ARGUS®

WEEKLY ECONOMIC COMMENTARY

May 8, 2017

Earnings Momentum Deflects GDP, Job Concerns

The U.S. stock market is now regularly trading at peaks, alternating new all-time-high days with consolidation sessions that simply power the next sprint upward. Some investors have posited that the key long-term market driver is monetary policy. Others believe the current rally leg is built on the promise of fiscal policy.

In our view, earnings (S&P 500 earnings from continuing operations) are the main engine that makes the stock market run. From our perspective, the stock market has been reinvigorated by the best earnings season in at least 11 quarters and potentially the best in the past 22 quarters.

Based on EPS growth reported so far in 1Q17, investors might have to go back to the third quarter of 2011 — when earnings increased 17% — to find a better quarter than the current one for earnings growth. Recall that in 2011, long-forgotten (in the market's short memory) stimulative mechanisms were still in place. These included "cash for clunkers" and first-time homebuyers credit. In 2011, the S&P 500 was coming off the recovery year of 2010, when earnings rose 48%.

The last time earnings grew in double digits on a year-over-year basis was the second quarter of 2014, when earnings rose by about 11%. The follow-on quarter (3Q14) just missed the double-digit gainer designation. Thereafter, stocks slid into an extended nine-quarter phase of single-digit gains or losses spread over the three calendar years of 2014, 2015 and 2016. The market did not get back to unequivocally positive earnings until 4Q16; but earnings in last year's final quarter were unexciting at about 5%.

EARNINGS TOPPING CONSENSUS, AND REVENUE NOT SHABBY EITHER

As of May 2, 2017, and with about 66% of companies having reported, S&P 500 continuing-operations earnings for calendar 1Q17 are up 15.4%. That is much better than our assessment a week ago, when earnings were up 12%, and meaningfully better than the pre-reporting forecast of 9% growth. Argus Chief Investment Strategist Peter Canelo went into 1Q17 earnings season predicting 13% growth, based on prospects for formerly laggard sectors moving into earnings-growth leadership.

One of the most telling data points in 1Q17 is earnings growth excluding Energy. For the past 8-10 quarters, energy ranged from a drag to a severe drag on earnings. For 1Q17, earnings growth excluding energy is 11.5%, or 360 bps less than earnings growth for all component companies. More than half of energy companies in the S&P 500 have reported, representing a meaningful statistical sample.

No surprise, positive surprises are smashing unforeseen negative results. About 76% of companies reporting to date have exceeded expectations. Only about 18% of companies have missed expectations, while about 7% have matched consensus (percentages add to 101% due to rounding).

Besides Energy, where percentage growth is astronomical in moving from negative numbers (losses) to positive numbers (profits), the best sectors for earnings growth in 1Q17 have economic sensitivity. Information Technology and Materials are both growing earnings in the 24%-25% range. Other double-digit earnings growth sectors include Healthcare and Financial Services.

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Materials earnings growth represents a bounce back against somewhat easy comps from a year, when commodity prices were seeking to stabilize after the horrendous January-February 2016 period. Growth in Information Technology earnings is more impressive, given that this sector has grown EPS throughout the nine-year bull market. Technology companies, in some cases seamlessly and in some cases bumpily, are migrating to the new world of cloud data center, machine learning, AI, and internet of things. Industrial company earnings remain challenging, reflecting strong-dollar impacts on overseas competitiveness and repatriation of overseas revenue. There may also be some uncertainty given the fraught language on trade, even though significant policy has yet to be enacted. Telecom Services is the only negative sector, as industry giants AT&T and Verizon are humbled by unlimited data plans from smaller rivals.

Earnings have been so good in 1Q17 that the growth in revenue has been little remarked upon. Sales growth is 7.6% year-over-year for calendar 1Q17, better than pre-reporting expectations in the 6%-7% range. The biggest contributor has been Energy, where the year-over-year recovery in petroleum prices would have been sufficient to drive 30% sales growth even in a flat volume environment. Several other sectors, however, are averaging high single-digit sales growth, including Consumer Discretionary, Information Technology, and Materials.

CONCLUSION

Based on our current modeling, we forecast three more quarters of double-digit growth across the remaining quarters of 2017. We will adjust on the fly — but for now, we forecast high-single-digit EPS growth across the four quarters of 2018.

Fiscal policy in the form of tax reform and infrastructure spending could influence the final outcome for 2018 earnings, most likely to the upside. Our forecast builds in no tangible progress on either of those initiatives and reflects the solid work by top-tier companies to build sustainable profit-growth models.

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