Focal Point

Q3 earnings resiliency masks a grim decline ahead

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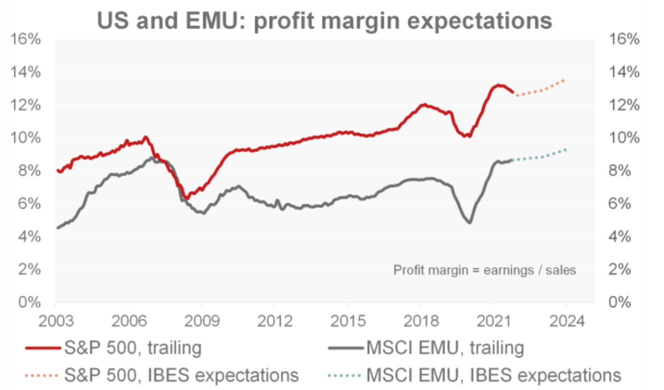
Our Focal Point series explores topical issues on macro, markets and investment

- The US earnings momentum has been resilient so far, and the Q3 reporting season is expected to see a reduced but still positive yearly growth. Ex-Energy expectations receded by 9pp since the end of June to -3.5% yoy, leaving scope for positive surprises vs. analysts' expectations.
- Still, we expect the tone of firms' guidance to be more subdued compared to Q2. We estimate 2023 earnings growth to be at +2% yoy for the US and nearly zero for EMU.
- Our earnings forecasts (based on macro models and finetuned by qualitative considerations) are below consensus, mainly due to the ongoing surging costs and negative GDP revisions, and the risks are heavily tilted to the downside.
- The gap vs IBES in 2022-2024 is increasing from -3% to -11% and -7% to -15%, for the US and EMU, respectively. In a severe scenario, 2023 yoy growth in the US is at -5% and at -10% for the EMU.
- PEs are likely to be further downgraded due to the high real rates and deteriorating financial conditions. But, as earnings are also most probably at risk, we see our underweight equity position to be justified in the short term.



Source: Datastream, GIAM

In the last months, global 12-month forward earnings forecasts came under pressure, especially in the US. Here, since the peak in June, US earnings have been revised down by 2.7% for 2022 and by 5.1% for 2023. This was mainly due to the worsening of economic activity, fall in confidence indicators, a strong USD and increasing operating costs. For the next quarters, analysts still expect an increase in margins that we deem to be seriously at risk. In the current note we present our view on future earnings developments and provide a justification for our short-term equity underweight position.

Q3 results to show resiliency after the downgrade

Since the end of June, Q3 earnings growth expectations declined by 8pp in the US, from 11% to 3.1% yoy, and, ex-energy, even from 6% to -3.5%. Apart from Energy, only Real Estate (RE) and Utilities managed to be roughly unchanged in terms of annual earnings growth. On the contrary, expectations in Europe increased by 3pp, from 25% yoy to 28% yoy, mainly due to Energy and Industrials. The latter has exhibited an increased earnings growth (+10pp) despite the ongoing energy crunch. The rest of the EU sectors showed a slight decline, except Healthcare which was stable. In relative terms vs. the US, EU Q3 expectations benefited from a weaker trade-weighted euro by -0.5% qoq in Q3, after -1.6% qoq in Q2. Empirically, a decline of the TW Euro by 10% yoy increases earnings growth by about 7%. Further positive factors for the EU were higher 10-year yields (+50 bps vs +30bps in the US) which supported financials and thus were more favourable for Europe, also due to the higher financials' weight in the index compared to the US (14.5% vs. 10.5%).

US yearly earnings growth in Q3 is expected to be below that of Q2 (+3.1% vs. 8.4%), while EU growth should remain stable (+29%). Highest growth is expected in Europe from Utilities, Energy, Industrials, Pharma and Staples. Tech and RE are slightly positive and Materials are negative (see appendix). More importantly, Staples, RE and Utilities are expected to accelerate their yearly growth vs Q2, while Energy and Materials should show a lower growth momentum.

The cited decline in the US earnings expectations represents a trend which is not likely to revert in the short term and which Europe is also going to join. That said, after the negative revisions, the Q3 season should show some resiliency, with also possible positive surprises, albeit below both Q2 (+4%) and the historical average since 2007 (ca. +6%). US Q3 pre-announcements have been better than for both Q2 and the historical average since 2004: the negative-to-positive pre-announcement ratio was 1.3 vs. 1.7 in Q2.

S&P 500: Q3 earnings reporting season (97 companies reported)

Sector	earnings growth, yoy Q2 2022 *	earnings growth, yoy Q3 2022	sales growth, yoy Q2 2022 *	sales growth, yoy Q3 2022	margin trend Q2 2022 *	margin trend Q3 2022
S&P 500	**-8.2%**	**-1.8%**	**6.9%**	**7.3%**	**-15.1%**	**-9.1%**
Median (all sectors)	5.8%	1.7%	9.9%	7.0%	-4.1%	-5.4%
Median, ex. Commodities	4.8%	1.7%	6.4%	7.0%	-1.5%	-5.4%
Median, ex. Financials	5.8%	2.9%	10.5%	7.4%	-4.8%	-4.6%
Median stock	7.5%	7.9%	8.8%	8.4%	-1.3%	-0.5%

Sector	earnings surprise % Q2 2022 *	earnings surprise % Q3 2022	sales surprise % Q2 2022 *	sales surprise % Q3 2022	margin trend Q2 2022 *	margin trend Q3 2022
S&P 500	**3.1%**	**4.5%**	**1.0%**	**1.2%**	**2.0%**	**3.3%**
Median (all sectors)	4.4%	3.5%	0.7%	1.4%	3.7%	2.1%
Median, ex. Commodities	4.4%	4.0%	0.7%	1.2%	3.7%	2.8%
Median, ex. Financials	4.5%	2.7%	1.0%	1.3%	3.5%	1.4%
Median stock	4.0%	3.7%	1.2%	0.7%	2.8%	2.9%

Source: Bloomberg, GIAM calculations

Note: Numbers for Q2 are based on similar amount of companies like in Q3, so far

margin trend = earnings growth - sales growth

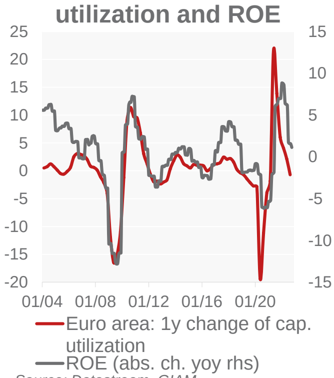
With 20% of companies from the S&P 500 having reported, the median US sector showed an annual growth of 1.7% for earnings and 7% for sales. In comparison to Q2 (with similar number of companies reported), earnings growth is weaker than that of sales, thus producing a negative margin trend. Furthermore, while surprises are positive, they are lower than in Q2 for earnings (+3.5% vs. 4.4%), but stable for sales (1.2%). A slowly deteriorating corporate environment and macro trend is also leading to a more negative price reaction in Q3 compared to history for firms that missed expectations (-6% vs historical mean of -3%).US Tech firms, in particular, suffer from ongoing earnings revision headwinds (12-month earnings revisions of, on average, -13% in the last 4 months for Meta, Google and Netflix), which add to the negatives of increasing yields. More recently, Meta's Q3 results also showed poor guidance and spiking capex, leading to a sharp price setback (-19%).

In sum, we could see an overall decent reporting season after the occurred reduction in estimates to 3.1% yoy as forecasted by IBES, despite a decline (on average) in confidence indicators in Q3 vs. Q2. Indeed, macro surprises recovered in part their initial fall, and activity was described as still "expanding modestly" in the Fed's last Beige Book. The 100 firms which reported so far show a surprise of +3.5% vs. expectations for the median sector.

Comprehensive earnings assessment

Notwithstanding resilient Q3 results vs. expectations, we see high chances for the tone of firms' guidance to be subdued compared to Q2. Furthermore, we predict a decline in earnings growth expectations in the next months, expecting to see in 2023 +2% yoy for the US and zero for EMU. These forecasts contain high risks on the downside.

Euro area: Capacity utilization and ROE



Source: Datastream, GIAM

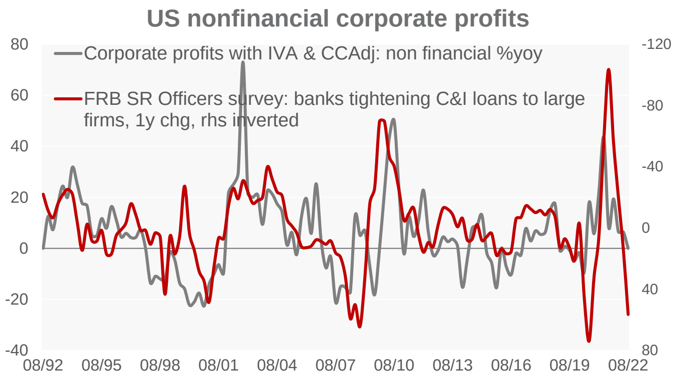
US S&P trailing earnings vs NIPA profits

Source:Datastream, GIAM

As a first step to assess the US earnings growth for the 2022-2023 period, we estimate the NIPA earnings (profits of overall US economy), which tend to lead S&P 500 IBES ones by 1-2 quarters. Based on our macro forecasts, NIPA profits' growth should decline visibly, still remaining slightly positive by year-end 2023 (+2% yoy). Independent variables in our proprietary model are ISM, CPI, unit-labour costs (ULC), and

US yield curve steepness (10Y-2Y). We developed a downside scenario assuming a moderate US recession. In such a scenario for 2023, we could expect earnings to decrease by nearly 4-6% yoy. The assumptions for the scenario are as follows: ISM to come below 50 in all quarters (falling to 44), CPI-ULC at 2%, lower than in the baseline and (10Y-2Y) to be steeper in 2023 (+100 bps).

As a second step, we use NIPA profits to forecast both IBES S&P 500 and EMU earnings. In a base scenario, the slowing momentum is confirmed. In 2023, US companies may escape negative earnings growth (+3% yoy) but not so EMU (-3%). For both, risks are tilted to the downside due to ongoing negative GDP revisions, but we judge EMU to be more at risk. Thirdly, as a cross check, we use an alternative set of models which give more weight to the recent trend of several macro variables (oil, trade-weighted Euro and USD, NIPA, yields, industrial production, unemployment, ISM and exports). Here, the models' results indicate higher resiliency and an annual earnings growth of 5% (US) and 4% (EMU).



Source: Datastream, GIAM Rsearch

Final forecast: consensus increasingly at risk

Our final earnings assessment is a prudent one vs. consensus, although our base scenario doesn't factor in a deep recession. For 2023, we forecast +2% for the US and 0% for EMU with risks tilted to the downside. In the base scenario, our gap in earnings levels vs IBES for 2022-2024 goes from 3%-11% and 7%-15%, in the US and EMU, respectively (see tables below).

	S&P earnings			
Year	GIAM base yoy	GIAM downside yoy	IBES yoy	GIAM vs IBES * base gap (levels)
2022	6%	0%	9%	-3%
2023	2%	-5%	7%	-7%
2024	4%		9%	-11%

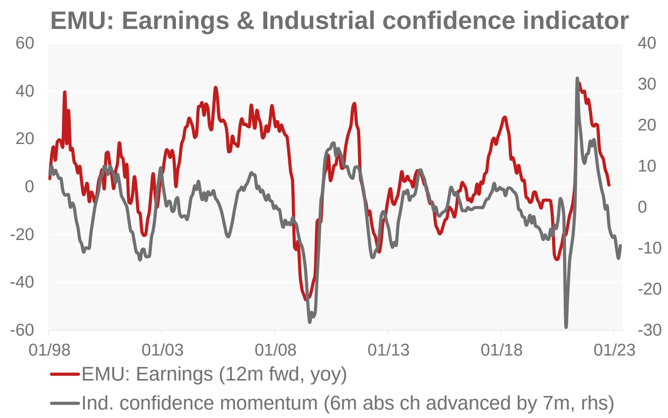
	EA earnings			
Year	GIAM base yoy	GIAM downside yoy	IBES yoy	GIAM vs IBES * base gap (levels)
2022	9%	1%	17%	-7%
2023	0%	-10%	4%	-10%
2024	2%		8%	-15%

Note: gap is in per cent vs earnings levels of the S&P or MSCI EMU

Source: Refinitiv IBES, GIAM calculations

Against our expectations, the consensus still sees an upside in firms' margins in the next quarters which we repute quite unrealistic and could be source of future disappointments, thus causing negative market reactions. In our opinion, the downside case for EMU earnings in 2023 is more negative than for the US and around -10% yoy growth vs. -5% for the S&P500. An extreme recessionary case in 2023 (like in 2001, 2008 or 2020, representing a tail risk) would cause a nearly -15%/20% earnings decline for the US and -30% for EMU.

Among risks, we see first of all energy crunch, along with the tightening of monetary conditions, ongoing softness in confidence indicators and negative GDP revisions: nearly -2pp in GDP forecast since the end of June for EMU, where a -1% GDP could correspond to a decline of 4.5% in earnings, judging from history). In the US we see threats coming from the strong USD, higher wages and unit-labour costs plus the surging cost of debt. EMU is at risk from plunging industrial confidence indicators (Sentix outlook, PMI, IFO expectations), fast declining capacity utilization momentum which ultimately should bring lower margins and ROE. The enduring war, persisting supply chain disruptions and energy supply uncertainty represent further headwinds.



Source: Datastream, GIAM

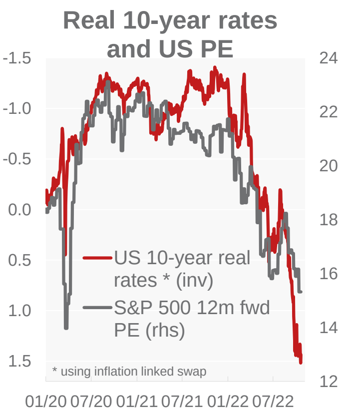
Furthermore, as additional headwinds to earnings and returns, we highlight the declining corporate financing surplus and tightening banking credit conditions - as signalled also in the last ECB Bank Lending Survey (BLS). The strong rise in capex since Q2 2020 has matched the pick-up in cash flows for the non-financial corporate sector. As a result, the financing surplus is unwinding. This confirms what NIPA profits' trend has shown: non-financial firms remained surprisingly in expansion mode during H1 2022 inducing also higher capex. Now, profits decrease so that free cash flows are squeezed. Banking credit conditions are expected to remain tight or even to become worse, given the aggressive stance of central banks (QT included) and recession fears.

The cited risks are more often reflected in several brokers' surveys which report firms to be increasingly worried about a tight US labour market, higher cost of debt, China's growth, geopolitical risks and the ability to maintain their strong pricing power.

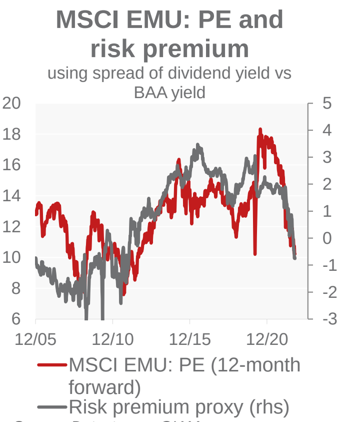
Earnings and valuation to justify an equity UW position

All in all, we think there are reasons to remain prudent on equities and maintain our underweight position. First of all, we see PEs pressured by higher credit spreads and real rates as central banks' stance will remain tilted on the hawkish side due to a sticky inflation which remains much higher than target.

Secondly, earnings estimates are also at risk in the next quarters and investors would probably be inclined to wait for the negative revision process to be well advanced before increasing their risk appetite again.



Source: Datastream, GIAM calculations



Source: Datastream, GIAM

A Fed pivot or a return to the diplomatic route from the Russian-Ukraine war would provide strong bullish impulses, but these are unlikely before the turn of the year.

We see the chance of slightly positive returns in 12 months, but short-term risks remain elevated. That said, should the S&P 500 experience a further decline reaching 3,300, the index would start discounting both the new rate regime as well as a sensible economic slowdown. In conclusion, we remain prudent, while acknowledging that in the next months the market could reach more attractive levels.

APPENDIX

S&P 500: Historical/Current/Future Earnings Growth Rates

Sector	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3		2022Q4	2023Q1	2023Q2	2023Q3
					01-Jul	Today				
Consumer Discretionary	19.4%	54.1%	-27.9%	-12.1%	28.7%	12.2%	-2.7%	58.3%	47.5%	29.4%
Consumer Staples	7.4%	7.7%	7.9%	2.2%	2.1%	-0.8%	-1.4%	0.5%	5.0%	7.5%
Energy	1798.0%	12611.0%	269.5%	295.5%	102.6%	118.0%	64.0%	32.6%	-27.7%	-15.7%
Financials	35.9%	9.9%	-17.1%	-19.3%	-4.4%	-15.9%	-3.4%	8.7%	14.3%	22.9%
Health Care	29.0%	28.0%	18.3%	8.7%	2.1%	-3.9%	0.2%	-7.5%	-4.6%	3.9%
Industrials	88.4%	43.8%	40.5%	31.6%	33.8%	27.3%	43.3%	29.5%	9.2%	9.4%
Materials	89.1%	64.2%	46.3%	17.5%	16.0%	-6.7%	-7.4%	-16.0%	-14.2%	0.9%
Real Estate	34.4%	17.6%	25.5%	13.1%	11.1%	10.9%	9.1%	-2.1%	-0.8%	2.6%
Technology	38.2%	24.6%	14.6%	1.5%	5.8%	-3.4%	-0.9%	-1.3%	6.2%	12.9%
Communication Services	35.6%	16.6%	-2.8%	-20.3%	-3.2%	-15.3%	-11.2%	2.4%	14.6%	14.9%
Utilities	10.3%	-1.3%	24.6%	-3.7%	-6.8%	-8.0%	4.8%	-8.2%	-0.4%	6.7%
S&P 500	**42.6%**	**32.1%**	**11.4%**	**8.4%**	**11.1%**	**3.1%**	**4.4%**	**6.1%**	**3.4%**	**9.6%**
S&P 500 Ex-Energy	34.3%	23.5%	5.2%	-2.1%	5.8%	-3.5%	0.4%	3.9%	8.0%	12.8%

Source: I/B/E/S data from Refinitiv, GIAM

Stoxx 600: Historical/Current/Future Earnings Growth Rates

Sector	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3		2022Q4	2023Q1	2023Q2	2023Q3
					01-Jul	Today				
Basic Materials	143.1%	92.6%	83.6%	40.9%	-17.5%	-20.3%	-30.9%	-46.6%	-47.7%	-24.6%
Cyclical Consumer	107.7%	9.3%	84.4%	22.0%	27.7%	25.4%	26.9%	-35.2%	-1.0%	-3.1%
Non-Cyclical Consumer	-5.1%	11.3%	-16.2%	-65.6%	32.0%	26.4%	13.1%	27.2%	2221.5%	-11.7%
Energy	546.9%	393.9%	206.5%	206.6%	110.5%	142.0%	74.6%	24.8%	-14.8%	-12.6%
Financials	47.0%	64.5%	0.4%	-2.9%	2.1%	-1.0%	23.7%	26.4%	-3.1%	26.2%
Healthcare	13.6%	12.7%	19.5%	18.2%	12.3%	13.1%	6.5%	5.9%	7.8%	11.6%
Industrials	246.3%	68.0%	66.9%	40.7%	30.1%	40.4%	15.4%	-22.6%	-12.4%	-15.5%
Technology	14.7%	49.0%	2.2%	8.6%	9.4%	1.7%	-5.4%	28.3%	16.5%	17.7%
Real Estate	24.9%	11.6%	33.3%	-72.9%	11.7%	4.1%	-22.2%	-3.2%	8.9%	2.3%
Utilities	-44.7%	45.8%	4.3%	25.7%	213.5%	201.7%	-24.2%	21.9%	10.6%	-12.2%
STOXX 600	**60.5%**	**59.2%**	**42.1%**	**29.3%**	**25.2%**	**28.4%**	**18.2%**	**3.1%**	**-3.2%**	**-1.4%**

Source: I/B/E/S data from Refinitiv, GIAM

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