of four consecutive periods of noticeable quarter-to-quarter deterioration. By then, the S&P 500 had yet to shed nearly half of its market value.

(Source: graph by Duke CFO Global Business Outlook, annotations by DM Martins Research)

To be fair, it is unclear whether the CFO Optimism index has been useful in predicting economic deceleration or stock market weakness outside the 2008-2009 recession period. Notice how sentiment deteriorated sharply (but briefly) in mid-2010, early 2011 and through the end of 2012 - while GDP growth decelerated to less than 1% by 3Q11 and to 1.3% by 2Q13, only to recover and breach the 3% mark by the end of 2014.
Key takeaways

I will likely use the CFO Global Business Outlook study as another (very important) data point in calibrating expectations for economic growth as well as stock market reaction in the next several months. As it stands, the research provides an indication of tighter business spending on the horizon which, all other variables equal, does not bode well for the economy and for stocks in the foreseeable future.

The sharp U-turn in consumer confidence over the past few months, which I mentioned in a recent article (see graph below) to support my cautious stance towards highly procyclical stocks, is also worth monitoring ahead of the holiday season. The metric could anticipate deterioration in one area of the U.S. economy that has remained relatively robust lately: consumer spending.

![Chart](https://seekingalpha.com/article/4295753-cfo-survey-skepticism-important-warning-signal)

(Source: OECD)

Lastly, I remind the reader that business spending and consumer sentiment speak primarily to economic activity, not to stock market behavior and the timing of an eventual sell-off. While yield curve inversions, for example, can precede recessions by a comfortable 12 to 18 months, the stock market usually turns sour well before the start of a recession or period of economic deceleration. For reference, the S&P 500 peaked in October of 2007 before crashing, not in March 2009 when GDP fell for the second consecutive quarter (which is generally considered the textbook definition of a recession).
Therefore, given today's challenging environment, hoping for the best but preparing for the worst might be the best approach to investing. I have recently discussed how investors might want to consider multi-asset class diversification, and I plan on adhering to this strategy as we approach the beginning of a potentially turbulent 2020.

Stocks have been on a very choppy ride in the past few months, and the future looks even more uncertain. But both my SRG Base and All-Equities SRG portfolios have been beating the S&P 500 in 2019 while also producing far superior risk-adjusted returns. To find out how I have created a better strategy to growing your money in any economic environment, click here to take advantage of the 14-day free trial today.

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**Disclosure:** I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

**Comments (1)**

**Kayode Omotosho**

You're right. Diversification is a good strategy at this point. Though, a lot of value has been created in the past decade due to improvement in technology and the globalization of talent. Therefore, I will be loath to think the market is too expensive.

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