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WEEKLY ECONOMIC COMMENTARY

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Earnings as Expected, and a Vive! From France

The future shape of trade relations is uncertain, but the good news from France was imported into the markets without a tariff. French centrist Emmanuel Macron and rightist Marine Le Pen will square off in a final May 7 election, after the two political outsiders garnered the highest vote percentages among the four main candidates and a handful of others in the 4/23/17 election. Macron had 23.78% of the vote, while Le Pen took 21.5%. The two finished ahead of center-rightest Francois Fillon and hard-left candidate Jean-Luc Melenchon, who each garnered around 19% of the vote.

Fillon has recommended that his supporters endorse Macron. While Melenchon has (so far) not sent a similar signal, his Socialist backers will not be voting for Le Pen. The early post-election analysis suggests that Macron has about a 20 point lead over Le Pen. Markets rallied on 4/24/17 on the perception that the more centrist candidate would prevail in the runoff, that the euro and the EU will be preserved, and that the nationalist populism, or populist nationalism, that led to Brexit and elected President Trump may have crested.

Whatever the thinking, U.S. investors sounded a Vive! at the French election results, even as the GOP agenda remains stuck in neutral. The U.S. stock market has rallied sharply since the election on the promise or at least hope of fiscal stimulus, in the form of tax reduction and infrastructure spending. The first-round results from France were equally more promise than substance. Markets may be willing to take an optimistic view of international and domestic policy events, simply because 1Q17 earnings season has lived up to its promise.

EARLY EARNINGS RETURNS BEST EXPECTATIONS

During the trading week beginning 4/24/17, approximately 150 S&P 500 constituent companies and a dozen DJIA components will report calendar 1Q17 earnings. This earnings season is a bit more back-end-loaded than recent periods, and as of 4/24/17 only about one-fifth of S&P 500 companies had reported. As expected, performance has been better than expected – which is to say, investors know that company-issued guidance will low-ball managements' actual earnings outlooks.

As of 4/24/17, and with about one-fifth of companies having reported, S&P 500 earnings from continuing operations had increased 11.8% on a share-weighted basis for 1Q17 compared with 1Q16. Growth on a market-cap-weighted basis was a slightly stronger 14.3%, signaling that larger companies are better able to execute on their strategies in this dynamic environment.

Companies continue to "surprise" on the upside, as they have increasingly done in recent quarters, as more and more companies issue guidance deliberately skewed to worst-case outcomes. About 76% of companies reporting 1Q17 results to date have topped consensus expectations; 18% have lagged Street forecasts; and about 6% have reported in line with consensus estimates. Going into earnings season, FactSet and other prognosticators had pegged EPS growth at about 9%, based on these consensus views. The approximately 3% outperformance relative to pre-reporting consensus is con-

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sistent with a market in which three-quarters of reporting companies beat the Street.

Too few energy companies have reported to draw any conclusions, but sector earnings for 1Q17 are expected to be slightly lower to slightly higher year-over-year; that is in contrast to multiple quarters in which energy earnings declined 50%-80% year-over-year. The sampling of industrial companies is large enough to be meaningful, and sector earnings are down about 9% year-over-year. Dollar strength since the election is hurting industrial companies' competitive position overseas, and energy capital spending at home is not quite sufficient to offset this negative.

On the upside, financial services earnings to date are up 17% year-over-year, with more than one-third of sector companies having reported so far. Although the widening in net interest margins remains more promise (that word again) than reality, banks are experiencing higher levels of trading activity; certain loan categories, including mortgages, are strengthening. Information technology earnings are up over 20%, although many of the heavy hitters have yet to report. Other sectors with double-digit annual EPS gains include materials and health care.

For more than a year, as EPS has ranged from flat to down in quarter after quarter, companies posting down earnings did so at twice the magnitude of companies posting up earnings. In other words, while the majority of companies were posting, say, average EPS growth of 12%, the smaller subset of companies with down earnings were posting average EPS declines of 24%; and that was sufficient to drag the composite down into flat to negative territory.

Along with the anticipated swing to positive in energy earnings, another thing that has changed in 1Q17 is the relative strength of companies growing their earnings compared to companies posting EPS declines. The larger group of companies posting up earnings (about three-quarters of companies reporting so far) have grown their EPS an average 21.5%, while the smaller percentage (less than 25%) of companies posting down earnings are reporting an average decline of 12%. This little-watched data point, which indicates a reduction in the negative drag from down earnings, is partly responsible for the double-digit EPS growth reported to date.

CONCLUSION

With less than a quarter of companies having reported as of 4/24/17, earnings season is far from over. But the sampling size is sufficiently meaningful to signal that 1Q17 season will be positive once all companies have reported.

The political season, meanwhile, is the definition of inconclusive. Promised stimulus, if enacted, could add to corporate earnings growth and add some years to an aging bull market. But in politics, unlike in business, all constituents have a voice (aka the House of Representatives), and finding consensus is never easy. Increasingly, stimulus is looking like a 2018 event, rather than a 2017 event.

In speaking with investors, successful companies often share a common message: managements prepare for all eventualities while focusing on what they can control. That likely makes sense from an investment perspective. We would focus investments in top tier companies with tangible earnings prospects, while preparing to ride out policy waves from Washington and abroad.

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