

MARKET SIGHT LINES



Third-Quarter Earnings: Lofty Expectations, an Uneven Picture

By **Michael O'Keeffe, CFA**
Stifel's Chief Investment Officer



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Company earnings reports offer valuable insights into both the businesses reporting and the broader economic environment. As third-quarter earnings season gets underway, we believe investors have some reasons to be encouraged. S&P 500 earnings growth for the third quarter, year over year, is expected to be 29.6%. That's a big number. And analysts have raised their aggregate expectations during the third quarter, a move that is somewhat unusual. As more and more earnings are released, we'll learn if results live up to these lofty expectations. We'll also learn about forces important to the economy and markets, like consumer activity, the cost of higher interest rates, and future plans around artificial intelligence. In this Sight|Lines, we examine the rising expectations for this earnings season and what company reports may reveal for investors more broadly.

THE TAKEAWAY: LOFTY EXPECTATIONS, BUT AN UNEVEN PICTURE BELOW THE SURFACE

A stronger earnings outlook is encouraging, but the breadth and durability of that growth – and what company reports reveal about the broader environment – will matter. In summary:

- **Rising expectations** – The earnings outlook is stronger than at the start of the quarter.
- **Concentrated earnings revisions** – Upward revisions were focused in a few sectors.
- **A positive earnings surprise is common** – Therefore, results should be gauged against typical reporting patterns, not just forecasts.
- **Assessing earnings alongside revenue** – Sales growth provides a useful check on the sources of profit improvement.
- **Understanding the consumer picture** – Resilient overall spending can coexist with pressure still on some households and businesses.
- **AI spending doesn't guarantee positive investment returns** – The buildout supports business activity, but financing needs and eventual returns remain in focus.
- **The outlook from here matters** – Forward guidance can help us assess whether strong earnings growth will continue.
- **Connecting earnings to valuations** – Investors assess business performance and the durability of expected profits as they decide the price they are willing to pay for a stock.

IN-DEPTH: LOFTY EARNINGS EXPECTATIONS, BUT UNEVEN SIGNALS BENEATH THE SURFACE

This earnings season will help us look beneath strong aggregate expectations to assess the breadth and durability of profit growth, along with what company results and guidance reveal about consumers, financing costs, and AI investment. Going deeper:

- Expectations have risen ahead of the reporting season:
 - Aggregate earnings-per-share estimates rose 1.4% during the third quarter, compared with an average quarterly decline of 2.2% over the past five years.
 - Expected year-over-year earnings growth for the third quarter is currently 29.6%.
- The aggregate expectations may be masking important differences across sectors:
 - During the third quarter, earnings estimates rose in three of 11 sectors, with energy and information technology leading.
 - Information technology earnings growth is expected to be over 65%, much due to semiconductors and related equipment.
- A positive earnings surprise is best gauged against historical patterns:
 - Over the past 10 years, 77% of S&P 500 companies beat earnings estimates, exceeding forecasts by 8%, on average.
 - Sixteen of the 19 companies reporting have beaten estimates, with aggregate earnings exceeding forecasts by 4.9%.
- Revenue will provide a helpful check on the quality of earnings:
 - Third quarter revenue growth is expected to be 12.4%, compared with earnings growth of 29.6%.
 - The estimated net profit margin is 15.0%, versus 13.0% a year earlier and a five-year average of 12.6%.
- Company reports can reveal nuances within otherwise resilient aggregate consumer spending:
 - Numerous reports have identified greater pressure on lower-income households, with middle- and higher-income spending remaining more resilient.
 - Forecasts show consumer spending growth remaining resilient in the third quarter but slowing in the fourth quarter.
- AI spending supports business activity, but financing needs and eventual investment returns will require a separate look:
 - The five major U.S. cloud and AI infrastructure companies have issued \$132 billion in debt through July.
 - This amount of borrowing and related capital expenditures brings into focus whether future AI revenue will justify investments.
- Forward guidance can help test the durability of what continues to be a positive earnings outlook:
 - Analysts have projected earnings growth of 28.0% for the fourth quarter and 15.8% for full-year 2027.
 - Potential headwinds include slower revenue growth, higher debt-servicing costs, and rising depreciation as potential constraints on future profits.
- Earnings and the durability of expected profits are drivers of stock valuations and market levels:
 - The forward price-to-earnings ratio was 19.1, equal to its 10-year average and below its five-year average of 19.8.
 - Since June 30, the index price rose 3.5%, while forward earnings estimates rose 10.4%, reducing the multiple.

WHAT WE THINK

We believe the stronger earnings outlook is encouraging, but this reporting season will help us assess how broadly that strength is shared and whether it can continue. Beyond the headline results, we'll be watching what companies say about consumer demand, higher financing costs, and the returns they expect from AI investment. Strong earnings can support markets without making every company equally attractive. We continue to guide investors to stay diversified, emphasize business quality, and assess the price they pay against the durability of expected profits, keeping their long-term objectives in focus.

Michael P. O'Keeffe, CFA 

Chief Investment Officer

michael.okeeffe@stifel.com | [StifelInsights.com](https://www.stifelinsights.com)

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