ARGUS®

WEEKLY ECONOMIC COMMENTARY

February 6, 2017

First Look at 4Q16 Earnings: Growth is Back

The Trump rally hit its first serious speed bump late in January as the post-election honeymoon glow gave way to the harsher light of political reality. The Trump agenda is complex and varied, and investors have been attracted by the pro-growth items – infrastructure investment and tax reform mainly – mixed in with the social and political agenda items, such as immigration. Investors are now realizing that coming to consensus on growth initiatives is complex and pushing any actual legislation through Congress will take time. Stocks, which have hurtled higher for three months, may ease into a corrective phase while Congress begins the hard work of turning ideology into policy.

Fortunately, the economic backdrop remains favorable for stocks over the long term, regardless of the policy transformation underway in Washington. According to Argus Chief Investment Strategist Peter Canelo, the commodity pricing environment and economic trends among our major trading partners are increasingly favorable. On a quarterly basis, CRB raw industrial materials prices are up 20% in the past year; and CRB Metals prices are up 40% in a year. Industrial materials prices correlate well with S&P 500 movements, so the upward trend is encouraging.

The positive movement in materials pricing is being driven by strength beyond our shores. Eurozone manufacturing activity is at a more than five-year high, while Eurozone services are at a 12-month high. Another mature industrial economy, Japan, is also at one-year highs in terms of manufacturing and services activity.

Perhaps most important for U.S. stock prices, earnings have begun to swing in a positive direction. The first glimmers of trend change were visible in 3Q16 earnings. The trend change is unequivocal in 4Q16 results.

4Q16 EPS TO DATE

Approximately one-third of S&P 500 constituent companies had reported results for calendar 4Q16. Normally 35% of anything would be enough of a sample size to draw broad conclusions; at the same time, investors should be aware of the cadence of the reporting cycle. The early reporting season is dominated by financials, which were strong this time; late reporting season will have plenty of energy companies, which as noted are still struggling. That said, we believe enough of a trend has been established to conclude that S&P 500 calendar fourth-quarter earnings are on track for mid-single-digit growth on a year-over-year basis.

As of 1/30/17, 175 of the constituent companies in the S&P 500 had reported calendar quarter results. On a share-weighted basis, which is the most widely used measure, 4Q16 earnings for these companies grew 5.0% compared with 4Q15 earnings. On a market-cap-weighted basis, earnings growth is 8.9%, which tells you that large and mega-cap companies are growing their earnings more rapidly than mid-sized and small-cap companies.

As is usual, the majority of companies (65%) have surprised to the upside on EPS, while just 19% have posted negative surprises. In the era of CFO earnings guidance, and given the incentive companies have to under-guide for any period, upside and downside EPS surprises may be losing some of their stock-price-moving mojo.

The best sectors for annual EPS growth in the reporting quarter to date are materials (up 23%) and healthcare and utilities (both up 15%). Information technology and financial services earnings to date are up 9%-10% for calendar 4Q16.

(continued on next page)

Within the sector roadmap, the best industries for earnings growth include: banks; healthcare equipment & services; pharma, biotech, and life sciences; semiconductors; technology hardware; and diversified materials.

The worst sector for quarterly earnings comparisons remains Energy, which is down 51%. Much more moderate negative trends are visible for consumer discretionary and industrials, both down in the 7%-8% area on a year-over-year basis. The worst individual industries for 4Q16 earnings include automobiles & components; transportation; and energy equipment & services.

Average share-weighted EPS growth for companies posting positive annual comparisons is 11.6%. Average share-weighted EPS decline for companies posting negative annual comparisons is 23.9%. This phenomenon, whereby down earnings are declining at twice the rate at which up earning are rising, has been persistent since the collapse in oil prices began late in 2014 and early in 2015.

This two-to-one dichotomy, which is anomalous in normal EPS reporting periods, is significant because it has acted as an outsized drag on overall EPS growth. Energy earnings are about to swing from a major headwind to a major tailwind as oil price comps turn favorable. If the preponderance of companies already reporting double-digit growth can maintain that trend, while formerly deeply negative sectors such as energy swing to strongly positive, than earnings could be positioned to grow at low-teens percentage growth rates across the early to middle quarters of 2017 and perhaps longer.

CONCLUSION

The chief policy risk to stocks is that President Trump will continue to play to his base with easily enacted executive orders that actually impede trade and international flow of goods and ideas. If these agenda items dominate in the long lag before actual growth initiatives are approved and enacted, already uneven economic growth could slow further, and stocks could be sluggish or worse in the 2017 first half.

Earnings, on the other hand, will likely only get stronger. The headwind that has been oil earnings becomes a meaningful tailwind beginning in 1Q17 EPS season. First-quarter 2017 energy earnings this year will compare against a 1Q16 environment in which WTI oil traded at $27 per barrel.

Energy is just a portion of overall earnings growth. To get back to double-digit EPS growth will require strengthening trends in the largest sectors, including information technology, financial services, and healthcare, along with outsized gains in economically sensitive areas such as industrials and materials. If global recovery extends from mature trading partners to emerging economies, the EPS growth outlook for S&P 500 companies only gets stronger.

Jim Kelleher,
Director of Research