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UBS House View Briefcase

Is the US headed for an earnings recession? 29 March 2019

Chief Investment Office GWM

Key message

Investors have become accustomed to a blistering pace of earnings growth in the US. Recently, however, the momentum has slowed, and there has even been talk of an earnings recession. While we expect growth to be muted in the first half of 2019, a material decline in profits looks unlikely. The slowdown is being exaggerated by a fading boost from US tax reform, as well as idiosyncratic headwinds in a handful of sectors, especially smartphones, semiconductors, and energy. Overall the outlook for the US economy remains positive and we expect stocks to continue to advance as investors come to appreciate that earnings growth will improve a bit.

House view

01 A period of unusually rapid profit growth is drawing to a close.

- S&P 500 earnings per share grew 23% in 2018, capping a ten-year period averaging an annual 12% gain.
- But growth is expected to slow to 4% in 2019, with the sharpest deceleration occurring in the first half of this year: consensus is now for a 2% contraction in the first quarter and a modest 1% increase for the second quarter.

02 This looks more like a pause than the start of a slump.

- While the slowdown primarily reflects slowing GDP growth, the weakness is being exaggerated by sector-specific headwinds – such as a maturing smartphone market and lower energy sector profits.
- The current bottom-up consensus for the median company in the S&P 500 is for earnings growth of 2.5% in the first quarter, 6% in the second, and 6.5% for 2019 as a whole.
- The Markit US Composite PMI's 54.3 March reading supports our view that this is a decelerating expansion, not an outright contraction.

03 We believe equity markets can continue to advance amidst an earnings lull.

- In the five prior earnings pauses – 1985, 1996, 1998, 2013, and 2016 – the S&P 500 rose an average of 15% over the 12 months prior to the pause and then over 20% in the 12 months after the pause as growth again accelerated.
- We do not expect a full-blown earnings recession for now. In addition, we remain overweight equities.

New this week

Investors are bracing for a weak first quarter for US earnings. The current consensus is for earnings to contract by 2% in the first quarter. But we expect full year earnings growth of 4%.

One liner

2018's exceptional earnings growth was never likely to last, but slower profit growth is not the same as falling earnings.

Did you know?

- Since 1982 there have been five episodes when last 12-month earnings growth was between -5% and 5% without an economic recession (1985, 1996, 1998, 2013 and 2016) after which earnings growth re-accelerated.
- The current earnings deceleration partly reflects sector-specific headwinds, such as a maturing smartphone market, an inventory overhang in semiconductors, and energy firms contending with year-on-year declines in oil prices.

Investment view

We remain overweight equities, while holding small countercyclical positions that should perform well if equities sell off. Investors who can purchase options should consider protective puts to reduce downside exposure in case tail risks materialize.

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