Market Bulletin

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David M. Lebovitz
Global Market Strategist

Tyler J. Voigt
Market Analyst

3Q18 US Earnings: The risks begin to crystallize

In brief

- After a relatively quiet summer, volatility spiked in October as investors worried about rising rates, peak economic and earnings growth and geopolitical tensions.
- The earnings season is off to another strong start, with health care, technology, and energy companies continuing to post impressive numbers. However, short- and long-term risks are beginning to materialize.
- While most companies have provided only anecdotal evidence, our work suggests that tariffs could hit 2019 earnings by $5-$7 per share.
- Cyclical value sectors that provide income and a more balanced total return can help enhance returns and dampen volatility. This can be achieved through a blend of both active and passive management.

Markets on a rollercoaster

Volatility has made a triumphant return, with the S&P 500 falling -7.2% since the end of September. This has been driven by a sharp move in interest rates, as the 10 year U.S. Treasury yield has risen 8 bps over this same time period, along with concerns about peak economic and profit growth. While we maintain our view that in the long-run the level of rates is what matters for equity performance, in the short-term, pace and magnitude matter much more. The past few weeks have served as a reminder of that.

With the 3Q18 earnings season underway, many investors are expecting that a string of strong earnings reports may alleviate some of the market's recent indigestion. While we believe that the current earnings season may provide a bit of relief, it will also bring a variety of risks into focus. To start, those sectors which derive a greater share of their revenues from outside the U.S. have begun to feel the impact of a U.S. dollar that has strengthened over the course of this year. Looking ahead to 2019, earnings growth looks set to decelerate as profit margins come under pressure from rising rates and higher wages, and the potential for an escalation in trade tensions to further undermine profitability remains a risk.

Earnings have acted as a safety net for the stock market this year, providing support when equities have begun to wobble. However, this safety net is beginning to fray, suggesting the market may be more exposed to economic and political risks in the year to come. However, we still see room for equities to climb higher – since 1945, the S&P 500 has risen by an average of 23% during the final twelve months of a bull market. It may be challenging to generate returns of this magnitude as rising rates will limit multiple expansion, but barring significant multiple contraction, mid-single digit returns still seem like a reasonable expectation for the year ahead.

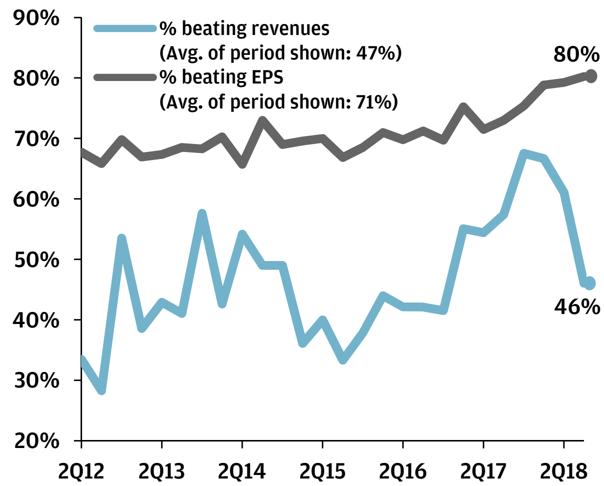
Don't forget about the dollar

This earnings season should continue to reflect many of the themes that have been present in prior quarters. With 55.8% of companies reporting, our current estimate for S&P 500 3Q18 profits stands at $40.58, which implies a 29.5% growth rate from a year earlier. Of the companies that have reported, 80% are beating earnings estimates, but only 46% are beating sales estimates; while this downshift in sales beats is notable, it is actually in line with the average seen since 2012. Finally, profit margins appear to have risen to 12.1% in 3Q18 - this represents a 2.0%-pt increase from a year ago, and the highest level of profit margins since 1990.

In general, companies continue to benefit from lower tax rates, above-trend economic growth, a moderate rise in wages and manageable interest rates. At the sector level, results from energy, health care, and technology companies are expected to be particularly good. Energy companies are benefitting from oil prices which are 45.0% higher than a year ago, and despite an uptick in investment spending over the past few quarters, have shown restraint when it comes to production. However, with key oil producers currently standing at the epicenter of a slew of geopolitical risks, it will be important to keep an eye on how oil prices respond.

EXHIBIT 1: EARNINGS BEATS HAVE REMAINED ELEVATED WHILE REVENUE BEATS HAVE COME BACK TO AVERAGE

% of S&P 500 companies beating earnings and revenue estimates

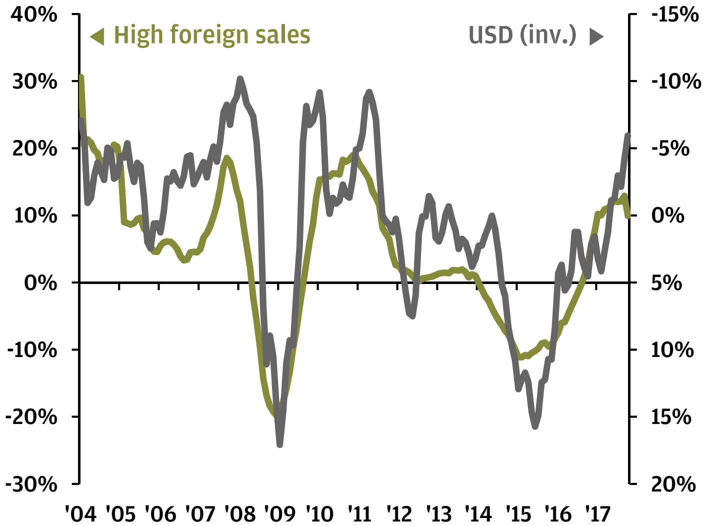


Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. 3Q18 earnings and revenue beats are based on 55.8% of the market cap having reported. Data are as of October 26, 2018.

Heath care earnings have also been solid due to increased demand for innovative technologies and therapies, as well as robust drug pipelines. However, many of these companies have a large international presence, and as a result have begun to feel the impact of a strong dollar. Technology names as well have seen revenues under pressure due to dollar strength, but continue to benefit from an increase in technology-related capital spending. That said, the dollar is only up 5.0% from a year prior, and above-trend global growth has remained a key support for tech sector earnings.

EXHIBIT 2: A STRONGER DOLLAR WILL BE A HEADWIND FOR PROFITS IN 3Q18

Year-over-year % change in sales and U.S. dollar broad currencies index



Source: Standard & Poor's, Federal Reserve, FactSet, J.P. Morgan Asset Management. High foreign sales is the average of the year-over-year % change in sales of the following S&P 500 sectors: information technology, materials, energy, industrials. The U.S. dollar has a 9 month lag and is represented by the Nominal Trade-Weighted U.S. Dollar: Broad Currencies Index. Data are as of October 26, 2018.

Financial companies in aggregate should benefit from easy year-over-year comparisons due to the negative impact of the 2017 hurricanes on insurance company bottom lines. That said, initial reports suggest capital market activity was a bit soft in 3Q, and loan growth has begun to slow due to higher interest rates. Profits in the consumer staples sector appear to have contracted due to higher commodity prices and rising input costs, as below-average margins make absorbing these price increases more difficult.

The bottom line is that after a number of stellar quarters, risks to earnings are beginning to materialize, and these risks are of both the short-term and long-term variety. The dollar may remain as a near-term headwind to profit growth if growth and interest rate differentials do not begin to narrow, while looking out a bit further, rising wages and higher interest rates both pose a risk to margins. Finally, tariffs are the icing on the cake – the risk here is harder to quantify, but if the worst case scenario does materialize it could put a significant dent in corporate profits.

Margin risks

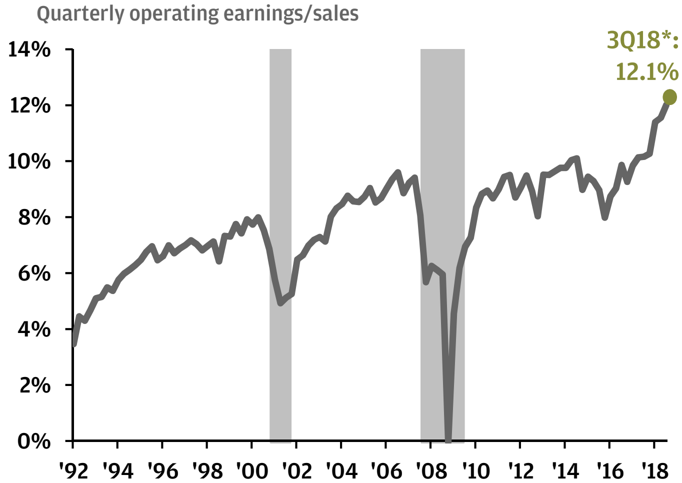
Earnings growth should remain solid through the remainder of this year as tax reform continues to provide a meaningful benefit to the bottom line. However, these tax related benefits will disappear in 2019, a development which will likely coincide with the Federal Reserve raising rates into restrictive territory and wage growth accelerating. This dynamic will put profit margins under pressure, undermining a key driver of earnings this cycle.

The model we use to forecast margins has a number of inputs, including average hourly earnings, investment spending, and multiple variables that capture changes in prices. Using data from the past 25 years, the model implies that a 1% increase in average hourly earnings should cause margins to compress by approximately 35 basis points. When this is taken into account alongside a backdrop of higher input costs and higher interest rates, margins look set to decline next year. That said, we believe that margins revert to the trend, rather than the mean - in other words, we do not expect profit margins to collapse, but simply retreat from their current level.

That said, there are other risks to profits, namely those that stem from tariffs. Companies have begun to focus on this in their 3Q18 announcements, with about a third of companies that have reported mentioning “trade” or “tariffs” on their conference calls. Data on the international share of S&P 500 revenues provides a breakdown by region, which can help us quantify the potential impact. To start, Asia accounts for about 8.3% of overall S&P 500 sales. By combining this information with data from the IMF on China’s share of GDP in Asia broadly, one can approximate the share of revenues coming from China (4.7%) and determine the impact on sales that announced and potential tariffs could have. Combining this information with our existing estimates for revenues and margins, it appears that if tariffs are applied to all $500bn of Chinese imports – and the Chinese retaliate in kind – S&P 500 earnings per share could be between $5 and $7 lower than would otherwise be the case. Even when tariffs are excluded, our model still suggests that profits and profit growth will be weaker than consensus currently expects. The outlook for earnings is becoming more challenging.

EXHIBIT 3: MARGINS ARE AT RISK OF COMING UNDER PRESSURE DUE TO A NUMBER OF FACTORS

Quarterly operating earnings/sales



Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. *3Q18 earnings are calculated using actual earnings for 55.8% of S&P 500 market cap and earnings estimates for the remaining companies. Data are as of October 26, 2018.

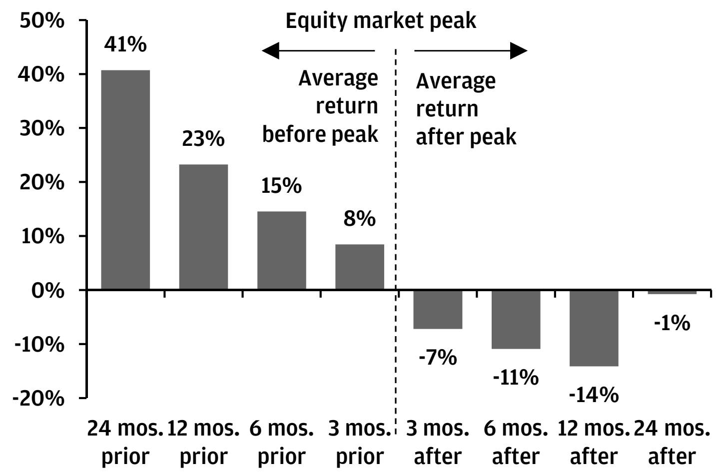
The road ahead

So where does this leave us? We expect that earnings growth will be the key driver of returns going forward, but also that earnings will come under pressure next year. Multiples will likely remain contained until the Fed begins to signal that it is done hiking rates, a development that best case is at least 9-12 months away. As a result, equity returns could be pressured in 2019, but we still see opportunities for investors.

First, as mentioned earlier, late cycle market returns tend to be fairly robust, with the S&P 500 rising an average of 23% in the final 12 months of every bull market since 1945. This makes the opportunity cost of being out of the market at the end of a bull run quite significant. We appreciate that investors may be nervous, and hesitant to maintain the risk-on approach that has dominated portfolios for the past few years, but we do not think it is time to get out of stocks.

EXHIBIT 4: HISTORICALLY, GETTING OUT OF THE MARKET TOO EARLY HAS COST INVESTORS

S&P 500 total return index 1945-2017



Source: Robert Shiller, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Chart is based on return data from 11 bear markets since 1945. A bear market is defined as a decline of 20% or more in the S&P 500 benchmark. Monthly total return data from the S&P Shiller Composite is used from 1945 to 1970. From 1970 to present, return data is from the S&P 500 total return index. Data are as of October 26, 2018.

Rather, we believe investors should focus more on income as a source of total return. It seems premature to fully rotate into the more defensive sectors of the market, but we do have a preference for value over growth. Within the value space, however, we prefer the more cyclical sectors like financials, energy, industrials and materials – these sectors have more attractive dividend yields than sectors like technology and consumer discretionary, but should not be as sensitive to changes in interest rates as utilities and consumer staples.

Finally, how you access these returns will matter. Active management has had a tough run over the course of this expansion, but when we look at the historical record, there is a clear cyclicality when it comes to the outperformance of stock pickers. Quantitative easing, historically low interest rates, and uneven global growth have created a challenging environment for active managers, but these forces are finally beginning to wane and the clouds are beginning to break. As the end of the cycle approaches, it will not be a question of active or passive, but rather how the two can be used in conjunction to create a smoother ride for investors.

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