Corporate Earnings – Weak, But Better than Feared

As of May 11th, about 85% of all S&P 500 companies have reported 1Q 2016 earnings. Corporate earnings are important as stock prices tend to follow a company's revenues and profits, as well as their perceived ability to deliver future returns. Let's review what first quarter earnings have told us so far.

Of the 438 companies within the S&P 500 that have released their quarterly earnings, 317 have exceeded forecasts, 30 have reported results that matched estimates and 91 have disappointed with earnings below expectations. This translates to around 72% that reported positive surprises and fewer than 21% that reported negative surprises. Given the significant number of companies that exceeded estimates, this possibly suggests that investors and analysts were too negative heading into the quarterly reporting period. Although lower than the 77% of companies that exceeded estimates in their 4Q 2015 results, the 72% that surpassed estimates in 1Q 2016 is still higher than the historic average of 67%. One possible reason why corporate profits have exceeded estimates is that many companies are benefiting from stock buyback activity. According to Yardeni Research, approximately 66% of reporting S&P 500 companies have reduced their outstanding share totals relative to year ago levels. While the percentage is lower than the comparable 4Q 2015 figure of 69%, a full 25% of them reduced outstanding shares by more than 4%.

Overall first quarter S&P 500 company earnings per share (EPS) are currently estimated at $26.79, representing a year-over-year (YoY) profit drop of 6% in what will likely be a fourth straight quarterly decline. While the 6% fall is lower than the 9.6% decline that analysts forecasted, the earnings drop is the largest since the second quarter of 2009.

Winners and Losers by Sector

As shown in the table below, just three of the ten major sectors within the S&P 500 are expected to post positive earnings growth for the first quarter (column Q1 2016 below). According to Standard & Poor's, the Energy sector will post a quarterly YoY loss for the first time since recordkeeping began. Excluding the drag from the Energy sector, S&P 500 earnings growth for the first quarter would still be negative at -1.6%. Consistent with our view for a better second half of the year for corporate profits, full-year 2016 earnings growth for the S&P 500 is estimated at positive 0.4%.

	EPS Growth %			
S&P 500 Sector	Q1 2016	Q2 2016e	2015e	2016e
Consumer Disc.	19.1	11.1	10.9	12.6
Cons. Staples	(1.1)	(3.4)	0.4	3.1
Energy	(106.2)	(77.9)	(61.4)	(69.7)
Financials	(4.5)	(2.8)	6.5	6.0
Health Care	7.2	3.5	14.0	8.0
Industrials	(3.5)	8.2	3.9	2.8
Info. Technology	(6.1)	(8.0)	5.2	(1.8)
Materials	(11.5)	(6.6)	(4.2)	1.0
Tele. Services	9.0	(1.0)	13.4	1.3
Utilities	(2.0)	5.0	2.7	1.6
S&P 500	(6.0)	(4.5)	(0.5)	0.4

Source: S&P Capital IQ

Other sectors with expected significant profit declines are Materials, Technology, and Financials. While the Energy sector clearly remains the biggest drag on corporate earnings, the low single-digit growth decline in most other sectors signals that many companies are likely taking advantage of the soft secular economic environment to realign, restructure, and reduce expenses to create a more streamlined operation. Such action often results in increased accounting charges against operating income.

There is a similar story for mid-cap and small-cap stocks. 71% of Russell Mid Cap companies and 63% of Russell 2000 (small-cap) companies have surpassed their first quarter earnings estimates. Once again, the percentage of companies exceeding estimates are up from 4Q2015 but remain low relative to historical trends.

Despite the better-than-expected overall tone for corporate earnings, several of the most widely-owned companies across mid and large cap indices have experienced significant earnings misses, which dampened investor sentiment early in the reporting season. In large-cap, four of the top five most-owned companies in the internet and technology industries missed both earnings and revenue estimates. In mid-cap, nine of the 21 most owned companies have also reported results below consensus estimates. On the positive side, forward management guidance trends have significantly improved to date. The percent of small- and mid-cap companies raising current quarter and/or full-year guidance is high relative to historic averages, while the percent of large-cap stocks is presently in line with its 12-year average.

Looking forward, we feel overall market direction will continue to depend on China's growth, continued stabilization in oil prices, the direction and timing of interest rates and, as mentioned, an expected recovery in corporate earnings during the remainder of the year. Because so much uncertainty exists today, including the run-up to the November U.S. elections, we continue to expect market volatility to remain elevated. Despite possible market overhangs, there are several key positives that may provide support to equity prices. These tailwinds include continued low global interest rates, continued strength in the labor and housing markets, tame inflation and accommodative central banks.

We continue to favor domestic equities over international, with a bias toward growth over value companies. We recommend staying fully diversified to limit outsized concentration in any one asset class. Lastly, in case market volatility increases, we believe it is prudent to retain an allocation to alternative investments that have low correlations to traditional investments.

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*The **Russell Midcap Index** measures the performance of the mid-cap segment of the U.S. equity universe and is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap represents approximately 31% of the total market capitalization of the Russell 1000 companies.*

*The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

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