1Q earnings preview: Stalling, not falling

US equities

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- After surging 23% last year, we now expect S&P 500 earnings per share (EPS) to grow just 3% in 2019. First-quarter EPS should be "flattish" as decelerating global GDP growth and pockets of weakness in industrials, smartphones, semiconductors, and commodities weigh on results.

- However, leading indicators of profit growth such as access to capital and business sentiment remain healthy, supporting our view that earnings growth will resume in the second half of the year with further gains into 2020.

- We trim our 2019 S&P 500 EPS estimate from USD 171 to USD 168 (+3%) and introduce our 2020 estimate of USD 179 (+7%).

- US stocks surged nearly 14% in the first quarter, the best quarterly return in a decade. With US equity market valuations no longer depressed at 16.6 times our forward 12-month earnings estimate, further market gains will likely require additional evidence that global economic growth will stabilize, driving a reacceleration in earnings growth later in the year.

Downshift in global economic growth...

First-quarter earnings growth will likely be somewhat tepid due to slower global economic growth and pockets of weakness in specific end-markets. In the US, the lift from tax cuts and higher government spending that boosted economic and profit growth in early 2018 is now fading. In addition, activity in the first quarter was likely further dented by the lengthy government shutdown and poor weather—flooding and extreme cold. As a result, UBS economists expect first-quarter GDP growth of just 0.7% annualized, the slowest pace of growth in three years and a substantial slowdown from 2018’s level of 3%.

In addition, non-US economies have also been sluggish. Chinese economic growth continues to decelerate as policymakers attempt to orchestrate a "soft landing" as they transition the economy away from reliance on heavy industry and infrastructure spending. The trade frictions between the US and China likely exacerbated the 1Q slowdown. Weaker growth in China seems to have had a knock-on effect on Europe. China is a key export market for Germany. The Brexit uncertainty likely hasn’t helped.

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Fig. 1: Earnings growth has decelerated
S&P 500 EPS growth; tan denotes impact of tax reform

Fig. 2: Somewhat muted growth in most sectors with notable weakness in commodities
1Q earnings growth, year-over-year

...and pockets of weakness in some end markets...
Furthermore, some specific end-markets for US companies continue to suffer. In technology, the disappointing smartphone product cycle for Apple and elevated semiconductor inventories should result in a mid-single-digit year-over-year decline in tech profits in 1Q (Fig. 2). Keep in mind that technology is the largest S&P sector and represents 23% of total S&P 500 EPS. Commodities will also be a drag. While oil prices have recovered from the late-December lows, the average price in the first quarter was 10–15% lower than in the first quarter of last year. As a result, earnings for the energy and materials sectors will likely decline at a mid-teens pace. The large banks have indicated that muted capital market activity in the first quarter due to sluggish trading volumes will be a drag on overall results (although this will be somewhat offset by aggressive share repurchases). Finally, the trade-weighted US dollar is up 5% year-over-year, which will crimp multinationals’ earnings growth and reduce aggregate 1Q S&P 500 EPS by roughly 1%.

Still, the profit picture certainly is not all gloomy. Tech enterprise spending is on solid footing, driving continued strong results in software and internet-related industries. Consumer spending is well-supported by a healthy labor market—new claims for unemployment insurance just hit a fresh multi-decade low and wages are rising at the fastest pace in a decade. In the industrial sector, aerospace results should be solid, driven by continued growth in global air travel. And within healthcare, innovation in medical devices and healthy biotechnology and pharmaceutical research and development spending should support continued solid growth for some segments of the sector.

...adds up to “flattish” profit growth As a result of some of the headwinds mentioned above, we expect the weakest S&P 500 revenue and earnings growth in three years in 1Q. The current bottom-up consensus estimates imply 2.5% revenue growth and a 2% decline in EPS. If corporate America beats estimates at a pace in line with the historical average, 1Q S&P 500 EPS growth should be in the 0–2% range.

However, we are encouraged that the flattish aggregate earnings appear to be masking stronger underlying profit trends. The median company should post 3–4% revenue growth and similar low- to mid-single-digit EPS growth despite the weaker headline figures.

But profit growth should continue and accelerate
While the scope of the slowdown in S&P 500 profit growth, especially relative to the blistering 23% growth last year, may seem alarming, we expect corporate profit growth to improve later in 2019 and into 2020. By the second half of the year, earnings growth should be back to a mid-single-digit run rate and we look for profits to advance further in 2020. Our conviction stems from the supportive leading indicators.

Access to capital for both businesses and consumers is the oxygen for economic growth. And measures of access to capital remain fairly healthy. One of our favorite measures is the Federal Reserve’s quarterly survey of bank loan officers. The most recent reading did show that banks were no longer loosening credit standards, but at the same time they weren’t tightening them either. Still the survey was conducted in late December and early January, during the peak of the equity market sell-off. We suspect the market action may have had some impact in the survey results. During the fourth-quarter earnings reporting season, bank management teams did not appear concerned about credit quality. With markets now only 2% below all-time highs, we would expect to see this survey improve when it is released in mid-May.
For consumers, access to capital is likely getting a bit better. After rising to a seven-year high in late 2018, 30-year mortgage rates have fallen sharply in recent months and are now close to 4%, or the average rate of the last five years (Fig. 3). Refinancing activity has increased and lower rates improve housing affordability. Homebuilders have noted that there has been a pickup in buyer traffic and new orders have been better than expected. Importantly, with inflation pressures well-contained, it’s unlikely the Fed will raise interest rates any time soon, so access to capital should remain favorable.

Fig. 3: Lower mortgage rates should support housing activity

Other leading indicators are also encouraging. The ISM Manufacturing survey of business sentiment leads earnings growth by six months (Fig. 4). As long as the survey remains above 50, corporate profits typically grow. While the survey has moderated in recent months, the latest reading of 55.3 remains healthy.

Fig. 4: Healthy business sentiment suggests continued earnings growth

In addition, some of the one-time headwinds from the first quarter (government shutdown, poor weather) are unlikely to repeat. Plus, there are some signs that the Chinese government stimulus measures are beginning to gain traction, which would be positive not only for growth in China, but should have favorable knock-on effects for Europe. Also bear in mind that inflation in Europe continues to disappoint on the downside and the European Central Bank has already signaled a lengthy dovish stance. Finally, we assume no further escalation in the trade frictions between the US and China.

So while both economic and corporate profit growth this year will be slower than 2018 levels, an outright contraction appears unlikely. Bottom-up stock analysts are beginning to anticipate this potential improvement in the earnings outlook. The bottom-up, next-12-months consensus EPS estimate for the S&P 500 has stabilized (Fig. 5).

Fig. 5: EPS estimates for the S&P 500 have stabilized

Trimming 2019, introducing 2020
As a result of slower global economic growth and weakness in certain end-markets, we are trimming our 2019 S&P 500 EPS estimate from USD 171 to USD 168, which represents 3% year-over-year growth. This compares to the bottom-up consensus estimate of USD 167, so our lower numbers should already be anticipated by investors. As we indicated above, earnings growth will likely be close to zero in the first half of the year but should then pick up in the second half of the year to a mid-single-digit level.

Looking out to 2020, growth should remain around this pace. From a big-picture perspective, global nominal GDP growth of around 6% should drive 4–5% revenue growth for the S&P 500, which will drive 4–6% earnings growth. Share buybacks should boost growth by another 1–2%. Our official estimate for 2020 S&P 500 EPS is USD 179 or 7% growth.
No reason to panic over “peak” profit margins

For the first time since 2016, profit margins will likely decline versus the year-ago period. This may cause some concern that the much-predicted decline in profit margins has begun, driven by higher labor costs. While it is true that profit margins are high and rising wage costs are a headwind for companies with a high percentage of costs from labor, we do not believe that margins have begun an inexorable decline. Instead, fairly tepid revenue growth, particularly relative to early 2018 levels, is likely the main driver of 1Q profit margin weakness.

As we mentioned earlier, revenue growth for the S&P 500 in 1Q will be a fairly sluggish 2.5–3%. As revenues moderately decelerate, it is not uncommon to see some margin pressure. After all, revenue trends are the main driver of profit margins. Margins come under the most pressure when revenues collapse during a recession and companies have a very hard time cutting back on fixed costs. Conversely, margins rise the most when revenues snap back in the early stages of a recovery from a recession when companies have excess capacity and don’t need to expand their cost base in order to meet rising demand.

Still, the degree of margin pressure in 1Q is a bit more than we would expect given still-positive revenue growth. As we dig into the numbers, it appears that most of the margin headwinds are due to currency translation (especially in sectors with high foreign sales, such as consumer staples and tech); high levels of spending on growth-oriented investments (in internet software and communications services); and declining revenues (in tech, energy, materials, and financials). It does not appear that rising wages are the main driver of margin pressures. In fact, for the S&P 500 in aggregate there is very little support for the notion that rising wages lead to falling profit margins (Fig. 7).

Large companies have many levers to pull in order to offset higher wages, including higher productivity, price increases, and outsourcing or offshoring. We’ll be watching margin trends closely as companies report results, but the risk of a meaningful and sustained fall in profit margins appears unlikely as long as the US economic expansion continues.

Results from early reporters have been mixed

So far, 23 S&P 500 constituents—companies whose quarters ended in February—have already reported first-quarter earnings. Results from this small sample have been mixed but generally supportive of our outlook. Eighty percent of companies have exceeded earnings estimates, but these companies have missed sales estimates. In aggregate, earnings are coming in 3.6% better than expected but sales are missing by 0.6%.

The mixed messages are evident by looking at a few specific companies. Results from Jefferies, a smaller investment bank, highlight the very sluggish trends in capital market and trading businesses in the first quarter. And results from FedEx were also disappointing, especially in overseas markets. Within semiconductors, memory-chip maker Micron highlighted the high levels of inventory, but investors were encouraged that the company is taking action to help get supply and demand back into better balance.

Still, the overall message is not negative. Consumer spending appears to be on solid footing with good growth from Nike and Costco and better-than-expected results from packaged food company General Mills. As we mentioned earlier, while 1Q results for some of the homebuilders were sluggish, management teams were optimistic about the outlook due to a pickup in customer traffic and lower
mortgage rates. Similarly, enterprise technology spending remains very solid. Bellwether IT consulting company Accenture reported its highest book-to-bill ratio in three years, suggesting a robust pipeline of demand as companies continue to spend on cloud, digitizing their businesses, and cyber security. Adobe and Red Hat confirmed the solid trends in software, reporting 25% and 14% revenue growth, respectively.

**Earnings growth acceleration required for the next leg of the bull**

The S&P 500’s 13% return in the first quarter was nearly a mirror image of the 14% decline in the fourth quarter. At the market low in December, the S&P 500 forward P/E was at 13.5x, the lowest level since 2013. In our view, at that time, investors were increasingly pricing in a high probability of a US recession in 2019. But following the sharp recovery in markets over the past three months, the S&P 500 forward P/E has moved up to 16.6x, which we believe is fair in a moderate growth and low interest rate environment (Fig. 8).

While we see few signs that a recession is impending or that the bull market should end in 2019, the first-quarter reporting season may not be a sufficient catalyst to propel stocks higher in the short term given the recent market gains. Results and management guidance will likely be uneven, with weakness in select geographies and industries offset by strength in others. Investors may have to have some patience before the equity market rally extends further.

Fig. 8: Equity market valuations have recovered to more normal levels

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Source: FactSet, UBS, as of 4 April 2019
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