

Market Bulletin

January 24, 2020

4Q19 Earnings: Lots of moving parts

In brief

- 2019 was a good year for equities as multiple expansion drove stock markets to new all-time highs.
- 4Q19 earnings look solid relative to a year earlier, but this is largely due to a disappointing 4Q18.
- The financial, technology and communication services sectors likely saw earnings grow; energy, industrials, materials and consumer discretionary earnings appear to be under pressure.
- Operating earnings seem to provide the cleanest read on corporate profitability; stable profit margins will be key for earnings growth in 2020.
- A focus on total yield (dividends + buybacks) should allow investors to maintain a cyclical stance while simultaneously muting volatility.



David M. Lebovitz
Global Market Strategist



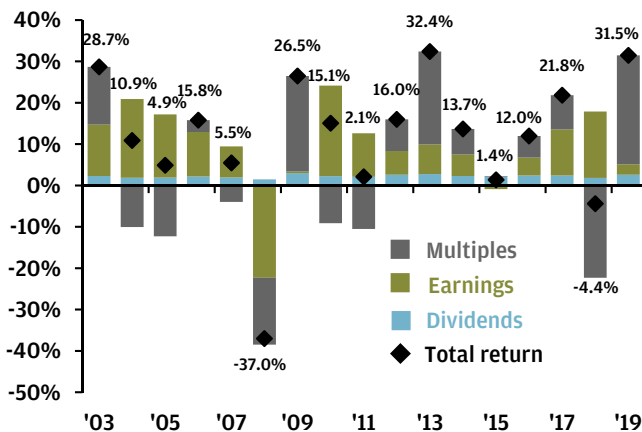
Tyler J. Voigt, CFA
Market Analyst

Going out with a bang

Equity markets finished 2019 on a high note, as a combination of easier monetary policy and cooling trade tensions lifted investor sentiment¹ to its highest level since February 2018. Nearly all of the equity market gains seen last year were a function of rising valuations; fears that drove the sharp sell-off at the end of 2018 failed to materialize, which allowed valuations to expand well above long-run averages. Overall, multiples were responsible for 83.7% of total returns in 2019, while dividends and earnings were responsible for 8.3% and 8.0%, respectively (**Exhibit 1**). However, taking a step back and looking at performance attribution over the past two years, earnings were the main driver of returns.

Operating earnings growth was mixed during the first three quarters of 2019, with mid-single digit growth in the first half of the year and a slight contraction in the third quarter. The third quarter contraction should not have come as a surprise, as 3Q18 saw both earnings and profit margins hit their cycle highs. 4Q18, however, was not friendly to corporate profits. An accounting rule passed in 2016 requires companies to mark their equity holdings at fair value each quarter and apply any gains or losses to net income; this ravished the profits of some financial services companies, leading aggregate earnings to decline sharply at the end of 2018. The good news, however, is that this created a favorable base effect for the 4Q19 earnings season, supporting our expectation that earnings growth will be positive on a year-over-year basis. Currently, with 19.9% of the market cap having reported, our estimate for Q4 2019 is \$39.49, which represents a 12.7% year-over-year growth rate.

EXHIBIT 1: 2019 returns were driven primarily by multiples
S&P 500 total return broken into multiples, earnings and dividends



Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Earnings contribution is the measured change in forward earnings per share estimates. Data are as of January 24, 2020.

Lower rates, write downs and a healthy consumer

While at the headline level earnings growth should be strong, from a sector standpoint fourth quarter

¹ As measured by the difference between bulls and bears in the AAI Sentiment Survey.

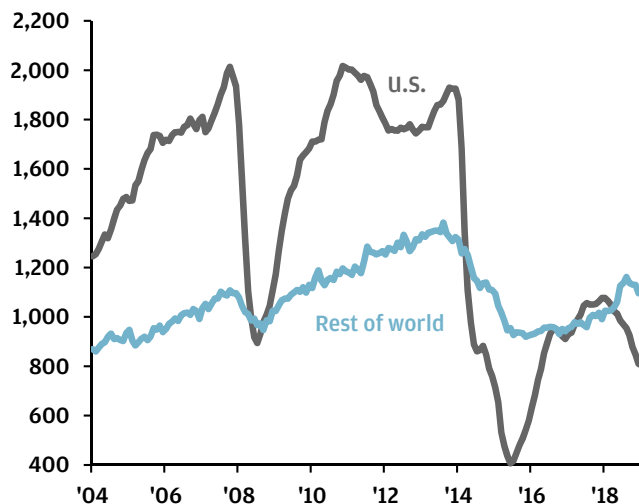
earnings look set to be mixed. Starting with financial services, a few trends have been clear. For the most part, consumer lending was solid in the fourth quarter, although a decline in net interest margins weighed on profitability in this line of business. However, better-than-expected investment banking and trading revenues helped to offset this weakness, particularly given the underwhelming performance of trading businesses at the end of 2018.

Energy companies struggled last quarter as the average price for WTI oil was down nearly 4% year-over-year. However, the impact was not only on revenues; a number of companies look set to write down the value of their oil field assets and take these charges against net income in the fourth quarter. That said, this is primarily a problem for exploration and production (E&P) companies, whereas companies in the refining and oilfield services businesses seem to have fared better into the end of last year. Furthermore, U.S. energy companies are struggling as a result of their North American operations, which have seen a significant slowdown in both activity and pricing, while their international businesses have continued to grow and partially offset this weakness (Exhibit 2).

Turning to globally exposed sectors like technology and communication services, although the pace of dollar appreciation slowed into the end of last year, dollar strength remained as a headwind to profitability. That said, the technology sector has seen the greatest number of companies issuing positive forward guidance coming into the earnings season. Digging a bit deeper, the drag in technology really stems from the semiconductor industry, which found itself under pressure due to rising trade tensions last year; on the other hand, software companies appear to have generated decent earnings growth in 4Q19 (Exhibit 3).

EXHIBIT 2: U.S. energy companies are struggling due to a slowdown in North American activity

Total rig count



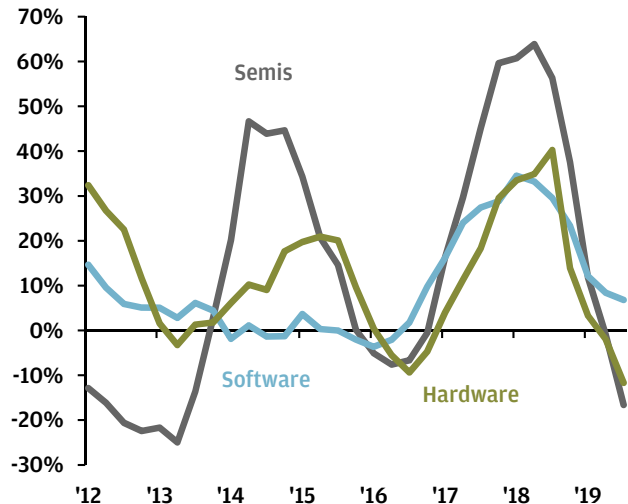
Source: Baker Hughes, FactSet, J.P. Morgan Asset Management. Rest of world rig count excludes the U.S. and Canada.; Data are as of January 24, 2020.

Profits at consumer discretionary and consumer staples companies appear to have moved in opposite directions in the fourth quarter, as consumer discretionary companies look set to post a year-over-year decline, while consumer staples companies look set to post a year-over-year gain. Auto companies in particular are dragging on headline earnings for the consumer discretionary sector, while companies focused on experiences and smaller ticket consumer goods continue to benefit from the backdrop of a healthy labor market.

Finally, the industrial and material sectors, which have been buffeted by the trade war over the past few quarters, continue to struggle. Airlines, however, remain a bright spot in the industrial sector; profits have been boosted by lower oil prices and a continuation of strong demand (as measured by higher passenger load factors), and are only somewhat impacted by issues with the underlying fleets. On the materials side, a rebound in U.S. housing activity on the back of lower rates seems to have provided a lift to companies in the construction materials business, whereby chemicals, metals and mining earnings appear to have declined.

EXHIBIT 3: Software earnings are still growing while semi and hardware companies have come under pressure

Year-over-year % change in last 12-months operating EPS



Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Semis are represented by the Semiconductor & Semiconductor equipment industry group, software is represented by the Software & Services industry group and hardware is represented by the Technology Hardware & Equipment industry group. Data are as of January 24, 2020.

Which earnings should I look at?

Write downs in the energy sector are reminiscent of 2015/2016, which was the last time we saw a significant and sustained gap emerge between operating and pro forma earnings. As such, many investors have been asking us which earnings they should look at. While the market prices off of pro forma earnings, these adjustments can make it more difficult to compare current earnings to prior periods. It is true that write downs stemming from weakness in commodity prices can be viewed as a non-recurring item, but when companies write down an asset, they cannot “write up” the asset at a later point in time.

While we understand the thinking behind some of the pro forma adjustments, we prefer to measure corporate profits using operating earnings, as not all of the adjustments being made seem appropriate.

Exhibit 4 highlights some of the differences between these three measures.

EXHIBIT 4: Differences in earnings measures lead to differences in growth rates

2019 S&P 500 earnings per share*		Year-over-year % change					
		2014	2015	2016	2017	2018	2019*
Pro-forma earnings	\$162.14	6.8%	-0.3%	0.5%	12.0%	20.8%	0.4%
examples of items added back: gains/losses on asset sales, asset/goodwill impairments, M&A costs, noncash compensation, amortization of pension gains/losses		↑ \$4.10					
Operating earnings	\$158.04	5.3%	-11.1%	5.8%	17.2%	21.7%	4.2%
add back: restructuring charges related to acquisitions, sales & discontinued operations		↑ \$17.80					
GAAP/as reported earnings	\$140.24	2.1%	-15.4%	9.3%	16.2%	20.5%	5.9%

Source: Compustat, FactSet, J.P. Morgan Asset Management. 2019 EPS measures are estimates. Data are as of January 24, 2020.

The question for investors, however, is which measure of earnings has the highest correlation with stock market returns. Based on data back to 2001, pro forma earnings have the highest correlation; that said, the data is extremely skewed by the fact that operating earnings turned negative in 4Q08. If this data is excluded, operating earnings exhibit the highest correlation. This dynamic, coupled with the fact that there is a far longer time series available, suggests operating earnings are the best measure for long-term investors to use when attempting to gauge corporate profitability.

Keep an eye on margins

As we look ahead, there are a handful of issues which will determine the trajectory of earnings over the coming year. To start, there are questions around oil and the U.S. dollar - if the dollar weakens and oil prices move higher, the net impact on S&P 500 profits should be positive. While we are confident in the view that the dollar will weaken over the long run, predicting short-term moves is far more challenging.

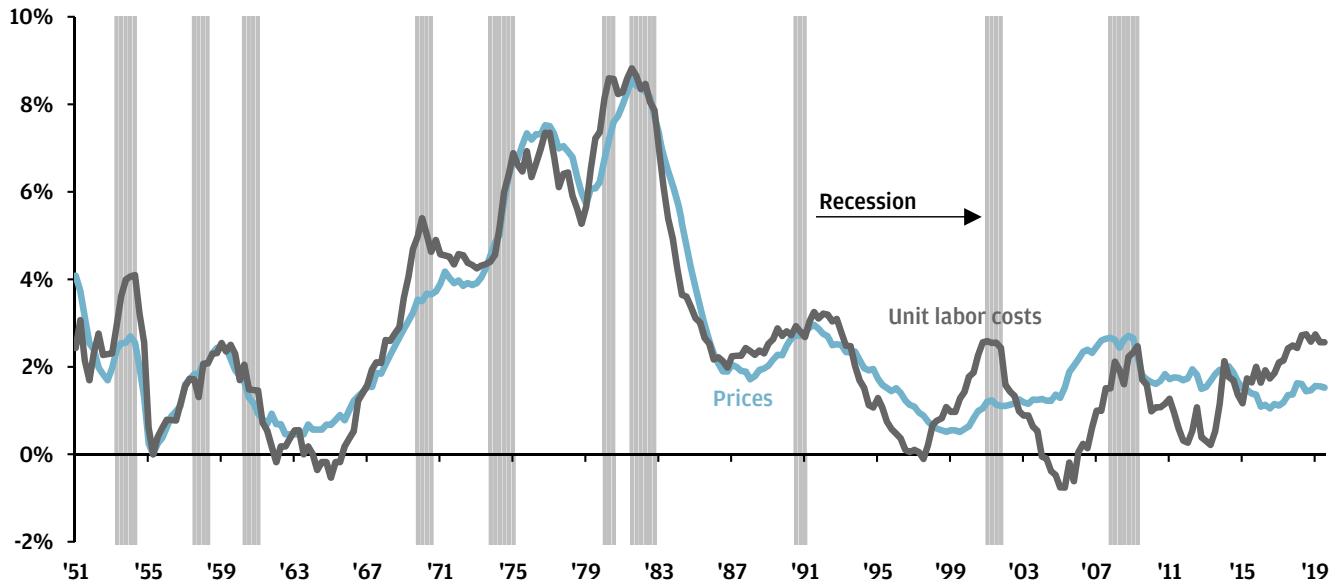
That said, if policymakers remain on hold and growth outside of the U.S. improves, the dollar should become less of a headwind in 2020. Meanwhile, higher energy prices would boost revenues in this beaten down part of the market, while simultaneously slowing the pace of asset write downs.

Equally, if not more important, will be what happens with margins and buybacks. While buybacks still provided a meaningful contribution to earnings per share growth in 2019, the pace of buybacks, and thus their contribution to EPS, slowed. This was mostly due to the benefits of tax reform, namely the repatriation of foreign profits, running their course and a slower pace of earnings growth. Looking ahead, we expect that trend to continue in the year to come as elevated equity valuations slow the pace of buybacks. However, if companies continue to buy back shares in similar dollar amounts, the appreciation in the equity markets over the last year means that buybacks will provide less support for earnings per share in 2020. That is not to say that buybacks will stop - rather, we expect they will contribute closer to 1.5%-pts to earnings growth, rather than the close to 2%-pt. contribution observed in 2019.

The impact of margins, however, is arguably more important. Profit margins peaked at a level of 12.1% in 3Q18, before falling precipitously in the fourth quarter due to a change in the way that companies account for equity investments. While margins typically come under pressure in the latter stages of a business cycle, analysts are actually looking for margins to expand this year. Analyst estimates point to earnings growth

of 9-10% for 2020 as a whole, with margin expansion a key driver of this growth. It is very difficult for margins to expand in an environment of moderate economic growth, muted inflation and rising wages - as a result, we forecast S&P 500 earnings growth will shake out in the low to mid-single digits when all is said and done (**Exhibit 5**).

EXHIBIT 5: Margins have been under pressure from labor costs which have not been offset by price increases
4-year annualized growth rate in unit labor costs and prices for nonfinancial corporate businesses



Source: BEA, FactSet, J.P. Morgan Asset Management. Data are as of January 24, 2020.

Investment implications

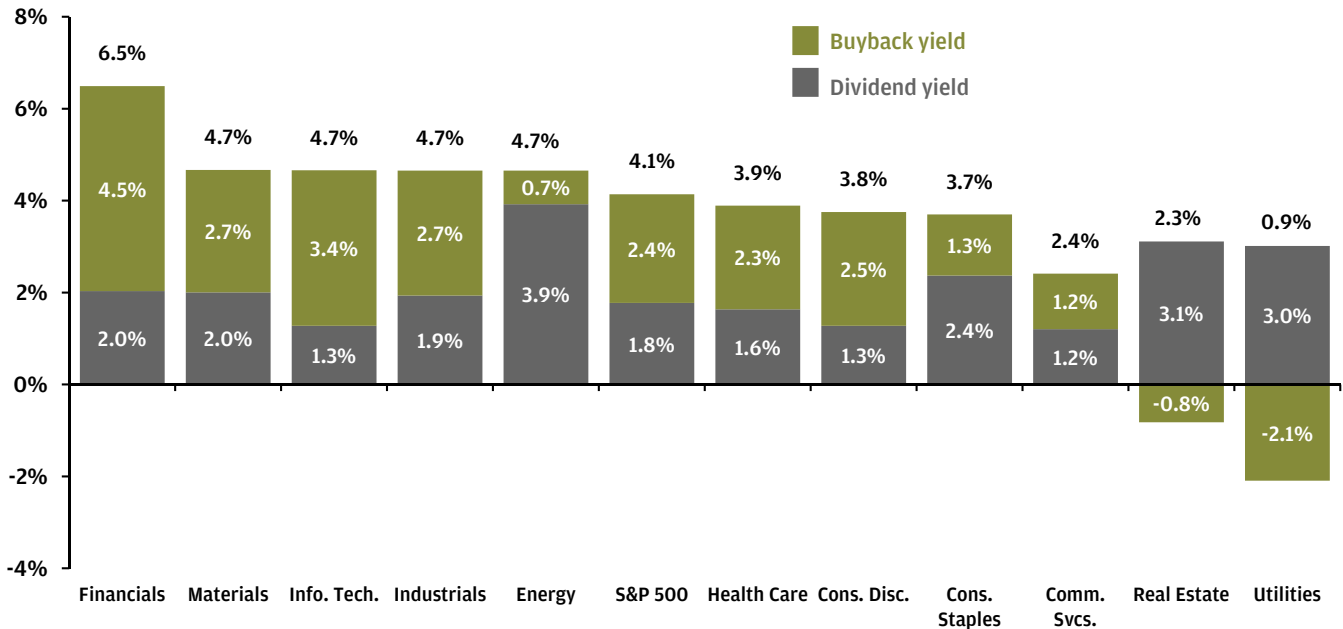
Although the fourth quarter should see a nice bounce back in operating earnings from a year prior, the devil is in the details. Pro forma earnings look set to show more muted, but positive growth, and estimates for 2020, seem entirely too robust given our expectations for the macroeconomic environment over the coming twelve months.

Adding insult to injury, U.S.-China trade and Brexit are only partially resolved, while the U.S. presidential election is looming large and will be a key source of

volatility over the coming year. We believe that stocks will finish the year with a positive total return, but the path is looking increasingly bumpy.

As such, we continue to focus on total shareholder yield (dividends + buybacks), as seen in **Exhibit 6**. This approach allows us to maintain cyclicity in portfolios, as we believe there is still upside in equity markets, while simultaneously muting some of the volatility that will manifest itself over the coming months.

EXHIBIT 6: Investors should focus on sectors with attractive total yields (dividends + buybacks)
 Last 12-months dividends and net buybacks divided by market cap



Source: Compustat, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of January 24, 2020.

From a sector standpoint, technology, financials and energy all fit the bill, with the more value-oriented sectors also commanding a valuation advantage. On the other hand, defensive bond proxies continue to look expensive; while there will be a time to turn more defensive, we are not there yet. Earnings will be the main driver of returns in the year to come, but understanding what is driving earnings will be increasingly complicated; as always, there are lots of moving parts.

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