Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Uphill Battle for Stocks?

By Mitch Zacks
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Technology stocks are under mounting pressure, and the S&P 500 remains in correction mode. The threat of a trade war is growing. Investors are understandably getting more skittish by the day.

Those are the headlines of the day in the financial world, and they are a source of worry for many. But I don't actually view the dual risks of tech regulation ("techlash") and a trade war as the biggest hurdles to big positive returns from equities in 2018. In my view, there's a bigger hurdle for stocks to clear this year – earnings expectations.

Strong Earnings, but Even Stronger Earnings *Expectations*

As of this writing, the estimated earnings growth rate for the S&P 500 in the first quarter is +17%, which (if it stands) would mark the highest quarterly earnings growth rate since Q1 2011 (+19.5%). So, we could be looking at the highest earnings growth rate in seven years. That's big, particularly this deep into an economic expansion, and also in light of some of the uncertainty afflicting the market of late.[1]

But we believe that there's a bigger story here. A closer look reveals a near record-breaking increase in earnings *estimates* looking ahead for 2018. The first two months of the first quarter marked the **biggest increase in the annual earnings-per-share (EPS) estimates** since tracking began in 1996. From Dec. 31 through Feb. 28, the bottom-up EPS estimate for 2018 increased by a staggering +7.3%. CEOs appear to be as optimistic as ever.[2]

What's more, rising earnings expectations aren't limited to a certain part of the economy – the estimate increases are broad-based. At the sector level, nine of the eleven S&P 500 sectors recorded an increase in their bottom-up S&P 500 EPS estimates during the first two months of the quarter, led by:[3]

- Energy (+18.9%)
- Telcos (+14.8%)
- Financials (+11.5%)

In short, U.S. corporations are hopeful that they're going to make even more money this year than they originally thought. While that sounds – *and is* – wonderful, it also raises the bar for earnings, thereby increasing the probability that a company could fall short.

In my view, stocks perform best when corporations surprise the street with earnings that far exceed expectations – an event generally known as a "positive surprise." The opposite holds true as well in my opinion, whereby stock gains tend to moderate when earnings aren't quite what the street expected. To the extent that earnings throughout the year fall in-line or short of expectations, I think we could see some limitations to stocks' upside potential in 2018.

Bottom Line for Investors

My bottom line for investors this week can be summed up with a single equation: Earnings Estimates + Tariffs + Tech Regulation = 2018's "Wall of Worry".

I've asserted that 'too high' earnings expectations could limit stocks' upside potential, but it's important to note that I still very much think stocks have upside potential. That's because I think that tariffs, a high bar for earnings, and new regulations for the technology industry all contribute to the construction of a shiny, brand new, "wall of worry." When I think of all the aforementioned negative forces together, I believe we'll see a pattern develop that I've seen numerous times in my decades as an equity investor. It goes like this:

- Phase 1: A negative (like tariffs, a trade war, and regulation) surfaces.
- Phase 2: Market participants fear the worst, and rush to price-in the worst-case scenario.
- Phase 3: Volatility ensues and talk of a bear market increases (we're at this phase today in my view).
- Phase 4: Over time, market participants realize that the feared negative did not turn out to be as bad as everyone originally expected.
- Phase 5: The market resumes its upward, longer-term trajectory.

Stocks have an uphill battle with a few nagging headwinds, and we'll be watching them develop closely. But I think we'll see phases 4 and 5 in the not-too-distant future.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Source – Zacks Investment Management's Stock Market Outlook Report

[2] Source – Zacks Investment Management's Stock Market Outlook Report

[3] Source – Zacks Investment Management's Stock Market Outlook Report

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