SLOWING CORPORATE PROFIT GROWTH AND EQUITY MARKETS

For some time now, our relatively downbeat outlook for corporate earnings has been a key driver of our cautious stance on risk assets and equities. Our outlook reflects our macroeconomic view, which sees a world where global growth is running below trend and recession risks are significantly elevated, but where—absent further negative shocks such as trade war escalation—there is still a good chance that recession can be avoided over the next 12 months. In this report we examine the prospects for corporate earnings this year and next and evaluate the potential impact on equity markets.

As Exhibit 1 illustrates, the current U.S. earnings growth downcycle has been largely consistent with the deterioration in macroeconomic momentum (represented here by the U.S. ISM survey). Taken at face value, the simple relationship between macro momentum and corporate earnings growth implies that U.S. stock market earnings should fall fairly significantly over the coming quarters. However, we think that scenario is unduly pessimistic. For one, connections between economic metrics and corporate earnings tend to be loose rather than precise. Further, it is very rare for U.S. earnings growth to turn substantially negative absent a recession, although growth slowdowns to around zero are not uncommon.
Indeed, that roughly describes the current 12-month rolling measure of EPS growth shown in Exhibit 1. Still, for growth to turn negative outside a recession has typically required a very large fall in commodity prices, leading to large drops in commodity company earnings and, finally, dragging down the overall equity index. The current drawdown in commodity prices is admittedly sizable, but given the diminished earnings weight of the U.S. energy and materials sectors it should translate to about a roughly two percentage point (ppt) drag on 2019 earnings. If the U.S. economy does slip into recession, a historically “normal” drawdown in corporate earnings would be around the 30% mark – but we stress that is not our base case scenario. Overall, flat or slightly positive earnings growth for 2019 looks realistic currently.

Meanwhile, analysts’ consensus projects the third quarter earnings season as the low point of this slowdown, and expects a nearly v-shaped reacceleration thereafter across most regions. In fact, Q3 might be the first quarter of negative EPS growth in the U.S. since early 2016. Current expectations for U.S. Q3 EPS growth are -3%, down from +3% in Q2 and +1.6% in Q1. Assuming companies beat analyst earnings expectation by 3%-5% (the typical range), we can expect an overall slightly positive growth rate for Q3. However, the risk this season is that macro headwinds restrain or even reverse this usual dynamic, leaving us with a negative growth rate. Similar forces are in play in Europe, where around -3% growth is expected, although there is a less consistent historical pattern of results beating expectations. In any case, a quarter of slightly negative EPS growth might generate news headlines and damage market sentiment, but by itself it should not have a significant impact on market valuations.

Of far more importance is how the Q3 earnings season will shape expectations for Q4 and 2020. In both the U.S. and Europe, the consensus anticipates a clear return to growth in Q4, followed by further acceleration into 2020. This leaves expectations for 2019 growth at 2% in the U.S. and 1% in Europe, and at around +10% for 2020 growth in both regions. In Japan and emerging market (EM) economies, the quarterly growth profile looks a little different, but here too a reacceleration is expected in 2020, to 6% in Japan and nearly 14% in emerging markets (from -1% and +2%, respectively), in 2019.

This reacceleration embedded in current forecasts looks unrealistic to us, and is a source of asymmetry in the equity market outlook relative to what we consider the likely economic outcomes. In short, realizing current EPS

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**EXHIBIT 1: SOFT MACRO DATA POINTS TO THE POTENTIAL FOR U.S. EPS DISAPPOINTMENT**

U.S. earnings growth has deteriorated alongside worsening macro momentum, as represented here by the ISM survey’s new order series. While at face value this relationship suggests an actual fall in U.S. earnings, we see a decline as more of a downside risk, and expect marginally positive EPS growth this year, followed by low-to-mid-single digit growth in 2020.

Source: Refinitiv, J.P. Morgan Asset Management Multi-Asset Solutions; data as of October 10, 2019. For illustrative purposes only.
Both the scale and composition of the global earnings re-acceleration expected by consensus expectations leave us braced for disappointment even if the economy avoids recession and delivers a middle-of-the-road outcome. Rather than double digit earnings growth in 2020, we are looking for something closer to the low-to-mid single digits. That outcome would be far from disastrous, and markets are used to a certain degree of disappointment vs earnings forecasts, but it would almost certainly not be enough to drive large equity market gains without further substantial valuation expansion. Higher valuations are possible in an environment of active monetary policy, but we would not count on them given how aggressive policy stances are already.

**ASSET CLASS IMPLICATIONS**

We retain a moderate underweight stance on equities in our multi-asset portfolios, reflecting our cautious macro outlook as well as our below-consensus outlook on earnings. Across equity regions we continue to favor more defensive markets such as the U.S. and Canada, and remain underweight more cyclically geared markets such as Europe and emerging markets.

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**EXHIBIT 2: 2020 CONSENSUS EPS FORECASTS ARE FALLING**

Expectations for 2020 EPS levels have been declining across regions, with the most cyclical regions such as emerging markets and Japan hit the hardest. Despite this, 2020 growth expectations remain high.

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1 The U.S. Department of Commerce Bureau of Economic Analysis national income and product accounts (NIPA)
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