Market Bulletin

February 4, 2019

4Q18 US Earnings: A fork in the road

In brief

- After a volatile December driven by concerns of rising rates, peak economic and earnings growth, and geopolitical tensions, markets have bounced back.
- 4Q18 profit growth is expected to slow relative to what was seen during the rest of 2018 as a result of lower margins, higher input costs, a stronger dollar, and slower global growth.
- The energy, financial, materials and healthcare sectors are expected to deliver strong earnings growth, while the technology and communication services seem to be coming under pressure.
- Small cap equities look most vulnerable to the rise in corporate debt; in the large cap space, certain sectors are more vulnerable than others.
- We maintain a preference for cyclical value – these are sectors that provide income above that of the broad index, which could help enhance returns and dampen volatility in the year ahead.

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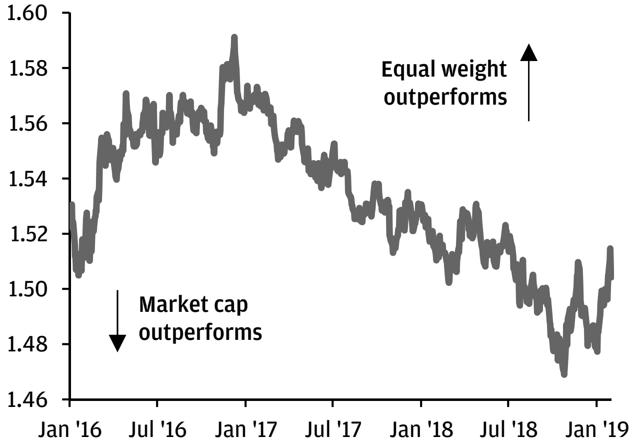
A December (and January) to remember

As 2018 came to a close, the risk that a late cycle U.S. economy would be short-circuited due to tighter monetary policy and trade uncertainty began to build. For investors, this translated into a concern that 2019 earnings growth would slow more than expected. Market volatility ensued and the S&P 500 dropped -19.8%, narrowly avoiding what would technically be considered a bear market.

Since then, and even despite the U.S. government being shut down for the better part of January, markets have come roaring back, with the S&P 500 up 15.2% from its December lows and 8.0% year-to-date. Even the average stock has been acting better, as evidenced by the outperformance of the equal-weighted index relative to the market cap weighted benchmark **(Exhibit 1)**.

EXHIBIT 1: THE AVERAGE STOCK HAS CONTRIBUTED TO THE RECENT BOUNCE

S&P 500 Equal-Weighted Index relative to the S&P 500 Market Cap Weighted Index, price return



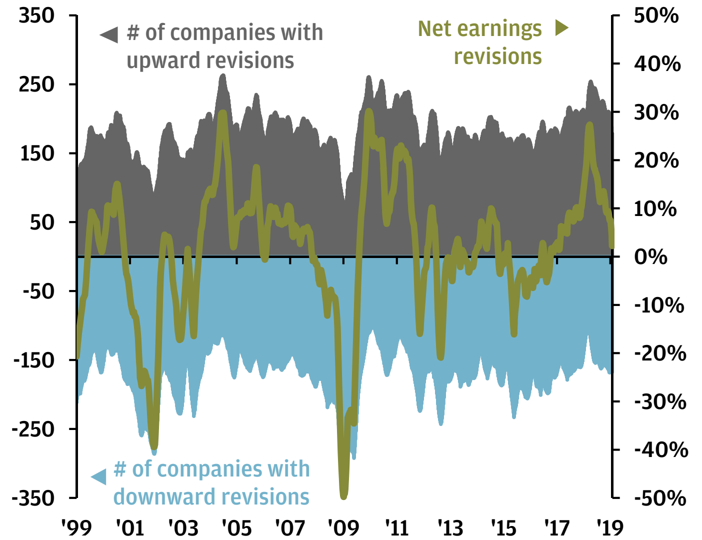
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of January 31, 2019.

While the stock market has bounced back nicely, perhaps some of this caution was warranted - as of 3Q18, S&P 500 had double-digit earnings growth in 8 out of the prior 9 quarters, the best run since the early 2000's and quite uncharacteristic for where we are in the cycle. Furthermore, this robust streak of profit growth was first driven by a bounce-back from the 2014-2016 energy and dollar-related malaise, and then by a reduction in the corporate tax rate that we estimate added around 7 percentage points to earnings growth last year.

While we acknowledge that earnings growth will decelerate in 2019, decent momentum seems to have been maintained into the final quarter of last year. With 56.8% of companies reporting, our current estimate for 4Q18 earnings per share is $38.38. As of last Friday, 71% of companies had beaten earnings estimates, but only 49% of companies were beating sales estimates, as a stronger dollar and softer growth put downward pressure on the top line. Adding to this uncertainty are signs that profit margins are coming under pressure, with S&P 500 margins currently tracking nearly a full percentage point lower than their 3Q18 level. 2019 consensus estimates have declined notably since the end of September, but with net earnings revisions approaching negative territory, the risks for next year remain tilted to the downside **(Exhibit 2)**.

EXHIBIT 2: EARNINGS REVISIONS HAVE ROLLED OVER

Number of companies with upwards and downward earnings revisions



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Revisions are based on the current unreported year. Net earnings revisions are based on the current unreported year and are calculated as: (# of companies with upward earnings revisions - # of companies with downwards earnings revisions) / # of total companies. Data are as of January 31, 2019.

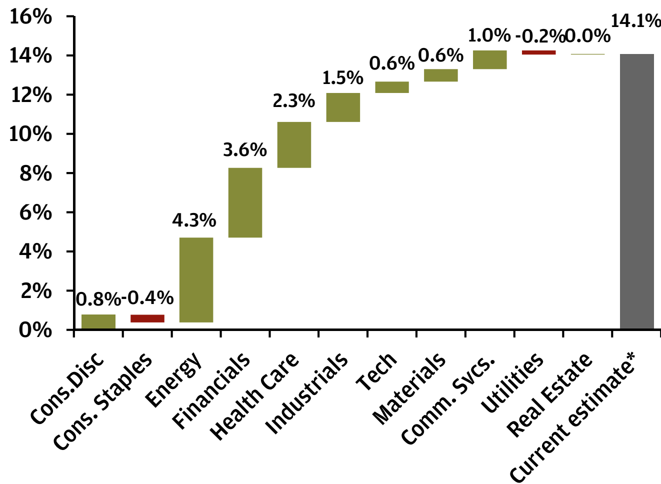
Higher costs + slower growth = lower earnings

Diving into the details of the current earnings season, the distribution of profit growth has shifted relative to what was seen during the first three quarters of 2018, with new sector leaders beginning to emerge. The energy and financial sectors, two areas which had seen robust earnings growth for the better part of 2018, will be joined by the materials and healthcare sectors as the primary drivers of 4Q18 profits. On the other hand, the information technology, consumer discretionary and communication services sectors look set to see earnings growth slow to a single digit pace after seeing +18% growth in the third quarter. Finally,

consumer staples and utilities companies look set to report their first negative growth rates since tax reform was enacted **(Exhibit 3)**.

EXHIBIT 3: ENERGY AND FINANCIALS WILL DRIVE GROWTH THIS QUARTER

Contribution to 4Q18 operating earnings year-over-year growth



Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
*4Q18 earnings are calculated using actual earnings for 56.8% of S&P 500 market cap and earnings estimates for the remaining companies. Percentages may not sum due to rounding. Data are as of January 31, 2019.

For energy companies, despite a peak-to-trough decline in oil prices of -41.8% in 4Q18, the average oil price during the quarter was still 6.8% higher than seen in 4Q17. This, combined with strong demand and still easy comparisons, should lead the sector to deliver another quarter of strong growth. We continue to see strong capital discipline and balance sheet management in the sector, with companies expressing caution about new investments (particularly related to exploration and production) and instead focusing on reducing debt.

Financials, particularly banks, have benefited from improving net interest margins growth and relatively strong lending and deposit activity, but have seen mixed results in investment banking. Furthermore, capital markets desks and asset management businesses suffered due to the market turmoil seen throughout the quarter, thereby dragging on broader financial sector profitability.

Consumer discretionary and consumer staples companies are facing more cost headwinds than any of the other sectors. In addition to rising wages, higher raw material costs, and higher interest rates leading margins to compress, these sectors are also seeing headwinds from increased transportation and freight costs. Furthermore, because these companies participate in relatively competitive markets, they lack pricing power which would otherwise allow them to offset at least some of these costs.

Finally, slower global growth coupled with a stronger U.S. dollar has weighed on the earnings of technology and communication services firms, as each of these sectors generates a significant amount of their revenue from abroad. Additionally, strong results at the end of 2017 has led to particularly challenging year-over-year comparisons.

Profits, margins and debt

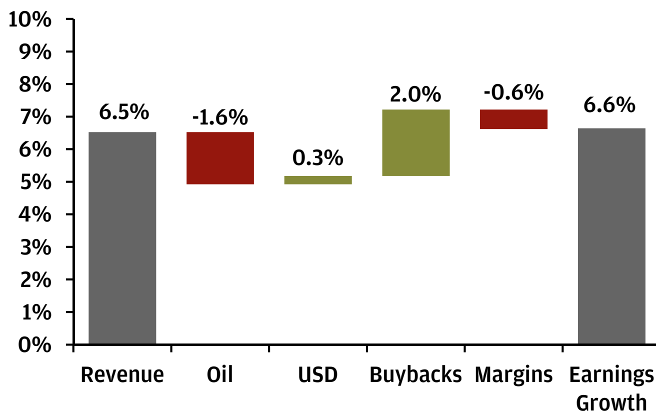
Double-digit earnings growth should be realized in 4Q, but questions remain about 2019. Our top-down earnings forecast, which is driven by econometric models that try to predict both sales and margins, has been pointing to 2019 earnings growth of around 6-7% since late last year **(Exhibit 4)**. Bottom-up, consensus estimates have since fallen in line with what our model has been forecasting for some time, making this less of a concern than would otherwise be the case. However, the significant decline in margins during the fourth quarter suggests that perhaps we have underestimated the impact of higher rates, tighter labor markets, and rising raw material costs in the coming year.

With the Fed now signaling a more dovish trajectory for monetary policy this year and gradual progress being made on trade, we see room for moderate economic and earnings growth in 2019. Beneath the surface, however, this slowdown in profitability could have a direct impact on the ability for companies to service a debt load that has grown steadily since the

financial crisis. Nonfinancial corporate debt has eclipsed the peak seen just before the financial crisis, now sitting at 46.4% of GDP, and risks stemming from the plethora of BBB-rated securities has become a regular topic of conversation as we meet with clients across the country. While we acknowledge that debt pressures will begin to build as profitability slows, it is important to remember that not all companies are created equal **(Exhibit 5)**.

EXHIBIT 4: EARNINGS GROWTH SHOULD MODERATE IN 2019

Contribution to 2019 year-over-year earnings growth

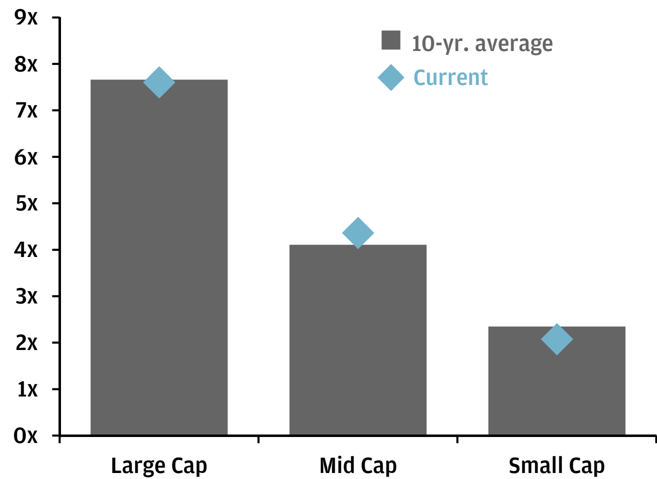


Source: Compustat, Federal Reserve System, NYMEX, Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Revenue and earnings growth estimates are based on J.P. Morgan Asset Management estimates. Oil and U.S. dollar contribution are based on regression analysis. Data are as of January 31, 2019.

In aggregate, the interest coverage ratio of the S&P 500 - earnings before interest and taxes (EBIT) divided by interest costs - does not seem to be signaling that problems are lurking right around the corner. Diving in deeper, however, there are clearly parts of the market that are more exposed to this issue than others. As of 3Q18, 35% of companies in the Russell 2000 index had negative earnings, suggesting that small caps are at greatest risk of not being able to service their debts. Large cap stocks, on the other hand, appear relatively well positioned to continue making timely interest payments.

EXHIBIT 5: INTEREST COVERAGE RATIO BY MARKET CAP

EBIT/interest expense paid on debt, last twelve months

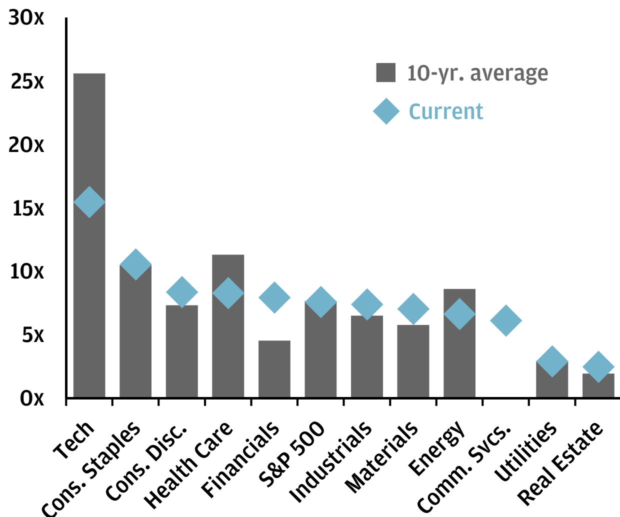


Source: Standard & Poor's, FTSE Russell, FactSet, J.P. Morgan Asset Management.
Large cap is represented by the S&P 500 index, mid cap is represented by the Russell Midcap index and small cap is represented by the Russell 2000 index. Data are as of January 31, 2019.

Taking a look at interest coverage on a sector basis also yields some interesting results **(Exhibit 6)**. Cash-rich technology firms currently have interest coverage ratios below their long-term average, although this seems to be driven by an increase in the nominal value of debt issued by these companies since the financial crisis, rather than by a decline in profitability. On the other hand, sectors like consumer staples, utilities, and healthcare look to be at risk if earnings growth slows at the same time that interest rates rise. We do not believe that a spike in defaults is imminent, but are reminded that some companies have been more productive with the debt they have issued during the course of this cycle, focusing on reinvestment opportunities rather than simply buying back shares and paying larger dividends. This story will continue to play out as we work our way through 2019.

EXHIBIT 6: INTEREST COVERAGE RATIO BY SECTOR

EBIT/interest expense paid on debt, last twelve months



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Communication services average is not included due to lack of comparability post sector reshuffle. Data are as of January 31, 2019.

Investment implications

A world of margin compression, slowing earnings growth, and rising interest rates is not ideal for the equity market. Furthermore, the bounce back we have seen since December has brought year-to-date returns in line with what many expected would materialize over the course of 2019. The reduction in the S&P 500’s forward P/E ratio to below its long-term average has provided the equity market with a bit more wiggle room than was previously the case, and a Federal Reserve that moves slowly, coupled with resolution on trade and moderate economic growth, could lead markets to grind modestly higher from here. However, any further upside will likely be accompanied by volatility that is more like what we saw in 2018, rather than 2017 - in other words, the ride will be bumpy.

As a result, we maintain our preference for cyclicals over defensives and value over growth, with financials, energy, industrials, and materials looking particularly attractive. Furthermore, we are inclined to focus more on large cap names rather than their small cap brethren. This preference for large cap, cyclical value should allow investors to capture the majority of the upside in markets between now and the end of the year, with above-average dividend yields providing insulation for equity portfolios during periods of heightened volatility. At the end of the day, however, investors remain focused on reasons to sell, rather than reasons to buy; until this sentiment turns, markets will remain choppy.

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