ARGUS®

WEEKLY STAFF REPORT

August 1, 2016
Vol. 83, No. 109

2Q Earnings Beating Low Expectations, But Still Signal Challenges

The first weeks of 2Q16 EPS season have gone largely as other recent earnings seasons have gone. Earnings are running ahead of consensus, but are far from spectacular. Excluding the continuing drag from the oil patch, earnings are slightly positive. In a switch, revenues for many companies are growing as fast as or even faster than earnings, as the former headwind from currency swings to a tailwind on recent dollar softening.

The biggest burst of earnings will come in the final week of July and first week of August. It is risky to generalize or extrapolate from the roughly 25% of the S&P 500 companies that have reported so far. Early reporting is dominated by banks, which weigh on results. Then comes a middle period in which the bulk of non-financial companies deliver results that in general will benefit from rather than be penalized by low interest rates. But late reporting will be dominated by oil companies, whose tough comparisons will weigh even more on results.

Still, even a partial snapshot is worth examining, particularly coming amid generally strong U.S. economic data in recent weeks and months.

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FIRST TAKE ON 2Q EPS

As of the end of the 7/22/16 trading week, 126 constituent companies of the S&P 500 had reported calendar second-quarter 2016 results. For the companies reporting so far and based on Bloomberg data, the average annual EPS change has been a decline of 1.1% on a share-weighted basis; a gain of 1.6% on a market-cap weighted basis; and a gain of 3.5% on a simple non-weighted change percentage basis.

The share weighted average is based on diluted shares outstanding of each compared quarter (2Q15 vs. 2Q16). Market capitalization weighted average is based on summary market capitalization as of 6/30/16. Arguably, market capitalization-based change gives a better perspective on overall corporate earnings than a simple arithmetic average. So whenever possible, we will compare market-cap weighted changes.

Excluding the 32 financial services companies that had reported as of 7/22/16, S&P 500 earnings are up 2.9% on a market-cap weighted basis. Excluding the five energy companies that have reported, S&P 500 earnings are also up 2.9%.

Among the 126 companies reporting so far, 83 companies (66%) have posted higher year-over-year earnings; average earnings growth is 13.9%. Of the 38 companies (30%) posting down EPS, average earnings decline is -15.6%.

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So far about 71% of companies have delivered positive EPS surprises; the vast majority exceeded expectations by less than 10%. Only about 16% of companies that have reported have delivered negative EPS surprises. It is common for upside surprises to sharply exceed downside surprises. CFOs routinely under-promise and over-deliver, in an oft-times futile attempt to prevent their stock from being slammed upon EPS release. And if earnings are going to miss, companies tend to pre-announce late in the reporting quarter rather than risk springing bad news on unsuspecting investors on the scheduled EPS release date.

Looking at a sector map of earnings can be misleading this early in the reporting period, particularly for sectors in which few companies have reported. Including only those sectors for which at least 20% of constituent companies have reported, Industrial are doing best with market-cap-weighted average EPS growth of 11.4% for calendar 2Q16. Next up is Healthcare with 10.4% market-cap-weighted average EPS growth. Consumer Discretionary EPS growth is not far behind at 8.1%.

Sectors with low-single-digit EPS growth include Consumer Staples, Materials, and Telecom Services (no utility companies in the S&P 500 had reported as of 7/22/16). Sectors reporting mid-single-digit earnings declines so far include Financial Services and Technology. The fewer than 15% of energy companies reporting so far have posted average EPS declines in the 70% range; this should represent trough earnings and the toughest comparisons for this embattled sector.

How does 2Q16 earnings performance line up with stock performance in the third quarter to date? Exactly, at best – and in some cases, not at all. Stocks in 2016 to date have been led by three defensive sectors (Utilities, Staples, and Telecom Services). The defensive sectors built such a substantial early lead that they will finish the year atop the leader board.

But for July and 3Q16 to date, the old leadership is lagging: Utilities are down fractionally and Staples are flat. New leadership has swung to risk-on and economically sensitive sectors. Based our sector ETF tracker, Consumer Discretionary is up 5% for July & 3Q to date. Financials and Healthcare are both up in the 3%-4% range. Technology is up 6%, enabling this former leadership sector to swing back into the green year-to-date with a 2% gain. Industrials and Basic Materials are both up in mid-single-digits, although Energy is taking a breather with a 2% pullback, following a 10% gain in 2Q16. For the S&P 500 overall, the 3.1% 3Q gain has accounted for about half of the 6% year-to-date gain.

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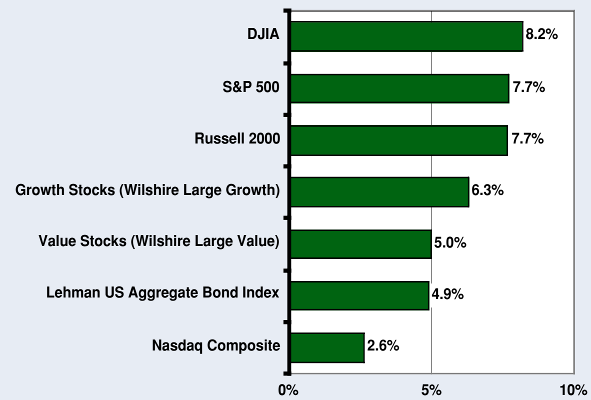
MAJOR INDEX

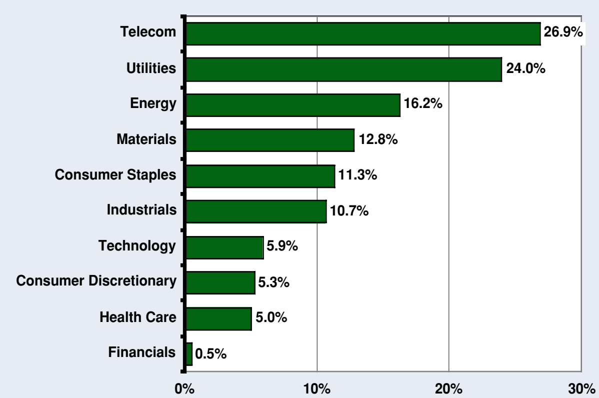
DATA AS OF JULY 22, 2016

Year-To-Date Return



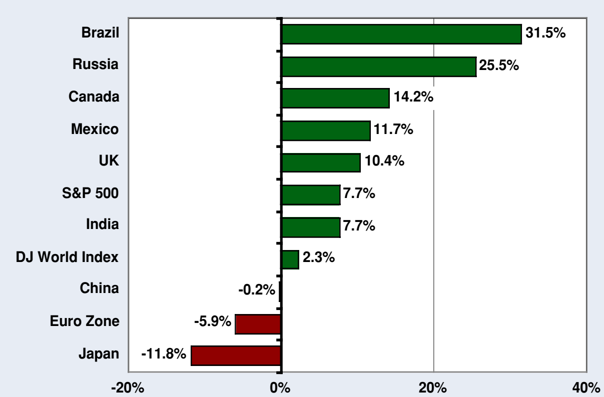
SECTOR PERFORMANCE

Year-To-Date Performance



INTERNATIONAL EQUITY MARKET PERFORMANCE

Year-To-Date Return



Source: Dow Jones, Argus Research

CONCLUSION

One of the more surprising outcomes of the EPS reporting period is not EPS at all – it is sales. For the one-quarter of S&P 500 constituents that have reported, revenue is up on average by 2.7%. Excluding financial services companies, revenue is up 3.4%.

The enormous headwind of strong dollar, both on competitiveness overseas and on revenue repatriation from overseas markets, is now swinging around. For some companies, currency is already a tailwind, albeit more like a tail-breeze. Equally notable is that despite exhaustive coverage of trends in the dollar and other currencies, equity analysts and strategists do not appear to have fully factored in the increasing tailwind from weaker dollar.

Argus believes that at least a modest beat against expectations for 2Q EPS is required to keep the fragile rally alive and carry it into the fall quarter, which is seasonally strong for stocks. We currently expect flat-to-slightly-lower EPS for 2Q16 to give way to strengthening trends in 3Q and 4Q EPS, setting the stage for a strong finish in the months following the presidential election.

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