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Earnings: Better than feared, but caution ahead

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We are now past the half-way mark in the earnings season and so far, companies have performed better than feared with a notable improvement in the breadth and magnitude of earnings beats relative to the last two reporting seasons.

For the first quarter, S&P 500 EPS remains on track to decline 1-3% year-over-year. Consumer spending resilience was a dominant theme among the reporters last week, which is encouraging in the face of persistent recession fears. Mega-cap tech companies also posted positive results, although the headline numbers belie some of the underlying negative trends in technology spending, in our view. Management tone regarding the outlook was a bit more measured, but forward consensus estimates are holding up better than in recent quarters and companies don't foresee an imminent recession.

Consumer spending remains healthy, but slowing

The first quarter GDP numbers released Thursday showed strong consumption growth of 3.7% over the period, so it wasn't surprising that companies continued to see consumers in good shape. The shift from goods towards services continues, with restaurants, hotels and airlines delivering stronger than expected results. Credit card companies Visa and Mastercard topped analyst expectations on the back of strong cross-border travel recovery. Chipotle Mexican Grill (CMG) issued strong guidance for the second quarter, while McDonalds (MCD) reported strong growth across all income groups. However, McDonalds did say that customers were being more cautious in their spending and management is starting to see some resistance to pricing in some places.

The shift towards services spending overall was also evident in the results of transportation and package delivery companies, which continue to see weakening demand for shipping services. UPS results fell short of forecasts, with management also lowering guidance on expectations of lower volumes. Management of J.B. Hunt Transport Services described current conditions as a "freight recession."

Consumers are also spending less on big-ticket and discretionary items. Kering, parent company of Italian luxury brand Gucci, noted lower demand from aspirational clientele in the US. However, consumers continue to maintain their spending on essentials such as food and household goods. As a result, consumer staples continue to enjoy pricing power without sacrificing too much volume. Pricing and mix provided a 10% revenue boost to consumer goods bellwether Procter & Gamble (PG), while volumes fell by about 3%. Beverage giant Pepsi also continues to benefit from price increases and raised its 2023 revenue and profit guidance.

Overall restaurant and consumer goods companies seem to be in a sweet spot, with consumers largely tolerating price increases while they are also getting some reprieve on input costs. Most of these companies expect pricing to moderate throughout the year and for margins to be stable, but are still suggesting that they could take prices higher if inflation remains sticky.

Housing stabilizing?

Homebuilder numbers came in much better than expectations. Pulte Group noted strong demand across buyer segments and price points. Unit sales was better than expected in a backdrop of limited inventory. However, affordability remains a major problem and homebuilders are using mortgage rate buydowns and other incentives to push through unit sales. So we caution against reading too much into the homebuilder numbers and we continue to expect home price appreciation to slow.

Tech results good, but not great

Moving on to tech, we saw strong moves in Microsoft (MSFT) shares this week after their strong earnings reports. However, Microsoft may not offer the best read-through to the broader IT sector. For instance, while Amazon's AWS cloud business did outperform expectations in the March quarter, management's commentary pointed towards a significant slowdown in April.

More broadly, we are seeing some negative trends in IT sector earnings that don't necessarily show up in the headline numbers. Large global IT consulting companies such as Tata Consultancy Services and Infosys whose customers are typically large enterprises saw a slowing demand environment. CDW, a distributor of IT solutions with outsized exposure to small and medium businesses, saw a change in the demand environment in March and sharply lowered expectations. We have seen similar weakness from hardware and component companies with exposure to the large cloud service providers and/or enterprises. A few semiconductor companies with high exposure to autos have started to discuss normalizing demand after two years of chronic shortages. Pricing—which has been a significant revenue driver—may roll over in the back half of the year. A few Asian semiconductor/component suppliers that benefited from shortages over the past two years are now seeing weaker orders and pricing as supply/demand normalizes.

In communication services, Alphabet (GOOG) and Meta (META) beat expectations. However, digital ad growth has slowed sharply on the back of tough comps, high inflation, and a shift in consumer spending from goods to services. The outsized reaction to META seems to be more due to idiosyncratic factors, with investor reaction to Alphabet's results being more muted.

Outlook

The better-than-feared results notwithstanding, we continue to think expectations for 5% growth in S&P 500 profits in the second half of the year are too aggressive, as the economy slows from the lagged effects of Fed rate hikes. Furthermore, we think markets are pricing in fairly high odds of an economic soft landing despite still high inflation and a more challenging environment for consumers and businesses to access to capital. Our June and December S&P 500 targets are 3,900 and 3,800, respectively.

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