Market Bulletin

April 27, 2018

1Q18 earnings update: A tailwind from taxes

In brief

- Volatility returned in the first quarter of 2018 as markets struggled to find their footing amidst concerns of inflation, softening economic data and political uncertainty.
- The 1Q18 earnings season is booming, with the number of companies beating earnings on pace for a new record and the margin by which they are beating, measured by the earnings surprise, also on a record pace.
- Cyclical sectors such as financials, technology, energy and industrials should have a strong quarter on the back of tax reform, strong global growth, a weaker dollar, rising oil prices and expanding margins.
- While 2018 will see a one-time surge in earnings, in part due to tax reform, investors should curb their enthusiasm for earnings in 2019 as rising rates and wages could begin to put downward pressure on margins.

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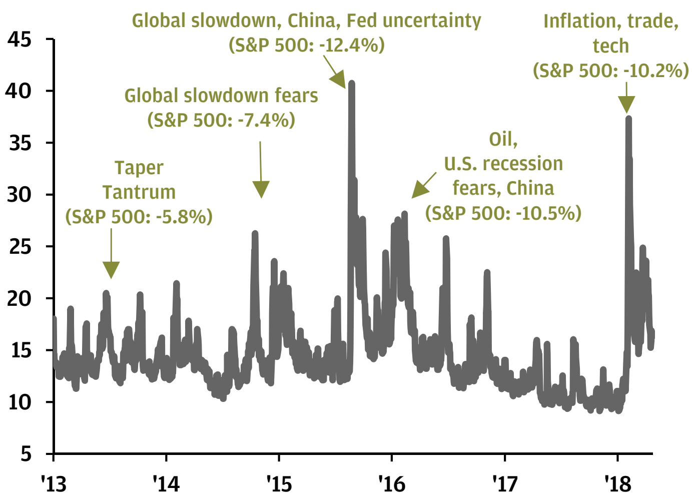
Volatility shows up to the party

After an abnormally calm market environment in 2017, the first quarter of this year saw equity volatility come roaring back. For the better part of this business cycle, investors have believed that deflation was a bigger risk than inflation; however, the pendulum began to swing the other way in January, as 10-year U.S. Treasury yields moved higher and investors priced in a third Fed rate hike this year. Against this backdrop, the VIX spiked to a level of 37 and the S&P 500 fell -10.2% from peak to trough – the largest correction seen since the beginning of 2016 **(Exhibit 1)**.

Since this risk-off episode, the stock market has been contending with a number of cross currents. Although U.S. economic growth softened a bit in the first quarter of this year, recent indicators point to a rebound in consumption and steady

EXHIBIT 1: VOLATILITY RETURNED IN THE FIRST QUARTER
CBOE Volatility Index (VIX), index level



Source: CBOE, FactSet, J.P. Morgan Asset Management.
Stock market returns are based on calendar year peak to trough declines experienced during VIX spike. Data are as of 4/24/2018.

manufacturing activity. This, coupled with U.S. fiscal stimulus, should lead growth to firm over the remainder of the year. Meanwhile, politics remain a source of uncertainty due to geopolitical tensions, uncertainty around regulation, and the threat of a trade war rising and falling on a daily basis. As such, investors have found themselves in an environment characterized by political headwinds and fundamental tailwinds, leaving the market struggling to find direction.

Over time, stock prices follow earnings, and despite some of the uncertainties mentioned above, the outlook for 2018 corporate profits remains robust. 2018 earnings estimates have been revised 11.1% higher since the end of 2017, as analysts continue to determine exactly how the new tax law will affect corporate profitability going forward. Furthermore, 1Q18 earnings season is off to a good start, and net earnings revisions remain in positive territory despite some recent cooling in corporate guidance. While we would not be surprised to see headwinds to profitability materialize down the road, the outlook for 2018 earnings continues to support the notion that equity markets will grind higher over the remainder of the year.

2018: The year of tax reform

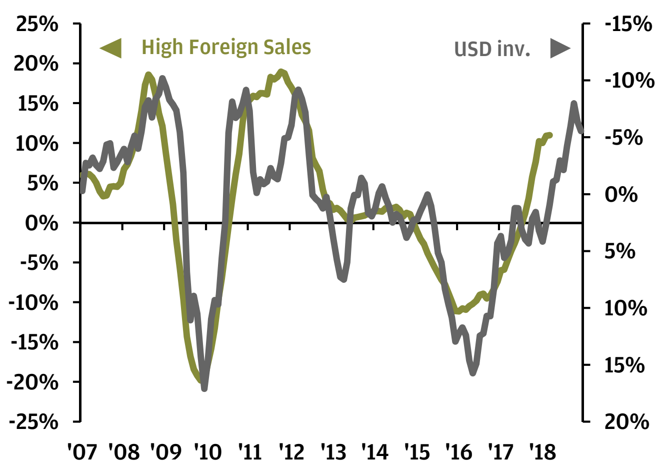
The first quarter earnings season is off to the races; with 250 companies or about 62% of market cap having reported, 82% of companies are beating earnings estimates and 66% of companies are beating sales estimates. Additionally, earnings surprises are sitting at their highest level since we began collecting the data in 2Q12 due to strong earnings beats in the financial, technology and industrial sectors; more broadly, these above-average surprises may be a function of analysts failing to price in the full benefit coming from the new tax law. Based on reported earnings and analyst estimates, operating earnings appear to have grown by nearly 29% over the past year as profit margins continue to rise and revenue growth remains well above the current business cycle average. We estimate that about 8 percentage points of this growth are a function of tax reform; the rest is organic, driven by strong global growth, higher oil prices, a weaker dollar and expenses which remain in check.

Strong earnings results this quarter have been driven by many of the usual suspects. Financials kicked things off on a positive note, with capital markets businesses benefitting from higher equity volatility in the first quarter and tax reform pushing effective tax rates lower. Rising interest rates provided a boost to net interest margins, but sluggish loan growth and mortgage origination weighed on profits; this dynamic should be watched closely for any further signs of deterioration, as a significant slowdown in loan growth would suggest that the U.S. economy may not be as healthy as many believe.

The impact of stronger global growth and a weaker U.S. dollar remain consistent themes across a variety of sectors **(Exhibit 2)**. Technology in particular has benefitted from these trends, and with regulatory concerns bubbling up towards the end of the first quarter, a robust earnings season should provide a welcome reminder that profitability in the technology sector is alive and well. Additionally, as technology companies continue reporting, it will be particularly important to look for any signals as to when these companies plan to start repatriating foreign profits. That said, we do not expect technology companies will see a tremendous benefit from tax reform, as the sector had one of the lowest effective tax rates prior to the new law being passed.

EXHIBIT 2: A WEAKER DOLLAR ACTS AS A TAILWIND FOR SECTORS WITH HIGH FOREIGN SALES

y/y change in sales, y/y change in nominal trade weighted dollar



Source: Standard & Poor's, Federal Reserve System, FactSet, J.P. Morgan Asset Management. High foreign sales is the average of the year-over-year % change in last twelve months sales of the following S&P 500 sectors: information technology, materials, energy, industrials. U.S. dollar has a 9 month lag. Data are as of 4/24/2018.

The industrial sector also looks set to benefit from global growth and currency tailwinds, as healthy demand supports a further increase in sales volumes. However, if commodity prices continue moving higher, some of these companies may see downward pressure on margins due to higher input costs. On the other hand, profits in the consumer staples sector are already under pressure; rising costs and increasing competition have weighed on profits and sales, and the majority of the revenue growth seen in the first quarter has stemmed from a weaker U.S. dollar.

Energy earnings should continue to rebound as global oil markets come back into balance and prices remain higher than they were a year ago. The most recent projections from the Energy Information Administration (EIA) suggest that global oil demand will finally exceed supply by the first quarter of 2019; absent an increase in production, global oil prices should act as a tailwind for energy profits over the remainder of this year. However, while the fundamental story in the energy sector continues to improve, valuations remain above their long-term average, and investors have been reluctant to return to the sector due to skepticism that oil prices will return to pre-correction levels.

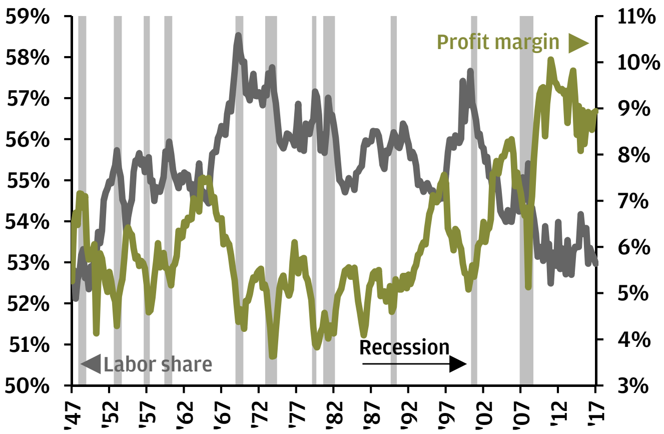
2018 looks set to be a good year for corporate profits, but investors should be cognizant of some of the risks going forward. The U.S. economy is beyond full employment, and 3% real economic growth this year could push the unemployment rate down to a level of 3.5%. A further decline in the unemployment rate should put upward pressure on wages, while simultaneously leading the Federal Reserve to continue lifting interest rates. Against this backdrop of rising wages and higher yields, corporate profit margins will begin to come under pressure, as shown in **Exhibit 3**. While we believe that profit margins revert to the trend, rather than the mean, this still implies a contraction in margins from current levels.

To infinity and beyond?

The robust rate of profit growth seen in 2017 and 2018 thus far will not continue forever, and in 2019 we expect that earnings growth will decelerate to a pace which is more consistent with where we are in the business cycle. However, it is important to note that deceleration is not the same as deterioration – while we expect profit growth will slow next year, we do not believe it will turn negative.

EXHIBIT 3: RISING WAGES ARE A RISK TO PROFIT MARGINS

Labor share of income and profit margins



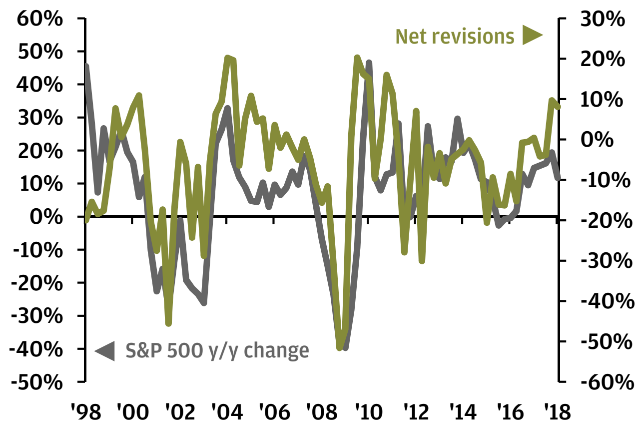
Source: BEA, FactSet, J.P. Morgan Asset Management. Labor share calculated as employee compensation as a percentage of nominal GDP. Profit margins are after-tax corporate profits with inventory & valuation adjustment as a percentage of nominal GDP. Data are as of 4/24/2018.

Many investors are surprised at the way markets have reacted to the strong earnings season thus far, often times failing to reward companies that beat analyst estimates. It seems that the market understands that the robust pace of earnings growth seen this year is a one-hit-wonder, and will not continue into 2019. This one-time surge is like going to see your favorite band in concert, and having them play all the songs you know right at the beginning – chances are you'll still enjoy the rest of the show, but it would be difficult to ignore the thought that perhaps you will not. Similarly, with earnings in a normal year growing by about 5%, the S&P 500 is giving investors 5 years of earnings growth in a single year – there is still room for earnings growth, but not at the current pace.

As shown in **Exhibit 4** below, net earnings revisions remain in positive territory, but have begun to roll over. With consensus forecasting S&P 500 operating earnings of $175 per share in 2019 – an implied growth rate of 10% assuming 2018 profits shake out in line with current estimates of $159 – it seems likely that at some point net revisions will turn negative. Furthermore, by April 1st earnings estimates for the current year tend to be very accurate, whereas earnings estimates for the next year tend to miss on average by about 9%, furthering the argument to moderate expectations for 2019 earnings.

EXHIBIT 4: NET REVISIONS HAVE ROLLED OVER BUT REMAIN POSITIVE

S&P 500 y/y change, net earnings revisions



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Net earnings revisions are calculated based on the number of companies with upward earnings revisions in the current reporting year subtracted by the number of companies with downward revisions in the current reporting year. This is divided by the number of companies in the index. Data are as of 4/24/2018.

Investment Implications

Perhaps unsurprisingly, the strong pace of earnings growth this year, coupled with the rollover in net revisions, should coincide with a slower pace of equity market returns going forward. Furthermore, when this dynamic is considered alongside a continued rise in rates – and the downward pressure that these higher rates will apply to price-to-earnings multiples – navigating equity markets will be more challenging in the years ahead. There is room for this bull market to keep running, but we are closer to then end than we are to the beginning. As a result, investors should temper their return expectations and increase their focus on the fundamentals, as earnings look set to be the main driver of returns.

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