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KEY TAKEAWAYS FROM FOURTH QUARTER EARNINGS

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KEY TAKEAWAYS

Earnings growth for the fourth quarter is tracking to a solid 17%, above prior estimates but below the pace of the previous three quarters.

The bar has been substantially lowered for the first quarter, setting up potential upside surprises, particularly if trade uncertainty is diminished.

We expect S&P 500 companies will be able to at least deliver mid-single-digit earnings growth in 2019, driven by solid economic growth, fiscal stimulus, and share buybacks.

Earnings growth slowed in the fourth quarter but was still solid. With two-thirds of S&P 500 Index companies having reported results so far, corporate America has delivered solid earnings growth—in the mid-to-high teens—for the quarter. However, slowing global growth and trade tensions have challenged the outlook, setting up slower earnings gains in the coming year. This week we provide key takeaways from fourth quarter earnings season, and update our 2019 earnings outlook.

THE NUMBERS

Year-over-year earnings growth for the fourth quarter is tracking near 17%, one percentage point above the growth rate reflected in year-end estimates (source: Refinitiv, formerly Thomson Reuters). This is solid growth, but below the 25% pace of the prior three quarters [Figure 1]. Tax cuts boosted earnings growth by 7–8 percentage points. Revenues (which are not impacted by the tax cuts) are tracking to a healthy 6% increase, similar to prior expectations.

1 SOLID BUT SLOWER EARNINGS GROWTH IN Q4; BIGGER SLOWDOWN LIES AHEAD

Source: LPL Research, Refinitiv 02/07/19

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

Companies in the communication services, energy, and industrials sectors produced the most upside to prior estimates. Energy and communication services, in that order, made the biggest contributions to earnings growth. Upside was limited by the financials and technology sectors, which came up short.

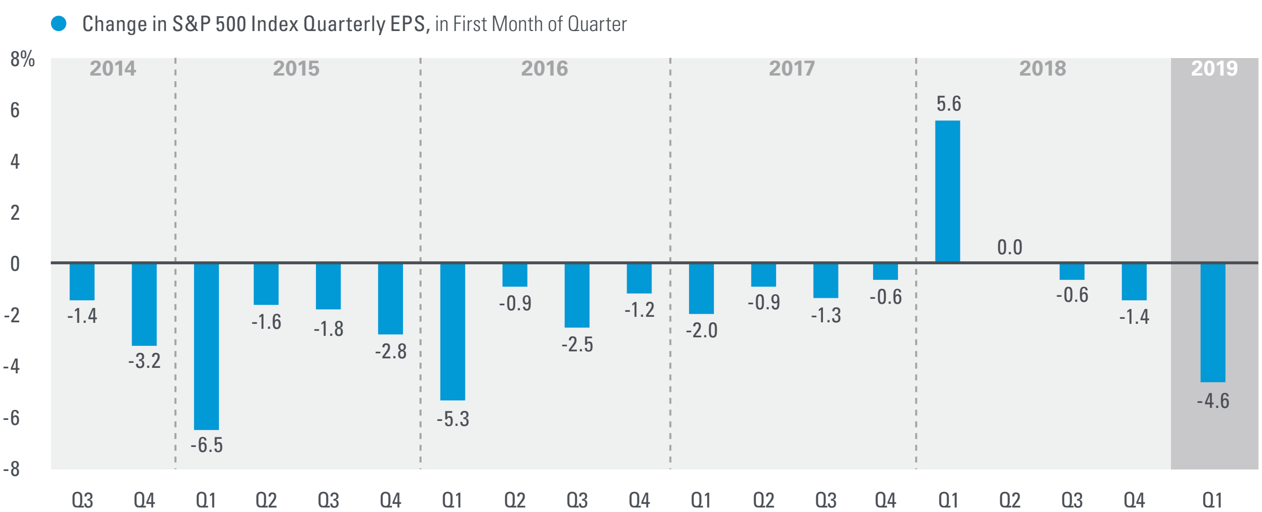
Forward-looking guidance has been tepid overall during reporting season, mostly because of the uncertainty surrounding the U.S.-China trade dispute and slower growth overseas. U.S.-focused companies have delivered stronger revenue and earnings growth than more global companies, according to analysis by FactSet, while consensus S&P 500 earnings estimates for the first quarter were cut by an above-average 4.6% in January, as shown in Figure 2. Excluding energy, though, the reduction has been typical.

KEY TAKEAWAYS

Our key takeaways from the quarterly results received so far are:

1. **Upside is tougher to come by.** At this late stage of the economic cycle, it is tougher for companies to produce big upside surprises. Slower growth overseas, particularly in Europe, makes it even more difficult, which means we should probably expect 2–3% upside, rather than the recent 3–6% range, to be the norm going forward.
2. **The bar for 2019 has been lowered substantially.** The more-than-4% cut to consensus first quarter earnings estimates—to near flat with the prior-year quarter—sets companies up to surprise on the upside when first quarter results start being reported in April.

2 THE BAR HAS BEEN SIGNIFICANTLY LOWERED FOR THE FIRST QUARTER



Source: LPL Research, Refinitiv, Strategas Research Partners 02/07/19

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

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After cutting overall S&P 500 estimates for 2019 by about 3%, analysts are now factoring in only a 4–5% increase for the year, including flat technology sector earnings.

3. **Trade uncertainty is a headwind.** Based on management commentary this quarter, most companies are feeling an impact from the China trade dispute, either through tariff costs, supply chain disruptions, dampened consumer and business confidence, or simply less demand for U.S. goods in China. Until this uncertainty is lifted and tariffs are reduced or eliminated, current estimates may be difficult to achieve.

THE OUTLOOK

Earnings growth will likely slow in 2019 as the one-year anniversary of the tax cuts passes. Still, we think that S&P 500 companies will be able to at least deliver mid-single-digit earnings growth in 2019 due to the following:

- **Solid domestic economic growth.** Our forecast is for U.S. GDP growth of 2.5–2.75% in 2019, supported by increased consumer spending, business investment, and government spending. The booming January jobs report, including steadily rising wages, reaffirms the strength of the consumer. January readings of the Institute for Supply Management (ISM) surveys on manufacturing and services, both in the 56–57 range, signal near-term earnings gains.
- **Fiscal stimulus.** The tax reform boost will be smaller in 2019 than in 2018, but tax cuts and increased government spending could still provide an incremental fiscal policy boost to economic growth this year. Policy uncertainty has clouded capital investment decisions, but capital investment incentives enacted in December 2017 remain in place, and a trade deal is a potential catalyst for more business spending.
- **Share buybacks.** Healthy corporate balance sheets, still-low borrowing costs, and repatriation of overseas profits at low tax rates (part of the December 2017 tax reform) all support another year of robust share buyback activity. We expect S&P 500 earnings per share to get at least a 2% boost in 2019 from buybacks, despite being somewhat politically unpopular.

There are risks to the downside, most notably from tariffs and trade. Other risks include further deterioration of the European economy, a jump in labor costs, or a surging U.S. dollar. A potential sharp drop in oil prices poses another risk, though the potential energy cost savings for consumers and businesses would help offset the drag on energy sector profits.

CONCLUSION

Corporate America has delivered solid earnings growth in the fourth quarter, though the pace of growth has slowed and is poised to slip further. Limited upside to prior estimates reflects the late-cycle economic environment, slower growth overseas, and trade tensions, but the lower bar for first quarter expectations should lead to more upside surprises.

We continue to expect mid-single-digit earnings growth for S&P 500 companies in 2019, driven by solid economic growth, fiscal stimulus, modest inflation, and steady share buybacks. Although the peak earnings growth rate for this economic expansion is almost certainly behind us, profit growth peaks have historically been followed by several years of economic growth and stock market gains.

We believe the earnings outlook is strong enough to support solid gains for stocks over the balance of 2019, and we reiterate our year-end fair value range for the S&P 500 of 3000 from our *2019 Outlook* publication. ■

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Institute for Supply Management (ISM) Manufacturing Index is an economic indicator derived from monthly surveys of private sector companies, and is intended to show the economic health of the U.S. manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change.

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