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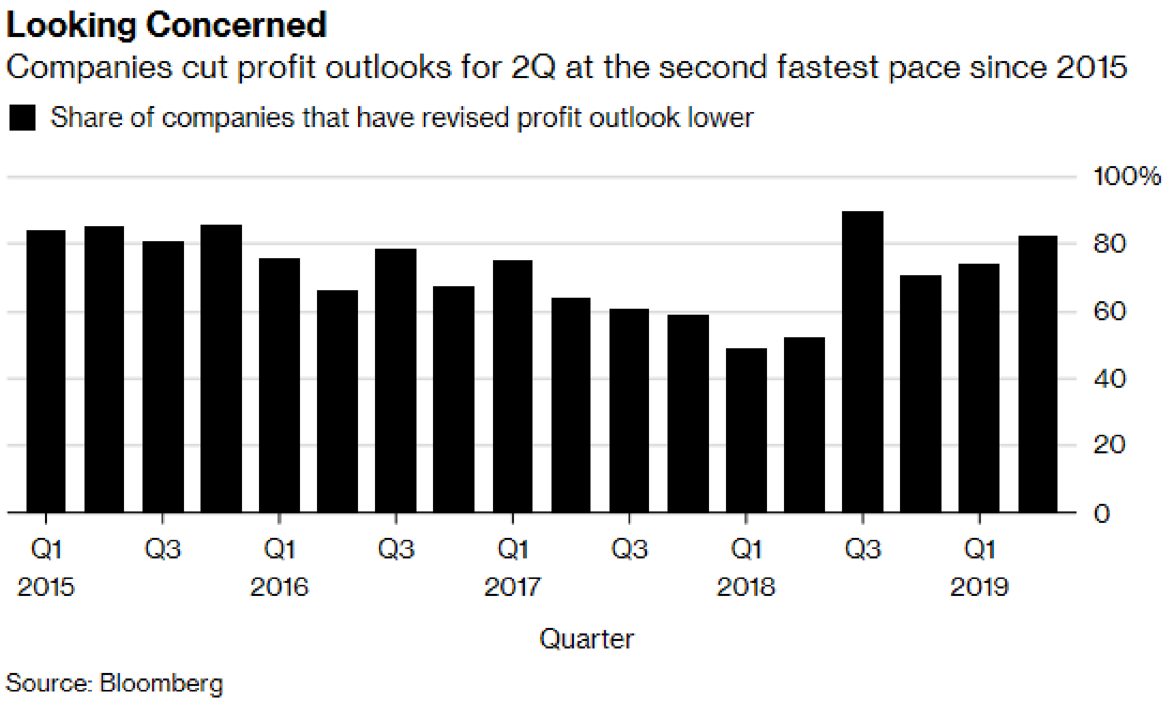
## Market Update: 3rd July 2019

**A house of cards about to collapse: The threat of Q2 corporate earnings to equity markets**

It looks like a storm is brewing in equity markets. With Q2 corporate earnings season expected to kick off in the next fortnight while equity valuations are reaching new highs, investors will be watching company releases closely to ascertain expected performance for the rest of the year. After a first half of the year which was plagued with economic and political uncertainty, teamed with an escalation of geopolitical tensions in the second quarter, corporates will be hoping for some reprieve in the second half of the year, however with lower global growth and the negative spill overs from increased tariffs feeding into revenues and profitability, hopes for a second half recovery in earnings have been abating in recent weeks. This has resulted in an alarming amount of downward reversions of earnings expectations.

It's not unusual for companies to cut profit expectations in the lead up to earnings season (to lower expectations for when they release earnings), however recently, more than 80% of S&P 500 companies that have revised profit estimates in the lead up to earnings reporting have slashed their forecasts. At the same time, equity markets continue to gain as investors overlook an increasingly poor earnings environment, placing higher weight on optimism over a US-China trade deal and monetary policy when they should be paying attention to earnings, which are what should really be driving stock prices.



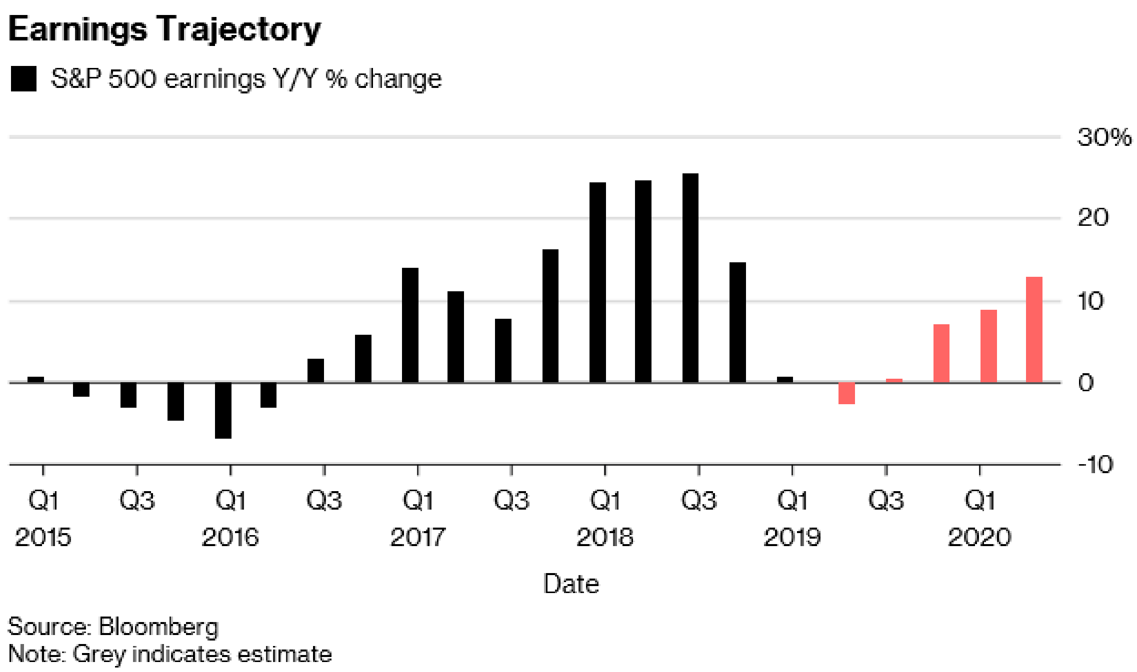
While revisions at this time of year are more likely, with companies more likely to disclose bad news just prior to the reporting date, the extent of the negativity within corporates presents investors with an insight into return potential for the second half of the year. According to Bloomberg data (as shown in the above chart), 82% of the S&P 500 companies that have revised their profit outlook have cut guidance. Upon closer examination, this proportion is similar to that seen in Q3 last year, just before stock markets declined by around 20%.

Equity analysts are also showing signs of concern. According to a recent study from Sundial Capital Research, in June analysts cut the forecasts on 116 more stocks than were upgraded, the most since September 2017. This is significant as analysts typically firm up forecasts in the last month of the quarter, whereas in this case, they are revising them downward on a large scale.

**Why are earnings expected to fall?**

In recent months, there have been a number of headwinds facing corporate profitability, ranging from a strong dollar (a key issue for US-based international companies), higher input costs and uncertainty from the escalation of global trade tensions to lower demand following weaker global growth. These risks have not changed, with the recent trade truce providing little certainty of the future trade relationship between the US and China and with the effects of the trade war continuing to feed through into company financials.

A key reason behind the bulk reversion of corporate earnings in recent weeks is that although the economic data was poor throughout Q1, broad expectations within the market were that although the outlook for the first half of the year was poor, corporate earnings would recover in the second half. It has become clear that this is now not the case, with a resolution of the trade tensions still yet to come and with the global economy suffering as a result of increased tariffs and lower economic growth, evidenced by recent economic data and downgrades in growth expectations from the IMF and World Bank. According to Factset, the estimated earnings decline for the S&P 500 is -2.6%. The below chart indicates the revised earnings trajectory from Bloomberg, showing a relatively flat Q3 followed by a small rebound in Q4.



**When are we expected to see the impact of earnings on markets?**

Citigroup Inc kicks of the second quarter earnings season on 15th July, followed by its peers in the US banking sector later that week. After avoiding a decline in Q1, this quarter should provide a test to S&P 500 companies, particularly considering the downward revision to economic growth expectations. Should the expectation for a -2.6% decline in earnings for Q2 hold, this would be the first time the index has reported a contraction in corporate earnings in 3 years.

It is key to bear in mind that companies will lower their forecasts to make beating them easier, therefore earnings per share against estimates will likely come in positive for Q2, however when we strip out the impact of share buybacks, an earnings contraction is on the cards. Given that the growth in stock markets has been built on sentiment and optimism rather than on underlying corporate earnings expectations and subsequent company valuations, what we are seeing in equity markets can only be described as a house of cards awaiting one swift breeze of earnings data. On average the S&P 500 is trading at values 17 times higher than expected earnings, representing an overpriced equity market.

**Sectors which have seen the biggest revisions**

At sector level, companies in 7 of 11 sectors have issued negative EPS guidance for Q2 2019, with Tech and Healthcare sectors announcing the largest downward revisions. In the tech sector, 26 companies have issued negative EPS guidance for the second quarter, above the sector 5-year average of 20.4. This is largely due to high overseas exposure and slowing global growth, negatively impacting revenue growth for tech firms. This could be significant as big tech stocks contribute considerably to S&P 500 index returns. During the sell-off in Q4 2018, the top 5 tech stocks in the index drove 25% of the loss on the index, with the sell off in the sector preceding the wider sell off.

**Portfolio positioning**

Overall, with risks now tilted towards the downside and with risk-off sentiment spreading across bond markets, investors will be forced to consider economic data and underlying company data with greater weighting in the coming weeks. As earnings season approaches, the volume of downward forecast revisions observed in recent weeks provides an insight into corporate profitability, with little signs of the recovery first expected in the second half now on the horizon. It remains our view that given the weakness in the economic data (which continues to feed through into economic indicators) and the continued weakness in the outlook for 2019, equity valuations are inflated and will decline in the near term. For this reason we remain defensively positioned for a decline in equity markets, and are poised to act as opportunities arise and conditions change.