



MORNING BRIEFING

October 15, 2019

Earnings Season's Greetings

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

(1) Big downward revision in Q3 earnings consensus. (2) Industry analysts turn from overly optimistic to too pessimistic as earnings reporting seasons approach. (3) 77/98 quarters of upside earnings hooks. (4) Another record high for forward earnings. (5) Global challenges for revenues growth. (6) US consumers consuming. (7) Shipments data mixed for S&P 500 Industrials and Information Technology. (8) Railroads huffing and puffing, while truckers are cruising. (9) Financials have loan demand, while margins are getting squeezed a bit. (10) Commodity producers face weak pricing.

Strategy I: The Squiggles Story. The Q3 earnings reporting season has started. Industry analysts' estimates for the S&P 500 operating earnings per share plunged 8.7% from \$44.85 at the end of last year to \$40.93 during the 10/10 week ([Fig. 1](#)). As a result, the y/y growth rate in the consensus estimate for Q3 plummeted from 5.1% at the end of last year to -4.1% ([Fig. 2](#)).

It's not unusual to see such downward revisions since industry analysts tend to be too optimistic about the future and become more realistic as the actual results approach during earnings-reporting seasons. Oddly, they tend to overshoot on the pessimistic side in the weeks before earnings seasons. That, in turn, means that there is often an earnings "hook" to the upside as actual results beat expectations.

Joe and I have weekly "earnings squiggles" data going back to Q1-1994. Of the 98 quarters since then through Q2-2019, there have been 77 such hooks by our count. (See [S&P 500 Earnings Squiggles Annual & Quarterly](#).)

In addition to tracking the consensus earnings "squiggles" for each quarter, Joe and I do the same for the annual consensus earnings squiggles on a monthly basis ([Fig. 3](#) and [Fig. 4](#)). They rarely show hooks, but they do confirm that analysts have an optimistic bias that gradually diminishes as each year progresses until their estimates converge with the actual annual results for S&P 500 companies.

Our monthly data for the annual squiggles start in 1980, spanning 25 months from February to February. Of the 39 years since then through 2018, we count 30 years with descending squiggles averaging -17.8%. The 9 ascending ones, averaging 7.0%, tended to occur following recessions. Even optimistically inclined analysts tend to turn pessimistic during recessions. That sets the squiggles up for upside surprises during recoveries ([Fig. 5](#)).

Now let's focus on the weekly data for the annual squiggles ([Fig. 6](#)). For the 10/10 week, they show that industry analysts expect that earnings per share will be up 0.8% y/y to \$163.27 this year, up 11.2% to \$181.53 next year, and up 9.2% to \$198.23 in 2021. That puts S&P 500 forward earnings at a record high of \$177.67 during the 10/10 week.

Strategy II: Mixed Fundamentals. An earnings hook could turn the actual Q3 earnings growth rate positive but not by much, since the underlying economic fundamentals are mixed for the major S&P

500 sectors. Consider the following fundamentals that should be relevant to the Q3 earnings-reporting season:

(1) *Global revenues*. By some estimates, about 30%-40% of S&P 500 revenues come from overseas. During their upcoming conference calls, the managements of companies that report disappointing results are likely to blame slower global growth, the tariff wars, and the strong dollar.

The y/y growth rate of S&P 500 revenues per share is highly correlated with the comparable growth rates in world industrial production (excluding construction) and in the volume of world exports ([Fig. 7](#) and [Fig. 8](#)). July data show that the former was up just 0.8%, while the latter was down 0.4%.

Keep in mind that both the production and exports series are “real” variables, while revenues are in nominal dollars. In any event, revenues per share rose 5.2% during Q2 even as global growth was slowing. Furthermore, as we observed yesterday, the weekly S&P 500 forward revenues series, which is a great coincident indicator of the actual quarterly revenues, rose to a record high during the 10/3 week.

Trump’s trade wars, particularly with China, have weighed on the global economy. For example, the y/y growth rate in the sum of the 12-month moving averages of Chinese exports (in yuan) to the US, Eurozone, UK, Japan, South Korea, and Australia was -0.2% during July ([Fig. 9](#)). Slower global growth and the trade wars have depressed the growth rate of US merchandise exports as well (down 0.1% during August), which are highly correlated with the growth rate in S&P 500 revenues per share ([Fig. 10](#)).

Also, revenues from abroad are getting clipped a bit by the strength of the trade-weighted dollar. It is up 2.3% y/y through early October ([Fig. 11](#)).

(2) *Consumers*. The good news for consumer-related stocks is that Americans are still doing what they do best; they are going shopping. Their purchasing power continues to rise along with payroll employment and inflation-adjusted wages.

Our Earned Income proxy for private-sector wages and salaries was up 4.2% y/y through September ([Fig. 12](#)). Retail sales rose 4.1% through August. The problem is that retailing is very competitive with narrow profit margins, especially as online shopping has become so popular. Online sales accounted for a record 35.0% of GAFO sales during July, up from 31.7% a year ago and 23.8% five years ago ([Fig. 13](#)).

On our website, we automatically update [Industry Indicators: Retail](#). It shows forward earnings and forward revenues rising to record highs in the following S&P 500 retailing industries: General Merchandise Stores, Home Improvement, Motor Vehicle Parts & Dealers, Electronic Shopping & Mail Order Houses, and Restaurants. The same can be said for the Consumer Discretionary sector.

Also showing strength has been the S&P 500 Homebuilding Index (up 47.4% ytd), which is highly correlated with the National Association of Homebuilders Index ([Fig. 14](#)). The latter is up from a recent low of 56 at the end of last year to 68 in September.

(3) *Industrials & Technology*. It’s a mixed picture for the S&P 500 Industrials and Information Technology sectors. Shipments of durable goods slipped below zero (-0.3%) on a y/y basis for the first time since November 2016 during August ([Fig. 15](#)). Here is the performance derby for some of the major shipments categories through August: communications equipment & related parts (9.8%), defense (6.7), motor vehicles & parts (3.7), fabricated metals (2.4), electrical equipment, appliances &

components (2.4), computers and related parts (2.1), machinery (1.6), nondefense capital goods excluding aircraft (1.4), primary metals (-6.9), and nondefense aircraft and parts (-30.2).

Worldwide semiconductor sales were down 16% y/y during August, though they have edged up over the past two months ([Fig. 16](#)). The forward earnings of the S&P 500 Semiconductors industry has been falling since early this year.

US industrial production rose just 0.4% y/y through August. Here is the performance derby for some of the major industries included in business equipment: communications equipment (8.1%), information processing (5.0), semiconductors & other electronics (0.7), industrial & other equipment (-0.4), transit (-2.1), and computer & peripherals (-2.5).

(4) *Railroads & Trucking*. Here is some bad news for S&P 500 Railroads: Not a pretty picture is the y/y growth rate in railcar loadings of intermodal containers (using the 26-week moving average) ([Fig. 17](#)). It is down 4.7% through the 10/5 week. This series is highly correlated with the growth rate of the sum of inflation-adjusted US exports and imports. Total rail car loadings are down 5.1% y/y and are also highly correlated with S&P 500 revenues ([Fig. 18](#)).

On the other hand, the news is mixed for S&P 500 Trucking. The ATA truck tonnage index remained in record-high territory during August. The three-month average is up 3.8% y/y. Then again, the PPI for truck transportation of freight was down to -0.2% y/y from a recent high of 8.2% last October.

(5) *Financials*. First, the good news for S&P 500 Diversified Banks: Commercial and industrial loans at commercial banks rose 5.1% y/y through the 10/2 week. In addition, mortgage applications to purchase a home increased 11.8% y/y through the 10/4 week. On the other hand, the yield curve remains flat, which may be putting some downward pressure on net interest margins.

The S&P 500 Brokerage and Investment Banking industry is facing some challenges up ahead. In addition, the IPO market has recently turned less welcoming to companies with no earnings, and a price war has broken out among discount brokers. These last two developments may be issues for Q4 earnings rather than Q3.

(6) *Energy & Materials*. Upside surprises among commodity producers in the S&P 500 Energy and Materials sectors are unlikely for Q3. The price of a barrel of Brent crude oil is down 27.0% on a y/y basis. The CRB raw industrials spot price index is down 9.5% y/y.

Strategy III: Q3 Sectors Estimates. I asked Joe for the latest Q3 earnings and revenues consensus estimates for the 11 sectors of the S&P 500. Here they are: S&P 500 (3.5%, -4.1%), Communication Services (9.8, -1.0), Consumer Discretionary (5.4, 0.7), Consumer Staples (3.4, 0.1), Energy (-6.1, -34.3), Financials (-1.0, 1.2), Health Care (12.8, 2.5), Industrials (0.3, 1.0), Information Technology (-0.4, -7.6), Materials (3.7, -11.2), Real Estate (3.7, 2.7), and Utilities (6.6, 2.2).

It's a mixed picture, for sure, with revenues growth ranging between 9.8% and -6.1% for the 11 sectors. The range for earnings is 2.7% to -34.3%.

CALENDARS

US. Tues: Empire State Manufacturing Index 1, George. **Wed:** Retail Sales Total, Ex Autos, Ex Autos & Gas, Control Group 0.3%/0.2%/0.3%/0.3%, Business Inventories 0.2%, NAHB Housing Market Index, MBA Mortgage Applications, Treasury International Capital, Beige Book, Brainard, Evans. (DailyFX estimates)

Global. Tues: Germany ZEW Survey Current Situation & Expectations -23.0/-26.8, UK Employment Change & Unemployment Rate (3-month) 26k/3.8%, Carney Vileghe. **Wed:** European New Car Registrations, Eurozone Headline & Core CPI 0.9%/1.0% y/y, Eurozone Trade Balance, UK Headline & Core CPI 1.8%/1.7% y/y, Canada Headline & Core CPI 2.1%/2.2% y/y. Australia Employment Change & Unemployment Rate 15k/5.3%, Carney, Lane, DeBelle. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings fell for two of these three indexes last week. These indexes began a forward-earnings uptrend during March, but only LargeCap is near a record high. LargeCap's forward earnings has risen during 28 of the past 35 weeks, MidCap's 18 of the past 31 weeks, and SmallCap's 17 of the past 29 weeks. LargeCap's is less than 0.1% below its record high two weeks ago, while MidCap's and SmallCap's are 3.8% and 7.9% below their October 2018 highs. MidCap's forward earnings is near a 14-month low now, while SmallCap's forward earnings is near a 15-month low because analysts are now including a large goodwill writeoff in their 2019 annual forecast for Frontier Communications. At their bottoms earlier in 2019, LargeCap's forward EPS had been the most below its record high since June 2016 and MidCap's was the lowest since May 2015. During mid-September, SmallCap's had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October as y/y comparisons became more difficult. In the latest week, the rate of change in LargeCap's forward earnings edged down to a 34-month low of 1.6% y/y from 1.8%. That's down from 23.2% in September 2018, which was the highest since January 2011. MidCap's -3.3% y/y change is down from -2.4% and is the lowest since December 2009. That compares to 24.1% in September 2018 (the highest since April 2011). SmallCap's -7.9% y/y change improved w/w from -8.4%. That's up from -9.6% in mid-September, which was the lowest since December 2009, and compares to an eight-year high of 35.3% in October 2018. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 0.8%, 11.2%), MidCap (22.7, -4.9, 13.1), and SmallCap (22.4, -16.0, 38.4).

S&P 500/400/600 Valuation ([link](#)): Valuations rose last week for two of these three S&P market-cap indexes, and continue to edge up from their three-month lows in late August. LargeCap's forward P/E rose 0.1pt w/w to 16.7 and is down 0.5pt from a 17-month high of 17.2 at the end of July. That compares to a five-year low of 13.9 during December and a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week's level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's forward P/E was up 0.2pt w/w, to 16.0 from 15.8. That's down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap's P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap's P/E has been at or below LargeCap's P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap's P/E fell 0.1pt w/w to a six-week low of 16.5 and is down from a 12-month high of 17.8 in mid-September. That's well above its seven-year low of 13.6 during December and compares to its 15-year high of 20.5 in December 2016, when Energy's earnings were depressed. SmallCap's P/E is below LargeCap's again after matching or being above for five weeks primarily due to substantially lower forward earnings for Frontier Communications. It had been below for 16 weeks through the end of August—the first time that has happened since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): With the Q3 books closed and earnings reports beginning to trickle in, analysts continued to trim their forecasts for the quarter. The S&P 500's Q3-2019 EPS forecast dropped 29 cents w/w to \$40.93. That represents an earnings decline of 4.1% y/y

compared to the prior week's forecasted earnings drop of 3.4%. The consensus' \$40.93 estimate is down 4.8% in the 15 weeks since the start of the quarter, which compares to a 2.3% drop for Q3 over the similar 15 weeks. While the consensus Q3 EPS estimate is below our forecast of \$43.00 and is now below the \$41.31 reported for Q2, we are expecting slightly positive y/y earnings growth of 0.8%. On a pro forma basis, Q3 earnings are expected to decline 3.2% y/y, which would be the first drop in 13 quarters and compares to y/y gains of 3.2% in Q2, 1.6% in Q1, 16.9% in Q4-2018, and 28.4% in Q3-2018 (which marked the peak of the current earnings cycle). Seven of the 11 sectors are expected to record positive y/y earnings growth in Q3-2019, with none rising at a double-digit percentage rate. That compares to seven positive during Q2, when three rose at a double-digit percentage rate. However, eight sectors are expected to beat the S&P 500's Q3 growth rate, up sharply from just three beating the S&P 500 during Q2. Industrials, Materials, and Utilities are the only sectors expected to post better (or less worse) growth on a q/q basis during Q3. On an ex-Energy basis, the consensus expects earnings to fall 1.0% y/y in Q3. That compares to ex-Energy gains of 3.9% in Q2 and 3.0% in Q1, and is well below the 14.2% y/y gain in Q4-2018. Here are the latest Q3-2019 earnings growth rates versus their Q2-2019 growth rates: Real Estate (2.7% in Q3-2019 versus 3.1% in Q2-2019), Health Care (2.5, 10.3), Utilities (2.2, 1.1), Financials (1.2, 10.0), Industrials (1.0, -9.5), Consumer Discretionary (0.7, 2.7), Consumer Staples (0.1, 1.7), Communication Services (-1.0, 17.6), Information Technology (-7.6, -2.2), Materials (-11.2, -12.7), and Energy (-34.3, -8.9).

S&P 500 Q3 Earnings Season Monitor ([link](#)): With just under 5% of S&P 500 companies finished reporting revenues and earnings for Q3-2019, revenues and earnings are beating the consensus forecasts by 0.8% and 5.0%, respectively. Those are about the same rates as during the same point in Q2, but the percentages of companies showing a positive revenue surprise and positive y/y revenue growth are weaker. Of the 23 companies in the S&P 500 that have reported through mid-day Monday, 87% exceeded industry analysts' earnings estimates. Collectively, the small sample of reporters have a y/y earnings decline of 9.6%, primarily due to Micron Technology's earnings deceleration. On the revenue side, 57% of companies beat their Q1 sales estimates so far, with results 3.5% higher than a year earlier. Ex-Micron, y/y earnings growth for the S&P 500 jumps to 10.8% from -9.6% and revenue growth improves to 5.9% from 3.5%. Overall Q3 earnings growth results are positive y/y for 78% of companies, and revenues have risen y/y for 83%. These figures will change markedly as more Q3-2019 results are reported in the coming weeks, but what companies say about their expectations for Q4-2019 and their early peek at 2020 prospects will be investors' main focus.

GLOBAL ECONOMIC INDICATORS

Eurozone Industrial Production ([link](#)): Output in August rose for only the third time this year, as production began 2019 with a 1.7% jump, though quickly lost momentum. Industrial production (excluding construction) edged up 0.4% in August, after falling five of the previous six months by 1.9%. Production is basically flat ytd, with the major industrial groupings showing a mixed picture. Both intermediate (-1.8% ytd) and energy (-0.5) output are down ytd—the latter barely—while capital goods (0.2) output is flat ytd, though has gained strength the past two months, up 1.3% and 2.1% during August and July, respectively. Meanwhile, consumer goods (5.5% ytd) production is up sharply so far this year, though excluding food, beverages, and tobacco (2.5) the gain in consumer goods output is smaller, with most of the weakness in the latter occurring during the three months through August. Looking ahead, the Eurozone's manufacturing sector in September contracted at its fastest pace since October 2012—with all three market groups covered by the survey (capital, intermediate, and consumer goods) deteriorating. The M-PMI fell to 45.7 from 47.0 in August—its eighth straight month below 50.0.

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