Sevens Report Alpha Webinar – What's the Outlook for Earnings

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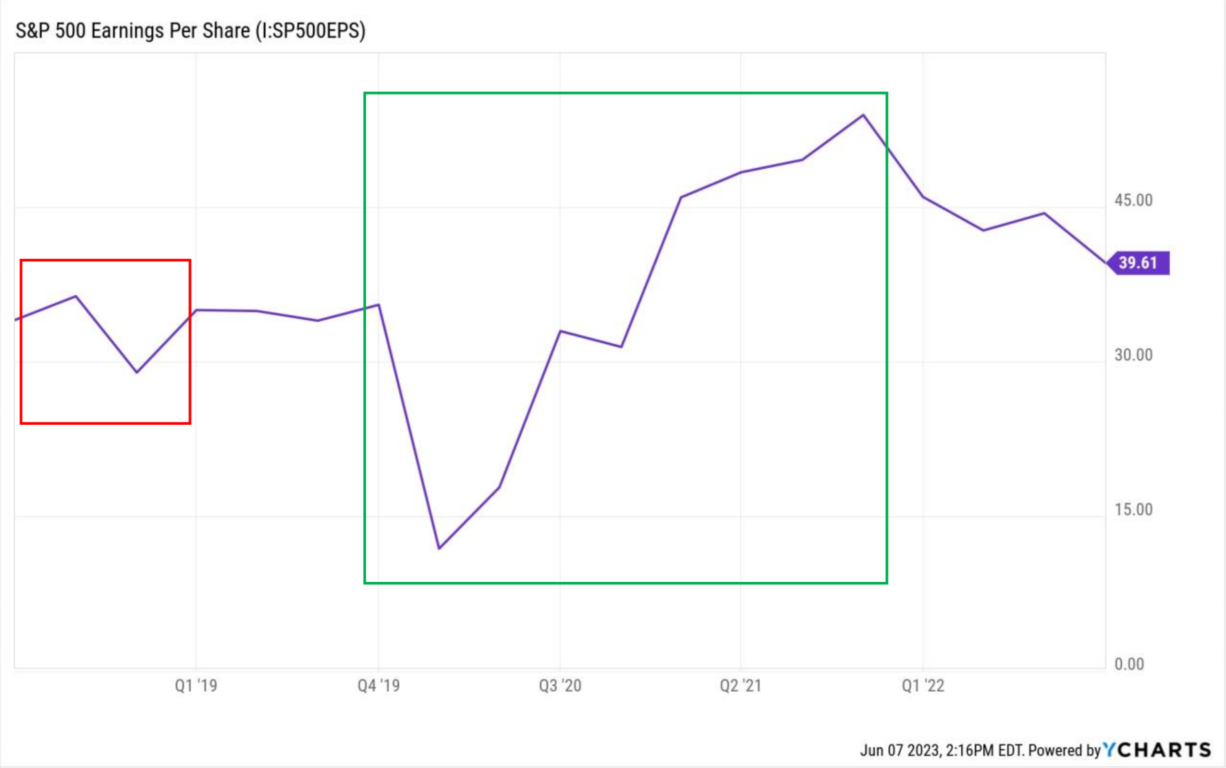
Earnings Can Move Markets

In 2018, declining earnings weighed on the major averages, and the S&P 500 dropped 8.33% during the second half of the year.

But, in 2021, earnings explosions boosted the S&P 500 to an 26.89% annual return.



Market Valuation Equation

You know the market multiple equation, but that's why earnings can move markets:

If earnings decline, then the "fundamental" valuation of the market will decline, too!

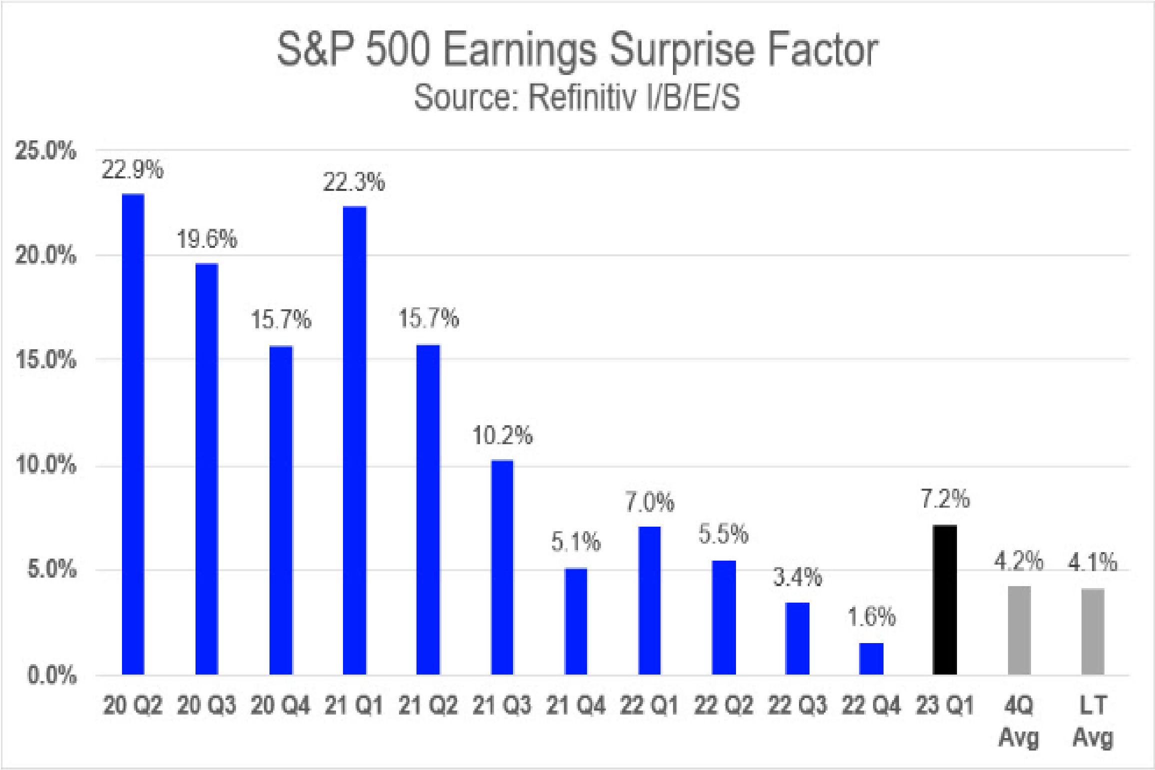
- Market Multiple times Next Year's Expected EPS.
  - Current: 18.98X * 225 = 4270.

Strong Q1 Earnings Have Boosted Stocks

Why Were Q1 Earnings a Positive Catalyst?

Reason 1: Expectations for Q1 earnings were very subdued.

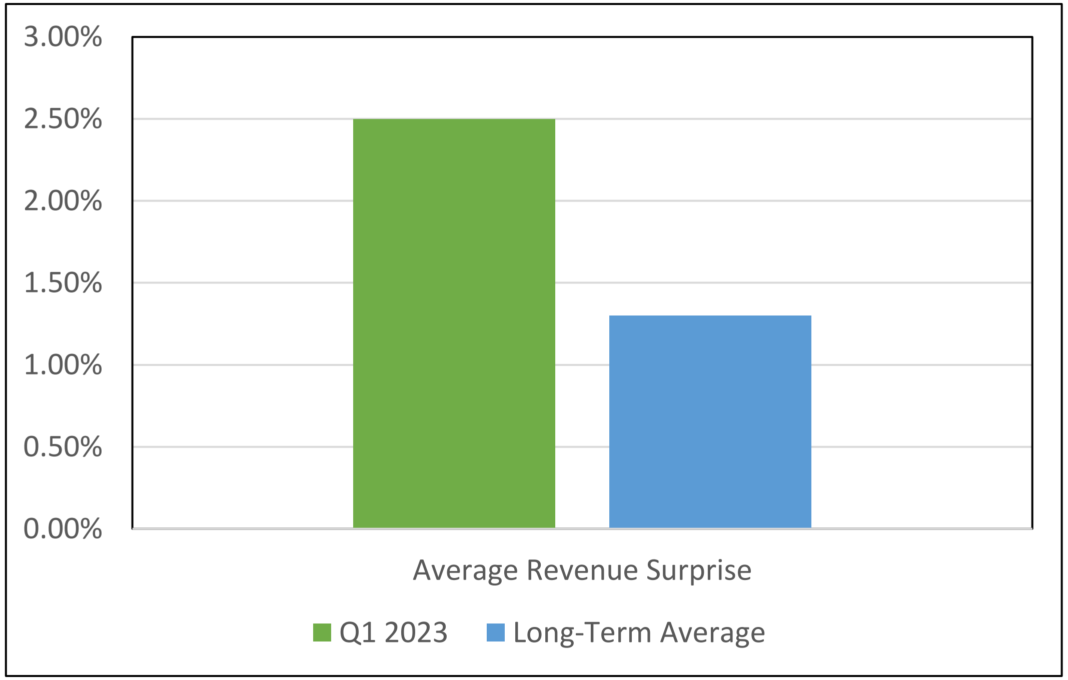
- Prior to Q1, there were 81 negative preannouncements vs. 26 positives. A 3.1 to 1 ratio, a four-year high.
- Expected EPS growth was forecasted at -4.7% q/q and revenue down -5.5% q/q.
- That created a “low bar” that was easily surpassed by the majority of companies.



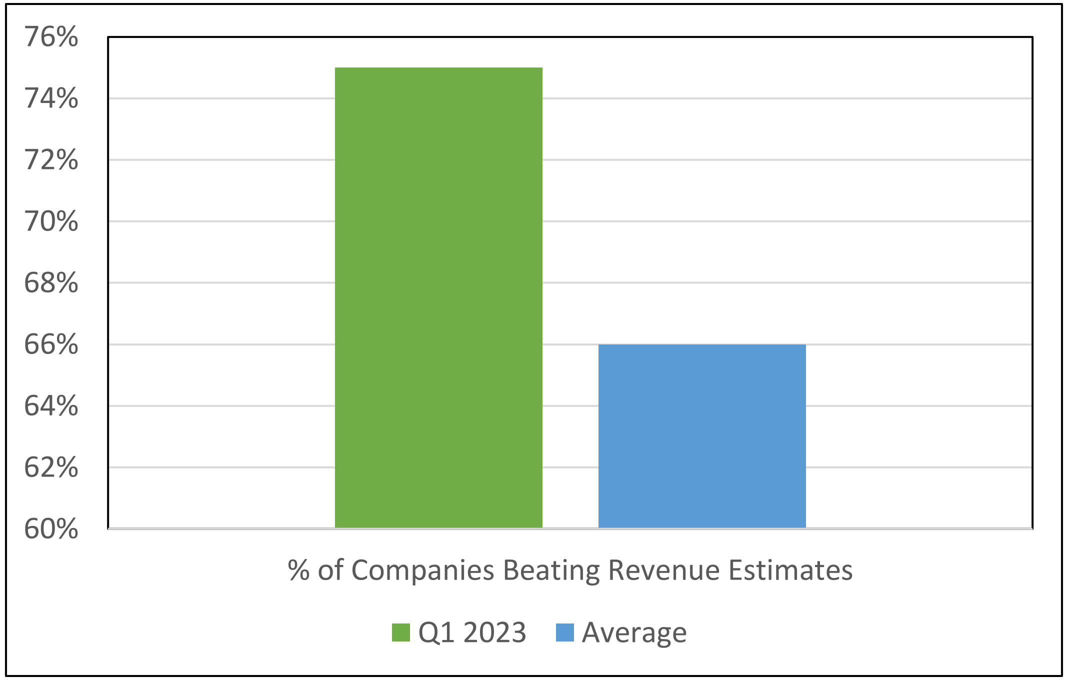
Why Were Q1 Earnings a Positive Catalyst?

Reason 2: Revenues Were Much Stronger Than Expected.

The average revenue surprise was 2.5% above expectations, considerably above the 1.3% long-term average.



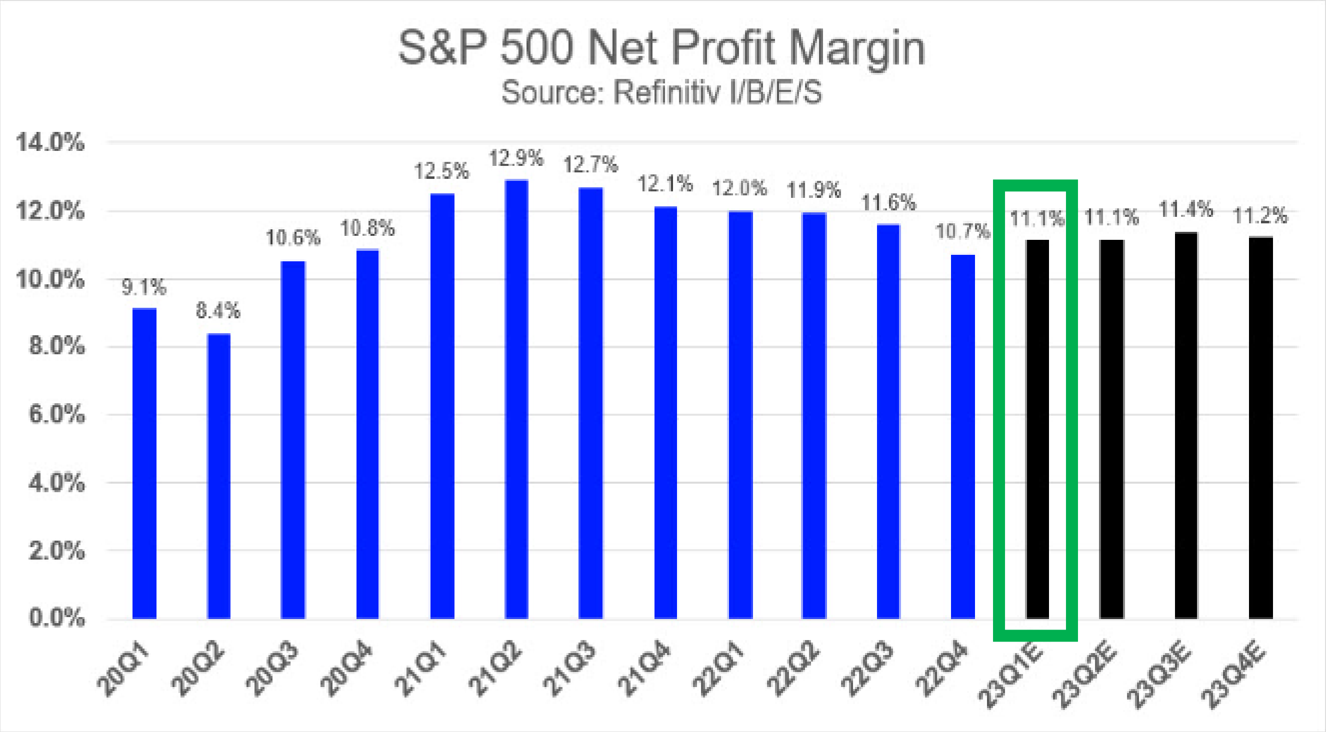
75% of S&P 500 companies beat revenue estimates in Q1, well above the long-term average of 66%.



Why Were Q1 Earnings a Positive Catalyst?

Reason 3: Margins were strong

- S&P 500 Corporate Profits were expected to continue the decline that started in mid-2021.
- But, for the first time in nearly two years, S&P 500 corporate margins rose, and that, combined with strong revenue, helped to better than feared earnings.



Has Better Q1 Earnings Resulted in Optimism For the Rest of the Year? No, it Hasn't and That's a Worry

Despite better than feared Q1 earnings, full-year S&P 500 earnings estimates haven't changed.

  - FY 2023 S&P 500 EPS was 222.05 prior to Q1 results and is 221.51 after Q1 results.

- 110 companies have issued Q2 guidance. 60% lowered guidance and 40% raised guidance.
- 266 companies updated full-year guidance. 41% lowered guidance and 59% raised guidance.

So, nearly 80% of S&P 500 companies beat Q1 earnings, but only about 20% upped Q2 guidance and just over 50% increased FY guidance? And, the street isn't upping full-year guidance?

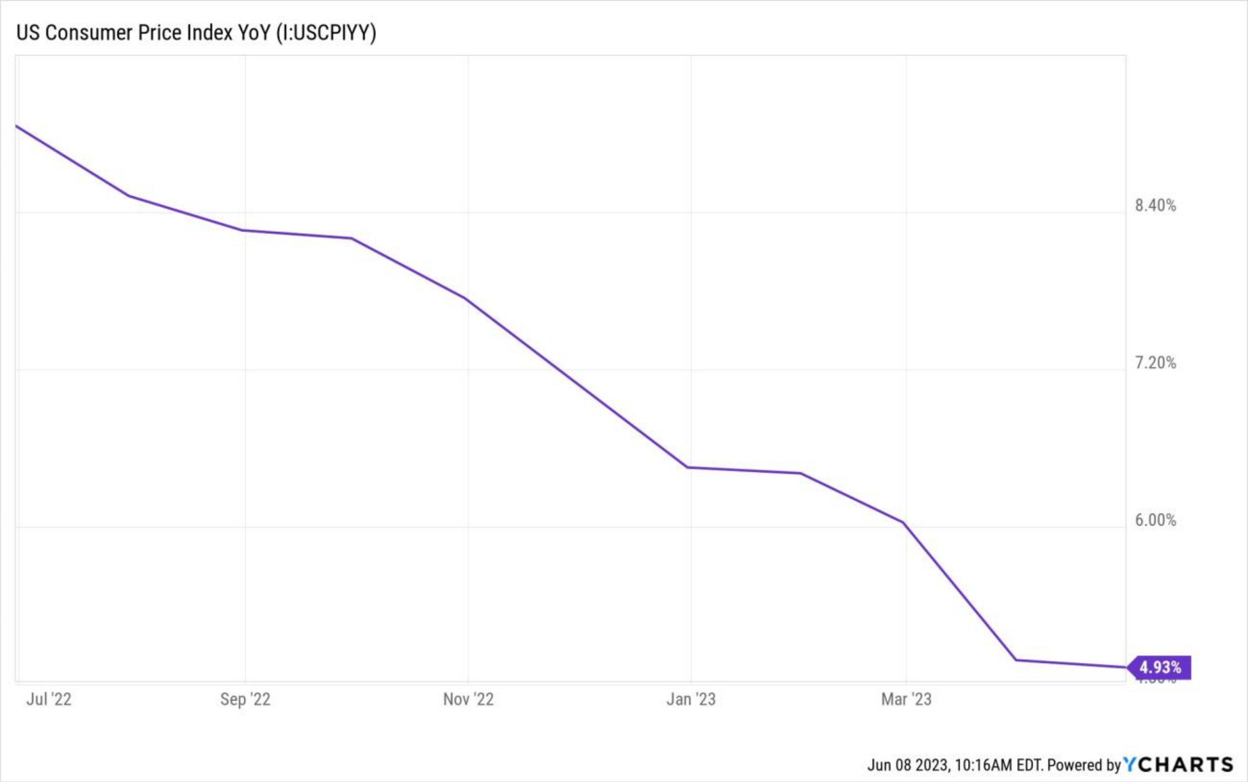
  - Why?

First Concern: Disinflation Hurts Earnings

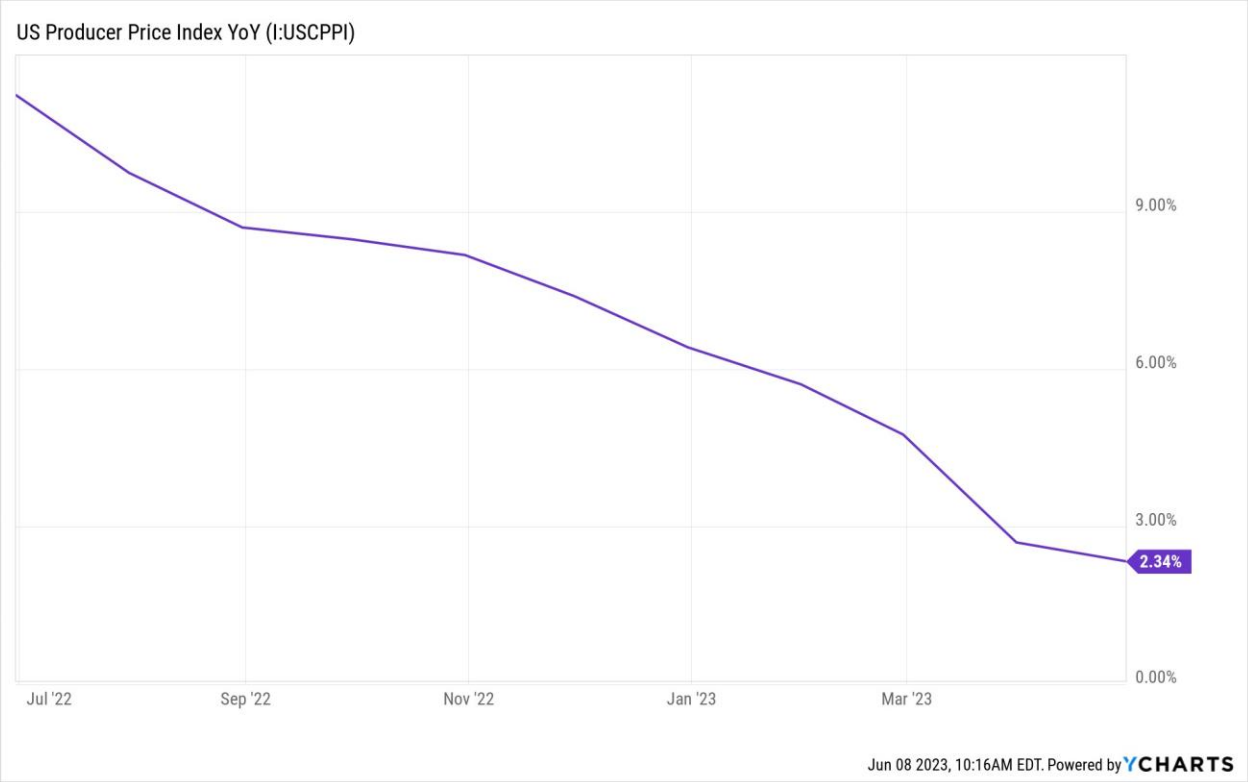
- Q1 EPS strength was driven by three factors:
  - Low expectations
  - Revenue beats
  - Higher margins
- Both revenue and margins may be vulnerable going forward.
  - Revenue beats were mostly driven by inflation, not massive increases in unit sales. If disinflation is truly taking hold, that will reduce aggregate revenues (or at least slow aggregate revenue growth).
  - Margins, meanwhile, bounced back in Q1 thanks to two main factors: Reduced input costs (raw materials deflation) and cost-cutting (META is the poster child for this).
    - Cost cutting can only work for so many quarters (perhaps again in Q2 but beyond that more uncertain).
  - Margins, were also strong on a drop in input prices and high consumer prices, but if we see disinflation, that will compress.

Loose Proxy for Corporate Margins

Consumer prices have declined.



Input prices have declined more.



Second Concern: Risk of Disappointment in 2H '23

- Here is the remaining consensus quarterly earnings expectations:
  - Q2 EPS, -6.4% (from Q1).
  - Q3 EPS, 0.9% (from Q2).
  - Q4 EPS, 8.4% (from Q3).

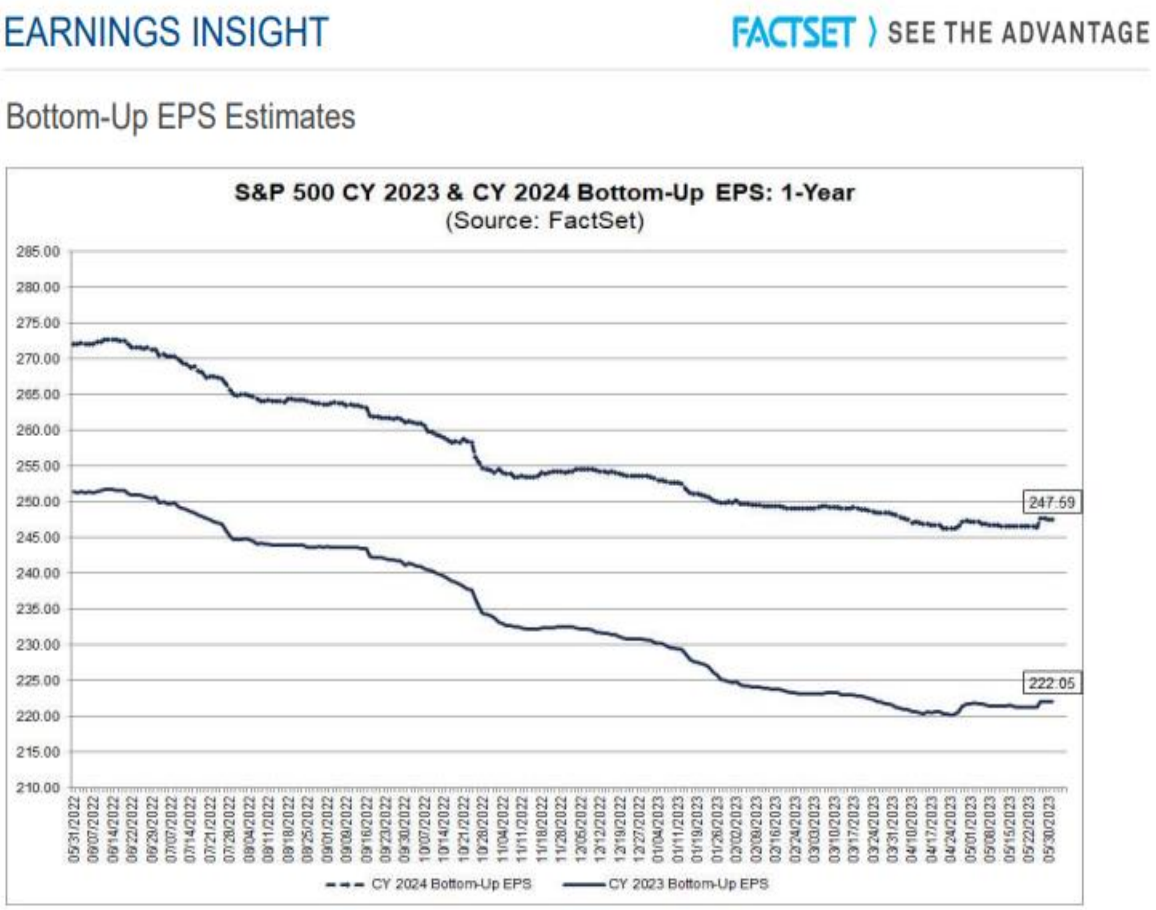
- Full year 2023 S&P 500 earnings remain largely unchanged around $225. But, to hit that number, it assumes that basically all the growth will come during the 4th quarter, a time when it's possible that 1) Disinflation has taken hold and 2) The economy is contracting.

Takeaways

- Earnings are important – they are responsible for a lot of the gains in the S&P 500 YTD.
- But, there are growing signs that the Q1 earnings beats aren't as healthy as we'd like them.
  - First, Q1 earnings still fell from Q4 '22, but by just -2.1% (which is less than the -4.7% expected decline). But, they are still falling!
- Risks for companies going forward include: 1) Revenue decline and 2) Margin compression. If we get both, then the expected 2023 and 2024 S&P 500 EPS will decline, and that's a problem for stocks.

Takeaways (Cont'd)

- 2023 S&P 500 EPS stated at $250/share. They are likely to end around $225/share (or slightly lower). That's a 10% drop.
- If 2024 S&P 500 EPS have a similar decline, then the market multiple equation changes.
- Current Expectation: 18*247= 4,446.
- 10% Drop: 18*222 = 4,001.
- Extreme case: MS at $185 for 2023, nearly a 20% drop from now!
- LPL: $213 for 2023, $230 for 2024.



Sectors with Protection

- Defensive sectors relatively perform well during earnings recessions.
  - **Utilities**
  - **Healthcare**
  - **Consumer Staples**
- These sectors performed best during earnings declines in ’00-’01, ‘06-’08, and the 2nd half of 2018 (all of these were slow growth-driven earnings declines).
- They are also the sectors that have seen some steep earnings reductions for Q2, possibly “lowering the bar” for performance.
- Conversely, tech and communications saw earnings expectations increase (thanks in part to AI and semiconductor optimism).