LPL RESEARCH
WEEKLY MARKET COMMENTARY

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EARNINGS SEASON TAKEAWAYS

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KEY TAKEAWAYS

We consider first quarter earnings season a success based on the upside surprise and resilience of estimates for the rest of this year.

It appears an earnings recession has been averted and better earnings days lie ahead, though trade uncertainty is a huge wild card.

Our base case remains that we will get a trade deal with China early this summer and consensus expectations for S&P 500 earnings growth in 2019 of 3–4% may prove to be conservative.

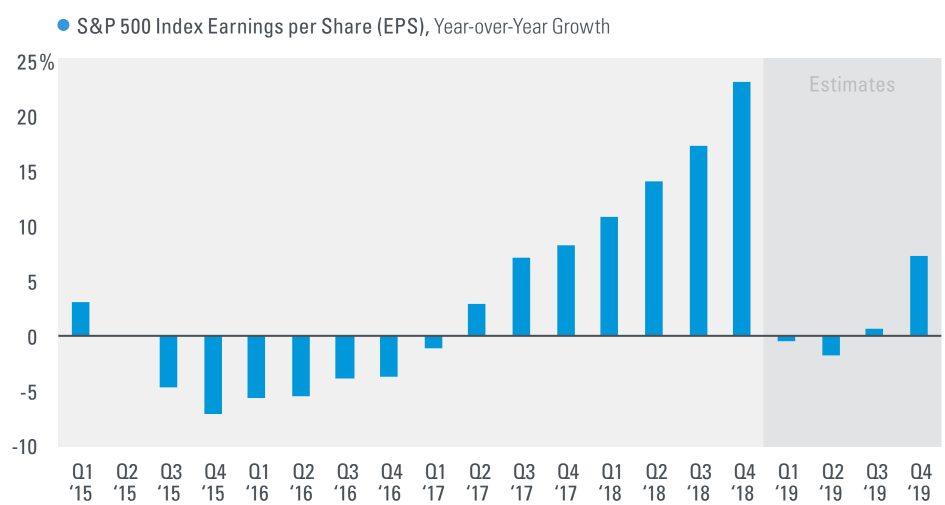
Earnings season delivered as expected. With 92% of results for S&P 500 Index companies in the books, first quarter 2019 earnings are tracking to roughly flat with the prior year [Figure 1]. While flat earnings don't sound impressive, we consider it a victory given consensus estimates were calling for a 4–5% decline when earnings season began (source: FactSet). Here, we recap the numbers and provide some key takeaways from earnings season.

GOOD NUMBERS OVERALL

We consider earnings season a success based on the amount of upside to prior estimates generated by S&P 500 companies despite several headwinds. Some numbers that support our assessment include:

- Companies generated solid upside to prior estimates of about 5% to get overall earnings up to flat. When earnings season began, consensus estimates called for a 4–5% decline in S&P 500 earnings. An upside of this size, which is slightly above the long-term average, is impressive considering persistent trade uncertainty.

1 LOOKS LIKE WE'LL AVERT AN EARNINGS RECESSION



Source: LPL Research, FactSet 05/17/19
Estimates based on FactSet consensus.
All indexes are unmanaged and cannot be invested into directly. Estimates may not develop as predicted.

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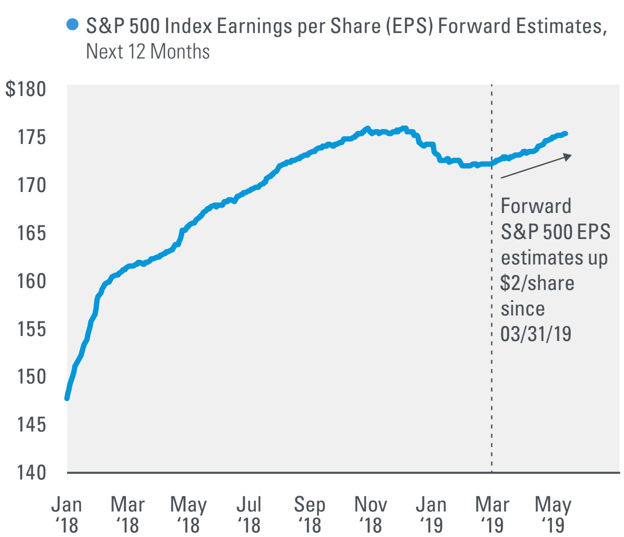
- Currency may have been as much as a two-percentage-point drag on overall earnings growth, suggesting companies have more earnings power than the overall growth number suggests.
- The median stock in the S&P 500 has grown earnings several percentage points faster during the first quarter than the aggregated market-cap-weighted measure. According to data from Credit Suisse, the median S&P 500 company is tracking to a 5.6% earnings gain. A few large companies are having outsized impacts, including Apple (AAPL), whose earnings per share (EPS) dropped 18% from the year-ago quarter.
- Estimates have held up well during earnings season. Since April 15, the 2019 consensus estimate for S&P 500 EPS has risen slightly to $168. We consider that a win given that estimates typically fall during earnings season. Consensus S&P 500 earnings estimates for the next 12 months have increased from $173 to $175 per share since mid-April [Figure 2], reflecting expectations for a ramp-up in growth later this year and into 2020.

2 GOOD ENOUGH GUIDANCE TO SUPPORT ESTIMATES



Source: LPL Research, FactSet 05/17/19

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BEYOND THE NUMBERS

Based on first quarter numbers and the changes to forward estimates, earnings results have been good. Here are some of our key takeaways that go beyond the numbers:

- It looks like an earnings recession will be averted. Even if we have an earnings recession (commonly defined as two consecutive quarters of year-over-year earnings declines), it would be extremely shallow. Although earnings may be flat in the first half of the year, we expect some acceleration in the second half.
- Tariffs are a huge wild card. If the latest round of tariffs remain in place and are followed by another round—meaning that tariffs would be imposed on all U.S. imports from China—then achieving any earnings growth at all this year will be difficult. It is apparent that the latest escalation of trade tensions caught management teams off guard, which means there is probably some downside risk to current estimates in the event of a prolonged impasse (though that is not our base case).
- Slower growth overseas—in the Eurozone and China in particular—has weighed on the results of U.S.-based multinationals. According to FactSet data, earnings growth for companies generating more than half of their revenue within the United States has been 6.2%, compared with a 12.8% earnings decline for companies that generate less than half of their revenue within the United States.
- Operating efficiency has become increasingly important. Companies must consider shifting supply chains away from China as tariffs are imposed. As costs increase, particularly wages, passing along higher tariff costs will become more difficult. This additional potential pressure on profit margins may cap the amount of earnings growth companies can achieve this year.

Our base case still calls for some upside to the 3–4% consensus estimates for S&P 500 earnings growth in 2019. However, hitting our 6–7% forecast published last fall may be a stretch if the

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United States and China are unable to resolve their differences within the next several months. Until then, tariffs could eat away at company profit margins, and business leaders may become more cautious with their capital investment decisions. Lower capital spending means less revenue and profits for corporate America.

CONCLUSION

We consider first quarter earnings season a success based on the upside to prior estimates and resilience of estimates for the rest of this year. It appears an earnings recession has been averted and better days lie ahead for U.S. companies. However, the threat of more tariffs is a huge wild card.

We are hopeful that significant progress can be made on the trade front next month, when President Trump and China's President Xi are expected to meet at the G20 summit in Japan. A prolonged impasse that lasts through the summer would introduce downside risk to our 2019 S&P 500 earnings growth target of 6–7%.

Our base case remains that we will get a trade deal with China early this summer and consensus expectations for 3–4% earnings growth may prove to be conservative. Earnings are hardly booming, but with a continued economic expansion, low inflation, and low interest rates, we see enough earnings growth ahead to push stocks up to our year-end S&P 500 fair value target of 3,000—though it probably won't get there in a straight line. ■

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DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

Forward price to earnings (Forward P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

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