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MARKET SIGHT LINES

U.S. Equity Earnings: Signs of Strength … and Weakness

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As earnings season comes to a close, we're learning more about the how U.S. companies have performed in the second quarter, as well as how company managements' forward guidance is changing. Equity analysts learn a lot from the earnings releases and related meetings with the managements of the companies they cover, giving them the opportunity to update their earnings forecasts for those companies. As we've discussed many times, earnings 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.

In this Sight|Lines, we share some key learnings from the second quarter earnings season.

THE TAKEAWAY: RESULTS HAVE BEEN MIXED, BUT WE'RE SEEING SOME POSITIVE SIGNS.

Most S&P 500 companies have reported second quarter earnings. In summary:

- A majority of companies have reported better-than-expected revenue and earnings.
- Consumer discretionary stocks did well, while energy companies have fallen short. Analysts, however, are generally positive on the energy sector looking forward. Companies with businesses focused in the U.S. did better than those with more of an international focus.
- The general tone during earnings calls was more positive than last year.
- Artificial intelligence (AI) was mentioned much more frequently than last quarter.

Overall, we've seen a modest decline in estimated 2023 and 2024 earnings for the S&P 500, with the former falling a little more. This means the earnings growth rate from this year to next has been increasing.

IN-DEPTH: RESULTS HAVE BEEN MIXED, BUT WE'RE SEEING SOME POSITIVE SIGNS.

Over 95% of S&P 500 companies have reported second quarter earnings, providing us an update on analysts' thinking about the future. Going deeper:

- Earnings have surprised to the upside:
  - 81% of the companies reporting had earnings higher than the consensus forecast.
  - This is likely supported by a stronger-than-expected U.S. economy in the first half of the year.
- 64% of the companies also had better-than-expected revenues.
- Sector results have been quite varied:

    - Consumer discretionary stocks did quite well, with earnings growth of 54.7%. Amazon (AMZN) is the largest contributor to earnings growth for the sector. If it were excluded, the growth rate for the sector would be reduced by more than half.
    - In contrast, energy companies' earnings growth fell 50.9%, due in part to the decline in oil prices, which averaged $80 a barrel in the second quarter, down from $110 a year earlier.
    - Analysts are generally positive on the energy sector looking forward. Of the roughly 11,000 research reports by analysts on S&P 500 companies, the energy sector has the highest percentage of "buy" ratings.
- U.S.-focused companies have fared better than global companies in the second quarter:
    - Companies with at least 50% of revenue from within the U.S. had earnings growth of 2.7%.
    - The other companies, which have a global focus, had an earnings decline of 18.7%.
- Compared to last year, company managements have been more positive than last year:
    - In parsing the transcripts of earnings calls, participants are using words like headwinds, inflation, and recession much less frequently than a year ago.
    - This also reflects the strong economy in the first half, as well as evidence of cooling inflation.
- AI has been in the news lately, as companies decide how best to deploy it in their business practices:
    - During earnings calls in recent weeks, AI was mentioned about twice as frequently as last year.
- Even with stronger-than-expected economic growth in the first half, earnings forecasts are declining modestly:
    - 2023 S&P earnings are now forecast to be $219.77, compared to the $228.92 from the start of the year.
    - 2024 S&P earnings are now forecast to be $245.26, compared to the $252.09 from the start of the year.
    - As a result, the earnings growth rate from 2023 to 2024 has increased to 11.6%, compared to 10.1% at the beginning of the year.

CONCLUSION

Second quarter earnings season is ending, and as is often the case, these results, and the forward guidance from company management, have been enlightening. A view of forward earnings is important for understanding where stock prices may go, both at the individual company and broad index levels. While results and related information have been mixed, there are some positive signals, like upside surprises and more constructive tones during earnings calls, contributing to a forward view that earnings this year and next will hold up going forward.

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