RESEARCH NOTE

Earnings power: Equities face a challenged profit landscape

In Q3, earnings beat preseason estimates but still experienced negative year-over-year growth, the worst quarterly performance since the 2015–16 earnings recession. Stock market returns are heavily reliant on earnings and, going forward, firms' ability to kick-start profitability will be critical for broader equity market returns. Looking ahead, the earnings landscape could remain significantly hampered by increasing labor costs, sluggish global growth and geopolitical uncertainty.

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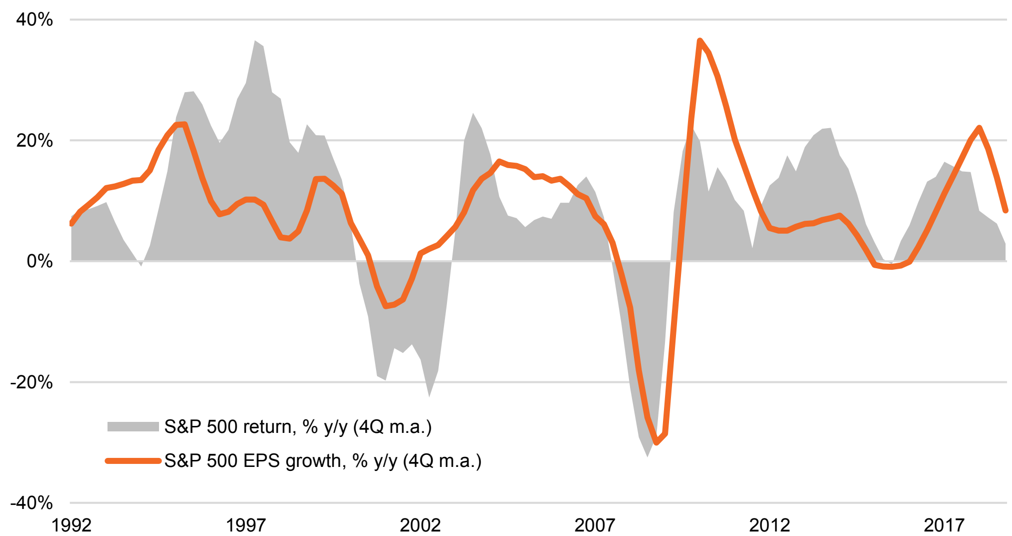
OVER THE LONG TERM, EQUITY RETURNS FOLLOW EARNINGS



Source: Bloomberg Finance, L.P.

How this slump compares to 2015–16

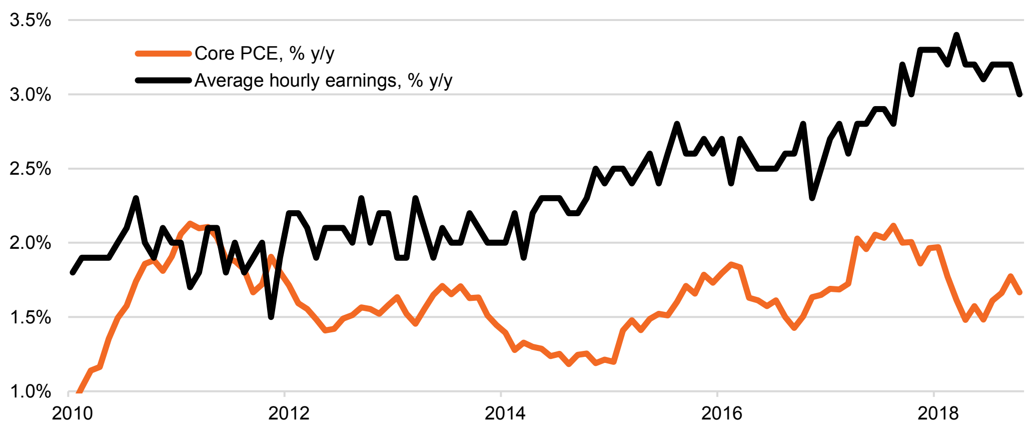
Despite headlines that Q3 earnings beat expectations, S&P 500 EPS growth fell 1.4% y/y, the first negative reading since mid-2016. On the surface, the current situation may seem very comparable to the 2015–16 earnings recession, which caused markets to stall but was shallow and followed by exceptional performance in 2017. The 2015–16 weakness in earnings was primarily led by the energy sector as crude prices fell from over $100/bbl to $29/bbl in a span of 18 months. Additionally, the last downturn was driven primarily by a decline in revenues, though margins did compress a bit.[1]

The current slump has had a different primary culprit, as revenue growth for S&P 500 companies has remained in positive territory. Rather, firms are being squeezed by shrinking operating margins. As wage growth has steadily risen, recently reaching an expansion high of 3.4% y/y, inflation has remained

1 Bloomberg Finance, L.P.

stubbornly muted.[2] Companies are stuck between a rock and a hard place: They must meet workers' demands for higher wages due to a tight labor market, but have been unable to pass those rising costs onto consumers due to a lack of pricing power.

RISING REAL WAGES PRESSURING U.S. EARNINGS

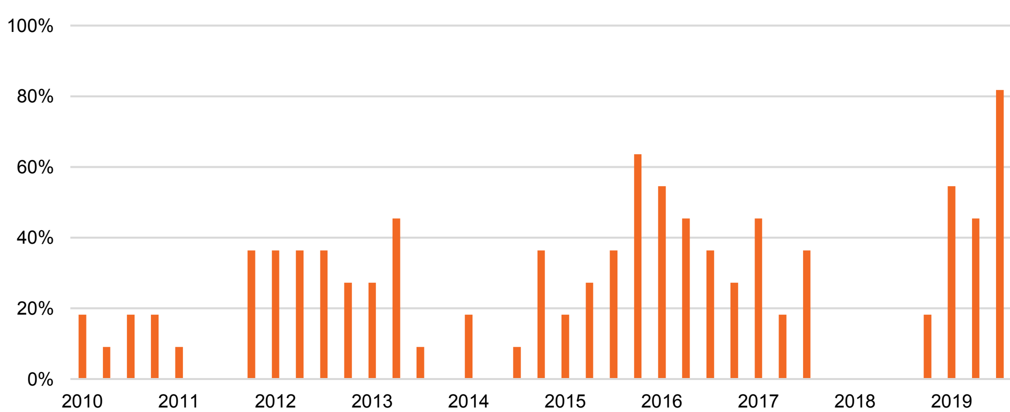


Source: U.S. BEA, U.S. Bureau of Labor Statistics.

This compression in margins appears to have had an impact across sectors, making weakness during the current earnings downturn more broad-based compared to the energy-driven 2015–16 period. Q3 2019 is on pace to show 9 of 11 S&P 500 sectors experiencing bottom-quartile post-crisis EPS growth, which is more than any quarter during the previous earnings recession.[1] While the current downturn has (so far) been shallower, it appears to have infected a broader cross section of the equity market.

EARNINGS WEAKNESS HAS BEEN BROAD-BASED

% of S&P 500 sectors showing bottom-quartile post-crisis EPS growth, quarterly data



Source: Bloomberg Finance, L.P., FS Investments.

The corporate sector came out of the 2015–16 episode like gangbusters, posting impressive EPS growth during both 2017 and 2018. This can in large part be attributed to the 2017 tax law, which lowered corporate tax rates from 35% to 21% and was a boon for profits. High levels of share buybacks,

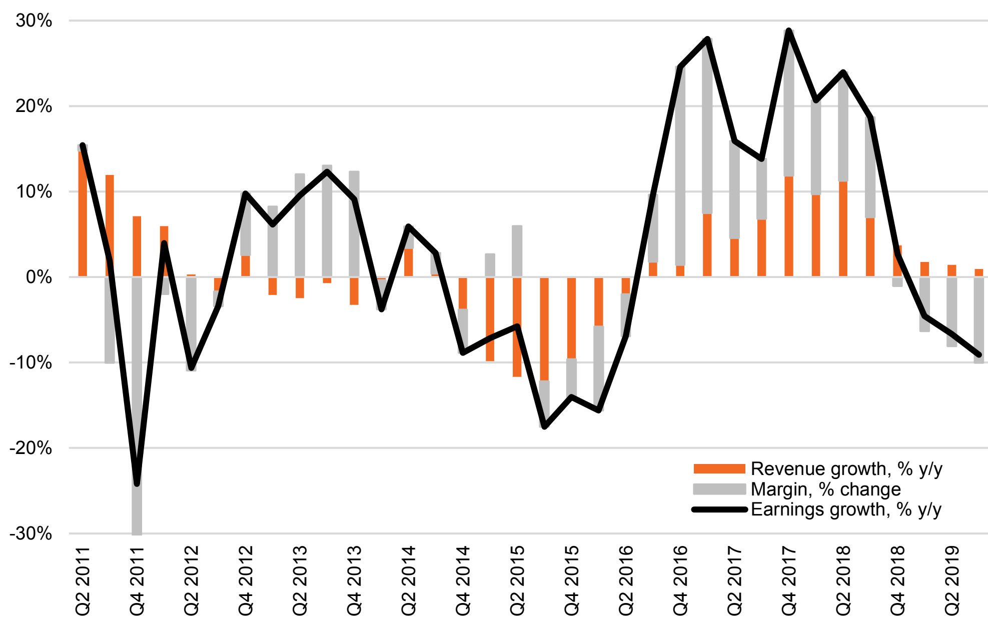
2 U.S. Bureau of Labor Statistics. Expansion high came in February 2019.

especially during 2018, also boosted EPS growth. It is unclear whether there will be catalysts of similar significance to boost earnings out of the current decline, particularly on the policy front as we head into the next election.

Global factors weighing on earnings

The current earnings slowdown has its roots in the global economic slowdown. The world economy has slowed significantly, with the U.K. and Germany even posting negative GDP growth last quarter. This slowdown has coincided with major global uncertainties, including the U.S.-China trade war and Brexit, which have had far-reaching impacts and continue to weigh on business sentiment. Additionally, global firms have faced many of the late-cycle factors that U.S. companies are dealing with, namely rising labor costs and stagnant prices, leading to margin compression.

GLOBAL EARNINGS PRESSURED BY SHRINKING MARGINS

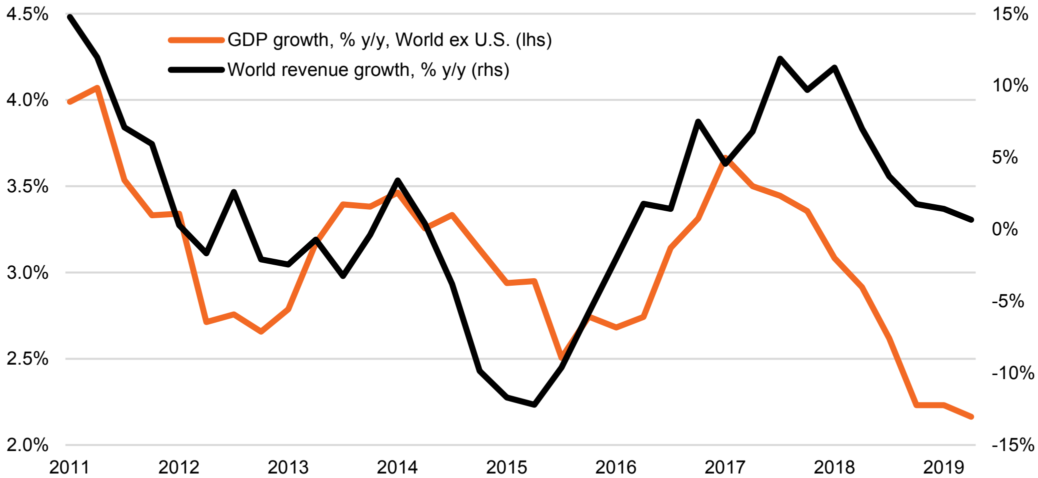


Source: Bloomberg Finance, L.P. Index used is the MSCI ACWI Index.

Against this backdrop, the next few quarters will be pivotal in determining whether this will be a quick and rather shallow earnings recession or the start of an extended period of chronically low earnings growth. Margins are likely to remain somewhat challenged given the late stage of the business cycle and labor market dynamics, putting the fate of earnings growth in the hands of top-line revenue growth, which is historically tightly tied to broad economic growth. The IMF projects growth in advanced economies to slow to just 1.7% in 2019 and 2020,[3] a far cry from the 2.5% growth seen in 2017 and 2.3% in 2018. If growth undershoots these estimates, revenues could decline meaningfully while margins remain tight, deepening the earnings drought.

3 IMF Global Economic Outlook, October 2019.

SALES RUN UP AGAINST ECONOMIC GROWTH

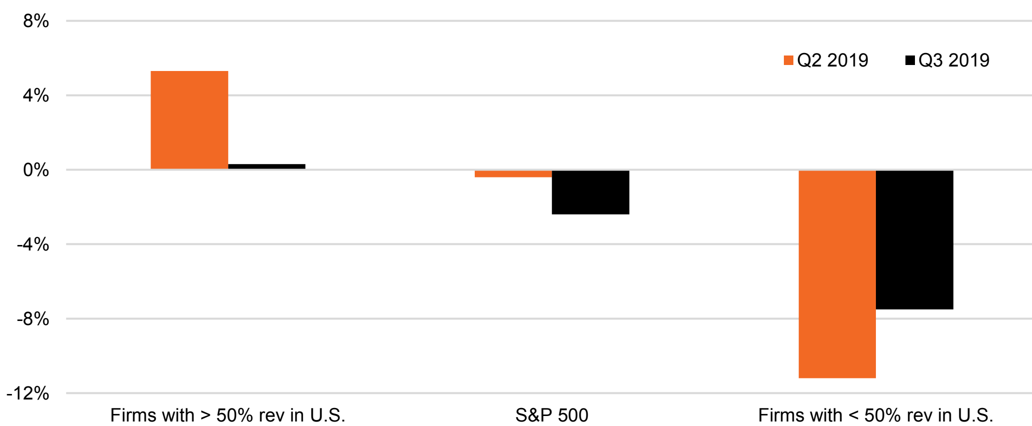


Source: Bloomberg Finance, L.P., Federal Reserve Bank of Dallas.

While the U.S. economy has thus far remained impressively resilient, it is difficult for firms in the U.S. to completely sidestep this broad global slowdown. Multinational firms in the U.S., which operate with global supply chains and customer bases, have been significantly impacted as activity has waned. Companies with higher exposure to foreign revenue sources have seen deeper earnings declines, while more domestically inclined firms have been more insulated.

GLOBAL WEAKNESS HAS HURT U.S. FIRMS WITH HIGH FOREIGN REVENUE EXPOSURE

EPS growth by revenue exposure, % y/y



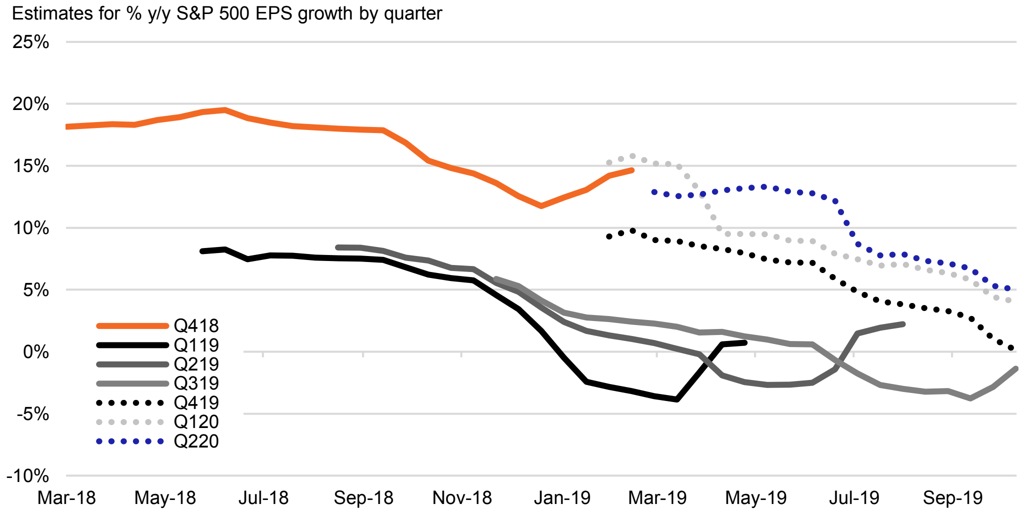
Source: Pavilion Global Markets, FactSet.

The dog still wags the tail

Equity markets appear to be facing a potentially volatile cocktail of headwinds and tailwinds. Forward earnings estimates in the U.S. show that analysts expect the next few quarters to experience a rebound, despite the myriad uncertainties across the globe. However, EPS growth estimates for the next three quarters have each been lowered by at least seven percentage points over the past six months.[1] This is in line with the past year of earnings reports, as actual results have materially undershot initial estimates over that period.

Looking forward, estimates for the second half of 2020 and 2021 have not moved much; indeed, they still look somewhat rosy. Should economic growth settle in at a slower pace than the past few years, earnings will likely continue to be challenged, spelling potential trouble for equity markets.

EARNINGS ESTIMATES HAVE CONSISTENTLY BEEN REVISED DOWNWARD



Source: Bloomberg Finance, L.P., FS Investments.

The uncertainty around the future path of earnings reflects the volatility of potential underlying economic outcomes. From the U.S.-China trade war to Brexit to the 2020 election, there is no shortage of issues with extremely wide ranges of economic ramifications. Even if ostensibly constructive outcomes are reached in any or all of these situations, markets will still have to digest the uncertainty surrounding the economy we are left with when the dust settles. Each of these factors will likely leave future earnings levels uncertain, potentially injecting volatility into equity markets going into 2020.
