By Chris Zaccarelli, CFA
July 23, 2018

Robust Earnings, Trade Fears

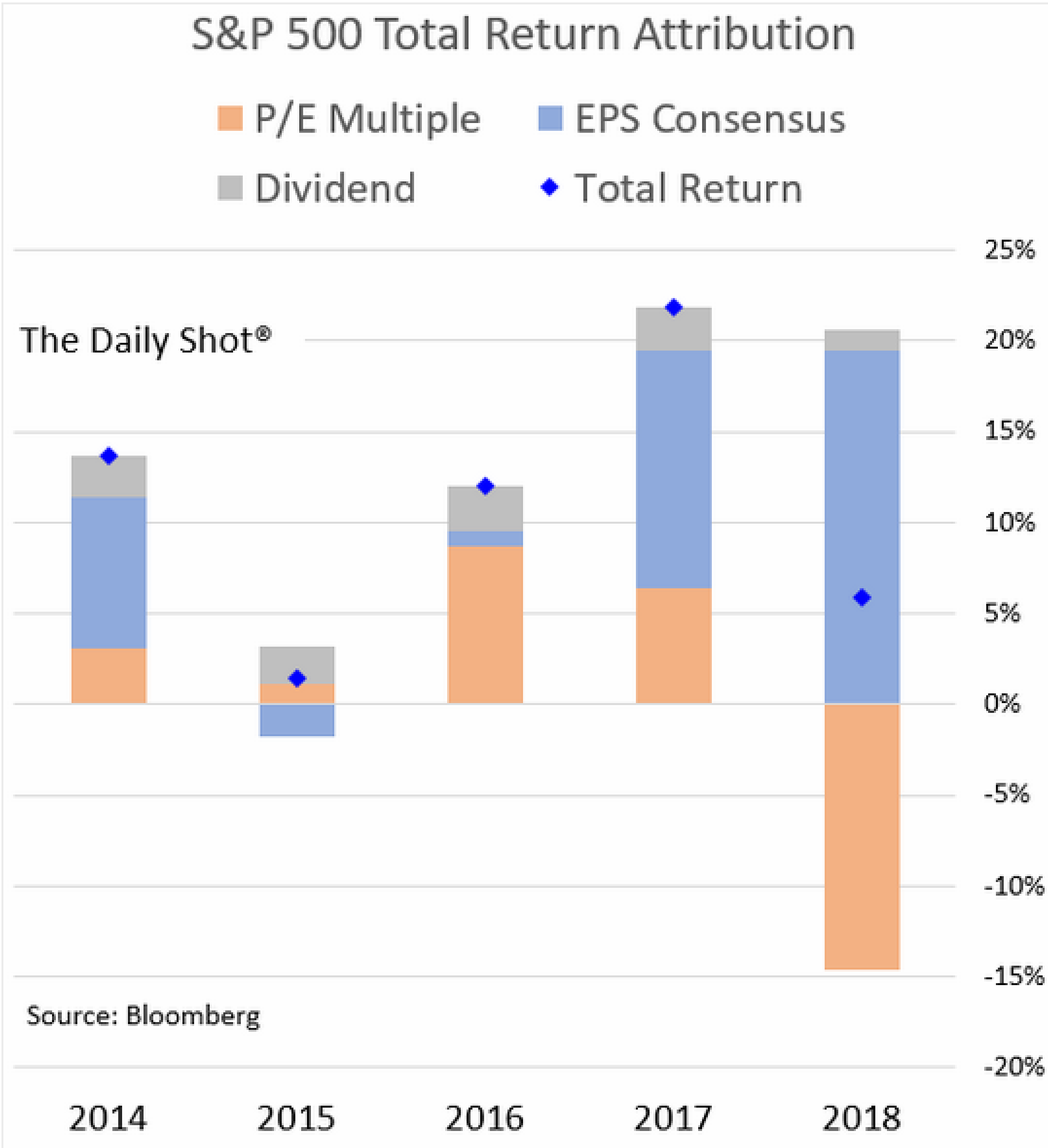
Summary

- Earnings continue to be very strong with 87 of the S&P 500 companies having already reported and over 85% of those companies beat earnings estimates, while more than three quarters beat sales estimates and 4 sectors have a perfect 100% beat ratio while 2 others are averaging close to 90%. (Source: FactSet)
- Despite the earnings momentum across corporate America, the stock market hasn't responded as positively, as Trade Fears and concerns the economic cycle is approaching the end has made investors more cautious. Earnings have risen over 20% over the past 6 months and because the P/E ratio has contracted sharply, the S&P 500 return has been low- to mid-single digits, not including dividends.
- As long as investors doubt that revenue and earnings growth will continue for the next 2-3 years then the market multiple will remain depressed, however, if the Trade War fears can be resolved then the multiple could spring back higher.
- My short-term forecast is for sideways markets as Trade War fears hang over the market, but once those are removed, the yield curve will steepen, the stock market will again resume its ascent – possibly with a double-digit total return in 2018 – and cyclical sectors (e.g. Financials, Industrials and Materials) will improve dramatically.

General Commentary

- Earnings continue to be very strong with 87 of the S&P 500 companies having already reported averaging 20.8% earnings growth. In addition, the earnings are even stronger than expected with over 85% of the companies beating earnings estimates and more than three quarters beating sales estimates. (Source: FactSet)
- That earnings strength is prevalent across most sectors with 100% of Industrial companies, Consumer Discretionary, Health Care and Materials companies beating earnings estimates, while 92% of Technology and 88% of Consumer Staples are also beating estimates.
- Despite the earnings momentum across corporate America, the stock market hasn't responded as positively, as Trade Fears and concerns the economic cycle is approaching the end has made investors more cautious.
- The chart on the next page shows the various components of "Total Return" (e.g. Price Change = Earnings Growth adjusted by the P/E ratio moving higher or lower. Dividends + Price Change = Total Return):

*** INTERNAL USE ONLY – Not to be distributed outside of IAA / Blackbridge ***



- As you can see from the chart, the majority of the benefits of higher earnings growth this year have been negated by a reduction in the Price-Earnings multiple.
- Although a Trade War could cause a recession – and I do believe that the headlines will get worse over the next few months before they get better – outside of this most dire outcome, the economy and earnings growth should continue to propel the market higher.
- As long as investors doubt that revenue and earnings growth will continue for the next 2-3 years then the market multiple will remain depressed, however, if the Trade War fears can be resolved then the multiple could spring back higher.
- My short-term forecast is for sideways markets as Trade War fears hang over the market, but once those are removed, the yield curve will steepen, the stock market will again resume its ascent – possibly with a double-digit total return in 2018 – and cyclical sectors (e.g. Financials, Industrials and Materials) will improve dramatically.