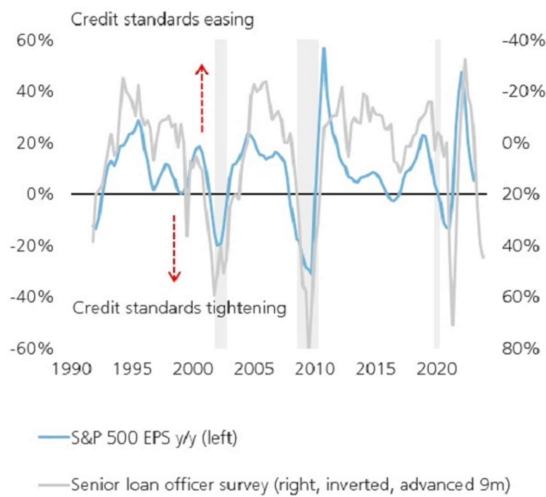

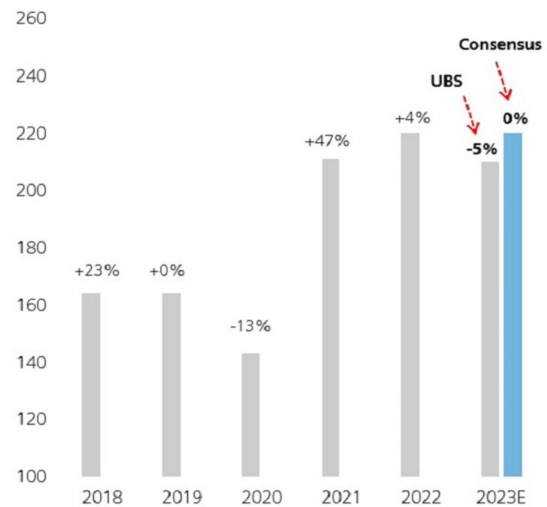

Chart 1: S&P 500 EPS y/y growth vs. US Senior Loan Offer Opinion Survey. Chart 2: S&P 500 EPS, actual, CIO and consensus estimates, in USD
Source: Bloomberg, FactSet, UBS as of April 2023

Chart of the week: Outlook for US corporate earnings challenging

09 May 2023, 04:00 am CEST, written by UBS Editorial Team

1Q US earnings have been better than feared, but with credit conditions continuing to tighten, Fed policy likely to remain restrictive, and non-negligible recession risks, we believe the outlook for corporate profits remains challenging. We estimate 2023 S&P 500 earnings will decline by about 5% y/y and forecast the S&P 500 Index at 3,900 by end-June and at 3,800 by end-2023.

The S&P 500 index traded well into the reporting season and 1Q earnings have been better than feared, with notable improvement in the breadth and magnitude of beats relative to the last two quarters. Around 80% of the S&P 500 Index has reported thus far, of which close to 75% are beating sales and around 77% are beating earnings estimates. Overall, S&P 500 earnings remain on track to meet our expectations of a 1–3% y/y decline in 1Q23.

Consumer spending resilience was a dominant theme among recent reporters, 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.

But despite the better-than-feared-results on the back of a slowing but still-healthy jobs market, improving supply chains, cost-cutting, and the weaker US dollar, we continue to think consensus expectations for 5% growth in S&P 500 earning in 2H23 are too aggressive. We believe the outlook for corporate profits remains challenging, and we estimate for full-year 2023 earnings to decline by around 5% y/y versus consensus forecast of 0% for the following reasons.

First, lending standards continue to tighten. 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. This was before the recent banking sector turmoil, which will likely add to the headwinds for lending activity. The only other instances when the SLOOS was at these levels was during the COVID-19 pandemic, global financial crisis, and the dotcom bust. If credit standards remain this tight or get more restrictive, profit growth will come under pressure. On credit conditions, at the press conference post the May policy meeting Fed Chair Jerome Powell—who received the Senior Loan Officer Survey data (to be released on 8 May) ahead of the meeting—said that "these tighter credit conditions are likely to weigh on economic activity, hiring and inflation."

Second, the Fed has opened the door to a pause but policy will be restrictive. The Federal Reserve raised the policy rate by 25bps, to a range of 5–5.25%, at its May meeting and opened the door to pausing the rate-hiking cycle. But, in our view, a pause doesn't mean that the Fed is getting ready to cut rates. With inflation still too high, private sector demand holding up, and the labor market still tight, we believe the Fed will watch key data releases closely, and remain on the sidelines and hold tight for a while. Overall, the lagged impact of the 500bps of hikes the Fed has already implemented and still restrictive Fed policy will likely forestall any re-acceleration in economic growth and earnings.

Third, recession risks remain non-negligible. 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. During past recessions, the median peak to trough drawdown in quarterly S&P 500 EPS was about 16%. If the US does enter a recession, we think earnings will be impacted but by a smaller magnitude.

So, overall, while the headwinds may not exert more sustained downward pressure on corporate profits and equity markets until later this year, we believe US stocks will have to contend with elevated valuations, a Fed that will not likely cut rates any time soon, tighter credit conditions, and cautious signals from the yield curve. We forecast the S&P 500 Index at 3,900 by the end of June and at 3,800 by end-2023.

We advise investors to diversify beyond US equities and consider investing in emerging market stocks which are expected to benefit from a weaker dollar, rising commodity prices, strong earnings growth, and China's stronger-than-expected recovery, alongside select opportunities in Europe.

Main contributor: Krishna Goradia

For more, see the report **Earnings: Better than feared, but caution ahead** 1 May 2023.

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