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Bracing for the earnings storm

This week, the Q2 US earnings season gathers steam, with a third of Dow Jones constituent companies and 114 S&P 500 companies reporting earnings for the second quarter of the year, making this one of the busiest earnings stretches so far this season. Over the last week, markets have remained relatively subdued in the lead up to a busy week of earnings and economic data, and as the ECB is expected to make its next interest rate decision on Thursday. When we examine the current market conditions, as we consult with numerous economists, fund managers and other market participants, at the moment we can agree on one thing: financial markets are puzzling.

Despite the spreading of risk-off sentiment resulting in a bond market rally, large inflows into safe haven assets and declining oil prices, equity markets continue to gain, and we continue to wait for a catalyst to bring equity markets to more realistic valuations, reflective of a lower growth environment. Equity markets have become increasingly unsynchronised with fundamental data, driven instead by optimism over central bank rate movements and trade relations.

With recession risks on the rise and with the equity market rally lacking support of economic fundamentals, this earnings season could signal the beginning of the end of the equity bull market, therefore investors will be watching this week's releases for clues on the future direction of markets.

Who is reporting and what are we looking for?

A number of high-profile companies report this week, with this week's earnings expected to offer a glimpse into every major sector of the economy. Investors will be watching closely for signals of economic weakness such as reduced hiring expectations, stalled capital expenses and lack of willingness in consumers to accept price hikes. At the same time, they will be looking to assess the impact of trade uncertainties and a strong dollar on US companies. Out of the 10 Dow Jones constituent companies expected to report, Coca Cola, Caterpillar, United Technologies, McDonalds and Visa make up some of the biggest names, with markets likely to focus on Caterpillar in particular, as the stock is typically considered a bellwether for the US economy. Of the S&P 500 companies to report, particular notice will be paid to Facebook and Boeing, both of which are due report today.

This week's shower of earnings reports could force investors to focus on the health of the underlying companies in the US market, with all three indices finishing last week with their steepest weekly declines since the end of May ahead of this week's earnings reports. At the same time, investors have been downgrading their expectations of a 50 basis point cut to interest rates, and now expect one rate cut this year. With expectations set ahead of next week's Fed decision, investors are turning to earnings, with markets expecting flat revenues and incrementally better earnings growth, with companies expected to muddle along through the uncertain business environment. In our view, when we examine the economic data and how this will feed into corporate earnings, with lower demand

and higher input costs expected to feed into corporate profitability, there is plenty of disappointment to be had on the earnings front.

What has happened so far

Prior to this week, results have thus far been relatively strong after a number of prominent US banks reported last week, however it would be wrong to see bank earnings and extrapolate. In the same week that the five largest US banks announced positive earnings reports, others around the globe left investors wondering how the bottom fell out so fast. Netflix sunk by the most in three years amid a surprise drop in US customers, while ASOS plunged after issuing another profit warning. At the same time, previous earnings bellwether Alcoa Corp beat on profit but also cut forecasts on global aluminium demand, adding to trade concerns over the impact of trade frictions.

Earnings Expectations

Analysts have been dialling back earnings expectations heading into the second quarter as economic conditions have deteriorated. According to Factset data, the S&P 500 is reporting a year over year decline in earnings of 1.9%, but year over year growth in revenues of 3.8%, indicating that profit margins are likely to be the most hit by the current economic backdrop. There is an argument that in such an uncertain environment, negative earnings guidance will offer a disproportionate weight when compared with normal conditions, which could drag stock markets lower over the coming weeks.

The impact of trade tariffs

The quarterly earnings reports may offer an insight into the degree by which some of the biggest American corporations have been buffeted by the US China trade conflicts and lacklustre economic backdrop outside of the US. While the new trade barriers have not been enough to stop major indices from reaching new highs, they are of great concern to individual companies that have increasingly cited trade concerns as a reason for poor performance in recent weeks, particularly in sectors such as industrials, basic materials and semiconductors. As the second quarter earnings season unfolds, the number of companies citing trade concerns will be closely watched by investors, threatening the equity bull market. A number of earnings calls have already cited trade concerns as a key factor influencing forecasts.

Key areas to watch this earnings season

Automotives

Automaker earnings are expected to provide an insight into how much slowing sales and technological disruptions are impacting profitability within the industry. After extending an alliance on electric and autonomous vehicles, Ford and Volkswagen are expected to report flat or shrinking revenue. Daimler is expected to post finalised results weeks after posting a preliminary loss alongside its fourth profit warning in a year. Analysts are predicting another unprofitable quarter for Tesla which is struggling to post profits despite industry dominance in electric vehicles.

In Asia, Nissan is restructuring and cutting jobs in an attempt to revive profitability, while Tata Motors is under pressure to cut costs due to the impact of Brexit, slowing Chinese demand and flagging demand for diesel vehicles.

Consumer

Slowing sales at consumer-focused companies such as McDonalds or Starbucks are likely to signal that consumers are cutting back on spending. Higher labour and commodity costs have forced prices up to maintain margins, therefore all eyes will be on the ability to pass increased costs onto consumers given a weakened economic environment.

Chinese demand will be key to European luxury retailers LVMH and Kering SA this week after showing resilience in recent quarters despite the ongoing trade dispute with the US and slowing growth in the region. The recent protests in Hong Kong are expected to feed into Richemont and Swatch Group expectations.

Entertainment

Competition in the streaming market is increasing, with AT&T and Comcast primed to enter the battle to win streaming video viewers, however first they must deal with the continued decline of their legacy businesses. Investors will be hoping that broadband sales can offset the declines in television services, however both companies appear to be in decline.

Industrials

Boeing is expected to announce the cost related to its beleaguered 737 max jetliner after a number of airlines have removed the 737 max from their flight schedules. The impact on Boeings financials alongside key airlines Southwest Airlines and American Airlines is expected to be seen this week.

Investors in Caterpillar will be looking for greater clarity on global demand in the second half of the year after announcing weakening Chinese demand in the first quarter of the year. Today's report will be watched closely for signs of tariff-induced stress, with performance typically being heavily based on the positioning in the economic cycle.

Technology

The key question for tech investors is whether top firms can keep growing revenue amid the US-China trade war, signs of slowing economic growth and a government antitrust investigation. For hardware companies, the focus will be on the loss of market share in China owing to the ban on exports to Huawei. As mentioned in previous market commentaries, a decline in US big tech stocks could prompt a wider market sell off.

Banking

Despite more positive US banking earnings reports last week, European banks are expected to trail behind US peers as trade tensions continue to weigh on client activity. With negative interest rates, European banks don't have a healthy stream of income from lending to fall back on, therefore further restructuring and cost cutting is expected from this sector.

Our Expectations

Overall, our expectation is that corporate earnings will display weakness in the second quarter, with companies citing trade tariffs, higher input costs and increased economic uncertainty as reasons behind lower earnings expectations for the second half of the year. While we still see revenue growth increasing on the whole, it is our view that profit margins will be most affected, resulting in negative earnings growth and higher P/E ratios which we view as being likely to result in a sell off in equity markets. Given our current strategy, if this happens, we are well positioned to benefit, and as always we will continue to monitor the intraday developments as this earnings season unfolds.

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