Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Early Observations from Q1 2023 Earnings Season

Results from Q1 2023 earnings season are arguably carrying extra weight for investors, as many try to gauge how higher interest rates and bank stress may have combined to impact profits in the first three months. As I write, it's still too early in the reporting season to draw sweeping conclusions. But I do think it's fair to say that any narratives about an 'earnings cliff' can be safely set aside. It's just not happening.[1]

As my colleague and the Director of Research at Zacks, Sheraz Mian, put it: "*The picture emerging at this early stage is one of resilience and stability, with an above-average proportion of companies beating estimates and providing a good-enough outlook in an uncertain macro environment.*"[2]

Indeed, 77% of the approximately 90 reporting S&P 500 companies have beaten earnings expectations, which marks a higher beat percentage for these specific companies than in each of the previous three quarters. One question that's emerging about this earnings season is whether analysts were too pessimistic in lowering earnings expectations, or whether corporations are delivering stronger-than-expected results in a better-than-expected macro environment.

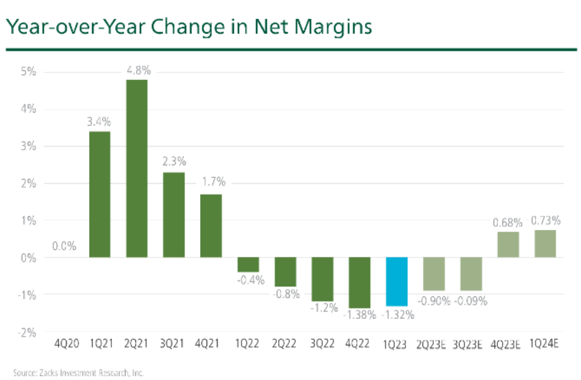
I think both are true.

On the analyst side, there hasn't been adequate appreciation for the idea that the earnings recession likely started about a year ago, which I think implies that we're nearing the bottom or already past it. Energy sector earnings have distorted the overall picture in the last year, with high commodity prices resulting in a profit surge that skewed results for the broad S&P 500. But when we strip away the energy sector's contributions, we find that S&P 500 earnings have been contracting on an annual basis since Q2 2022. In short, forward estimates today don't seem to be considering the possibility of an earnings recovery in the second half of the year.

Banks have also been a key driver in this quarter's better-than-expected results (to date), but not in the way most investors expected in the wake of regional banking stress. The worst fears of a financial contagion did not come to fruition, and major banks have performed far better than anticipated. As a result, Q1 earnings for Financials are now expected to be up +7.6% from the year-earlier period, a significant improvement from the +0.3% growth expected just one week ago.

The three most prominent players in the space – JPMorgan, Bank of America, and Citigroup – handily beat top- and bottom-line estimates. JPMorgan's Q1 earnings, for instance, were up an impressive +52.4% from the same period last year on +24.8% higher revenues on record net-interest income. Earnings estimates for the June quarter have been increasing for these major banks as well, which I think investors should read as a significant positive surprise. Remember, just one month ago many were questioning the health and stability of the banking sector.

A final observation I'd make about this earnings season is that operating margins appear to have turned the corner for the positive. The past year has posed many challenges for corporate profits, largely from rising labor costs and some companies' limited ability to pass on rising input costs to consumers. Those pressures appear to be easing now, and there's a good argument that margin pressures may have peaked in Q4 2022 (see chart below). This metric is critical, as operating margins are an important gauge of profitability and also a leading indicator for stocks.



Bottom Line for Investors

As I mentioned at the outset of this column, it's still early in Q1 2023's earning season, so there will be plenty more insights and takeaways to parse. I'll likely revisit the earnings story once all the results are in.

But our early read is that earnings overall are shaping up to be far better-than-expected this quarter. In my view, analysts got too cautious in anticipating the fallout from bank stress, which to date has not materialized into much of an economic impact. But there have also been persistent expectations for a recession—which has yet to arrive—baked into estimates. When looking out at estimates for future quarters, the key question becomes: *what happens if the U.S. avoids recession altogether?*

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] Bloomberg. April 22, 2023. https://www.bloomberg.com/news/articles/2023-04-22/better-than-feared-earnings-has-analysts-rethinking-projections#xj4y7vzkg

[2] Zacks.com. April 24, 2023. https://www.zacks.com/commentary/2083630/big-tech-earnings-looming-what-to-expect

[3] Zacks.com. April 24, 2023. https://www.zacks.com/commentary/2083630/big-tech-earnings-looming-what-to-expect

Weekly Market Update

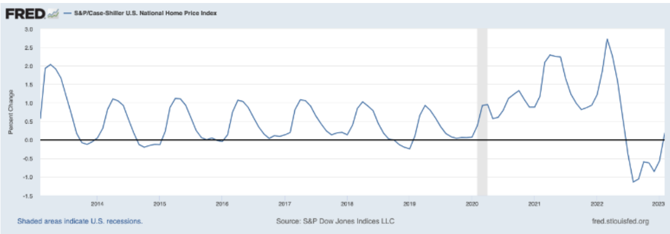
Important Market News We Think Worth Considering

STEADY INVESTOR WEEK

Home Prices Tick Slightly Higher After Seven Months of Decline

The U.S. housing market has endured a soft patch for about a year, but February data signaled that a ‘bottoming’ may be underway. Following seven straight months of declines, the S&P CoreLogic Case-Shiller National Home Price Index rose 0.2% from January to February (see chart below).[1]

S&P Case-Shiller Home Price Index (% Change)



Source: Federal Reserve Bank of St. Louis[2]

On a year-over-year basis, prices were up 2% in February. Part of the reason for price support likely stems from mortgage rates, which fell in December of last year and early in 2023. The markets’ expectation for a recession later this year combined with a likely ‘pause’ in rate hikes from the Federal Reserve eased pressure on long-duration Treasuries and also the 30-year fixed mortgage rate, which finished last week at 6.39% – down from a peak of over 7%. Another reason for the bump in home prices likely came from inventories that remain low, which has kept markets competitive, particularly in the East and South. Prospective buyers have been increasingly opting for new single-family houses versus existing homes, with sales of new houses jumping to an annual pace of 683,000 in March, the highest level in a year.

Trends in U.S. Shipping Signal Weakening Overall Demand

The Dow Jones Transportation Index has fallen about -10% from highs, an indicator we referenced in last week’s Steady Investor. The takeaway, in short, was that markets seemed to be anticipating a slowdown in shipping and freight, a possible sign of economic weakness or a recession ahead. Diesel gas prices may be telling the same story – wholesale diesel recently fell to $2.65 a gallon, a significant decline from $5.34 last summer. Benchmark diesel futures fell this week to $2.45 a gallon, a 15-month low. Last year, record diesel prices impacted everything from construction sites to goods sold at retail locations, and those higher costs may have dampened the appetite of many producers to ramp up in the new year. It’s also true that many stores and warehouses remain overstocked as a legacy of the goods-driven consumption boom, which is negatively impacting fuel demand. According to federal record-keepers, the impact on domestic demand was over -8% (year-over-year). The upshot to this story is that lower diesel costs may lure many producers back into the market, and encourage a rebound in manufacturing production.[3]

Another Labor Shortage in the U.S.

$42.5 billion in new government funding is earmarked to install, repair, and maintain broadband networks across the U.S., as part of President Biden’s infrastructure plan. Millions of American households still do not have access to fixed broadband, and the legislation meant to change that. The problem: there aren’t enough workers available to lay cable and repair wired broadband networks. According to the Fiber Broadband Association, an additional 205,000 “fiber splicers” – which is what the needed broadband workers are called – will be needed through 2026 to complete all of the needed projects, which marks a nearly 50% increase from current levels. One potential solution to this labor shortage is for cellphone companies to provide more wireless internet service across rural areas, which would also qualify for the federal subsidies. But the longer-term issue with this approach is that wireless has lower capacity and speeds than fiber, which is likely to create problems as Americans use an increasing amount of data for everyday needs.[4]

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[1] Wall Street Journal. April 25, 2023. https://www.wsj.com/articles/home-prices-rose-in-february-for-first-time-since-june-985486a6?mod=djemRTE_h

[2] Fred Economic Data. April 25, 2023. https://fred.stlouisfed.org/series/CSUSHPINSA

[3] Wall Street Journal. April 25, 2023. https://www.wsj.com/articles/sliding-diesel-prices-signal-warning-for-u-s-economy-c6400724?mod=djemRTE_h

[4] Wall Street Journal. April 25, 2023. https://www.wsj.com/articles/high-speed-internet-plan-worker-shortage-be83a843?mod=djemRTE_h

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