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RBC WEALTH MANAGEMENT

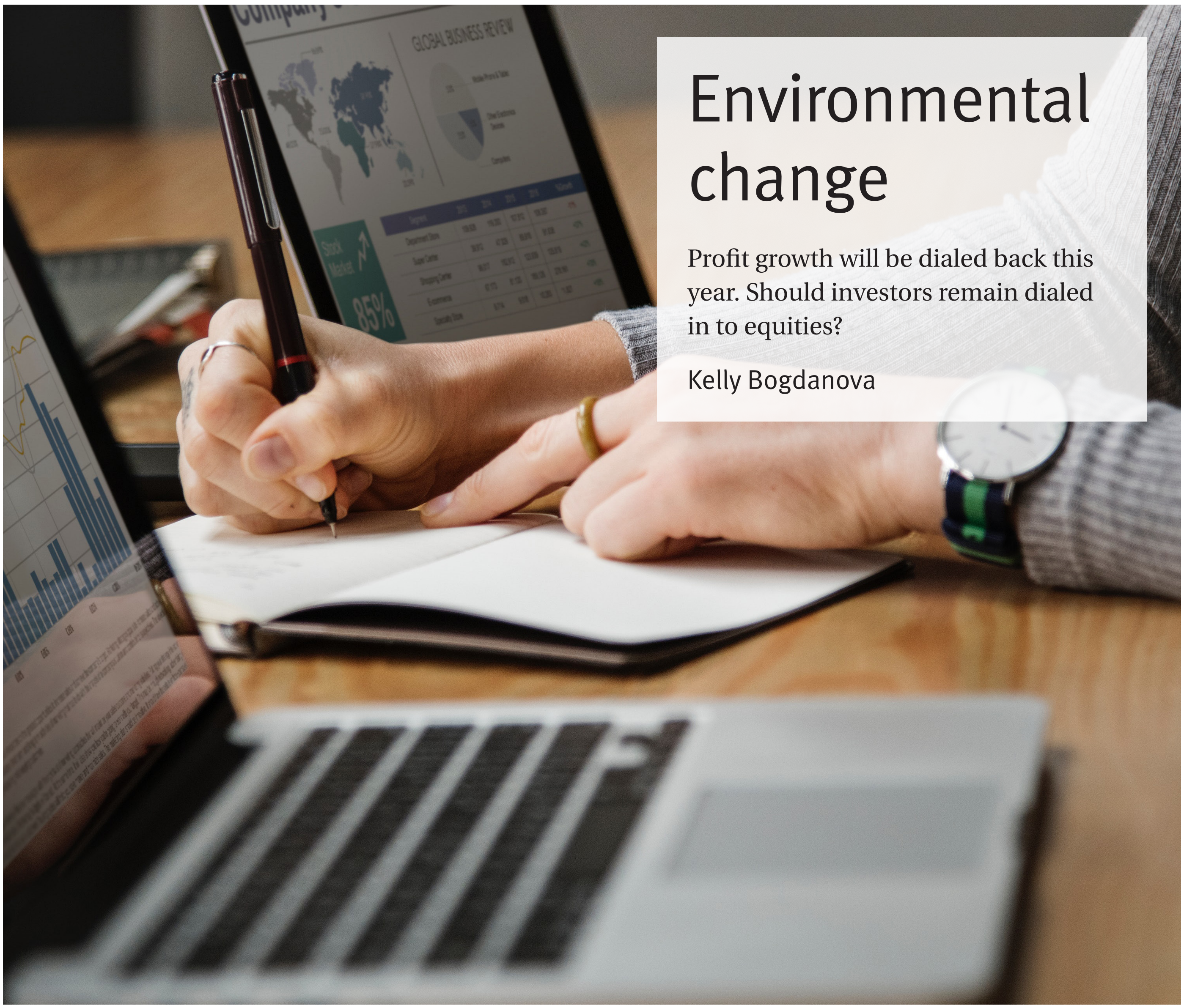
Global Insight

Focus Article

Environmental change

Profit growth will be dialed back this year. Should investors remain dialed in to equities?

Kelly Bogdanova



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All values in U.S. dollars and priced as of January 31, 2018, market close, unless otherwise noted.

Wealth Management

Focus article

Environmental change

The breakneck pace of 2018's profit growth is receding in the rearview mirror, and a variety of factors should further clip momentum. But while earnings growth will be dialed back, we look at why investors should remain dialed in to equities with a constructive—yet vigilant—stance.

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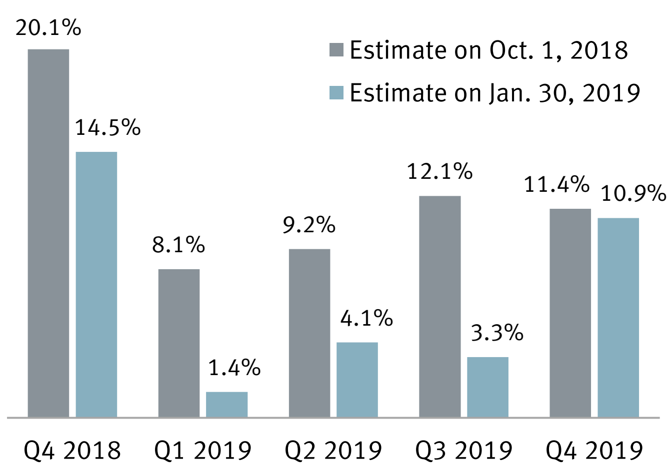
Amid the noise from the stock market correction and subsequent rebound, a notable shift in the operating environment has taken place affecting many U.S.-based companies. Corporate earnings, revenue, and profit margin trends have moderated in Q4 2018, and we expect the momentum will dial back further in 2019. Given the old Wall Street adage, "Earnings are the mother's milk of stocks," this is worth investors' attention. Over the long term, earnings drive equity prices.

While much of the deceleration in the revenue and earnings outlooks was likely factored into stock prices late last year during the sharp U.S. and global equity selloff, earnings-related headlines could become amplified this year and surprises could lead to additional volatility. Economic softness at home and abroad, tariff uncertainties, the more complex political backdrop in Washington, and the rapidly waning effect of the corporate tax cut are leaving management teams less certain about growth prospects. We think a constructive yet *vigilant* stance is appropriate. Therefore, despite reasonable valuations we remain Market Weight U.S. equities, rather than make aggressive new commitments.

Reasonable retreats

The forecast for 2019 S&P 500 earnings growth has declined from 10% y/y last October, to 5.2% currently, according to the consensus of Wall Street analysts. The new, lower estimate equates to $170 per share, which we think is appropriate and achievable.

Change in consensus forecasts for quarterly S&P 500 earnings growth (y/y)



Forward earnings growth estimates have come down meaningfully. Expectations now seem reasonable to us.

Source - RBC Wealth Management, I/B/E/S data from Refinitiv; data as of 1/30/19

Thus far, there are few signs an “earnings recession” (outright earnings decline) could unfold this year.

Thus far, there are few signs an “earnings recession” (outright earnings decline) could unfold this year. If the Fed refrains from raising interest rates too far, too fast, as it has signaled recently, and if some tariff risks recede, the $170 estimate could end up being too low. But 5.2% estimated growth doesn’t leave much room for missteps or negative tariff or economic developments.

Consensus revenue and profit margin expectations have moderated as well, but to a lesser extent. The 2019 S&P 500 revenue growth forecast retreated from 5.4% in October to 4.7% currently, and margin growth from 17.2% to 16.8%. Both of these lowered estimates are reasonable, in our view.

Cautious clues

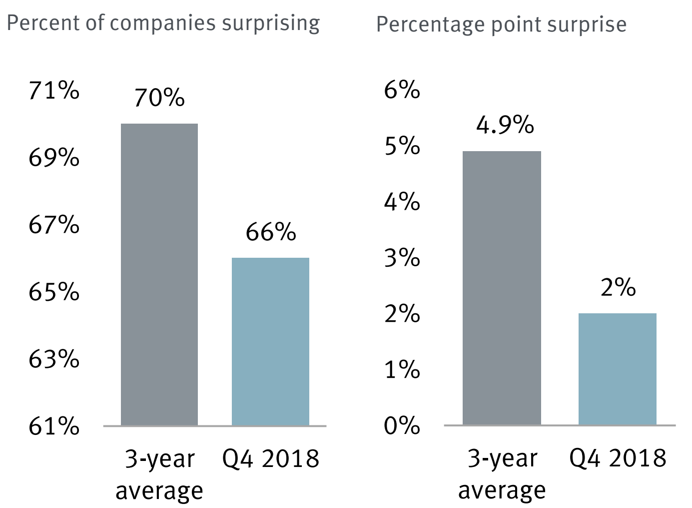
The Q4 2018 earnings season is underway and the developments provide hints about how this year could unfold. Overall results and management guidance have been better than expected, especially in light of the negative sentiment that prevailed just before the reporting season began.

On conference calls, executives’ comments have been positive on balance, but appropriately restrained given the multiple macro uncertainties. Management teams normally don’t have much incentive to go out on a limb with their forecasts, and they have even less now.

More companies have described demand for products and services as healthy rather than mixed or weak—a good sign for overall economic growth. The proportion of cautious remarks represents 34% of firms among those that have commented on demand trends thus far, according to RBC Capital Markets. A number of executives have pointed to softer European momentum. Tariff challenges have been mentioned by a small group, but still don’t seem like much of a factor, at least at this stage.

Q4 earnings and revenue beat rates are tracking modestly below the preceding quarter, but the magnitude of the beats—the percentage upside to estimates—is lagging. For example, earnings are exceeding the consensus forecast by 2.0%,

S&P 500 Q4 earnings surprises



Thus far, fewer companies have exceeded estimates than in the past, and the beats have been smaller.

Source - National research correspondent, FactSet, Thomson Financial; data as of 1/30/19 with 38% of S&P 500 market cap having reported Q4 2018 earnings much lower than the 4.9% average during the past three years. Nevertheless, the Q4 trend has improved as more companies have reported results, and that figure could rise as the earnings season progresses.

RBC Capital Markets notes wage/benefit pressures are being most frequently cited as headwinds for profit margins. This is interesting given wage growth is not showing up as being problematic in broader economic data. Other expense categories have generally been neutral-to-favorable, so any wage/benefit pressures at the company level are largely being absorbed.

Macro murkiness?

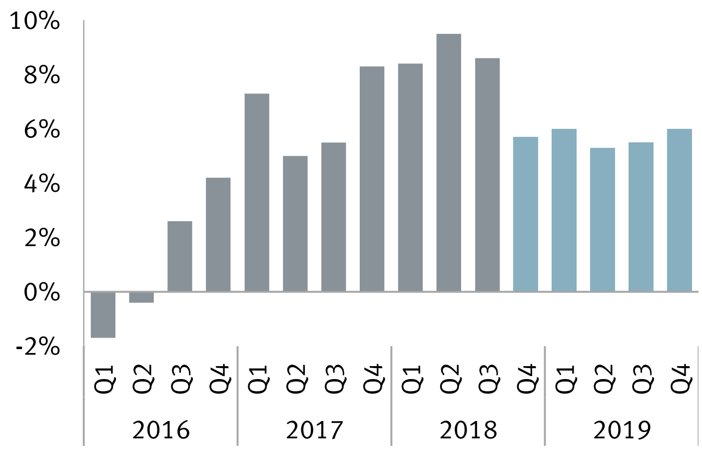
In addition to Q4 trends, challenging prior-year comparisons and important economic trends point to slowing earnings growth in 2019, in our view.

The corporate tax cuts, which represented a roughly 7–8 percentage point boost to the bottom line in 2018, will drop out of the 2019 data. Even though companies will still realize the benefits of low taxes, they will no longer be a factor in the year-over-year growth calculation.

Also, robust 2018 growth of 20%+ pushed earnings up to an elevated level that will be difficult to exceed by any meaningful degree, in our view.

S&P 500 revenue growth (y/y)

Actual in gray, consensus estimates in blue



Despite the headwinds, revenue growth estimates (in blue) are at respectable levels.

Source - RBC Wealth Management, I/B/E/S data from Refinitiv; data as of 1/30/19

Year-over-year arithmetic aside, pockets of weakness in the domestic and global economies, including overall slower rates of growth, are factors.

U.S. housing, for example, has been soft for months and took another step backward in December when sales of previously owned homes fell 10% y/y and transactions retreated to the lowest level in three years. Auto sales have fallen too. Domestic manufacturing activity and new orders—a key leading indicator—declined notably in December, and capital spending intentions have softened lately. Business sentiment has pulled back, albeit from a very high level, in the U.S. and other major economies.

RBC Global Asset Management has trimmed its 2019 U.S. GDP growth forecast from 2.50% to 2.25%, further below its 2.9% estimate for last year. GDP should be supported by ongoing, positive consumer trends. By no means would an economy expanding around the 2.25% level be troubling, but it would be below the average of previous expansion cycles.

Global growth will likely be softer this year too. Europe's largest economies—Germany, the U.K., France, Italy—are in the midst of a malaise for a variety of reasons. China faces ongoing challenges from slower economic momentum, debt constraints, and U.S. tariffs. An executive of FedEx, one of the most economically sensitive, globally oriented U.S. companies, put it best on an earnings conference call recently, "The peak for global economic growth now appears to be behind us."

S&P 500 companies with overseas revenues are much more tied to Europe than China or broader Asia, but slowing in these two large economic regions tends to dampen overall corporate prospects.

Constructive condition

The earnings outlook is murkier than it was a year ago.

The earnings outlook is murkier than it was a year ago. While recent estimate cuts have likely been factored into stock prices, economic uncertainty and policy risks related to trade/tariffs, the Fed, and the complex political backdrop in Washington leave room for surprises in 2019.

As long as modest U.S. GDP growth of 2% or so remains feasible and Europe and China stay near their current subdued trends without much more slippage, we believe the S&P 500 can eke out mid-single-digit earnings growth in 2019. Reasonable valuation levels of 16.5x trailing earnings and 15.9x the forward $170 consensus forecast, which is slightly below RBC Capital Markets' estimate, provide an appealing, albeit less exciting, investment environment. We believe it supports a Market Weight position in both U.S. equities and total equity exposure in portfolios.

Our long-standing view remains that investors should give equities the benefit of the doubt as long as the economic, credit, and earnings cycles are favorable for stocks. Five of our six favorite forward-looking U.S. recession indicators are signaling the expansion will persist for at least the next 12 months or so. The other indicator is in neutral territory. None are signaling an imminent recession.

Given the U.S. economic cycle looks increasingly to be in its late stages, a higher level of investor vigilance is warranted.

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