May 12, 2022

MARKET SIGHT LINES

A positive "season" so far: Where are earnings headed?

By Michael O'Keeffe, *Chief Investment Officer*

Most quarters we report on the prior quarter's "earnings season," the industry term for the release of company earnings. These earnings reports are important for a number of reasons. First, we can assess the results of individual companies in our portfolios or the companies we're considering adding. But second, we get a "top-down" sense of the strength of earnings overall and how they are growing. And finally, we learn of challenges and opportunities facing companies and a sense of where earnings might be headed. Given the recent amplified volatility in equity markets, a review of earnings may be helpful. So, in this week's Sight|Lines, we review the results and learnings of the almost complete first-quarter 2022 earnings season and the implications for equity markets looking forward.

THE ROLE OF EARNINGS IN STOCK MARKET RETURNS

Earnings, of course, play a key role in stock market returns. At the most basic level, one invests in a company to share in its earnings through any dividends paid, plus price appreciation that is driven, in part, by the prospect of improving earnings going forward. Part of this math is captured in the price-earnings (P/E) ratio, the dollar value set by investors for each dollar of company earnings. If P/E stays constant and earnings grow at a certain amount, then given this P/E relationship, the price would grow at the same amount. For example, a 10% increase in earnings would result in a 10% increase in the stock's price. Add to that any dividends paid, and you have your total return. Notably, if people become more positive about the stock, which ultimately means greater confidence in earnings growth, investors may be willing to pay more for each dollar of earnings, driving up the P/E ratio, which should drive a higher return. Of course, future worries may erode P/E, which puts downward pressure on the stock. Other factors may influence the P/E ratio, so more about that later. But earnings are very important. So, let's have a look at the first-quarter results.

S&P 500 FIRST-QUARTER 2022 EARNINGS ARE STRONG

As of last Friday, 87% of the S&P 500 companies have reported earnings. Of those, 79% have posted earnings better than expected and 74% have posted revenues that exceeded consensus expectations. The blended earnings growth rate for the S&P 500 is 9.1%, which is higher than the 4.6% estimated by analysts at the start of the season. In aggregate, companies are reporting earnings that are 4.9% above expectations. The biggest positive surprise is in the utilities sector, with an 18.9% difference between actual and expected earnings. On the other hand, the consumer discretionary sector is reporting the largest negative surprise (-34.2%) between actual and estimated earnings. Given the risk-off sentiment, companies that report negative earnings surprises have seen a larger average price decline (-3.5%) relative to recent history.

SUPPLY CHAINS AND COST PRESSURES WEIGHING ON RESULTS

The consumer discretionary sector is the worst-performing in the S&P 500, down 29.4% this year. Companies reporting in this sector, such as Amazon, Tesla, Home Depot, and Nike, have mentioned a few common themes during their calls. For example, while inventory levels have started to improve, supply chain disruptions are still impacting revenue. COVID-related restrictions in China are creating challenges for retail traffic and demand. And rising prices along with a labor shortage, especially in hotels and restaurants, are creating some pressure on margins.

HOW EARNINGS FORECASTS ARE EVOLVING

Figure 1 shows how the consensus forecasts of earnings growth for 2022, 2023, and 2024 have been changing over the last year. We started 2021 with the consensus view that earnings would grow 16.6% and 9.6% for 2022 and 2023, respectively. But continued inflationary pressures stemming from supply chain disruptions, Russia's invasion of Ukraine, and China's zero-COVID policy have led to a more hawkish Federal Reserve (Fed). As a result, analysts have lowered some earnings forecasts for the year. The latest estimates forecast earnings growth of 10.1%, 10.0%, and 8.9% for 2022, 2023, and 2024, respectively. As a point of reference, our long-term earnings growth assumption for U.S. large cap stocks is 6.0%.

OTHER LEARNINGS FROM THIS EARNINGS SEASON

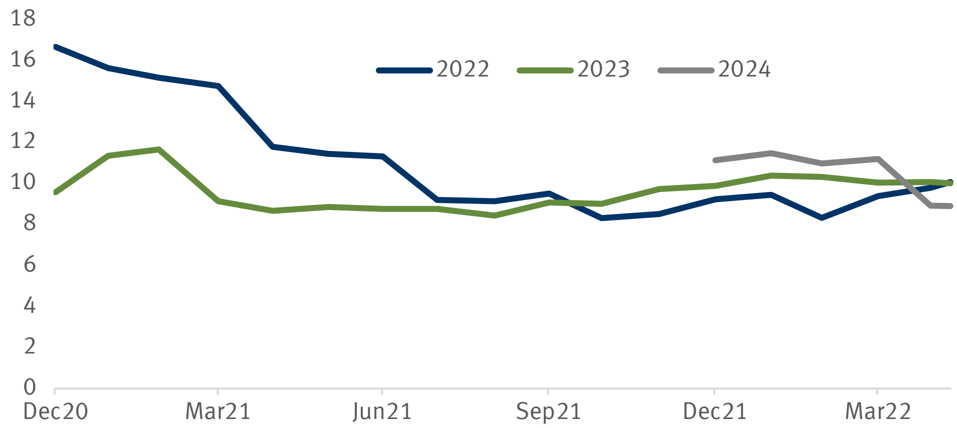
During earnings season, market watchers sometimes develop a sense of an overall "feel" for the environment. Sometimes many are upbeat, sometimes they are balanced (some positive, some negative), and other times there is a general sense of worry or concern looking forward. These sentiments are often captured through a company's "forward guidance." During the first-quarter earnings season, 72 of the S&P 500 companies reporting thus far have issued guidance for the next quarter, 50 of which have been negative. This percentage (69%) is above the 5- and 10-year averages. When we consider this along with the shift in Fed policy, higher rates, and overall market volatility, the environment may be putting downward pressure on P/Es, ultimately fueled by investors' more muted optimism about longer-term future earnings. This helps explain, in part, why markets have lost ground in 2022. The forward 12-month P/E ratio for the S&P 500 is 17.6X, which is below the five-year average (18.6X) but above the 10-year average (16.9X).

CONCLUSION

When we develop our "near-term" guidance on stocks, we often ask ourselves the question: Do we see markets higher a year from now? In the current environment, our answer to that question is "yes," but we acknowledge the challenges facing investors, the increased volatility, and the risks to the downside. Our analysis of earnings season is a big input to our process. And still, given the evidence that earnings are holding up, we do see equities higher a year from now.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com

Figure 1. Estimated Annual Earnings Growth (%)



Source: Stifel Investment Strategy via FactSet, as of May 11, 2022

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0522.4740688.1