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CIO Viewpoint

An earnings recession? Reading between company lines

Investment Solutions

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Companies' fourth quarter earnings were weak across regions, amid softer demand and higher input costs, notably energy, materials and labour. Sales, however, continued to grow, surprising positively across the US, Europe and Japan. We assess what corporate profits are telling us about the health – or upcoming decline – of the economy, and where to invest in equity markets.

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In the US, S&P500 firms' earnings fell on the previous year for the first time since the pandemic, with materials, financials, technology, utilities and communication services leading the decline. Net profit margins dipped for the sixth consecutive quarter. However, there were some bright spots. Indeed, energy, industrials and consumer discretionary firms saw robust earnings growth. A shift from goods towards services spending is helping small-cap firms. Overall, the tone was nevertheless downbeat.

In Europe, with around 75% of companies having reported to date, Stoxx600 firms' earnings per share (EPS) are estimated to have risen 4% in Q4, helped by energy firms, financials and defensive industries such as utilities, consumer staples and industrials. Revenue growth of 15% was higher than expected. Advertising agencies saw sales rise after several years of anaemic growth – a positive surprise. However, energy heavily skewed the picture, with energy majors booking record 2022 profits. Stripping out energy firms, European firms' EPS fell -3%. And there were other unwelcome surprises. UK banks said the big earnings boost from higher interest rates may now be over, disappointing investors.

In Asia, where the earnings season is ongoing, firms are seeing margins squeezed. Indications to date are that Indian and Japanese firms grew revenues in Q4 but saw profits fall year-on-year. The end of pandemic restrictions and the resumption of in and out-bound tourism helped in some countries. Some travel firms saw demand return to pre-pandemic levels. Japanese firms increased spending on factories and equipment for the seventh quarter in a row, aided by the ongoing reopening momentum, and continued supply chain diversification away from China. Company reports to date suggest net profits fell in South Korea, Thailand and Taiwan, and rose in Singapore and Malaysia.

In China, the earnings season has yet to begin in earnest. Preliminary results from some firms listed on the Shanghai and Shenzhen exchanges have been in line with or slightly below expected levels. At China's big international internet firms, earnings have generally surprised on the positive side. Analysts will be eagerly parsing the impact of the reopening as firms report in the weeks ahead. We believe 2023 earnings expectations could be upgraded.

Key takeaways

- Companies' Q4 earnings were weak, and contracted in aggregate for S&P 500 firms. Market expectations for 2023 have now fallen more in line with our own estimates
- To date, companies have done a good job of managing costs, and consumer demand has proved resilient in many countries, but margins could be squeezed further in 2023
- Asia's earnings season is less well advanced. 2023 earnings expectations for Chinese firms are likely to be upgraded
- Within equities, we prefer Chinese, emerging market and Japanese small and mid-cap companies, value stocks and the healthcare and financial sectors.

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Of course, corporate earnings are backward looking. Investors tend to focus more on management guidance for the year ahead. Here, analyst downgrades to 2023 earnings expectations have been the largest since the Global Financial Crisis. Most analysts now expect S&P500 profits to be broadly flat in 2023. Even this may prove optimistic: on average, earnings have fallen 17% during recessions since 1960. However, market forecasts are now much closer to our own base case estimates of earnings contracting -5%, which factor in recessionary episodes in the US in the second half of 2023.

The case for optimism

To date, companies have done a good job of managing costs. Large technology firms have been quick to shed workers, and big manufacturing companies are now following suit. Consumer staples firms in the US and Europe have managed to defend margins by increasing prices and making efficiency savings, which have not to date deterred their customers. Indeed, consumer demand in the US has proved surprisingly resilient, as evidenced by strong January retail sales. Even if demand slows in the US and Europe later this year, as we expect, China's reopening could provide an offsetting boost for some companies. It should prove particularly welcome news for commodity producers and luxury retailers. Meanwhile, further easing of supply chains could help other sectors as 2023 progresses– notably carmakers and the video game industry, which are still struggling with shortages of electronic chips.

The case for pessimism

That said, Q4 earnings were distorted by firms running down pandemic-era inventories and consumers spending pandemic-era savings, and neither will last indefinitely. Companies could face an ongoing hit to margins in 2023 amid slowing demand and still-high inflation. The outlook is unusually hard to predict. Big US retailers say spending on clothing and electronics has dipped in recent months. Meanwhile, there is a limit to how much firms can pass on cost increases. Food giant Kraft-Heinz is not planning further price increases in 2023, after raising them 15% last year. Pressure on wages continues, with unemployment near record lows in the US and Europe. This is not just a problem for central banks. In the US, Home Depot said it expected 2023 profits to fall after a USD billion boost in employee's wages. Poland and Hungary are seeing double digit wage growth. Even in Japan, the land of historic wage restraint, the country's big carmakers have announced the largest wage rises in 20 years.

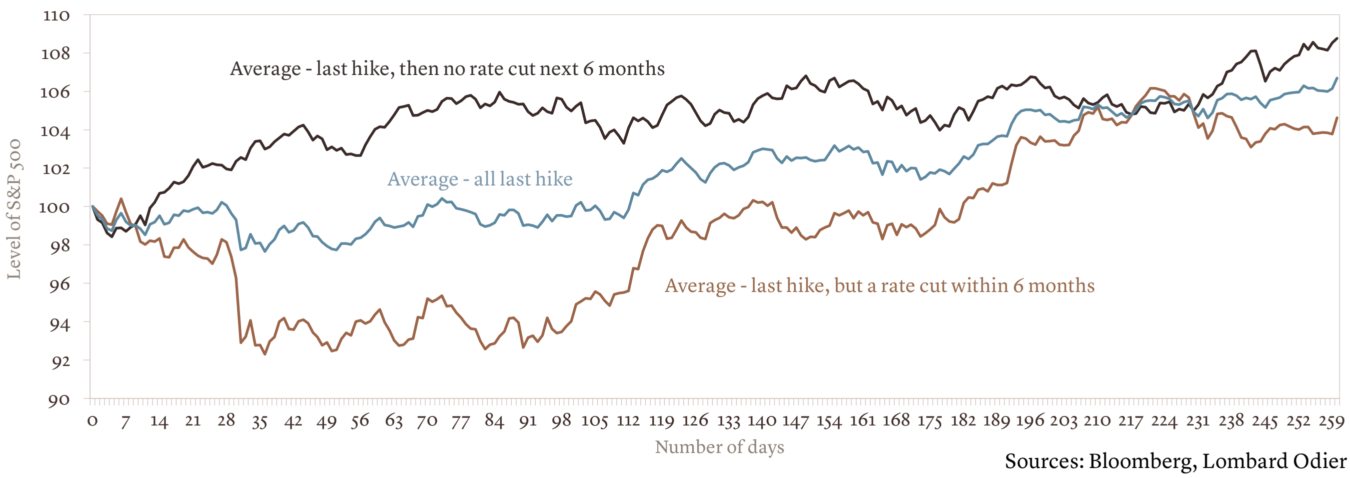
S&P 500 projections

What does this mean for equity markets? Here, the main driver in 2022 and the start of 2023 has been more the interest rate outlook than the corporate earnings picture. Markets have tended to rise on bad US economic news – in the expectation of lower interest rates – and fall on strong data, in the expectation of more hikes ahead, or rates on hold for longer. Higher-for-longer rates will likely cap any rise in valuations, while high bond yields erode the relative incentives for multi-asset investors to hold stocks. Still, we believe the US federal funds rate will peak at around 5.5% in June and inflation will gradually fall nearer 3% by year-end. Our historical analysis suggests US equities can perform well after the last rate hike (see chart). We model a range of scenarios for the S&P 500 in 2023. From a rise to 4,500 in a best-case scenario (with 5% revenue growth, and both margins and valuations maintained broadly at current levels), to 3,200 (where stubbornly high inflation takes rates to 6% or above). Most likely, we think the index will end the year somewhere in the middle of these scenarios, around current 3,900 levels.

In this environment, we favour a neutral exposure to stocks, and a patient approach to equity investing, looking for more nuanced opportunities outside the US. We prefer areas more insulated from slowing growth, and/or cushioned by lower valuations. This translates into an overweight position in Chinese, emerging market and Japanese small and mid-cap stocks – the latter to benefit from strong domestic demand – over the US and Europe. We also favour value over growth stocks, and more resilient, defensive sectors within allocations, including healthcare and financials.

US equities have generally fared well after the last Fed rate hike

S&P 500 historical performance analysis



Sources: Bloomberg, Lombard Odier

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