

MARKET STRATEGY VIEWPOINT

Earnings Revisions Should Set a Careful Tone

January 30, 2019

Analysts have been busy reducing their earnings estimates for 2019 and earnings season commentary from key U.S. companies has been somewhat cautious so far.

An easing of broad economic conditions, slowing activity in China, trade issues, and the U.S. government shutdown have been issues raised as potential drags on corporate earnings growth.

Consensus S&P 500 Earnings Estimates Coming Down

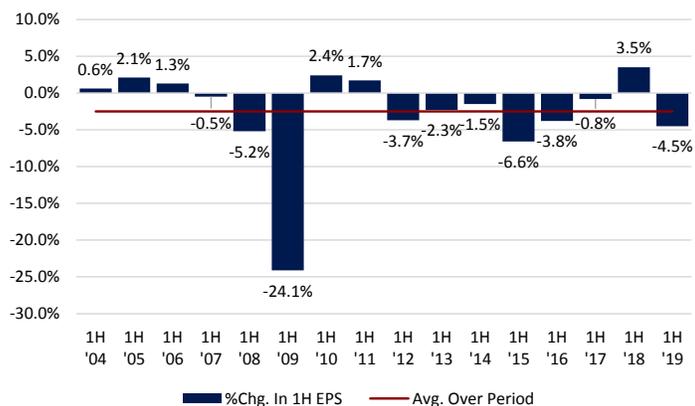
Early 2019 earnings news has been highlighted by a few key companies guiding their earnings targets lower for the year. Investors have stepped somewhat cautiously around names such as Caterpillar, 3M, Intel, and Apple after management guided revenue and/or earnings estimates down. Most have cited broader economic or China-specific uncertainties for their more cautious approach to their forecasts. While the names we mentioned certainly capture headlines, what may be flying a bit under the radar for most is that earnings estimates for S&P 500 Index companies broadly have been falling materially.

According to FactSet Research Systems (an aggregator of earnings estimate data), cuts to earnings estimates for the first half of 2019 have been the most pronounced in four years. On Jan. 18, FactSet indicated the combined earnings growth estimate for Q1 and Q2 2019 had fallen by 4.5%; the steepest drop since the first half of 2015. Only estimate revisions in 1H (first half) 2015, 1H 2008, and 1H 2009 have proven worse than we have seen so far in 2019.

On Jan. 25, FactSet updated the consensus S&P 500 earnings growth estimates to read +0.7% year-over-year for Q1 2019, +2.4% for Q2, +3.1% for Q3, and a bullish +11.1% for Q4. For 2019 in total, FactSet indicated consensus earnings growth now stands at +6.3%, down materially from previous estimates. We are giving due attention to earnings developments as they will likely impact how investors view market conditions this year.

Figure 1: First Half Consensus EPS Estimate Revisions for S&P 500

Source: FactSet Note: Estimate revisions measured Oct 15 to Jan 15. EPS = earnings per share

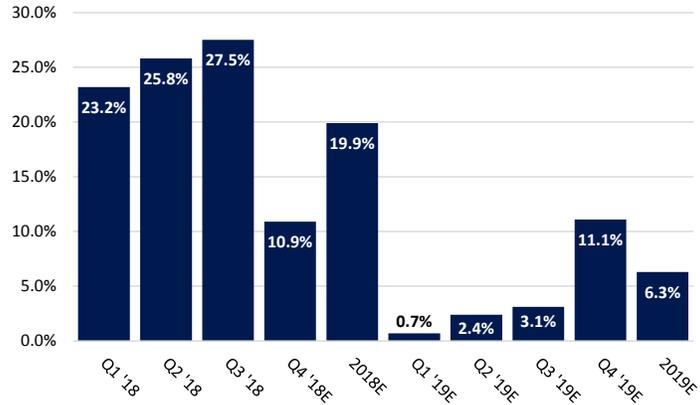


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In our view, the material downshift in EPS growth expected this year is a key reason to be well-disciplined when it comes to choosing the proper equity exposure for 2019.

Figure 2: Year-over-Year EPS Growth - S&P 500 Index

Source: Thomson Reuters; FactSet E = consensus estimates as measured by FactSet



Earnings Estimates May Be Revised Lower Still

While 2019 earnings estimates have been materially curtailed over the last few months, economic data we monitor may indicate analysts could have more work to do to bring down forecasts. For starters, estimates for Q4 2019 seem a bit out of line, which can be typical as analysts hold out hope for a late-year earnings recovery amid the paring of expectations. Eventually, in our view, those Q4 forecasts could fall as well. However, more important than the behavioral aspect of earnings forecasting, what we have witnessed in recent ISM New Orders data may point to further reductions in earnings estimates still to come.

Figure 3 on the next page points to the correlated relationship between S&P 500 forecasted Earnings Before Interest and Taxes (EBIT) and ISM Manufacturing and Non-Manufacturing New Orders survey data. The correlation between the two data sets is .715 over the time horizon presented. If history is any guide, the recent erosion in ISM New Orders (see 3-month moving average) may be a precursor to future estimate reductions. Indeed, the chart seems to indicate that ISM New Orders leads a change in EBIT estimates, which stands to reason.

Granted there are low interest rate and low tax rate benefits to final earnings-per-share (EPS) numbers reported by S&P 500 constituents that are not fully captured in this chart. The correlation between EPS estimates (including interest expense and taxes) over the time horizon presented is .663; indicating a positive relationship. However, the underlying earnings power (EBIT) of S&P 500 companies, perhaps influenced by the directional change in New Orders, is something in which investors may want to take note.

Historically ISM New Orders has led a change in EBIT estimates or a measure in the underlying earnings power of constituent companies.

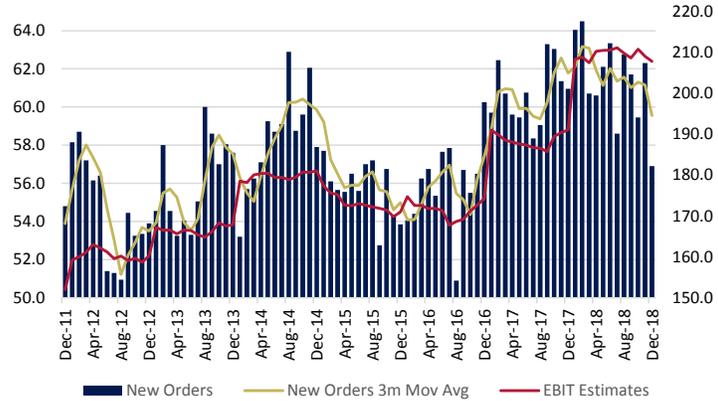
EBIT = Earnings Before Interest and Taxes

The recent drop in New Orders and the potential for further weakening (given slowing economic conditions) may help prompt analysts to further modify their projections.

In terms of Figure 3, the EBIT estimate (red line) could fall to more closely mirror the trajectory of the ISM 3-month moving average (gold line).

Figure 3: ISM Manufacturing & Non-manuf. New Orders vs. S&P 500 EBIT Estimates

Source: Institute for Supply Mgmt (ISM); Bloomberg - EBIT estimates based on Bloomberg consensus



What Does This Mean?

In our view, the inputs from New Orders data and recent downgrades in earnings projections seem to fortify a note of caution for equity markets in 2019. While these numbers alone may not spell a bad year for stocks they may be foundational in how investors choose to think about risk management in their multi-asset portfolios? Earnings are indeed important to how investors view the likely performance of stocks. As such, the slowing or change in the earnings trajectory may cause investors to take less risk in equity portfolios and hold down their return expectations this year.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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