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MARKET INSIGHT

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EARNINGS GROWTH ESTIMATES COULD FALL FURTHER AND WEIGH ON STOCK MARKETS

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"The earnings growth consensus is still far too optimistic and disconnected from the actual macroeconomic environment."

DON'T FIGHT THE FED

Without a doubt the last two months will enter the pantheon of memorable financial market episodes: the worst December since 1931 followed by the best January since 1987. If there is one thing this turnaround has demonstrated, it is that the main driver of risky assets is not earnings forecasts, macroeconomic data, politics, or even lines on charts; no, the only thing that really matters is the amount of money injected into or withdrawn from the system by the US Federal Reserve (the Fed), that is, whether Jay Powell is hawkish or dovish.

The anticipation of a pause in the Fed's monetary tightening cycle and the easing of fears over the dry-up of global liquidity reinvigorated investor sentiment and fuelled the strongest rally in 40 years. The flip side is that this monetary policy U-turn is now priced in and investors may well again focus on economic fundamentals and business prospects. This is where the problem lies: we observe a surprising divergence between the consensus of company profit growth and the receding economic outlook for 2019 and 2020.

Normally, it is the dynamic of earnings revisions that strongly influences stock market trends. When stock analysts revise their growth expectations upward, investor confidence and risk appetite strengthen, pushing stock market indexes higher. However, financial markets may disconnect from the earnings per share (EPS) momentum and focus on other factors. According to our analysis, this is precisely what has happened since the beginning of the rebound starting on Christmas Eve: EPS growth forecasts have been sharply revised downwards in all markets while the S&P 500 has advanced more than 17% (Exhibit 1). Surprisingly, it doesn't seem that this dichotomy has caught the attention of investors at this time, who are far more interested in the Fed and the linear rise in indexes.

EQUITY ANALYSTS ARE TOO OPTIMISTIC

For the United States, analysts' consensus is on revenue growth weakening from 6.9% in 2018 to 3.4% in 2019[1], then on a re-acceleration in 2020 to 4.5%. With respect to EPS, after an estimated decline in growth from 18.6% in 2018 to 4.8% in 2019, growth more than doubled at 9.8% is expected for 2020. Even more strikingly, only three sectors out of 23 are expected to have negative growth in 2019 and net margins are expected to increase (12.5% in 2018, 13% in 2019, 13.4% in 2020). Irrespective of the sterile debate on the timing of the beginning of the next recession, economists expect a weakening of economic growth (2.9% in 2018, 2.5% in 2019, 1.9% in 2020; Bloomberg consensus). Moreover, the recent slowdown in some cyclical sectors of the economy, such as housing and manufacturing, has significantly increased the likelihood of a recession next year[2].

What about eurozone? The gap between economic forecasts and business prospects is even more remarkable. Despite the continued deterioration of the euro zone economy since Q1 2018 and forecasts of a slowdown in GDP growth this year (1.9% in 2018, 1.4% in 2019), financial analysts predict a modest acceleration in sales growth (3.1% in 2018, 3.8% in 2019), as well as a sharp acceleration in EPS growth (3.1% in 2018, 7.5% in 2019). The extent of this optimism is, to say the least, illustrative: only one of the 23 sectors considered is predicted to decline in 2019 and net margins should even slightly improve from 7.2% to 7.6%.

DOWNWARD REVISION TREND COULD ACCELERATE

Logically, given the link between economic growth and earnings growth, declining macro forecasts have pushed equity specialists to significantly lower their EPS targets for 2019. Since the beginning of the year, in the space of just a few weeks, the consensus has changed from 7.7% to 5% growth in EPS. The consensus is now expecting negative growth of -1.7% year-on-year in Q1 2019, the first quarter of decline since Q2 2016. However, we believe that the earnings growth consensus is still far too optimistic and disconnected from the actual macroeconomic environment. How can you justify an increase in sales and profits in a slowing economic cycle? How can you explain an expansion of margins with financing costs and wages increasing?

There are other more technical arguments that advocate for the continuation of EPS downward revisions. First of all, we observe a seasonal pattern of revisions: analysts generally wait to have the final figures of the previous fiscal year, as well as those of the first quarter of the current year, before significantly revising their target price. Growth expectations are generally high at the beginning of the year and begin to be sharply downgraded during Q2. Secondly, according to Societe Generale's research, it appears that at the end of the cycle, financial experts first lower the fair value of stocks by increasing the weighted average cost of capital (WACC) then further degrade their estimates to reflect deteriorating growth prospects. This is at least what happened in 2001 and 2008. We observe that in 2018 analysts have indeed increased the WACC.

MACRO HEADWINDS ARE PLENTIFUL

Who is right - economists or equity analysts? There are many reasons why economic experts are pessimistic, and although they can't boast a record of the most accurate predictions, our observations make us lean toward their side. Domestic macroeconomic factors likely to weigh on US earnings prospects are numerous: the strength of the US dollar, the loss of confidence due to uncertainties concerning the US-China trade war, the negative fallout from the US government shutdown and the reduction of money supply. Earnings guidance for US corporates already reflect a slowdown in profit growth (or even a decline) and a drop in margins. International conditions are just as worrying, especially with the rapid deterioration of world trade, the slowdown in Chinese growth, and the euro zone teetering dangerously close to a recession. The negative impact of the deterioration in global economic conditions can be seen Q4 2018 results: US companies with the highest international exposure suffer more than those that are less exposed (EPS: 8.4% versus 16.6%; sales: 6.7% versus 7.2%).

"Who is right - economists or equity analysts?"

BOTTOM LINE

Given the economic context and the technical factors mentioned, and noting the severity and magnitude of downward revisions in recent months, we would not be surprised to see earnings growth remain in negative territory in Q2 and Q3, implying a possible earnings recession (two consecutive quarters of negative annual EPS growth). Be that as it may, the inflection and acceleration of earnings growth to 9% expected in Q4 appears to us to be highly unlikely. Without further support from central banks, investors may well be disappointed with the loss of consensus optimism and become risk-averse again. Unless, while the narrative of synchronised growth evolves into a global slowdown, even after 10 years of excessive support, central banks do rush again to the rescue of investors.

[1] Factset data, median of sector estimates (GICS Industry Groups, S&P 500 for US equitie, MSCI Europe for European equities). US figures excluding financials ; European figures excluding financials, energy and materials
[2] The NY Fed's 12-month recession probability indicator has risen from 14% to 23% since November 2018

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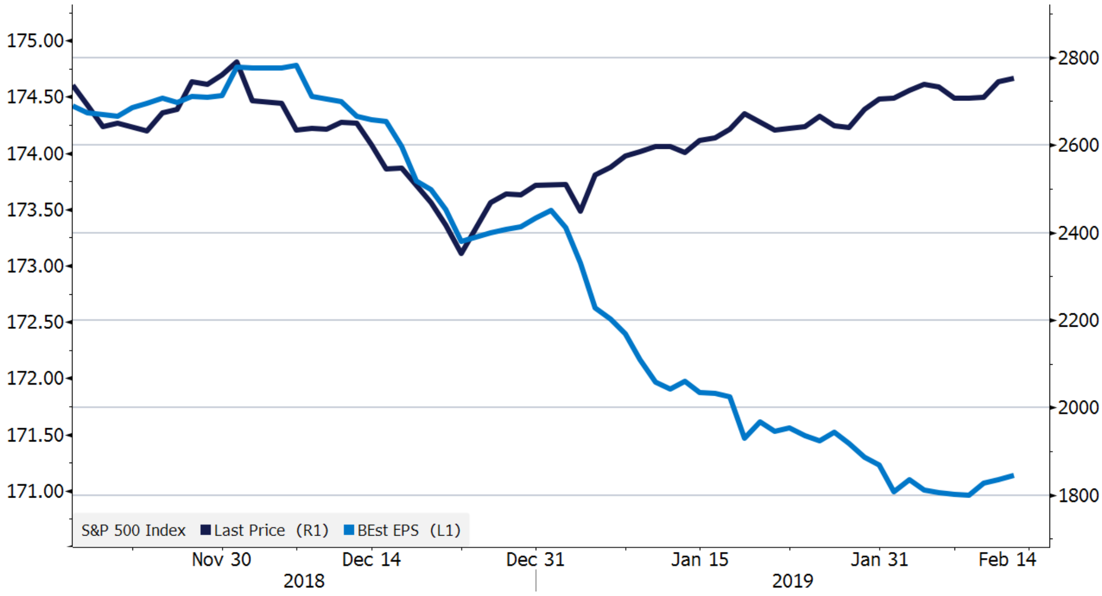
EXHIBIT 1: THE MARKET RALLIED DESPITE NEGATIVE EPS MOMENTUM



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