



MORNING BRIEFING

March 20, 2019

Dodging an Earnings Recession?

See the [collection](#) of the individual charts linked below.

(1) 2018: A good year for earnings, and bad one for stocks. (2) 2019: So far so good for stocks despite weak earnings. (3) Q2 earnings growth still (barely) positive, while Q1 likely to be down slightly. (4) Weekly data on forward revenues, earnings, and margins turning more upbeat for comparable quarterly data—maybe. (5) Joe explains growth vs value styles. (6) Melissa explains how Baby Boomers are weighing on one popular measure of wage inflation.

Strategy I: Is the Earnings Recession Over Already? Joe and I track the weekly I/B/E/S data compiled by Refinitiv of the analysts' consensus expectations for the S&P 500 operating earnings as well as the actual results. For the four quarters of last year, I/B/E/S reports the following growth rates: Q1 (23.2% y/y), Q2 (25.8), Q3 (27.5), and Q4 (14.2) ([Fig. 1](#) and [Fig. 2](#)). It was a great year for earnings, but a lousy year for the stock market, especially during Q4.

This year is starting on a sour note for earnings, yet stock prices have rebounded nicely so far. While the Q4-2018 growth rate was still in the double digits, the typical upward earnings hook was anemic. Furthermore, corporate managements' guidance about the 2019 outlook during their latest conference calls was generally cautious. That triggered a sharp drop in earnings expectations for Q1-2019 ([Fig. 3](#)). The growth rate for that quarter plunged from 5.5% at the end of last year to -1.5% during the 3/14 week ([Fig. 4](#)).

As a result, there has been lots of chatter about an earnings recession, particularly by bearishly inclined investment strategists who are warning about an imminent reversal of the post-Christmas stock market rally.

While Q1's growth rate for expected earnings is ever so slightly negative, the Q2 consensus estimate remains ever so slightly positive, and is showing signs of bottoming just north of zero. Here are the 3/14 week consensus growth estimates: Q1 (-1.5%), Q2 (1.1), Q3 (2.6), and Q4 (9.4). Barring any unforeseen calamities, it looks like the bears won't be getting two back-to-back negative quarters for S&P 500 earnings growth.

Strategy II: Forward Earnings Moving Forward Again? It's only a hint so far, but analysts' weekly consensus expectations for both S&P 500 revenues and earnings in 2019 and 2020 may be just starting to bottom after their recent dips ([Fig. 5](#)).

The implied profit margins for this year and next year may be starting to bottom too, at 11.9% and 12.6%, respectively, during the 3/7 week. The 2019 expected profit margin is now 0.1ppt below the 2018 margin, while the 2020 estimate is probably still too high.

In any event, the time-weighted averages of these three key weekly variables are forward looking, and are also showing signs of bottoming after dipping earlier this year. That's important because all three

are very good weekly indicators of the actual quarterly results ([Fig. 6](#)). Let's have a closer look at the latest data:

(1) *Forward revenues*. S&P 500 forward revenues was remarkably strong last year ([Fig. 7](#)). It has been edging down so far this year, but during the 3/7 week it was only 0.7% below its record high during the 1/3 week. Meanwhile, S&P 400/600 forward revenues has been relatively flat at record highs since late last year.

(2) *Forward earnings*. S&P 500 forward earnings edged up for a third straight week during the 3/14 week, following declines nearly every week since the beginning of November ([Fig. 8](#)). But it remains just 1.9% below its record peak during the 10/26 week. The S&P 400/600 forward earnings continue to fall modestly so far this year.

(3) *Forward profit margin*. The S&P 500/400/600 forward profit margins were all boosted by Trump's corporate tax cut at the start of last year ([Fig. 9](#)). All three have been dipping since late last year. The S&P 500/600 are still both holding onto their tax-cut boosts, while the S&P 400 may be starting to give some of it back.

Strategy III: What's in Growth vs Value Styles? In last Wednesday's [Morning Briefing](#), Joe compared the bull market performance of the S&P 500 to its Growth and Value indexes. Today, he dives deeper and looks at the makeup of those indexes. In addition to the Growth and Value indexes, S&P also has "pure" versions of these indexes.

Companies in the S&P 500 are given both a growth and value score, using various fundamental, price change, and valuation measures. (See our [S&P U.S. Style Indices](#).) Here's what S&P uses to arrive at the growth and value scores for each company:

(1) *Growth score inputs*: three-year earnings-per-share growth relative to stock price, three-year sales growth, and 12-month percentage price change.

(2) *Value score inputs*: book-to-price ratio, earnings-to-price ratio, and sales-to-price ratio.

Companies then are ranked based on their separate growth and value scores, and then by the ratio of their growth rank/value rank. Companies at the top that compose 33% of the total index market cap are designated "Pure Growth," while the bottom 33% become "Pure Value." Companies in the middle are considered a blend of both growth and value. Here's a brief synopsis of each index:

Among the 506 issues in the S&P 500, 296 appear in the Growth index and 384 in the Value. So there's some overlap. Looking at their total market cap (not necessarily their S&P style index weightings), the 10 largest issues that appear in both the Growth and Value indexes include: Berkshire Hathaway, Johnson & Johnson, Exxon Mobil, Procter & Gamble, Intel, Home Depot, Coca-Cola, Oracle, Comcast, and Walt Disney.

Within the pure indexes, companies are weighted by their style score rather than their market capitalizations. The Pure Growth index contains 104 issues, and Pure Value 119 issues. Below are the top-five holdings in each of the four Growth and Value indexes:

(1) *S&P 500 Growth*. The top five companies, making up 22% of the index, are: Microsoft, Amazon, Facebook, Alphabet-class C and Alphabet-class A.

(2) *S&P 500 Pure Growth*. The top five, making up 11% of the index: Keysight Technologies, Ultra

Beauty, Devon Energy, Netflix, and CSX.

(3) *S&P 500 Value*. The top five, making up 17% of the index: Apple, JP Morgan, Bank of America, UnitedHealth, and Chevron.

(4) *S&P 500 Pure Value*. The top five, making 10% of the index: Baker Hughes, Ford, Valero Energy, Prudential, and MetLife.

When comparing the Pure Growth index with its broader Growth counterpart, investors might expect Pure Growth to have a higher valuation, higher revenue and earnings growth rates, and a higher profit margin. Conversely, Pure Value is likely to have a lower valuation, growth rates, and margin than does Value. That's true looking at their historical data, but not necessarily so when using consensus forecasts.

US Economy: Boomers Weighing on Wages. The most widely followed measure of wage inflation—average hourly earnings (AHE) for all private-sector workers—has been remarkably subdued given that the unemployment rate is so low and the number of job openings is at a record high. So why has wage growth been so sluggish?

A new Dallas Fed [study](#) confirms our long-held view that Baby Boomers have been weighing on the overall measure of wage inflation because more experienced workers that are paid more are weighted more heavily in the standard measure. Factoring out this weighting, the Fed economists find that their measure of individual wage growth could be around two percentage points higher than the popular measure suggests. Consider the following:

(1) *Subdued wages, lots of jobs*. AHE, the Bureau of Labor Statistics' widely followed wage inflation measure that has been available monthly since March 2007, ran well below 3.0% from May 2009 until edging above it during October 2018, based on the three-month average. It rose to 3.3% during December and remained there through February. The straight yearly percent change rate was at 3.4% in February—the highest since April 2009 ([Fig. 10](#)).

Despite this evidence of a modest pickup in wage inflation, the Dallas Fed economists observed that wage inflation has been minimal when adjusting for price inflation. They observed that the four-quarter average growth in AHE recently stood at 2.9% and that when factoring in 2.0% as the average inflation rate, workers' real wages are growing only 0.9% despite the low unemployment rate.

Indeed, the unemployment rate is near historical record lows at 3.8% during February ([Fig. 11](#)). Meanwhile, job openings are at a record high and have exceeded the number of unemployed persons since March 2018 ([Fig. 12](#)).

(2) *Misleading measure, heavy weighting*. But the AHE measure may be misleading. The measure is not the same as the average wage growth that individual workers experience. "That is, AHE growth weights a worker's wage growth by that individual's earnings as a share of total earnings. As such, the wage growth for workers with relatively high earnings receives greater weight in the AHE calculation than if the weight were the same for all workers," the Fed economists observed.

It is because of this compositional issue that AHE wage growth "will typically be lower than average individual wage growth." Workers who account for a lower share of earnings will tend to have relatively high earnings growth because they tend to be younger and more likely to see faster pay raises than older, more established workers.

Using data from the Current Population Survey and their own methodology to circumvent the weighting issue, the Fed economists calculate that individual wage growth could be more like 5.0%, about a full 2.0 percentage points higher than the AHE.

(3) *Enter WGT, shifts in and out.* Of course, AHE isn't the only monthly measure of wage inflation. The Atlanta Fed's [Wage Growth Tracker](#) (WGT), available since March 1983, has been consistently rising faster than 3.0% since August 2015 ([Fig. 13](#)). This measure has usually outpaced the wage inflation rate based on AHE for all production and nonsupervisory workers—which is also available that far back, so we can compare the two ([Fig. 14](#)).

The WGT addresses a different compositional interplay than the Dallas Fed economists solved for in their study, but it has a similar message. Unlike AHE, the WGT accounts for labor force shifts between workers who recently entered the labor force and those who recently exited it.

In our 8/16/17 [Morning Briefing](#) discussing wages, we covered a 3/7/16 [Economic Letter](#) in which San Francisco Fed economists explained: "In particular, while higher-wage baby boomers have been retiring, lower-wage workers sidelined during the recession have been taking new full-time jobs. Together these two changes have held down measures of wage growth." With so many of this generation still to retire, they predicted, "the so-called Silver Tsunami will be a drag on aggregate wage growth for some time."

CALENDARS

US. Wed: MBA Mortgage Applications, FOMC Rate Decision 2.25%-2.50%, Interest Rate on Excess Reserves 2.40%. **Thurs:** Leading Indicators 0.1%, Jobless Claims 225k, Philadelphia Fed Business Outlook 5.0. (DailyFX estimates)

Global. Wed: UK Headline & Core CPI 1.8%/1.9% y/y. **Thurs:** Eurozone Consumer Confidence -7.1, UK Retail Sales Including & Excluding Auto Fuel 3.3%/3.5% y/y, Australia Employment Change & Unemployment Rate 15k/5.0%, Japan CPI Headline, Core, and Core-Core 0.3%/0.8%/0.4% y/y, BOE Bank Rate & Asset Purchase Target 0.75%/£435b, ECB Publishes Economic Bulletin. (DailyFX estimates)

US ECONOMIC INDICATORS

Manufacturing Orders & Shipments ([link](#)): Both core capital goods orders and shipments posted solid gains in January, while total factory orders barely budged for the second month and total shipments fell for the fourth straight month—the longest streak since mid-2015. Overall factory orders eked out a 0.1% gain in both January and February after a two-month drop of 2.7% from September's cyclical high. Orders for machinery, transportation equipment, mining, oil field & gas field machinery, and electrical equipment, appliances & components all rose more than 1.0% in January, but were nearly entirely offset by declines in orders for computers & electronic products, primary metal products, and fabricated metal products. Meanwhile, unfilled orders ticked up only 0.1% in January after a three-month slide, suggesting factory orders are likely to remain soft. Total shipments sank 0.4% in January and 1.2% since reaching a new cyclical high in September. Looking at the core measures, nondefense capital goods orders ex aircraft (a proxy for future business investment) rebounded 0.8% after a two-month drop of 1.9%, holding at a very high level—within 1.5% of a new record high. Meanwhile, the comparable shipments measure (used in calculating GDP) did reach a new record high in January, rising for the third time in four months, by 0.8% m/m and 1.5% over the period. Despite January's gain, core capital goods orders contracted 5.2% (saar) during the three months ending January, based on the three-month average, the third straight decline. The comparable shipments measure accelerated

2.0% (saar) over the same period, above December's pace though down from August's recent peak of 8.4%.

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