

Market Bulletin

October 29, 2018

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.



David M. Lebovitz
Global Market Strategist



Tyler J. Voigt
Market Analyst

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.

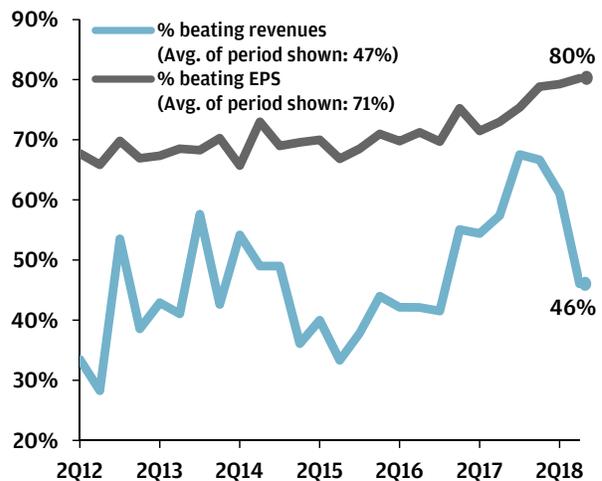
Don't forget about the dollar

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

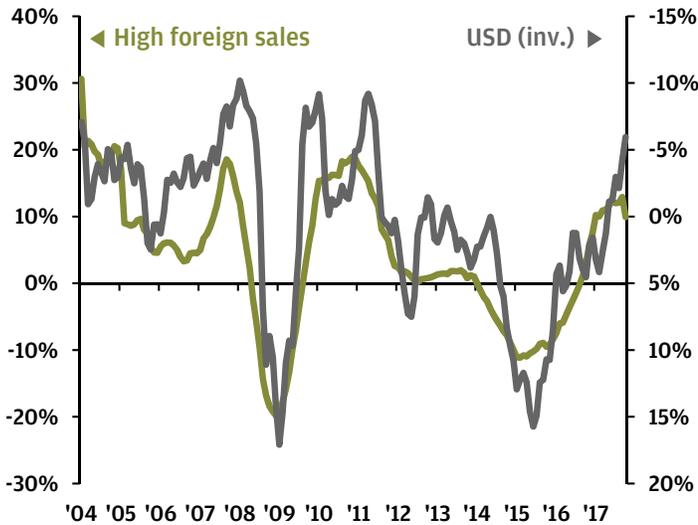


Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. 3Q18 earnings and revenue beats are based on 55.8% of the market cap having reported. Data are as of October 26, 2018.

Health 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

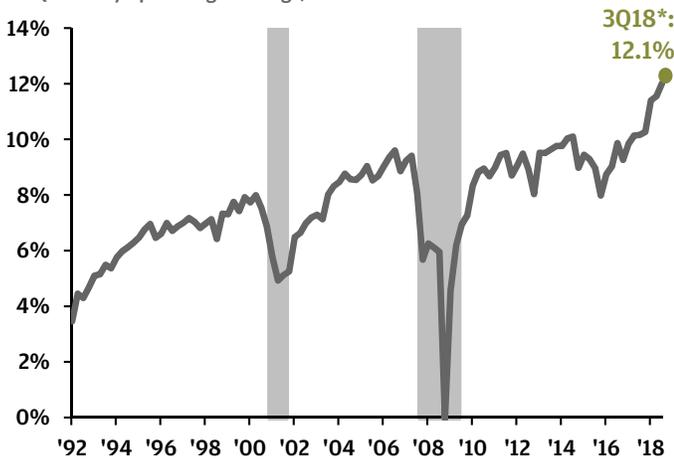
Earnings growth should remain solid through the remainder of this year as tax reform continues to provide a meaningful benefit to the bottom line. However, these tax related benefits will disappear in 2019, a development which will likely coincide with the Federal Reserve raising rates into restrictive 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.

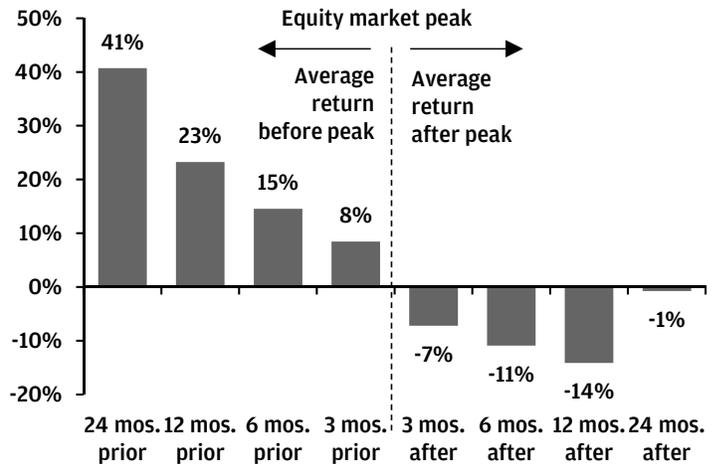
The road ahead

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 cyclicity 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.

The Market Insights programme provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the programme explores the implications of current economic data and changing market conditions. For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our [Company's Privacy Policy](#). For further information regarding our regional privacy policies please refer to the [EMEA Privacy Policy](#); for locational Asia Pacific privacy policies, please click on the respective links: [Hong Kong Privacy Policy](#), [Australia Privacy Policy](#), [Taiwan Privacy Policy](#), [Japan Privacy Policy](#) and [Singapore Privacy Policy](#).

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), or JPMorgan Asset Management Real Assets (Singapore) Pte Ltd (Co. Reg. No. 201120355E); in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management (Canada) Inc., and in the United States by JPMorgan Distribution Services Inc. and J.P. Morgan Institutional Investments, Inc., both members of FINRA; and J.P. Morgan Investment Management Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other countries in APAC, to intended recipients only.

Copyright 2018 JPMorgan Chase & Co. All rights reserved.

MI-MB_3Q18 EarningsBulletin

0903c02a823ff9cc