Mitch on the Markets

What to do When Growth Stocks Stop Growing

By Mitch Zacks
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The broad outlook for U.S. corporate earnings is getting weaker, seemingly by the day.

For Q1 2019, total S&P 500 earnings are expected to decline -3.6% from the same period last year, though on +4.8% higher revenues. Growth is expected to be negative for 9 of the 16 Zacks sectors, with Technology and Energy as the biggest drags. All that said, we could be looking at the first earnings decline since the second quarter of 2016.

Technology sector earnings are expected to decline -10% from the same period last year on +3% higher revenues, with the semiconductor space potentially serving as the biggest drag. But even if we remove tech's impact on total S&P 500 earnings for the quarter, we would still get a negative reading by our estimates: down -1.5% from a year ago.[1]

As you can see from the chart below detailing quarterly earnings and revenue growth, there's a stark contrast from last year's performance to this year's expected result:

The Sugar Rush of the Tax Cut May be Fading Fast

Indeed, for full-year 2019, total earnings for the S&P 500 index are expected to be up a paltry +2.5% on +4% higher revenues, which is obviously a far cry from the robust +23.3% earnings growth on +8.8% higher revenues we saw in 2018.[2]

In short, the immediate impact of the tax cut was significant and the growth created was substantial, but the momentum may be fading just as fast. The challenge for investors will be to find companies that continue generating solid profits even as wage pressures rise, credit markets tighten, tariffs weigh, and broad GDP growth levels off.

One place to look may be in the "Value" category or within defensive categories, like Staples and Utilities. Over the course of this entire bull market, growth stocks (like FAANG) have far outpaced value stocks (think blue chips). If one compares the Russell 3000 Value Index to the Russell 3000 Growth Index, this outperformance is plain to see.[3]

Which brings up a valid argument – is it possible that Value is poised to outperform Growth looking ahead, in a period when economic growth is expected to be modest and interest rates are expected to be higher? I think it's a distinct possibility in the medium term, and perhaps a strong possibility in the short term. If uncertainty about the growth outlook grows with time, and as corporations reduce earnings expectations, investors may pivot to favoring companies with reliable earnings. And those companies, generally speaking, often reside in the Value and defensive categories.

Bottom Line for Investors

The very strong growth we experienced in 2018 was primarily because of the tax cut legislation, in my view. The pure arithmetic of the lower corporate tax rate represented a one-time boost to corporate bottom lines, which will be part of base comparisons for this year – and will also serve to make earnings in 2019 look weak by comparison. On top of this comparability issue is the impact of slowing economic growth, particularly beyond U.S. shores.[4]

What's more, these low growth expectations for the coming quarters still remain vulnerable to further downward revisions, which would only serve to increase uncertainty. In uncertain times, investors may be best served looking for reliable earnings.

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] Zacks.com, March 20, 2019. https://www.zacks.com/commentary/362428/weak-earnings-growth-ahead
[2] Zacks.com, March 20, 2019. https://www.zacks.com/commentary/362428/weak-earnings-growth-ahead
[3] Real Clear Markets, December 7, 2018. https://www.realclearmarkets.com/articles/2018/12/07/amid_stock-market_corrections_the_boring_becomes_beautiful_103525.html
[4] Zacks.com, March 20, 2019. https://www.zacks.com/commentary/362428/weak-earnings-growth-ahead

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