



CIO expects S&P 500 EPS to contract 5% in 2023 (USD 210) before growing by 10% (USD 230) in 2024. (UBS)

# S&P 500 EPS: Down but not out, for now

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**The past month has certainly been eventful in financial markets, highlighted by the failure of a few US regional banks and the unleashing of Fed measures to provide liquidity to the financial system.**

The turmoil in the banks has raised concerns that access to credit will become more challenging and lead to a slowdown in economic growth. While we agree that access to bank credit will likely become more difficult for certain segments of the economy, we think these headwinds will take time to show up in corporate fundamentals. In fact, we think 1Q23 numbers could be surprisingly resilient.

## **Early reporters—better than recent quarters**

Results from the early reporters—roughly 20 S&P 500 constituents whose fiscal quarter ended in February— increase our conviction. The median company in this group has beaten earnings estimates by 6%, which is better than the roughly 3% beat witnessed in recent quarters. Management guidance about the outlook has also been healthy. The median 2Q EPS estimate for these companies is unchanged, versus a 2% decline for the next quarter in the most recent reporting seasons. In general, management teams highlighted that, so far, there has been no change in the outlook due to the banking stress.

Still, we don't want to sound too exuberant about the upcoming 1Q results. Even if S&P 500 constituents beat earnings by 3-5%, that would still translate into a decline of 1-3% relative to the year ago period. And obviously results will vary by company and sector, with likely messy numbers from many of the smaller banks that are most exposed to the deposit flight and higher deposit costs.

## **Still, there are challenges ahead**

Even though 1Q results may be good, we believe corporate profits still face challenges ahead. First, the yield curve—the spread between 10yr and 2yr US treasury yields—has been inverted on a sustainable basis since last summer. After all prior inversions in the last 50 years, the US economy has always slipped into recession, with the downturn starting about 15 months after the inversion. If history is a guide, economic conditions could be more challenging late this year.

Second, lending standards have been tightening for some time. The January 2023 Senior Loan Officer Opinion Survey (SLOOS) showed that a net 45% of banks tightened lending standards for large- and medium-sized firms.

Finally, although inflation is cooling, it remains too high. The Fed has more work to do in order to get inflation back down to its 2% target. And with the labor market still reasonably strong, we are skeptical the Fed will be able to cut interest rates this year. We think the Fed will likely need to keep monetary policy restrictive, forestalling any re-acceleration in economic growth that could re-ignite inflation.

### **Full year consensus estimates still look too high**

Taken together, these conditions suggest investors should expect continued economic headwinds that will cap equity market upside and present downside risks in the months ahead. But the headwinds may not exert more sustained downward pressure on corporate profits and equity markets until later this year, and quite possibly late in the year. Consensus expectations for a re-acceleration in S&P 500 earnings growth and margins appears unlikely, in our view. We expect S&P 500 EPS to contract 5% in 2023 (USD 210) before growing by 10% (USD 230) in 2024. Our estimates are about 5% lower than bottom-up expectations.

### **Equities to remain range-bound**

It's always difficult to determine how investors will perceive quarterly results. As we discussed, the results and guidance look poised to be better than what some investors may expect. And in some respects (the scope of the earnings beats and the near-term guidance), this earnings season could be better than the last few.

But we are also cognizant of the fact that the S&P 500 forward P/E of 18x is near its highest levels in about a year and higher than pre-pandemic levels. Further, it's pretty unusual for the S&P 500 to trade above 18x. Historically this has only happened when consensus earnings growth expectations were robust (14% on average, compared to 4% today) and/or the 10-year Treasury yield was less than 2%. So despite sentiment that seems somewhat cautious, valuations appear to be much more optimistic. For this reason we think any earnings season-related upside will be somewhat limited.

We continue to think that the S&P 500 will remain in the wide range that has been in place over the last several months from the high 3,000s to the low 4,000s. Ultimately, what breaks the market out of this range will likely be investor conviction in a soft landing—which could drive the S&P 500 to around 4,400—or a hard landing—which could see the market fall to 3,300. Given the ongoing headwinds that we outlined above, we don't think the risk-reward in the market is very compelling. Our year-end price target for the S&P 500 is 3,800.

### **Positioning**

Given the headwinds we've highlighted, a defensive bias across sectors remains appropriate. While market breadth has been narrow this year and mega-cap "tech" has performed like a defensive, we think that investors can get much cheaper defensive exposure in consumer staples or utilities, whose valuations look low for a late cycle environment. We have most preferred views on the consumer staples, industrials, and utilities sectors and least preferred views on the consumer discretionary, financials, and information technology sectors.

Although we recently downgraded value stocks to neutral, we still prefer them to growth stocks which are rated least preferred. In the near-term, cyclical segments within value face elevated earnings risks and higher-quality growth stocks could continue to be perceived as "safe havens" during this period of economic uncertainty. But on a relative basis, growth stocks are trading at nearly twice their historical average valuation premium to value stocks and carry under-appreciated earnings risks. The double risk of elevated valuations and under-appreciated earnings risks in a potentially more challenging economic environment suggests growth stocks may be more vulnerable, in our view.

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### **Content is a product of the Chief Investment Office (CIO).**

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