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ON OUR MINDS

Earnings Growth On Fire

Michael A. Tyler, CFA®, Chief Investment Officer

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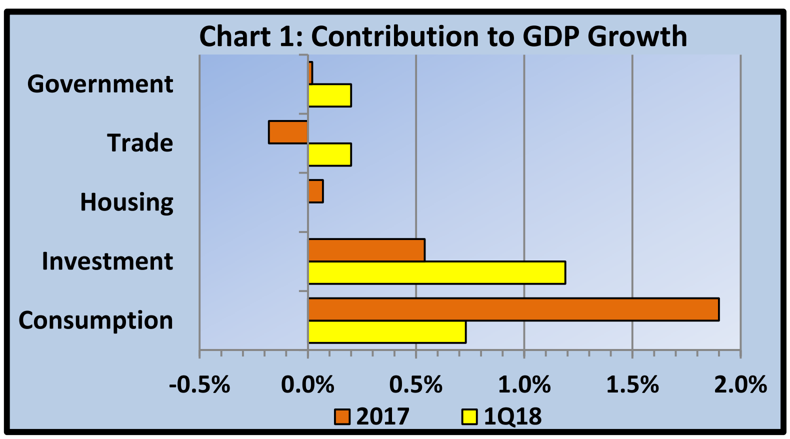
Bull markets don't die of old age, the sages tell us. They are resistant to politics, and they don't care too much about most foreign policy questions either. Instead, bull markets get killed by anticipation of economic recession, by rampant inflation, or by tight monetary policy. Recession depresses corporate earnings; inflation depresses the present value of future earnings; and overly hawkish Fed policy does both. The reverse is true, too: Bull markets are born and sustained by the prospect of economic growth, modest inflation, and neutral or accommodative Fed policy.

Is the current, nine-year bull market finished? U.S. stock markets still haven't recaptured their late January highs, but they haven't collapsed, either. Through last Friday, the S&P 500 was essentially flat year-to-date, and only 7% off its all-time high. The markets have generally settled into a short-term trading range after their rocketship January and submarine February, awaiting whatever catalyst will cause either a bullish breakout or a bearish breakdown.

The next catalyst likely won't be interest rates or inflation. Although the Fed has already raised overnight interest rates six times in the past 30 months, the pace remains very gradual and the Fed's tone remains one of restraint. Similarly, inflation remains subdued at about 2%, with some areas (housing, health care) consistently running hot and others (retail, technology) seeing stable or falling prices.[1] So if the market is to break out of its recent trading range, it will likely be to follow the direction of economic growth and anticipated corporate earnings.



Source: Bureau of Economic Analysis

On the "macro" side, recent economic indicators have been strong, albeit slightly less robust than they were a few months ago. Gross domestic product (GDP) growth, for example, slowed from 2.9% in the December quarter to 2.3% in the March quarter. The quality of growth also deteriorated slightly, as shown in Chart 1. Companies padded inventories while consumer demand growth slowed over the same period; the slowdown in consumer spending also reduced our dependence on imports, which bolstered the reported overall economic growth rate.[2]

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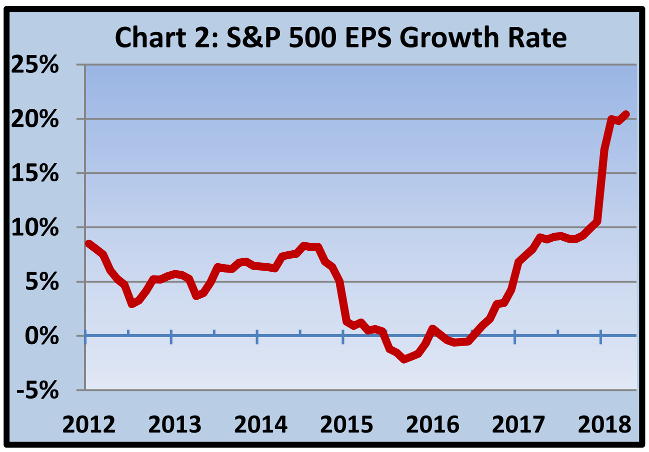
[1] Recent data suggest that prices are beginning to creep up a little faster, however.

[2] Imports are calculated as a subtraction from GDP, while exports add to GDP. Similarly, additions to inventories are considered to be productive output, while depletions of inventories detract from GDP.

Other economic releases have been more favorable. Job growth remains robust, and the number of weekly jobless claims has been running lower than at any point since 1969 – nearly a half-century ago, when our population was one-third smaller than it is today. Durable goods orders have been growing steadily. Housing starts are at their highest levels in a decade and vacancy rates remain low. Surveys continue to show high levels of confidence among both consumers and businesses.

In short, the big picture is essentially solid, if a bit muddier than it was three months ago; this could simply be a natural pause after last year's growth spurt. From a "micro" perspective, however, this pause disappears: corporate earnings growth is accelerating, as shown in Chart 2. Other than during the "profits recession" of 2015-16 (when depressed oil prices and an overly-strong dollar crushed corporate earnings), S&P 500 earnings growth had been tracking fairly steadily at about 7% to 10% from 2010 through the end of last year; but expectations suddenly skyrocketed last December with the enactment of the Tax Cuts and Jobs Act.



Source: FactSet, Eastern Bank Wealth Management

When stock markets peaked three months ago, investors could only estimate the impact of the TCJA; the tax package had not yet affected workers' paychecks nor consumer behavior, and corporate CFOs didn't yet know how much of their foreign earnings they would repatriate, how much of their tax savings they would return to shareholders in the form of dividends or buybacks, or whether to accelerate investments. As companies have reported their first-quarter earnings, answers to these questions are coming into better focus.

In a word, first-quarter results have been spectacular. As of last Friday, about two-thirds of all S&P 500 companies had reported earnings, producing aggregated 10% revenue growth and 26% EPS growth. Both of these numbers are the strongest we have seen in more than a decade.[3] The robust top line indicates that confident consumers and businesses are opening their wallets more often, while the stunning bottom line shows the effect of the tax cuts.

These results are well ahead of Wall Street's estimates, too: According to analysts at Morgan Stanley, about 70% of reporting S&P 500 companies have beaten the street's revenue expectations, and 80% have topped the earnings forecasts; that's well above the historical averages. Not only that, but average company topped its earnings forecast by a solid 9%.

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[3] Note that Chart 2 only goes back to 2012. A truly long-term version of this chart would show that the S&P 500 companies, taken as a whole, have never sustained 20% EPS growth for more than about a year. Some slowdown from the first quarter's fiery pace is inevitable within the next few quarters. As earnings growth decelerates, investors will be forced to reckon whether the market is headed for a "soft landing" of stable single-digit growth or a "hard landing" of earnings contraction; upon that reckoning rests the prospect of an extended bull market or an incipient bear market.

While these figures may encourage investors to rock-and-roll all night (and party every day), a more sober attitude is still warranted; investors have had to kiss a few frogs. Even during a strong earnings season, some companies have come up short, and their share prices have been hammered. Shortfalls have come from companies as diverse as consumer products giant Procter & Gamble, home furnishings supplier Masco, defense contractor General Dynamics, and telecom carriers AT&T and Charter. Other companies, such as Caterpillar and Lockheed Martin, posted strong results but softer forecasts than investors had hoped to see.

Most of these companies posted decent revenue growth but disappointing profit margins. What's more, the companies with weaker profit margins most often identified higher raw material costs as the primary cause of their margin squeeze. Oil's jump from $26/barrel in early 2016 to nearly $70 today is well known; but other commodities have had similar runs: copper has soared nearly 60% in two years, while the Thomson Reuters Core Commodity index has risen 32% in the same period. Upstream companies (those closest to raw material production) are realizing price increases, while downstream companies (those making the "final products") have been unable to pass those increases along to their commercial or consumer customers.

One especially noteworthy example is that Alcoa soared while Arconic dove; Alcoa is an upstream aluminum producer while Arconic (its former subsidiary) is a downstream producer of specialized alloys and machined materials. Companies in the intermediate stages of the value chain, such as PPG Industries or 3M, have had only partial success in protecting their profit margins, and their stock prices have reflected this intermediate position.

In short, investors should be somewhat concerned that raw material price inflation is evident. By itself, this phenomenon won't sink the stock market or the economy, but it could be troublesome if it leads to faster consumer price inflation or to sustained erosion of profit margins. We're beginning to see evidence of both outcomes, as the scattered earnings shortfalls were accompanied by "core" inflation reaching 2% in March for the first time in several years.

Still, the burden of proof remains on the bears. Economic growth remains healthy if a bit slower than last year. Inflation is slightly higher, but most likely not enough to cause either investor angst or a Fed overreaction. While stock prices look reasonably valued relative to earnings, the modest P/E ratio begs the critical question: Can earnings keep growing? Stocks often look cheapest when their P/E ratios are lowest, because that's when the denominator (earnings) has hit a cyclical peak; it may even be true that an earnings peak is only visible in retrospect. So far, however, the evidence still suggests that solid earnings growth remains in prospect for a considerable period to come– even if the current torrid pace is unstainable.