



US Q3 Earnings Results

MONETARY AND CAPITAL MARKETS DEPARTMENT

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The Q3 US corporate earnings season coincided with a significant stock market correction. The earnings reports showed that the S&P 500 firms' earnings growth was exceptionally strong in Q3 but was expected to decelerate notably starting next year. Justifications for downward revisions of the 2019 earnings growth included weakness in overseas demand, tariff-related cost increases, a stronger dollar, wage pressures, as well as fading effects of corporate tax reform and fiscal stimulus. On the bright side, analysts noted a still-robust earnings and capex trajectory expected over the next two years, and limited dependence of the US corporate sector on foreign revenues. Markets sold off sharply in October-November amid concerns about peak profit margins, decelerating growth, trade tensions, and high valuations. This note discusses key messages from the Q3 earnings calls and associated market developments.

Corporate earnings at the S&P 500 firms reached multi-year highs in Q3 and exceeded analysts' expectations (Figure 1).

The outturn was underpinned by strong revenue growth, high pre-tax profits, and a fall in the effective income tax rate because of the tax reform. The Q3 results also surpassed analysts' expectations in terms of breadth (share of companies and sectors beating estimates) and depth (size of average earnings surprise) (Figure 2). Overall, three-quarters of companies beat analysts' estimates on earnings. Trade tensions have not had a tangible impact on US corporate performance so far, as even sectors with large international exposures (e.g., IT and industrials) posted robust results. In their earnings calls, executives noted that the actual impact of tariffs on Q3 results was minimal because implementation of the 10% tariff on \$200 bn of imports from China only took effect in late-September. Some companies reported a weakening in sales from a stronger US dollar.

Figure 1: S&P 500 Firms: Profitability

(Percent of assets)

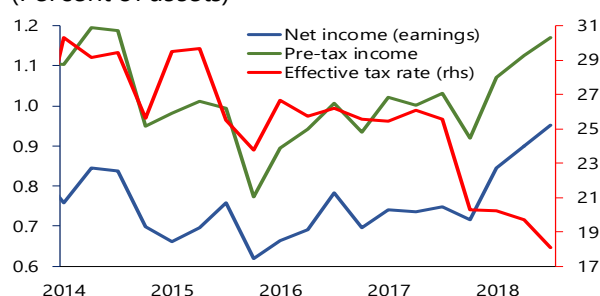
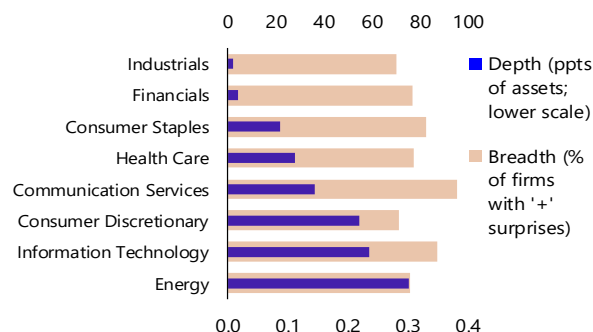


Figure 2: S&P 500 Firms: Earnings Surprises

(Percent of firms; percentage points of assets)



EPS growth was revised down but forecasts of profitability remained high. The strong 26% earnings-per-share (EPS) growth this year is partly attributable to the tax reform. The expected EPS growth for 2019 was revised down from 10.2% to 8.6%, while the EPS growth for 2020 was little changed at around 10% (Figure 3). Expected profitability (ROA) over the next 1-3 years was revised down more marginally and remains high. Sales growth was also projected to slow from currently elevated levels. Some commentators expect that estimates may need to be cut further in coming months. In their earnings calls, companies saw a fading boost from fiscal stimulus, increasing

pressure from tariffs on imports from China (with the potential for a jump to 25% in January 2019), higher interest rates, rising input costs, and wage pressures as headwinds for earnings. While equity investors are growing more concerned about stretched valuations and slower growth ahead, few are projecting a profits recession in the next two years. The expected earnings growth is still above the long-term average and above global industrial production growth.

Risks to corporate fundamentals are skewed to the downside because of trade tensions and higher labor costs, but companies count on resilience and flexibility. On company earnings calls, investors were attuned to the negative effects of trade tensions and labor market tightness. Tariffs would affect US companies through lower export revenues and higher input costs. However, views on trade effects were mixed. Some commentators noted the resilience of large US firms, most of which generate over two-thirds of their revenues domestically, while the IT, consumer, and energy sectors are more exposed internationally. Most companies did not even mention tariffs in their calls. Among those that did, only about one-third said the impact would be negative as they expect to pass on the impact via higher prices. Others suggested that they could shift supply chains to southeast Asia, India, Mexico, or the US, with some adjustment already underway. Separately, tightness in the labor market has led to an increase in wages and difficulty in hiring skilled workers. Some firms announced plans to increase automation and reduce staffing costs.

Corporate investment remains high relative to recent history. Capital expenditures and research and development (R&D) expenses rose this year and are now near post-crisis highs (Figure 4). Furthermore, estimates of capital spending plans over the next 1-2 years have continued to grow unabated throughout the earnings season, signaling strong business sentiment.

Payouts to shareholders remained ample, while net borrowing was small. Share buybacks and dividends rose to post-crisis highs in Q3 (Figure 5). Buybacks have been predominantly financed with profits and cash holdings. The latter has been supported by tax-related repatriation, mainly in

Figure 3: S&P 500 Firms: Annual Earnings-per-Share Growth

(Year-on-year percent change)

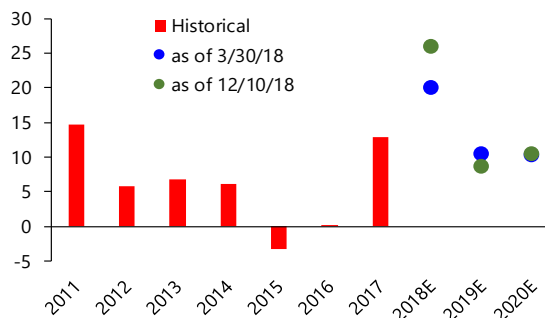


Figure 4: S&P 500 Firms: Capex and R&D Expenditures

(4-quarter moving average; percent of assets)

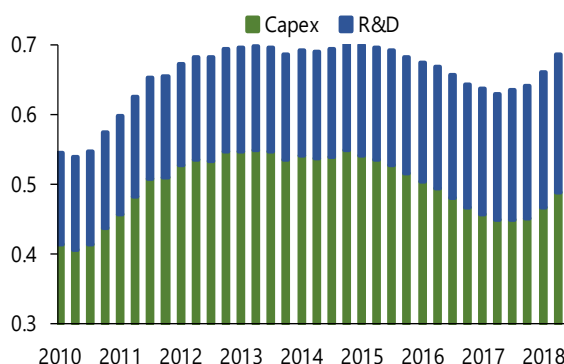
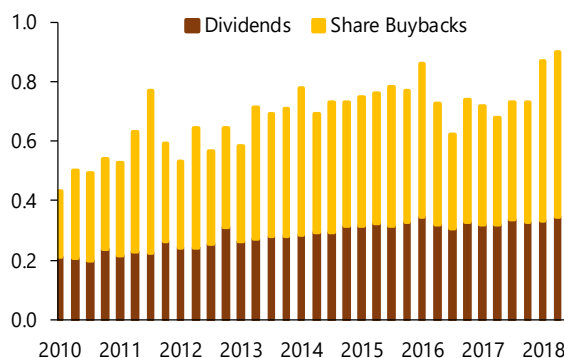


Figure 5: S&P 500 Firms: Share Buybacks and Dividends

(Percent of assets)



the IT sector which accounts for 40% of announced buybacks. Although companies have announced \$738 bn in buybacks thus far this year, they have only completed \$582 bn, suggesting a significant amount remains in the pipeline. Financial risk-taking in the form of payouts, M&As, and financial asset purchases now accounts for over 60% of operating cash flow, while the remaining amount is used to fund economic activities—capex and R&D (Figure 6). Companies across a variety of industries reported efforts to pay down debt and reduce risks through debt refinancing and maturity extensions. Indeed, net borrowing was small in aggregate and leverage at S&P 500 firms continued to decline.

Equity prices dropped during the earnings season and market volatility rose, signaling tighter financial conditions ahead. The sell-off has so far reached a 10% peak-to-trough, marking the third deepest correction this cycle. Concerns about an inflection point in earnings had a disproportionate impact on cyclical, growth sensitive and globally-oriented sectors (Figure 7). The decline in market prices was accompanied by downward revisions in earnings growth, a slowdown in payouts, worries about trade tensions and concerns about extended valuations in the IT sector. The price decline in the IT sector was the second largest across major industries after the energy sector (driven by sharp declines in oil prices). The sell-off helped to partially normalize valuations at tech firms and more broadly (Figure 8). However, forward PE ratios are still above historical average levels. Further downgrades of earnings projections will be watched closely, given growing concerns about the economic outlook.

Figure 6: S&P 500 Firms: Sources and Uses of Cash
(Percent of assets)

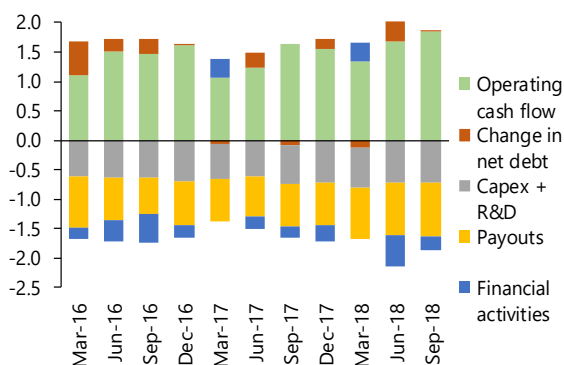


Figure 7: S&P 500 Firms: Changes in Equity Prices
(Percent; 10/3-12/10; data by sector)

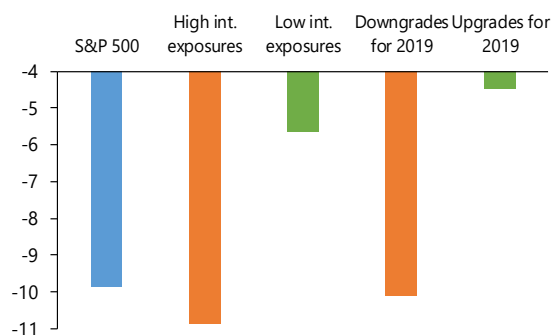


Figure 8: S&P 500 Firms: Equity Valuations
(P/E ratios across major sectors)

