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Earnings Provide a Steady Foundation for a Stumbling Market

Seven months into the Trump presidency, the GOP has little to show for its political hegemony in Washington. During the first few months of stalled or failed initiatives, investors assumed that the new administration — which is short on Washington insiders — just needed to get past the Beltway learning curve. In the wake of Charlottesville and the ouster of Steve Bannon, however, a new pessimism has taken hold, and investors are now more skeptical that meaningful fiscally stimulative legislation will be enacted this year.

This sentiment is expressed tangibly in recent sharp moves in equities. About half of the 1%-plus one-day declines in the S&P 500 in 2017 have occurred in the past two weeks. Small cap indices such as the Russell 2000 and the S&P 600 have slipped into, or are on the edge of, negative territory for the year. DJ Transports are diverging from the broader DJIA. After gliding peacefully through the first half of the year, the VIX has bounced wildly in recent weeks. Individually, none of these indicators are crucial. In aggregate, they paint a dangerous picture of a market at risk of tipping over.

Stock market bears argue that, much as past-year gains in the S&P 500 were partly built on the Fed's easy money policy, gains in 2017 have been built on hopes for fiscal stimulus. With GOP leaders and the president trading harsh words, bears argue, cooperation on infrastructure investment and tax reform becomes more difficult. The Trump Bump will melt away, they warn, if the GOP squanders this first year of its legislative dominance.

Stock bulls counter that Washington has historically been overrated as a market driver. The true driver of stock market performance is economic activity, and, specifically, the expression of economic activity in corporate earnings. Earnings performance in 2Q17, bulls argue, should signal that all is well with the stock market.

A SECOND CONSECUTIVE DOUBLE-DIGIT GROWTH QUARTER

Earnings season always has fuzzy edges, based on companies that report late or early, or that straddle two quarters within their reporting period. A handful of technology and retail companies have yet to report; both groups frequently report May-July periods rather than April-June quarters.

That said, the calendar 2Q17 earnings season has been a good one. With about 93% of S&P 500 companies having reported as of Friday 8/18/17, earnings from continuing operations were up 11.2% on a share-weighted basis (the most common metric). Energy was a big contributor, despite accounting for little more than 6% of index weight.

Excluding Energy, which grew EPS by more than 250% from the prior year, total 2Q17 earnings would have been up 8.8%. Still, no one was excluding Energy when lamenting about the feeble trends in EPS growth in 2015 and 2016, when EPS alternated low single-digit gains with low single-digit declines.

Beyond Energy, the best-earning sectors in 2Q17 included Information Technology, up 19%; and Materials, up about 10%. Other sectors grew EPS in high single-digits, including Financial Services (up 8%); Industrials (up 7%); Healthcare (up 7%); and Utilities (up 7%). Telecom Services and Staples were both up about 5%; Consumer Discretionary swept up the parade with 2% growth.

That lag in Consumer Discretionary included the usual suspects. Retailing earnings dipped 6%; but automotive OEMs and parts were also a drag. Notable individual industry winners in 2Q17 included software, up 16%, and semiconductors, up 44%, both within Technology; oil, gas, and

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consumable fuels, up 221%; and professional services and transportation, both within Industrial and both up in the mid-teens.

Upside surprises are a fact of life in earnings season: companies have every incentive to guide conservatively, given that those that guide accurately risk seeing their stock price thumped. About 72% of companies surprised to the upside in 2Q17, slightly better than the long-term average in the 70% range. What we found notable was the magnitude of upside surprise, particularly in several economically sensitive sectors.

The aggregate upside surprise was 4.7%, which is better than average. The best sector surprise was in Technology, where the average company reported EPS that topped the Street consensus by 7.8%. Healthcare stocks on average surprised by 6.2%. Other notable upside-surprise sectors included Materials, Consumer Discretionary, and Telecom, all in the 4%-5% range.

Sales trends were also positive in 2Q17. For the 93% of companies that had reported as of mid-August, revenue increased an average 4.9%. Even backing out the contribution from Energy, where revenue increased a sharp 15%, total 2Q S&P 500 sales growth ex-energy was a healthy 4.1%.

Notably, the second quarter included no real currency benefit. For most companies, foreign exchange was neutral to a slight headwind in 2Q, based on the average value of the dollar against major trading partner (MTP) currencies, compared to its impact in 2Q16. That is about to change in 3Q17 and subsequent quarters.

The dollar appreciated sharply in 2014-2016 and added more strength in early 2017. But with the U.S. perceived as a potentially less reliable partner in time of crisis, the dollar has lost some of its reserve-currency bid. While consumers feel little immediate impact from forex moves, corporations will see a meaningful dollar-related tailwind beginning in 3Q17, strengthening in 4Q17, and carrying into 2018.

Most research firms underestimated S&P 500 earnings power in the first half, and the Street is scrambling to increase full-year 2017 EPS targets based on the strong first-half performance. In 1Q17 and again in 2Q17, earnings largely met the expectations laid out by Argus Chief Investment Strategist Peter Canelo. Argus may modestly raise its second-half EPS expectations, however, based on the deeper-than-expected decline in the dollar.

CONCLUSION

For now, we are reiterating our 2017 forecast of $132 per share in S&P 500 earnings from continuing operations. Our outlook assumes a still-active consumer, modest industrial expansion, a continuing benign inflation outlook, and a Fed that shows restraint regarding further rate hikes and the unwinding of its balance sheet.

We are also reiterating our 2018 outlook, which calls for high single-digit EPS growth. The further out we go, the more wild cards there are in the pack. In addition to the factors just noted, our 2018 forecast depends on the enactment of at least some fiscal stimulus measures in the U.S. and a generally stable geopolitical environment.

Based on our normalized earnings forecast, which incorporates three years of historical EPS and two years of projected earnings, the S&P 500 had approached fair value at its prior early-August peak just under 2,500. With the index currently about 2% below its all-time high, fair value is still in sight, if slightly further out. It is worth noting that market rallies tend to stop not at fair value, but at some point 10%-20% above fair value (even after adjusting for extreme overvaluations in 2000 and 2007).

The latest rupture between Republican leaders and President Trump may have a silver lining if Congressional leadership simply "goes it alone" in formulating policy, rather than waiting for a united front. The president showed himself willing to sign off on healthcare policy in which he had little direct input; he might respond similarly to tax or infrastructure policy presented in a finished form.

Even a modicum of progress in Washington would be helpful. But earnings growth suggests that such progress is not indispensable.

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