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WEEKLY ECONOMIC COMMENTARY

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# First Cut at Second-Quarter Earnings

The calendar second-quarter earnings season is underway, with earnings coming in nicely, if not (so far) quite as strong as we had anticipated. The S&P 500 is having a better-than-average July, rising 1.9% since July 1; compared to the average 0.9% July gain over the past 37 years.

Investors, however, are not necessarily rewarding companies for a job well done. Since the unofficial start of calendar 2Q17 EPS season on 7/15/17, the index has drifted a few points lower. As the data flow has intensified, early enthusiasm over EPS has whittled down.

Our enthusiasm is intact, and we expect investors to respond positively to a second consecutive quarter of double-digit EPS growth – even if earnings are not quite there yet. With just over one-fifth of S&P 500 companies having reported, and with low-earning financial stocks over-represented in the early sample, we continue to model calendar second-quarter 2017 earnings growth (from continuing operations) in the low-double-digits.

**THE EARLY RESULTS**

As of 7/24/17, and with approximately 103 (21%) of S&P 500 constituent companies having reported, the annual change in earnings per share for 2Q17 is 9.3%. Of the 103 companies, 86 have reported higher EPS, with average growth of 16.2%. Only 16 companies have reported lower annual EPS, but their greater rate of decline – on average, these companies reported a 28.3% EPS decline – has weighed disproportionately on overall EPS growth.

Excluding financial service companies, earnings growth would be in low double-digits at 11.3%. Almost half of all financial services companies that are constituents of the S&P 500, or 30 out of 66 (45%), have already reported. While the Financial services weighting in the S&P 500 is about 14%, financial services represents 29% of the companies that have reported so far. Financial services earnings are sensitive to shared inputs, such as the market rate of interest; and financial services earnings are up less than the market, having risen 6.3% for calendar 2Q17 to date. Once the financial services contribution normalizes, we should see overall 2Q17 EPS climb into low double digits.

Excluding the few energy companies that have reported, earnings growth is actually reduced by 50 basis points, to 8.8%; for over two years, excluding energy companies had the effect of raising overall quarterly earnings. Energy earnings so far are up 95%, off a depressed year-earlier base. Like financial services, energy companies are sensitive to a shared input: in this case, the price for crude and finished energy products. We therefore regard early energy EPS reports as indicative of the broad trend in energy 2Q17 earnings. The bulk of energy companies are late reporters, and the addition of multiple high-double-digit EPS reports late in the quarter should have the effect of pulling the total index average higher as the reporting period winds down.

Sector performance is as always mixed; with the sample size likely too small in some sectors, it makes sense to await a higher percentage of company reports before drawing final conclusions. Still, on a preliminary basis, the sectors with the best annual growth after the aforementioned Energy sector include Information Technology (23.6%), Healthcare (12.2%), and somewhat surprisingly Real Estate (up 25.0%).

On the other side, the consumer sectors are not showing much growth, with earnings from Staples and Discre-

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tionary up 8.7% and 5.3%, respectively. So far, no S&P 500 constituent companies in the Utilities or Telecom Services sectors have reported.

Industrials are doing the worst, with a reported 8.4% annual EPS decline. With about one-third of sector companies having reported, that is likely a good enough sample size for the sector overall. Better times should lie ahead for Industrials, however, given the 8.2% year-to-date decline in the U.S. dollar (DXY), as measured against major-trading-partner currencies. Given where the dollar was in 3Q16 compared to where it is today, we expect the dollar to swing from diminishing headwind to 2Q17 earnings, to minor but accelerating tailwind to 3Q17 earnings. This should be beneficial to Industrial constituent companies, which have extensive overseas exposure.

Most companies "surprise" on earnings, though it should be no surprise given that CFOs have every incentive to provide low-ball guidance to the Street. More significant than the number of surprising companies is the dynamic in EPS surprises: i.e., whether they are increasing or decreasing on a percentage basis year-over-year.

For calendar 2Q17 so far, 79.6% of reporting companies have surprised to the upside while only 13.6% have surprised to the downside. Consider that for 2Q16 EPS season, a lower percentage (71.9%) surprised to the upside, while a higher percentage (17.6%) surprised to the downside. Analysts assume CFOs are providing low-ball guidance, so analysts issue estimates above guidance. The nearly 800-basis-point annual increase in companies that successfully surprised the Street suggests that investors have been underestimating the earnings potential among S&P 500 constituent companies.

**CONCLUSION**

Another data point, though less closely watched, is also a positive indicator for future EPS growth. For that same set of companies representing the 21% of S&P 500 constituents that have reported, sales growth has averaged 4.56% for 2Q17 to date. Importantly, Energy is not a huge upside outlier that is pulling the entire group misleadingly higher. Energy sales growth for the quarter-to-date is about 11%. Other sectors with sales growth for 2Q17 exceeding the index average include Consumer Discretionary, Information Technology, Healthcare, Financial Services, and Materials. Only Real Estate, Industrials and Consumer Staples lag the index average. As noted, no Utilities or Telecom Services companies have reported.

Companies can "engineer" earnings growth in a down economy by cutting costs, laying off employees, and exiting niche businesses. But it is an economic maxim that you cannot cut your way to growth indefinitely.

Second-quarter's mid-single-digit sales growth has come at a time when inflation is tame (inflation can contribute significantly to sales growth) and when currency exchange is flat to slightly negative to top-line comparisons. Altogether, the nearly 5% revenue growth reported for 2Q17 EPS season to date is a positive sign that earnings growth is being driven by operating leverage rather than by financial engineering.

We'll update our earnings-season report once or twice more in these pages before 2Q17 EPS season is "put in the books." We think the reports to date does nothing to shake our confidence that the S&P 500 can deliver on our forecast for low-double-digit EPS growth for calendar 2Q17. That in turn should support low-double-digit EPS growth for 2017 overall.

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Investors