Market Bulletin

October 11, 2019

3Q19 Earnings bulletin: Skating on thin ice

In brief

- Manufacturing is under pressure but services look okay; manufacturing matters much more for equity markets than it does for the U.S. economy.
- Most sectors look set to struggle this earnings season, but healthcare and utilities are two bright spots.
- There are structural and technical reasons why value has underperformed growth; we prefer focusing on cyclicals relative to defensives.
- 2020 earnings estimates are still too high; as these decline in the coming months, focus on cash flow and total yield.

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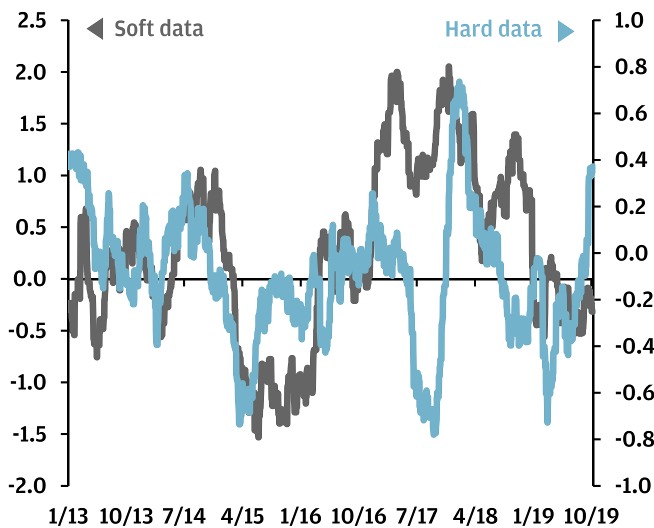
Manufacturing matters

The economic backdrop in 2019 has been characterized by weakness in manufacturing being offset by the resilience of services and the health of the consumer. However, the past few weeks have seen a deceleration in the pace of employment growth and a notable softening across the nonmanufacturing sector. The idea that this expansion will continue has been predicated on manufacturing weakness remaining contained, but this dynamic is increasingly being called into question.

Digging a little deeper, there has been a notable divergence between the hard and soft data. While the soft, or survey data, has come under pressure, the hard data has been better than expected (Exhibit 1). At the end of the day, the data in aggregate suggest that U.S. economic growth is slowing, but not stalling.

However, this is not necessarily true for the rest of the world, which is far more exposed to manufacturing and trade than the United States. Forecasts suggest that the Eurozone and Japan saw meager growth in 3Q19, while emerging markets were a bit of a mixed bag. The risk of recession outside of the U.S. has been rising.

EXHIBIT 1: Survey data has been weak relative to expectations, while hard data has fared better
Bloomberg U.S. Economic Surprise Index



Source: Bloomberg, J.P. Morgan Asset Management. Hard data is a simple average of the housing and real estate, industrial, labor market, personal/ household and retail & wholesale subindices. Data are as of October 11, 2019.

But why does this matter for equities? The S&P 500 is far more exposed to global manufacturing activity than it is to services, and weaker manufacturing data matter for profits. For this reason, equity markets tend to exhibit a strong positive correlation to manufacturing survey data, which accounts for the majority of the soft data in the U.S. The divergence between soft and hard data suggests that sentiment has been a key driver of recent volatility, as fundamentals have not disappointed to the same extent as the surveys. That said, given that uncertainty continues to permeate the air, the more cautious tone in markets seems warranted.

Tiptoeing around zero

The outlook for third quarter earnings growth is a bit cloudy. Operating earnings have grown at an average pace of around 4% so far this year, but the hurdles facing the 3Q19 earnings season are quite high. 3Q18 saw profit margins peak at a level of 12.1% with earnings per share up 32% from a year prior, and these challenging base effects and margin dynamics have led analyst estimates into negative territory over the past few weeks. Applying the average earnings surprise since 2012 suggests that earnings growth may shake out in the low single digits when all is said and done, but at the current juncture, the risks feel tilted to the downside.

With 22% of S&P 500 market capitalization having reported, our current estimate for 3Q19 operating earnings growth is -2.7% from a year prior. 91% of companies that have reported have beaten earnings estimates, while 45% have beaten sales estimates. Margins appear to have contracted on a year-over-year basis to a level of 11.6%, but are still up from last quarter. Finally, buybacks look set to add about 2% pts to the overall level of earnings growth, providing a partial offset to the decline in margins.

From a sector standpoint, there are not too many bright spots. The financial sector looks set to drag on headline earnings growth, as elevated volatility, lower nominal rates, a flatter yield curve, and a downshift in global IPO activity have all undermined performance. In general, M&A activity has shown some signs of life and wealth management businesses appear healthy, but this strength is insufficient to offset other areas of weakness.

The energy sector looks to have struggled as well, with the average price of WTI oil down -19.2% from a year ago. While lower oil prices may help refiners, they have a negative and material impact on upstream company profits. Furthermore, the spike in oil prices

due to disruption in the Persian Gulf was too short-lived to have a positive impact on energy earnings last quarter. That said, companies in the sector have focused on using their cash flow in more disciplined ways, with a focus on returning cash to shareholders through both dividends and buybacks. We expect this will continue as the sector looks to have cut production, with rig counts for both oil and gas down -12.4% and -12.1% relative to a year ago.

The globally-exposed sectors faced headwinds from slower global growth and a stronger U.S. dollar (+2.5% from a year prior) **(Exhibit 2)**. Both industrials and materials lie at the epicenter of the global trade conflict, as both are highly sensitive to changes in manufacturing. While parts of the industrial sector tied to the consumer, such as airlines, have been more resilient, there are some company-specific issues that look set to offset this positive contribution. Turning to technology, semiconductor and hardware businesses likely dragged on the overall pace of earnings growth, whereas software and technology services companies look set to post positive results. With a new smartphone cycle underway, however, the clouds may begin to break over hardware businesses into the end of the year.

EXHIBIT 2: Slower global growth make it hard for revenues to offset margin pressures

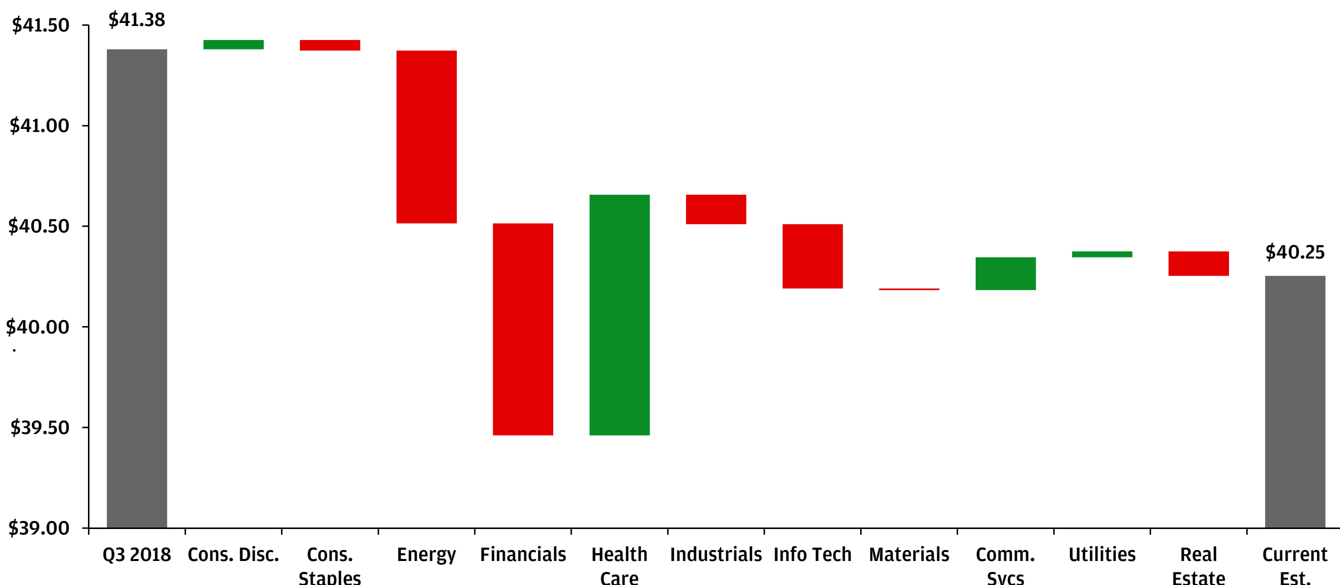
S&P 500 sales per share, y/y, Global GDP growth, y/y

Source: Standard & Poor's, Compustat, FactSet, J.P. Morgan Economic Research, J.P. Morgan Asset Management. Data are as of October 11, 2019.

That said, not everything about this earnings season is negative. As shown in **Exhibit 3**, the healthcare sector should be a key contributor to 3Q earnings, as M&A activity during prior quarters continues to provide an inorganic boost to growth via margin expansion.

EXHIBIT 3: S&P 500 earnings contribution by sector

Contribution to 3Q19 earnings relative to a year ago



Sources: Standard & Poor's, Compustat, FactSet, J.P. Morgan Asset Management. Data are as of October 11, 2019.

Consumer discretionary and communication services also look set to provide a modest positive contribution, which is likely tied to the continued health of the consumer in the third quarter. Finally, utilities should be another bright spot during the upcoming earnings season, with all sub-sectors expected to post positive earnings growth and gas utilities expected to see growth in the double-digits.

Is there value in growth?

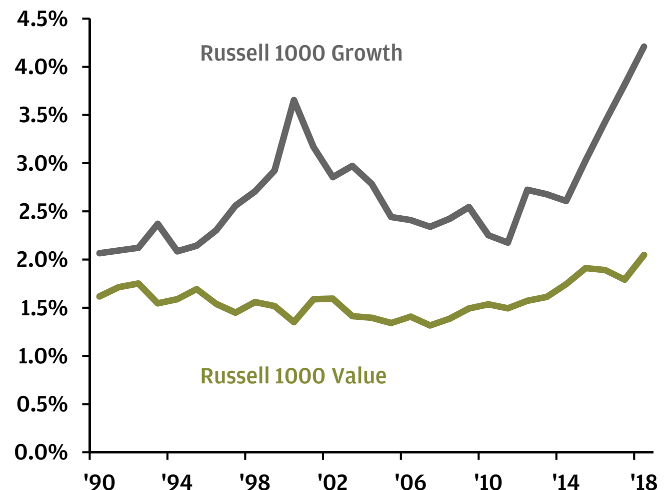
One of the most frequently asked questions in client meetings has to do with the underperformance of value relative to growth. Frankly, we have not seen too many good answers as to why this might be the case. Furthermore, the sharp August rotation we saw out of growth and into value seems to have fizzled in recent weeks, as expectations for slower economic growth but not a recession have taken hold and the "grab for growth" has once again come into play.

So why has value underperformed so much, and will it underperform going forward? The idea behind value investing is to be long undervalued securities and short overvalued securities, and then allow mean reversion to work its magic. Historically, whether something is cheap or not was based on its book value. For decades, book value was easy to calculate, as businesses tended to be manufacturing intensive and assets were comprised of property, plant, and equipment.

However, accurately calculating book value has become more challenging given growth in the technology sector and rise of capital-lite business models. When a company designs a piece of software, for example, it usually expenses the cost, rather than capitalizing it **(Exhibit 4)**. The result of this is that the asset which is created (the software), never shows up as an asset on the balance sheet. As such, if one subscribes to this idea, then the book value of capital-lite technology companies has been understated; if we were to re-run the numbers, some of the high flying growth names of the past decade would have actually looked a bit more value-like.

EXHIBIT 4: R&D spending tends to be expensed, rather than capitalized

R&D spending as a % of sales, Russell 1000 Growth and Russell 1000 Value



Source: Compustat, FTSE Russell, FactSet, J.P. Morgan Asset Management. R&D stands for research and development. Data are as of October 11, 2019.

That said, this miscalculation is not the only reason that value has underperformed. Work by Baruch Lev at New York University and Anup Srivastava at the University of Calgary highlights that mean reversion has occurred at a slower pace over the past decade; cheap stocks have tended to stay cheap, while expensive stocks have tended to stay expensive. Furthermore, easy monetary policy has reduced equity market volatility, thereby leading to a reduction in large moves which often times push cheap/expensive stocks in or out of their respective evaluation buckets. Lev and Srivastava also point to subdued bank lending and softer consumer demand as the reason why industries and firms that found themselves categorized as value companies stayed there; during the past 10 years, the top five value industries were banking, retail, insurance, wholesale, and utilities[1].

1. Lev & Srivastava. Explaining the Demise of Value Investing. https://ssrn.com/abstract=3442539. August 2019.

It is almost like value has not been able to get out of its own way.

Investment implications

Earnings are skating on thin ice – we expect modest profit growth on average over the remainder of the year, but a more challenging environment in 2020. Slower economic growth is no longer a forecast, it is a reality, and with that will come slower revenue growth, particularly given the global nature of the S&P 500. At the same time, consensus estimates for margins appear too high, and at the current juncture point to margin expansion over the course of 2020 back to a level of 12.5%. While wage growth is not robust, input costs are rising, and we believe that margins will remain at or near current levels.

2020 estimates should begin to adjust in the coming months, and investors will need to be more precise in their equity allocations. The economy does not appear to be headed into recession tomorrow, which suggests that it is still prudent to maintain some cyclicality in portfolios. That said, we continue to focus on quality businesses with resilient cash flows, and yield as a driver of return. With the risks increasingly tilted to the downside there is no point in swinging for the fences, but we still see value in equities, particularly relative to bonds.

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