

# Market Bulletin

April 12, 2019

## 1Q19 Earnings: Is the party almost over?

- Markets have bounced back nicely in 2019 after a volatile December, but this bounce has been driven almost entirely by multiple expansion.
- Earnings revisions have moved sharply lower, causing 1Q19 estimates to fall into negative territory. That said, estimates have likely fallen too far.
- The financial and healthcare sectors are expected to see positive earnings growth, while globally exposed sectors should struggle due to slower global growth and a stronger dollar. Meanwhile, lower oil prices compared to a year ago should weigh on energy sector profits.
- With effective tax rates now similar on a year-over-year basis, margins are no longer getting the artificial boost they did in 2018, and are expected to contract year-over-year due to rising wages and input costs.
- We prefer large cap over small cap, and cyclical value sectors that provide income and a more balanced total return profile.



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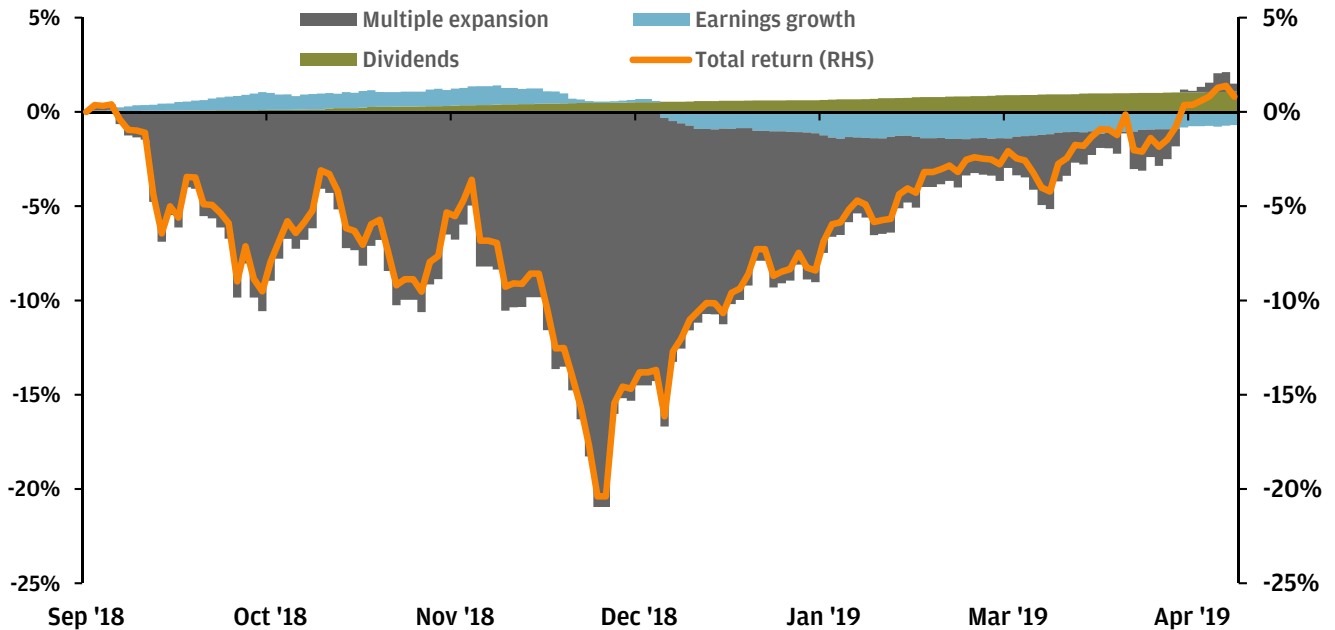
### The round-trip flight

The S&P 500 has risen 15.9% so far this year, putting the index on pace to return 70.1% in 2019. While solid returns to start the year were expected given the sell-off in December, trees do not grow to the sky, and it seems unlikely that this annualized return will be achieved. Furthermore, despite the fact that the Federal Reserve has paused its interest rate hiking campaign, better data out of China (in the form of the March PMIs) suggests that global growth may accelerate in the coming months, allowing long-term interest rates to move higher. If this is the case, it will limit the extent to which multiples can rise.

The reason why this is important is highlighted in **Exhibit 1**, which decomposes the S&P 500's return from the end of 3Q18 through the end of 1Q19 into earnings

growth, multiple expansion and dividends. Valuations led the market lower in December, and then rebounded back to average levels earlier this year as concerns over the trajectory of global growth began to fade.

**EXHIBIT 1: THE BOOM AND THE BUST WERE DRIVEN BY VALUATIONS**  
 Cumulative total return since 9/30/18 broken into earnings, multiples and dividends



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

However, the extreme pessimism that took over markets at the end of last year was not entirely unwarranted, as U.S. economic growth was softening at a time when growth in the rest of the world was already subpar. This dynamic led earnings estimates to move lower over the course of the first quarter; not only have these revisions been negative and broad-based, but also there has been a clear downward trend in corporate guidance during the past few months.

While any extended period of negative earnings growth would pose a threat to the current expansion, declining earnings estimates can actually help the stock market move higher, as lowering expectations makes beating those expectations that much easier. At the current juncture it seems like earnings estimates may have declined too far, and while consensus is looking for negative earnings growth from a year prior, our view is not quite as downbeat.

That said, earnings will be key in determining where we go from here. Lingering uncertainty around the trajectory of policy and growth will weigh on multiples over the long run, even if a temporary pause at the Fed allows them to move higher in the near term. As such, any sustainable upside in markets from current levels will need to be driven by earnings, which look set to grow between 3% and 5% for 2019 as a whole.

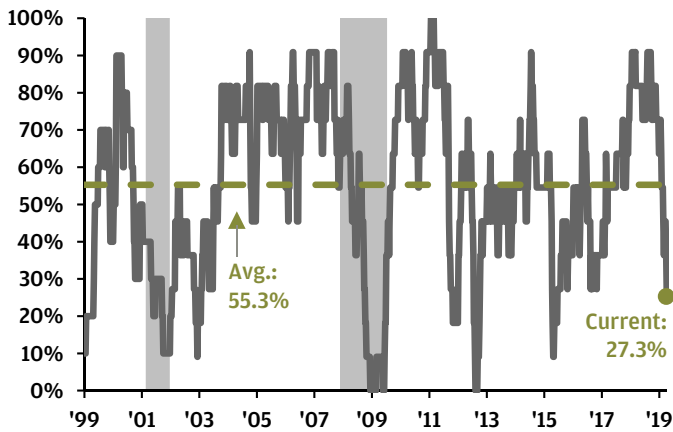
### The earnings party takes a pause

One characteristic of the current earnings season has been the unrelenting downward bias to estimates and guidance over the past few weeks. 1Q19 revisions have moved sharply lower since the beginning of the year,

falling roughly -7.8% compared to the typical path of revisions falling -3.3% over the same time period during this cycle (**Exhibit 3**). Furthermore, and as shown in **Exhibit 2**, the share of S&P 500 sectors with positive net earnings revisions is just below 30%, a level that has historically coincided with periods of economic stress or recession.

**EXHIBIT 2: EARNINGS REVISIONS HAVE HAD A CLEAR DOWNWARD BIAS**

% of GICS sectors with positive net earnings revisions



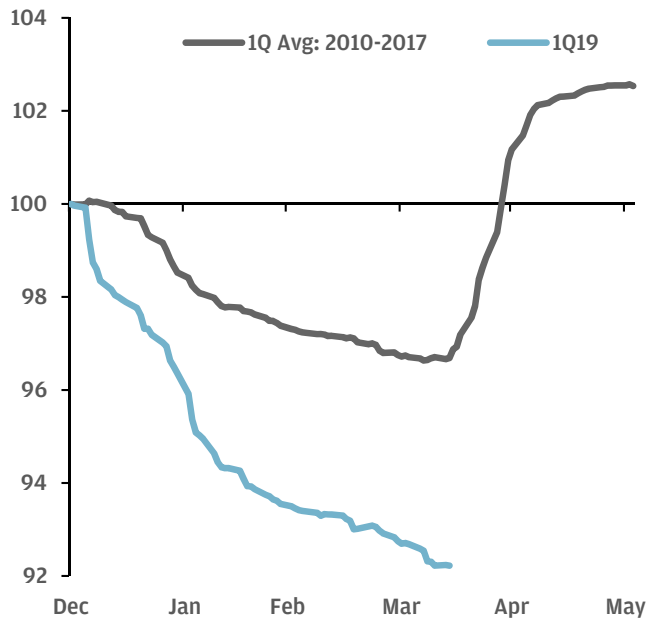
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

Consensus estimates for negative earnings growth against a backdrop of dwindling positive revisions suggests that the current earnings season may prove to be challenging for investors. Indeed, only two sectors - health care and financials - are expected to see meaningful earnings growth; estimates across the other nine sectors are flat or negative. That said, given that analysts tend to be overly pessimistic on quarterly profits by the time an earnings season begins, we believe that aggregate Q1 2019 S&P 500 earnings growth will finish in positive territory when all is said and done.

Despite the sharp drop in yields over the past few months, it appears financials still saw positive earnings growth in the first quarter. Continued tightening in the labor market has allowed consumer finance companies to hold up relatively well, but a flatter yield

curve and extreme volatility in capital markets at the end of last year likely offset some of this strength. Furthermore, health care companies are expected to see positive earnings growth due to solid revenue growth and margin expansion, with health care providers and biotech firms projected to see the best results. To an extent, this is a function of robust M&A activity in the sector, which has led to favorable year-over-year comparisons.

**EXHIBIT 3: FIRST QUARTER ESTIMATES FEEL OVERLY PESSIMISTIC**  
Indexed to 100 on 12/31 of the prior year



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

The more globally exposed sectors look set to struggle, as a slower pace of global economic expansion and a 6.1% y/y increase in the U.S. dollar during the first quarter weighed on revenue growth across the board. Profits in the technology sector were hampered by weakness in semiconductors and hardware, a trend that is validated by the softer economic growth seen in EM Asia during 1Q. That said, software, communications equipment and IT services are all expected to see positive earnings growth,

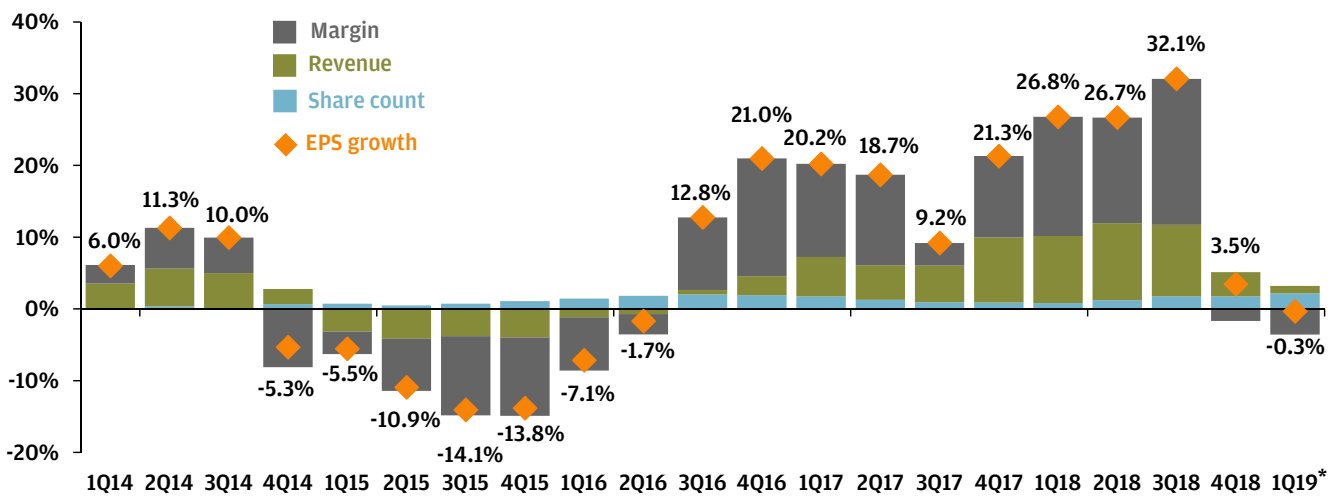
reflecting a shift in capital spending toward smaller-ticket items given broader policy uncertainty.

Energy sector profits look set to come in lower than a year ago, as 1Q18 was a particularly good quarter for energy companies and average WTI prices are down 13.1% y/y in the first quarter. Specifically, exploration and production, refining and oilfield services companies look set to struggle, but storage and transportation - businesses that are more agnostic to oil prices - should be a bright spot.

### Much ado about margins

Although 1Q19 earnings growth looks set to be a bit tepid, margins should show some signs of improvement following the accounting issues that led to a 2%-pt decline during the fourth quarter. That said, we still expect margins to decline on a year-over-year basis, and believe that they will remain under pressure for the better part of 2019. Wages and other input costs continue to rise and, at the same time, pricing power remains muted, thereby limiting the ability for margins to expand. It is also important to note, as shown in **Exhibit 4**, that the majority of the benefit from tax reform showed up in margins last year; with comparisons now apples-to-apples in terms of the effective tax rate, this tailwind has become nothing more than a light breeze.

**EXHIBIT 4: THE BENEFIT FROM TAX REFORM SHOWED UP IN MARGINS**  
 Quarterly growth broken into revenue, changes in profit margin and changes in share count



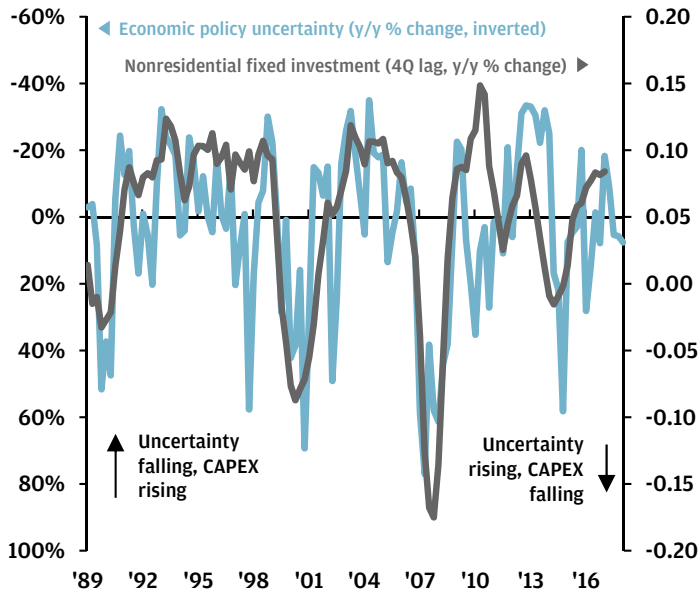
Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.  
 EPS levels are based on quarterly operating earnings per share. Percentages may not sum due to rounding. Past performance is not indicative of future returns.  
 \*1Q19 earnings are calculated using actual earnings for 4.5% of S&P 500 market cap and earnings estimates for the remaining companies. Data are as of April 12, 2019.

A lack of pricing power and slowdown in revenue growth during the first quarter is directly related to broader issues facing the global economy. There has been a significant divergence between manufacturing and services, with the former deteriorating much more than the latter; using purchasing manager index (PMI) data as a proxy, the spread between the two is nearly 2 standard deviations away from its long-term average.

This weakness in manufacturing has been driven by a combination of short-term headwinds and longer-term uncertainty. The majority of the deceleration in manufacturing activity has stemmed from Europe, as auto plants were forced to retool their emissions equipment and adhere to new emissions standards in 2018. That said, recent data on eurozone industrial production suggest that some of these headwinds may be beginning to fade, and

better numbers out of China could help provide an additional short-term boost. On the other hand, however, uncertainty remains elevated, which will continue to hold back a broader rebound in business spending and manufacturing.

**EXHIBIT 5: MANUFACTURING IS BEING HELD BACK BY UNCERTAINTY**  
Economic policy uncertainty index, nonresidential fixed investment, year-over-year % change



Source: Baker, Bloom & Davis, BEA, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

While it feels like progress is being made on U.S./China trade, and a clearer timetable for Brexit has evolved, uncertainty around the broader trajectory of global growth will continue to weigh on capital spending (**Exhibit 5**).

Resolution on some of these issues could ignite animal spirits, but that seems a bit unlikely at the current juncture. Rather, the gap between manufacturing and services should gradually close, leading global growth to realign with its longer-term trend. While this would be a positive development, it would not materially change the outlook for pricing power or margins.

## Investment implications

With the S&P 500 up over 15% so far this year, but risks to earnings tilted to the downside and multiples unlikely to sustainably expand beyond their current levels, the medium term outlook for equities has darkened. That said, equities continue to look attractive relative to fixed income, and could very well move higher in the short-term given firmer economic data and a Fed on hold. In the current environment, we maintain a preference for large caps over small caps, and value over growth.

Within value, we are hesitant to fully embrace defensive sectors like consumer staples and utilities. Although both of these sectors generate healthy streams of income, the 10-year Treasury yield looks set to grind higher over the coming months; this should be a headwind for these sectors given their negative interest rate sensitivity, leading us to maintain our preference for financials, industrials, energy and materials. These sectors offer some incremental yield above and beyond that of the S&P 500, but do not have the same negative relationship with changes in interest rates. Thus, given our expectation that volatility will pick up over the remainder of the year, we believe that focusing on cyclical value and “bubble wrapping” portfolios remains the best approach for long-term investors.

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