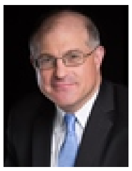
Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Will corporate profits sink in 2019?



By Mitch Zacks
Portfolio Manager

I believe that investors should prepare for a slew of headlines in the second quarter regarding a possible "earnings recession" with corporate profit margins getting squeezed. Normally I would say to ignore the headline risk and focus on the fundamentals. But in this case, future headlines about negative earnings growth will not be without merit, in my view.

Indeed, U.S. corporations are likely to feel some profit pressure in the first half of 2019. This is coming off a year when the largest U.S. corporations were the most profitable they've ever been – net margins for members of the S&P 500 reached +10.7% in the fourth quarter, the best on record.[1]

But profit headwinds are starting to swirl. According to the Bureau of Labor Statistics, average hourly wages are up over +3% year-over-year through March,[2] and with labor markets continuing to tighten, employers are likely to continue feeling the effects. According to the National Federation of Independent Business, the percent of business owners who cited 'labor costs' as their biggest issue jumped to 10% in February, which is also the highest on record.[3]

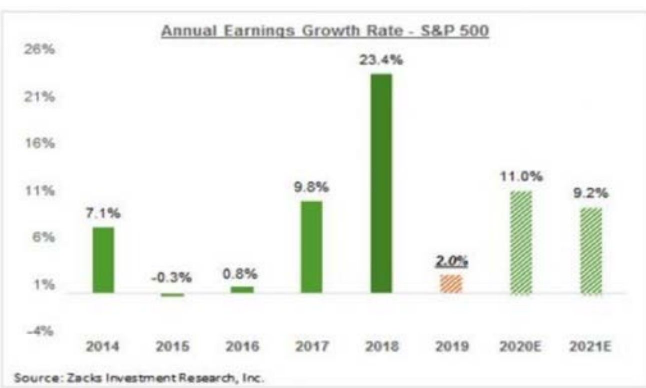
Meanwhile, corporations are also feeling cost pressures from rising energy prices. U.S. crude-oil futures prices climbed +32% in the three months ending March 31, on the heels of OPEC production cuts and fresh U.S. sanctions on Iran and Venezuela. The U.S. is in a unique position today, more than ever, to combat rising energy prices by ramping up domestic production, so this issue is arguably one that the economy has greater control over.[5]

Taken together, and adding in the fact that earnings in 2018 were so strong, earnings growth in Q1 2019 is expected to turn negative, the first earnings decline since the second quarter of 2016. Total S&P 500 earnings are expected to decline -4.0% from the same period last year on +4.6% higher revenues and 100 basis points of compression in net margins. Earnings growth in Q1 is expected to be negative for 10 of the 16 Zacks sectors, with Technology and Energy as the biggest drags.

Technology sector earnings are expected to decline -10% from the same period last year on +3% higher revenues, with the semiconductor space as the biggest drag. Excluding the Tech sector's weak growth in Q1, total earnings for the rest of the index would be down by -2.1% from the year-earlier period.

But the headwinds pushing up against U.S. corporate earnings may not last the entire year, and that's why I would urge investors to focus less on negative earnings headlines over the next three months and think more about where earnings will end the year. Which, according to Zacks estimates, is back in positive territory.

For full-year 2019, total earnings for the S&P 500 index are expected to be up +2.0% on +3.5% higher revenues, which while seemingly low should be viewed in the context of the +23.4% earnings growth on +9.2% higher revenues in 2018.[5]



Source: Zack Investment Research[6]

Bottom Line for Investors

Pundits, analysts, and the financial media may paint a bleak picture of U.S. corporate earnings over the next few months. And while the coverage may be somewhat sensationalized, with some warning that a U.S. recession is coming sooner than most think, it will not be without merit. Investors will be challenged by the notion that negative earnings imply a bearish outcome.

But I would urge investors to keep their cool and look at how earnings are likely to finish the year, and to remember that as expectations of earnings fall, the opportunity for positive surprises rises. And markets like positive surprises.

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] The Wall Street Journal, April 3, 2019. https://www.wsj.com/articles/investors-brace-for-hit-to-profits-as-costs-rise-11554283800

[2] Bureau of Labor Statistics, April 5, 2019, https://www.bls.gov/news.release/empsit.t24.htm

[3] The Wall Street Journal, April 3, 2019https://www.wsj.com/articles/investors-brace-for-hit-to-profits-as-costs-rise-11554283800

[4] The Wall Street Journal, April 3, 2019. https://www.wsj.com/articles/investors-brace-for-hit-to-profits-as-costs-rise-11554283800

[5] Bureau of Labor Statistics, April 5, 2019, https://www.bls.gov/news.release/empsit.t24.htm
[6] Zacks.com, April 3, 2019, https://www.zacks.com/commentary/370376/is-the-earnings-picture-really-weak