LPL RESEARCH

WEEKLY MARKET COMMENTARY

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Q2 EARNINGS: MUDDLING THROUGH

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KEY TAKEAWAYS

We expect slightly positive earnings growth in the second quarter, with substantial drag from falling technology sector earnings.

The big question for investors this quarter is how much tariff costs are reflected in analysts' earnings estimates.

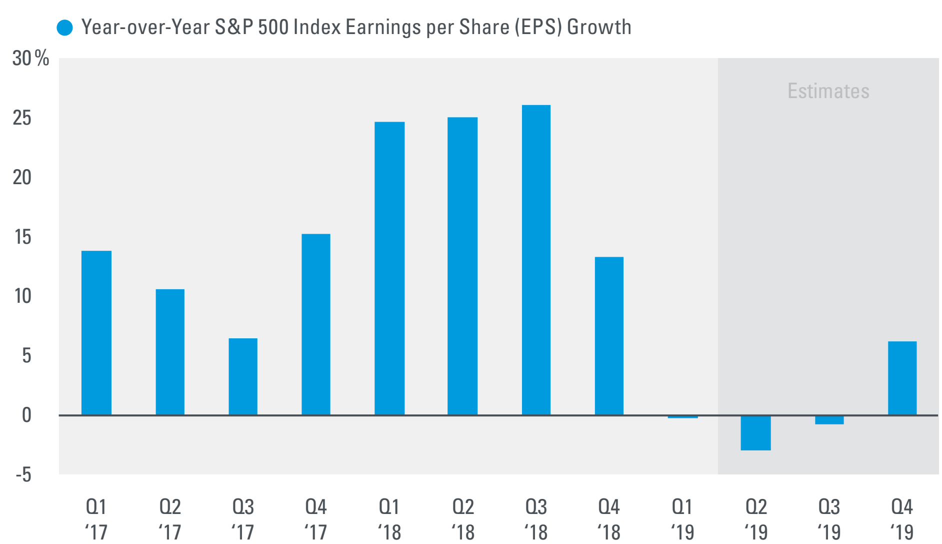
We expect better-than-expected earnings may be a catalyst for stock market gains in the second half of this year.

Second quarter earnings season gets rolling this week. Consensus estimates are calling for a modest year-over-year decline in S&P 500 Index earnings amid the downshift in U.S. and international economic growth, tariffs, and ongoing trade tensions. Quarterly earnings almost always beat quarter-end consensus estimates—this quarter will likely be the 41st in a row to do that—so we expect a slight year-over-year gain that would continue the stretch of consecutive quarterly earnings gains since the 2016 earnings recession [Figure 1]. Nearly60 companies will report this week (July 15–19). Here we preview second-quarter earnings season and share our outlook for profits in the second half of 2019.

LOW BAR AGAIN

Seventy-seven percent of companies issuing guidance for the second quarter have lowered estimates, which is above the 5-year average of 70%, according to FactSet data, lowering the bar so to speak. However, the overall consensus S&P 500 earnings estimate has fallen only by a below-average 2.6 percentage points over the past three months, much less than the 7 percentage point reduction in first-quarter 2019 S&P 500 earnings expectations ahead of the first-quarter reporting season. We think earnings stand a good chance of beating estimates

1 EARNINGS LULL EXPECTED TO BE TEMPORARY



Source: LPL Research, FactSet 07/12/19

by the typical 3–4% when factoring in the lower bar, a generally steady U.S. economy, the results already in for May 31 for quarter-end companies, and the latest trade developments (more on that below).

THE BIG QUESTION

The big question for investors this quarter is how much tariff costs are reflected in analysts' earnings estimates. China tariffs remained in place after President Trump's meeting with China President Xi at the G20 Summit in Japan last month. We suspect those tariffs are mostly reflected in second-quarter estimates (and probably third quarter as well). Estimates were reduced significantly earlier in the year, and companies have already taken steps to mitigate impacts by altering supply chains. Tariffs have also received a lot of attention on earnings conference calls this year, giving analysts a fair amount of information to react to.

We will be closely watching management commentary on trade and estimate revisions for clues on these impacts during reporting season.

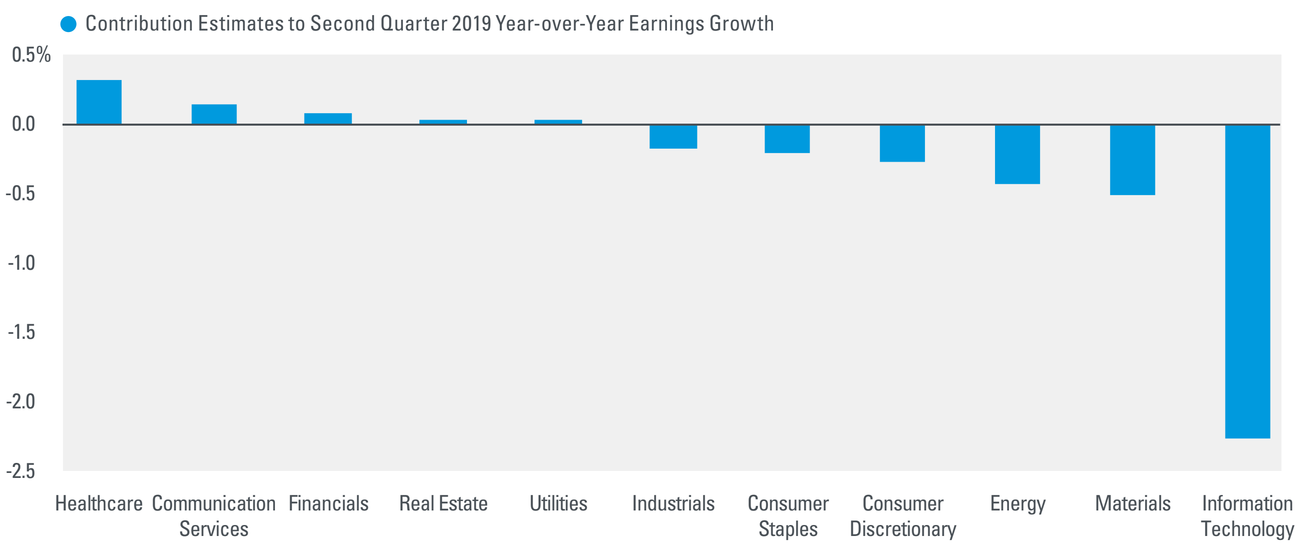
GREENBACK IMPACT

A stronger U.S. dollar may weigh on second-quarter earnings, as it did in the first quarter. The average price of the U.S. Dollar Index in the second quarter of 2019 was 5% above year-ago levels. As a result, currency may cut 1–2 percentage points off S&P 500 earnings for the second quarter (roughly 40% of S&P 500 companies' profits come from outside the United States). The dollar's weight on profits has already been a primary theme, as half of the 24 companies that have reported second-quarter results thus far have cited currency headwinds. The drag will likely continue through the current quarter, although we expect the Federal Reserve's policy U-turn to limit further dollar strength and eventually weaken the earnings headwind.

SECTOR DRAGS

Technology company earnings will be especially impactful this season due to low expectations and the sector's large weight in the S&P 500 Index [Figure 2]. The sector is expected to report

2 TECHNOLOGY A BIG DRAG ON SECOND QUARTER EARNINGS



Source: LPL Research, FactSet 07/12/19

S&P 500 GICS subindexes represented.

The economic forecasts may not develop as predicted.

a double-digit earnings decline, and if realized, technology earnings could be a significant drag on overall index profits. In fact, more than two-thirds of the second quarter's estimated 3% earnings decline is from technology, based on current FactSet estimates. The sector's biggest constituent, Apple, is expected to drag the overall S&P 500 earnings down one-half of a percentage point by itself, based on its estimated 16% drop in earnings.

Oil price fluctuations are likely to cut into energy companies' profits. The average oil price during the second quarter was just a hair below $60 per barrel, 11% below the average price in the year-ago quarter. That decline is similar to what WTI Crude experienced in the first quarter of 2019 when energy earnings fell 26%. This quarter likely won't see that much of a drop, but energy sector earnings are unlikely to grow, and neither are earnings for the materials sector. Based on consensus estimates, the two natural resource sectors, which are both China sensitive, are expected to clip nearly one full percentage point from the overall S&P 500 earnings growth rate for the quarter.

OUTLOOK FOR 2019 PROFITS

In early June we slightly reduced our 2019 S&P 500 earnings per share (EPS) forecast from $172.50 to $170 due to heightened trade tensions with China.* If achieved, that $170 EPS number would represent roughly 5–6% EPS growth. Our forecast is above Wall Street's consensus of $167 (source: FactSet), which we suspect is too low considering the mostly positive fundamental environment.

Trade is a huge wildcard—hitting our EPS number likely requires some resolution to the U.S.-China trade dispute—but we think better-than-expected earnings may be a positive stock market catalyst over the second half of 2019. Though President Trump's meeting with President Xi at the G20 Summit in Japan prevented additional tariffs from being implemented, substantial tariffs remain in place.

CONCLUSION

Earnings are in a bit of a lull. Slower growth amid trade uncertainty and tariffs will likely wipe out most of the earnings growth we might have had, and second-quarter earnings will probably be only marginally positive when all results are in.

Nonetheless, we think fundamentals of the economy, including fiscal stimulus put in place over the past two years, support improving earnings growth later this year. We think the current macroeconomic environment has mid-single-digit earnings growth power. But for now, tariffs on Chinese goods are hurting U.S. company profit margins. Meanwhile, trade uncertainty has weighed on business confidence and hampered capital investment, which limits revenue growth opportunities for corporate America.

Until we get more clarity on trade, earnings are unlikely to grow much. We think we will get some of that clarity over the next few months, which supports our belief that consensus estimates for S&P 500 EPS may be too low. ■

*Please see the *Midyear Outlook 2019: FUNDAMENTAL: How to Focus on What Really Matters in the Markets* for additional description and disclosure.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Economic forecasts set forth may not develop as predicted, and there can be no guarantee that strategies promoted will be successful.

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All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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