WILSONS

# US Earnings: Slowing but not Reversing

Our weekly view on asset allocation.

30 May 2022

# Investor Concern Around the Earnings Outlook

Stubbornly high inflation and an increasingly hawkish Fed have sent bond yields up a sharp 125 basis points this year to a current level of 2.75% (3.1% was the recent peak).

This higher long-term discount rate has pressured equity valuations, particularly the long duration tech-related equities that dominate the US equity market.

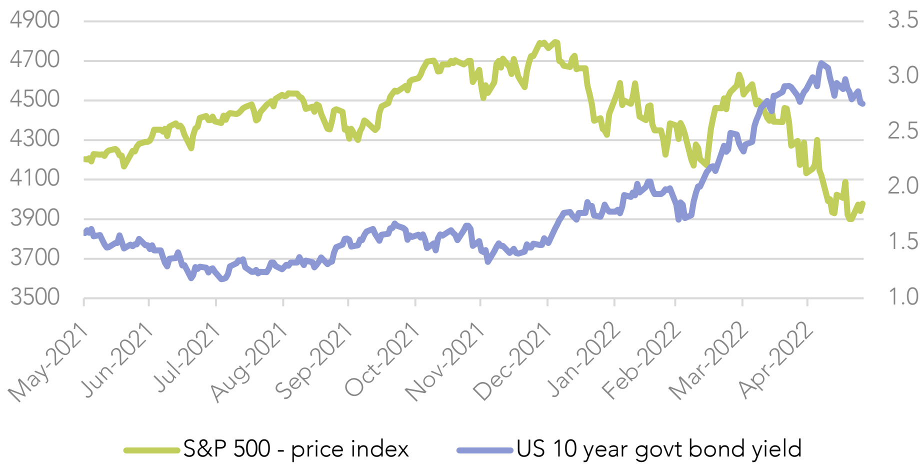
While the valuation correction in high multiple stocks has been the dominant narrative so far this year, economic and profit growth concerns appear to be creeping into investor thinking.

Earnings performance remains central to the outlook for the US stock market. While there has been considerable focus on multiple expansion in respect of the bull run in US equities, earnings have been the key to the US market's stellar performance. This is the case when looked at over the past 10 years or ~2 years (post-COVID March 2020).

So, if the US market is set to encounter either a significant cyclical or structural earnings problem, then this could significantly alter the prospects for US equities. Despite market weakness this year, US earnings have (on average) remained relatively resilient, with aggregate earnings estimates continuing to be upgraded (see figure 5).

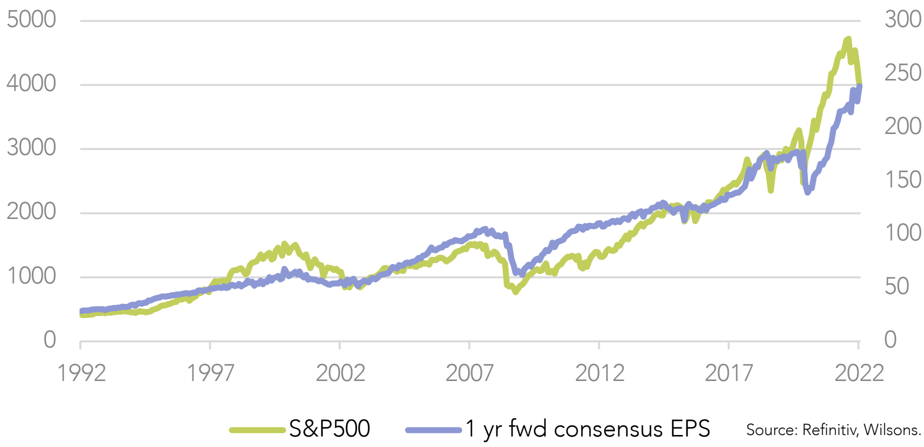
However, as the US and global economy slow, at the same time as inflation pressures persist, investors are becoming more concerned around the earnings outlook. In particular, investors are wary of the potential for a combination of slower demand combined with sticky cost pressures to crimp corporate profit margins.

**Figure 1: Higher interest rates have pressured US Equities this year**



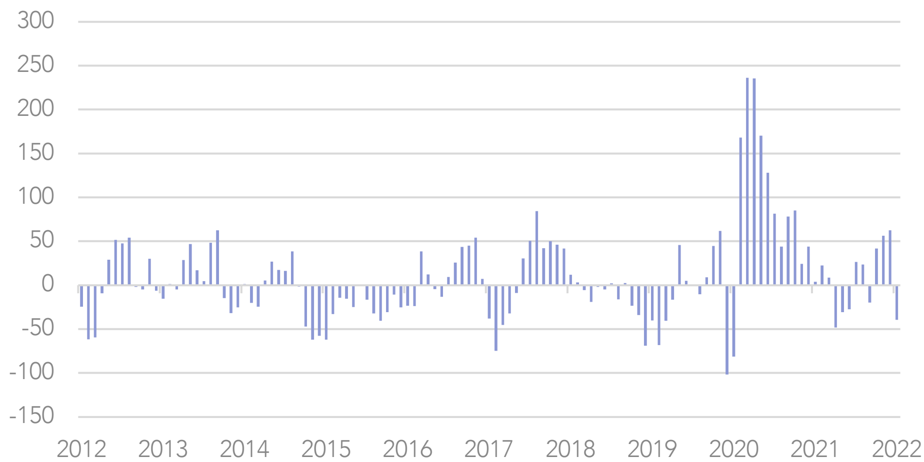

Source: Refinitiv, Wilsons.

**Figure 2: US stocks became overheated in 2021 but have largely tracked a strong earnings cycle**



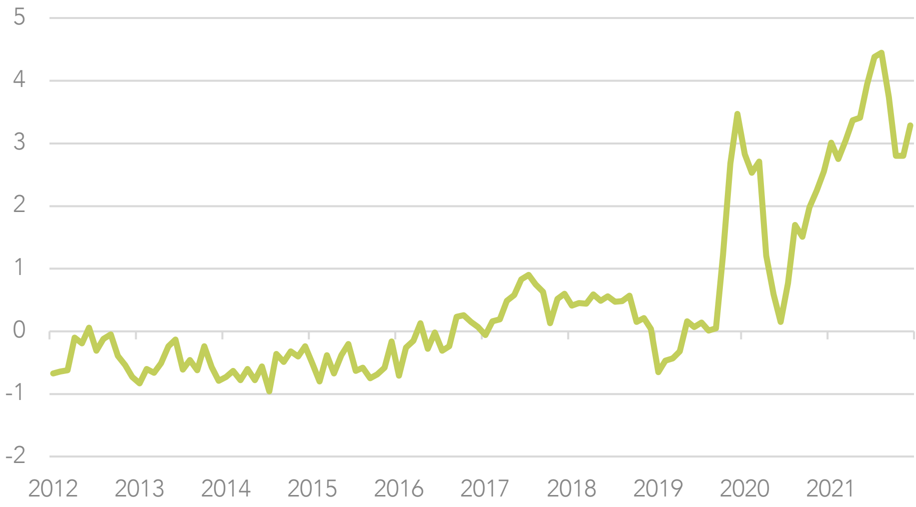

Source: Refinitiv, Wilsons.

**Figure 3: US Economic data has surprised to the upside this year but has been more mixed recently**



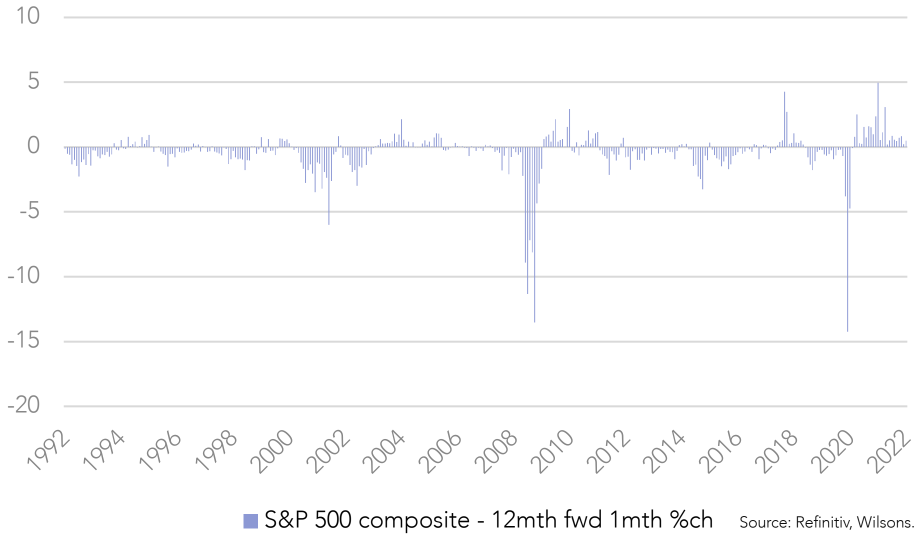

Source: Refinitiv (Citigroup US Economic Surprise Index monthly).

**Figure 4: Global supply chain pressures have eased from peak levels but improvement has stalled recently**



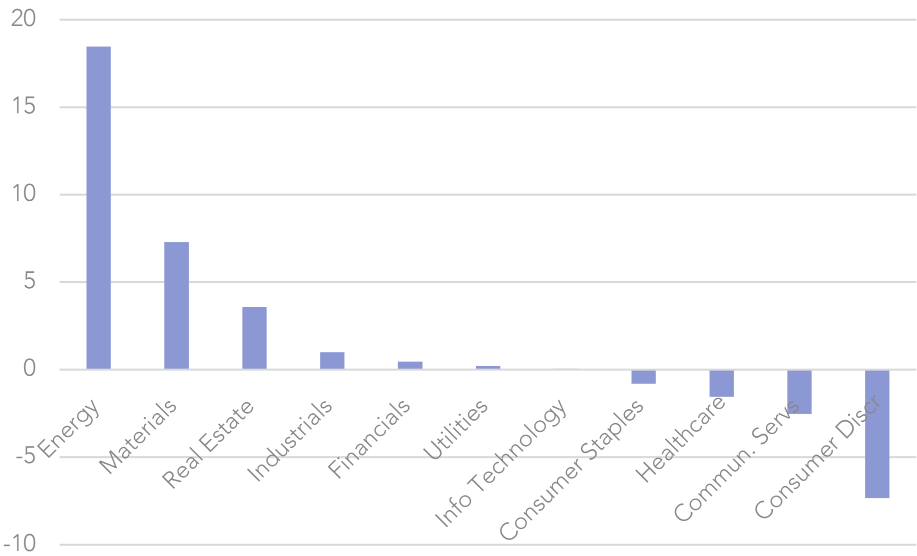

Source: New York Fed (global supply chain pressure index).

**Figure 5: US market earnings are still being upgraded in aggregate**




Source: Refinitiv, Wilsons.

**Figure 6: Energy dominating consensus earnings upgrades. Consumer discretionary looking weak (12-month forward expected earnings)**




Source: Refinitiv (1 month consensus eps revision).

The recently completed US Q1 reporting season was more mixed than previous seasons. Still, it delivered more good news than bad, with Q1 estimates rising over the course of the reporting period. Indeed 1 year forward estimates for the overall market still edged up, despite the current groundswell of bearishness. This keeps the record run of consecutive 23 months of positive earnings revisions intact for now.

A closer inspection reveals an increasing skew to the earnings revision cycle, with energy doing much of the heavy lifting recently. 7 out of 11 sectors remain in upgrade mode, albeit upgrades are being led decisively by the energy sector. In contrast, consumer discretionary now has the weakest earnings revision trend by a fair margin.

As we have discussed previously, the post-COVID earnings upgrade cycle for the US equity market has been the longest on record. We think this upgrade cycle is now drawing to a close. We consider estimates of 10% growth in CY22 and a similar increase in CY23 to be too optimistic.

## Upgrade Cycle Likely Over

Downgrades to consensus aggregate estimates are, of course, normal in the long-term history of the US equity market. Importantly, a downward revision trend does not preclude decent market performance over the medium-term. However, the market typically struggles if earnings downgrades are sufficiently enough to see a stalling in earnings growth, or if earnings go into reverse.

Negative earnings growth typically happens in concert with economic recessions, although "earnings recessions" tend to be a bit more frequent (see figure 8). A soft landing for both the US economy and the earnings cycle is still our central case.

Even if we avoid an economic recession as we expect, there is still the risk that a combination of slower growth and sticky cost pressures lead to a significant margin squeeze. We have seen margin pressures come through in certain recent results (particularly in retail) though we think it is premature to suggest a broad-based margin crunch is coming for US earnings this year.

Top lines remain reasonably robust, albeit revenue growth looks to be slowing from its breakneck pace. A number of companies have been pointing out difficult year-on-year comps recently. 2021 was a phenomenal year for US earnings, so we do expect a significant slowing in top line revenue growth even if the economy achieves a soft landing.

Cost pressures are acute in many sectors; however, there is a significant degree of pricing power in the system, so margins are holding in many areas. We expect margins are peaking, but we do not see a major step down in US margins in the near-term.

We still expect there is enough economic momentum and pricing power in the big cap end of the US stock market to keep US earnings growing moderately (mid-single digit), but as discussed, we do think there is downside risk to estimates, particularly for 2023.

The Q2 reporting season, which kicks off in about 6 weeks, will be interesting for what it reveals in respect of the extent of the slowdown in top line growth as well as cost pressures and margins.

A shift to net downgrades and more moderate earnings growth does not preclude a positive return over the next 6-12 months, particularly if inflation fears begin to recede and bond yields settle into a range. US valuations look much better than they did 6 months ago, and could probably absorb some modest downgrading in our view.

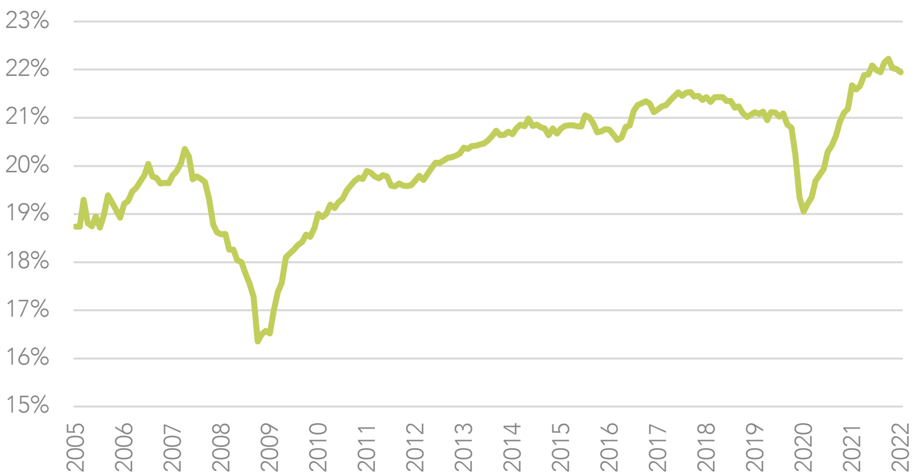
Perhaps of most interest will be where the downgrades occur. So far, downgrades seem to be driven mostly by cost pressures but also some over-optimistic extrapolation of COVID demand surges in certain areas. The debate now appears to be whether we go into a period of more normal demand or we move quickly into a period of sub-par economic demand. Our base case is the slowdown is gradual, at least in aggregate terms.

## Slower Earnings Growth not a Barrier to a Market Revival

We are going into a slower period for earnings with a more normal estimate revision pattern tilted toward downgrades. This is not necessarily a bad thing for the stock market, particularly if it combines with some relief in terms of inflation pressure, monetary policy expectations and a more benign period for long-term bond yields.

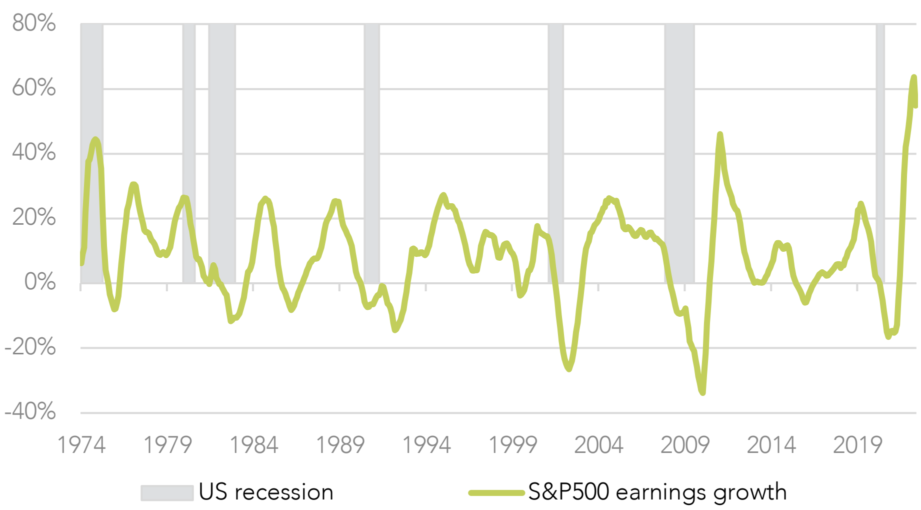
A quick shift from the recent earnings boom to an earnings recession (not our central case) would be much tougher for the market, so economic data and the next US earnings season will be closely watched. For now, we still prefer Australian to US equities, though recent sharp underperformance is bringing the growth focused US market back onto our radar.

**Figure 7: US profit margins are peaking. How much reversion is coming?**




Source: Refinitiv, Wilsons.

**Figure 8: US "profit recessions" are more frequent than "economic recessions"**




Source: Refinitiv, Wilsons.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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