

CIO Flash Bulletin

Earnings
season:
it's all about
transparency
and guidance

Investment Solutions

14 November 2018

Equity markets suffered a rough October and investors are now crunching through an earnings season trying to make sense of the outlook for 2019. Faced with the uncertainties of next year, shareholders are punishing firms unless they beat analysts' revenue estimates and profit expectations while providing upbeat outlooks. It is worth mentioning that most companies usually provide forward guidance at the beginning of the year (generally in February) and not during the Q3 earnings season.



Stéphane Monier
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US companies continue to outperform European & Japanese businesses

In the US, third-quarter earnings have proven very healthy. At the time of writing, 91% of US companies have reported results and 82% of these have beat earnings-per-share (EPS) estimates. Increase in earnings per share was 28% vs 19% expected by analysts, the highest observed in eight years. In Europe where 86% of companies have posted earnings, the results are more mixed and 52% companies beat earnings expectations. Finally, in Japan, where reporting lags, 45% of those companies which have reported have beaten profit expectations. Charts 1 and 2 show that sales growth and company earnings are higher in the US than in Europe and in Japan, which is largely due to President Trump's tax reform.

Even if the earnings season seems to be satisfactory, investors' fears are visible in the wake of the October's market correction. Lower expected global economic growth, rising interest rates (increasing repayments for firms with the highest debts), the recent strength of the US dollar and trade tensions are all complicating the outlook for 2019. In such a difficult environment, several companies provided less detailed forward indications than in previous years, which unfortunately fed the markets' volatility. However, we believe that markets overreacted and therefore, current valuations do not reflect underlying fundamentals.

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Investors punish misses in estimates and earnings opacity

The first lesson that we can learn from this earnings season is that investors have severely punished company stock prices unless they have been able to beat forecasts for all three key metrics of sales, earnings and, most importantly, guidance. Historically, this kind of rising threshold has been widely interpreted as a leading indicator of a bear market, or at least a sign that market growth is peaking or that margins have topped out. Insistence on spectacular guidance, rather than fundamentals, looks to us more like an indication of investors' shorter-term uncertainties over macroeconomic questions rather than an indication of a truly imminent end to the bull market or a signpost to underlying problems.

This earnings season also shows that transparent company reporting is key to retain investors' trust. An opaque earnings model is not just irritating to analysts; it is an obstacle to meaningful comparisons and accountability. Investors have harshly penalised companies that presented broad earnings reports lacking detail. For instance, Alphabet (the parent company of Google) dropped 10% in October because the company historically provided little detail. Similarly, Apple was down 9% after announcing in November that it will no longer report unit sales. Even if the decision may be interpreted as a natural evolution while the world's biggest company by market value moves from a hardware maker to a software and services provider, the immediate conclusion among analysts was that sales of the iPhone are declining. As mentioned, markets are expecting more visibility and have started to avoid some specific risks. This type of behaviour is quite common in late-cycle economic conditions because investors tend to be skeptical about companies' outlooks and this sometimes results in important market moves, as we saw in October.

Investment implications

In a nutshell, earnings results were very supportive in the US and in line with expectations in Europe and in Japan. Nevertheless, we believe that investors overreacted to some expectations misses and that the October's market drop was disproportionate compared with the prevailing macro fundamentals. In our view, the macro picture does not point to an end of the market cycle and we remain constructive on equities. Earnings growth may have peaked in the US but the outlook for 2019 remains sound. The consensus for EPS growth in 2019 is 9% for the S&P 500 and the Stoxx Europe 600, and 8% for the Topix index.

Since June, we have started to implement a strategy of gradual risk reduction in our multi-asset portfolios by selling illiquid assets such as emerging debt (local and hard currency), corporate credit, convertibles and high-yield credit. The next step in this strategy would be to sell liquid risk assets, namely equities. However, the recent sell-off has created some interesting short-term opportunities in equity markets, which might lead us to adjust our tactical views in coming weeks should further divergence between share prices and equity fundamentals arise. At the moment, we favour the banking sector, IT software and services, energy, healthcare and industrials.

Chart 1. Proportion of companies beating forecasts Q3 2018

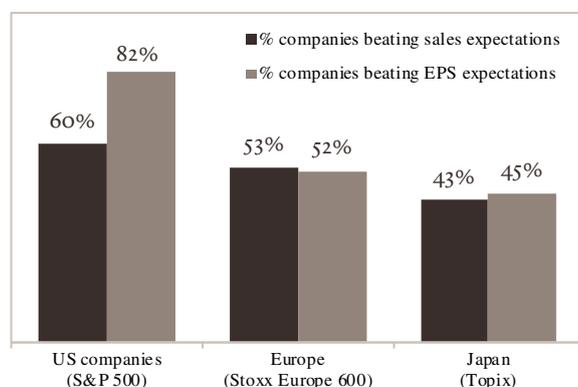
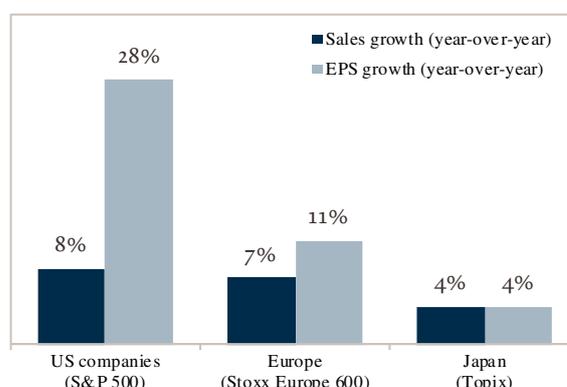


Chart 2. Sales and EPS growth Q3 2018



Sources: Bloomberg, J.P.Morgan

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