Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Are We in the Midst of an Earnings Recession?

With all the recent talk on weak manufacturing numbers, endless trade wars, and the impeachment inquiry, few commentators have pointed out that we may be in the midst of a technical earnings recession. And given the high value we place on corporate earnings here at Zacks Investment Management, this is a factor we're most certainly monitoring closely.

The background: As I write, we now have Q3 results from 74 S&P 500 members, which account for about 20% of the index's total market capitalization. So far, the results are mixed – total earnings (aggregate net income) for these 74 companies are down -3% from the same period last year on +3.2% higher revenues. When we combine the results from these 74 companies with our estimates for the yet-to-report companies, total earnings are expected to be down -4% from the same period last year on +4.1% higher revenues.[1]

In the second quarter, the blended earnings decline for the S&P 500 was -0.4%, which was about the same as the decline in Q1. Put this all together, and that's where the earnings recession narrative comes from.

As you absorb this data, it may feel like the odds are stacked against this bull market. I can empathize with the feeling that an earnings recession may be more than enough reason to err on the side of caution. But before moving in that direction – and potentially considering changes to your asset allocation – I want to share a few silver linings in the earnings story with you.

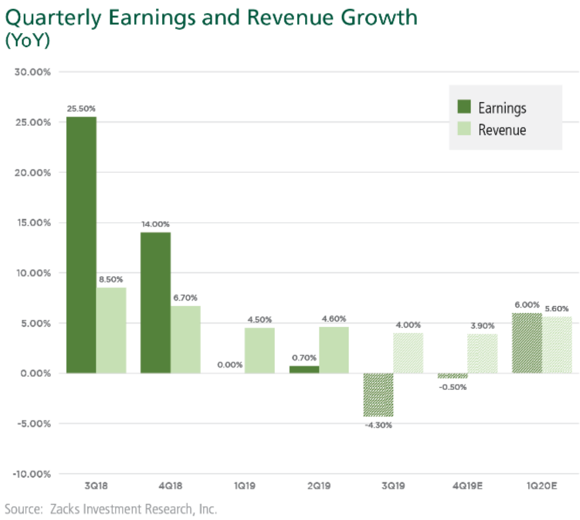
Let's start with the second quarter. The blended earnings rate for the S&P 500 was indeed -0.4% from the previous year, but 75% of all companies reported a positive earnings-per-share (EPS) surprise and 56% of companies reported a positive revenue surprise. The 5-year average of companies beating earnings expectations is 72%, so even with negative year-over-year EPS growth the 75% beat rate is ultimately a positive result.[1]

Fast forward to Q3, and we're seeing a similar trend forming. So far, 83.3% of reporting S&P 500 companies have beaten EPS estimates and 59.5% have reported beating revenue estimates. Assuming this trend largely holds, we could see another quarter where more companies are beating earnings expectations than normal. And that's a good thing.

There is another factor in play, too, that I believe you should bear in mind. S&P 500 companies are facing an uphill battle for earnings growth, considering the tough comparisons to last year when growth was boosted by the tax cut legislation. We expected this to weigh on earnings growth in 2019, and many corporations warned that this would be the case. I think that's one of the reasons why we're seeing strong performance from the S&P 500 this year, even as year-over-year earnings come in slightly negative.

The sector with some of the toughest comparisons is Tech. The Tech sector is the biggest earnings contributor in the S&P 500 index, bringing in 22.9% of the index's total earnings in the forward four-quarter period. It follows that weak earnings in tech can be a major drag to total S&P 500 earnings. If we excluding the tech sector's drag, the estimated total earnings growth for the remainder of the index would be down only -1.8% (-4% with tech included).

As we drift further from the effect of the tax cut, we expect the year-over-year comparisons to normalize a bit with earnings growth coming back into the positive in the quarters ahead:



Source: Zacks.com[1]

Bottom Line for Investors

Moderating U.S. economic growth and notable slowdowns in other major global economic regions are certainly a factor in the S&P 500 year-over-year earnings declines. Uncertainty about the global trade regime and increasingly protectionist policies are not helping matters either. But it's important to remember that S&P 500 companies are currently facing very tough comparisons from last year, and even still, more companies than average are reporting better-than-expected results. As we drift away from the tough comparisons and maybe – just maybe – get some clarity on trade, I think the earnings picture will improve and return to positive year-over-year growth.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior 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] October 18, 2019, Zacks.com. https://www.zacks.com/commentary/571787/are-q3-2019-earnings-results-really-that-good?

IN FOCUS THIS WEEK

- The clock is ticking on Brexit, will a deal be reached?
- WeWork fails to go Public. What does this say about tech IPOs?
- Q3 corporate earnings growth is weaker than what was expected. What does this mean for the market?
- How is the trade war affecting China's growth?

China Flirts with Sub-6% Growth

For as long as anyone can remember, China has consistently posted growth comfortably above the 6.5% range. Those days are over. In Q3, China reported economic growth of 6%, which falls squarely on their government's baseline target for expansion. Indeed, this GDP reading marks the slowest growth for the world's second-largest economy since 1992.[1] The effects of the trade war are no doubt taking a toll, as business activity slowed and tariffs have eased demand. To be sure, China's growth has been decelerating over the past few years, but a breach of the 5% growth mark could send worrisome signals across the global economy.

WeWork's Roller Coaster Ride Ends in Takeover

The office space and tech startup, WeWork, was just days away from issuing an initial public offering (IPO) at a nearly $50 billion valuation. But as Wall Street started to scrutinize the books and management practices, it became abundantly clear that WeWork was, in the classic tech startup sense, a cash-burning and money-losing bubble. This week, the private equity firm and WeWork's primary financier, SoftBank Group, moved to secure a deal to take control of the company and wrest control from embattled CEO, Adam Neumann. SoftBank's takeover terms ended with a generous payout for Neumann of over $1 billion, with the company being revalued at $8 billion.[2] WeWork never ended up going public, which may ultimately be a good sign for how markets are operating – investors are keen on avoiding high flying tech IPOs that are overvalued and burn cash.

Brexit Deadline Approaching Fast with No Deal in Place

As we go to print, there are only 3 days left until Britain is set to leave the European Union, but there is still no agreed-upon deal in place to do so. While the United Kingdom and the EU have reached a deal in principle, Prime Minister Boris Johnson is still tasked with selling the deal to Parliament – something he has yet to accomplish. This week, U.K. lawmakers endorsed a Brexit deal but they still need time to review the 100-plus page document.[3] As such, they rejected Johnson's plan to swiftly move the deal through Parliament. The clock is ticking.

S&P 500 Corporate Earnings Update

Earnings continue to hit the tape daily, and as of this writing, we have Q3 results from 124 S&P 500 companies, which account for 29.3% of the index's total market capitalization. Total earnings, or aggregate net income, for the 124 companies are down -2.4% from the same period last year on +3.1% higher revenues, with 82.3% beating EPS estimates and 63.7% beating revenue estimates. Earnings growth is weaker than what we saw from this group in recent periods, but revenue growth is tracking modestly higher and a bigger proportion of companies are beating EPS estimates at this stage of the reporting cycle – a silver lining. We had expected challenging earnings results in Q3 and the results show it – but better-than-expected performance is arguably what's leading to the stock market's fairly warm reception thus far.[4]

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[1] The Wall Street Journal, October 17, 2019. https://www.wsj.com/articles/china-economic-growth-slows-even-more-11571364058

[2] The Wall Street Journal, October 23, 2019. https://www.wsj.com/articles/wework-employees-feel-sting-as-ex-ceo-stands-to-reap-11571870011?mod=hp_lead_pos11

[3] The Wall Street Journal, October 22, 2019. https://www.wsj.com/articles/boris-johnsons-brexit-deal-clears-vital-hurdle-in-parliament-11571768188?mod=djem10point

[4] Zacks.com, https://www.zacks.com/commentary/insight/bio.php?auname=sheraz-mian

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