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https://blog.en.erste-am.com/earnings-season-triggers-downward-revisions/

Earnings season triggers downward revisions

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Earnings are key for equity investors, as also my colleague Harald Egger emphasized in this blog two weeks ago. This basic truth is even more relevant as usual at a time when a multi-year equity bull market has ended and a wobbly global economic backdrop is weighing on market sentiment. In this situation, corporate earnings can provide important clues whether current market turbulences are mostly reflecting top-down anxieties or something more fundamental in the corporate sector is going on, which will put pressure on valuations.

Uninspiring earnings season so far

Unfortunately, the ongoing reporting season has not been overly reassuring in this respect. While the reporting period is still incomplete and – as usual – results differ between markets and sectors, what we have seen so far does not support expectations that corporate earnings will provide any support for equity markets in the near future. Quarterly earnings per share (EPS) were down 6.5% year-on-year in the US and 4.5% lower in Europe. More importantly, sell-side consensus estimates both for 2016 and 2017 have been drifting lower since the beginning of the year, mostly reflecting the ongoing earnings releases. For Europe, the consensus EPS for the Euro Stoxx 600 has been cut by more than 6%, and in the US, for the S&P 500, by 3% (see figure 1).

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However, downward revision of earnings forecasts have not been only the result of disappointing fourth quarter results as such, because there were clearly also bright spots, particularly in the US. At least equally important were in many cases that even positive releases came together with signals from management – the business outlook, earnings guidance, payout plans – which are suggesting that the earnings outlook on average will remain subdued going forward.

There is another aspect worth noting about the incoming financial results: they provide yet another confirmation of the fact that the US and Europe continue performing differently. In the US, after 87% of all 4Q results from the S&P 500 universe are in, a massive majority of companies (more than 70%) according to Bloomberg data, posted better earnings than anticipated. While this is clearly positive, at the same time, a majority of companies disappointed in terms of topline growth. Both trends were surprisingly similar across all sectors (with only the telecom sector as the single exception). Figure 2 provides a summary: the red columns (share of positive EPS surprises) are generally above the 50% line, while the blue columns (positive topline surprises) are below 50% and also below the corresponding share of positive EPS surprises.

US: Profit margins may come under pressure

Again, it seems, US companies managed to surprise on the upside in terms of margins, despite a lacklustre topline growth. This has been the pattern for some time now, but it is getting increasingly worrisome considering the macroeconomic backdrop. If the US economy slows, as many expect, and at the same time wage momentum, which has been picking up as of late, is gaining further traction, margins will come under pressure from both sides, and earnings of the US corporate could be in for some disappointment during 2016.

2

EU: 4Q15 topline surprises on the upside

In Europe, after 60% of companies in the Euro Stoxx 600 reported, the picture is completely the opposite from the US. On this side of the Atlantic, only a minority (less than 40%) of companies managed to beat the consensus in terms of earnings, which is the weakest figure for many years. At the same time, a clear majority of companies (60%) reported stronger topline figures than expected. Like in the US, the pattern was surprisingly consistent across sectors (see figure 3 which shows that the blue bars – topline surprises – are mostly above the 50% threshold, while earnings surprises are below). Apparently, the European corporate sector has been better in mainting its topline, but it is struggling to improve its margins.

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To what extent the differences between the US and Europe are cyclical (the US is much further in the cycle) or structural (e.g. technology playing a much bigger role in the US than in Europe) is difficult to say.

2016/17 earnings will be key

For investors the implication is that the big picture has not changed, although everything got a bit more worrisome: In the US, the key question is, how resilient earnings will be in 2016 and 2017, i.e. how successful companies will be in defending their margins after the cyclical earnings peak has been passed. In Europe, on the other hand, the key question remains if and when the corporate sector will finally start delivering the earnings growth which the market has been anticipating and partly pricing in for years now. Positive developments on both sides of the Atlantic will be necessary to prevent a further decline in stock prices.

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