Market Bulletin

April 12, 2019

1Q19 Earnings: Is the party almost over?

- Markets have bounced back nicely in 2019 after a volatile December, but this bounce has been driven almost entirely by multiple expansion.
- Earnings revisions have moved sharply lower, causing 1Q19 estimates to fall into negative territory. That said, estimates have likely fallen too far.
- The financial and healthcare sectors are expected to see positive earnings growth, while globally exposed sectors should struggle due to slower global growth and a stronger U.S. dollar. Meanwhile, lower oil prices compared to a year ago should weigh on energy sector profits.
- With effective tax rates now similar on a year-over-year basis, margins are no longer getting the artificial boost they did in 2018, and are expected to contract year-over-year due to rising wages and input costs.
- We prefer large cap over small cap, and cyclical value sectors that provide income and a more balanced total return profile.

David M. Lebovitz
Global Market Strategist

Tyler J. Voigt
Market Analyst

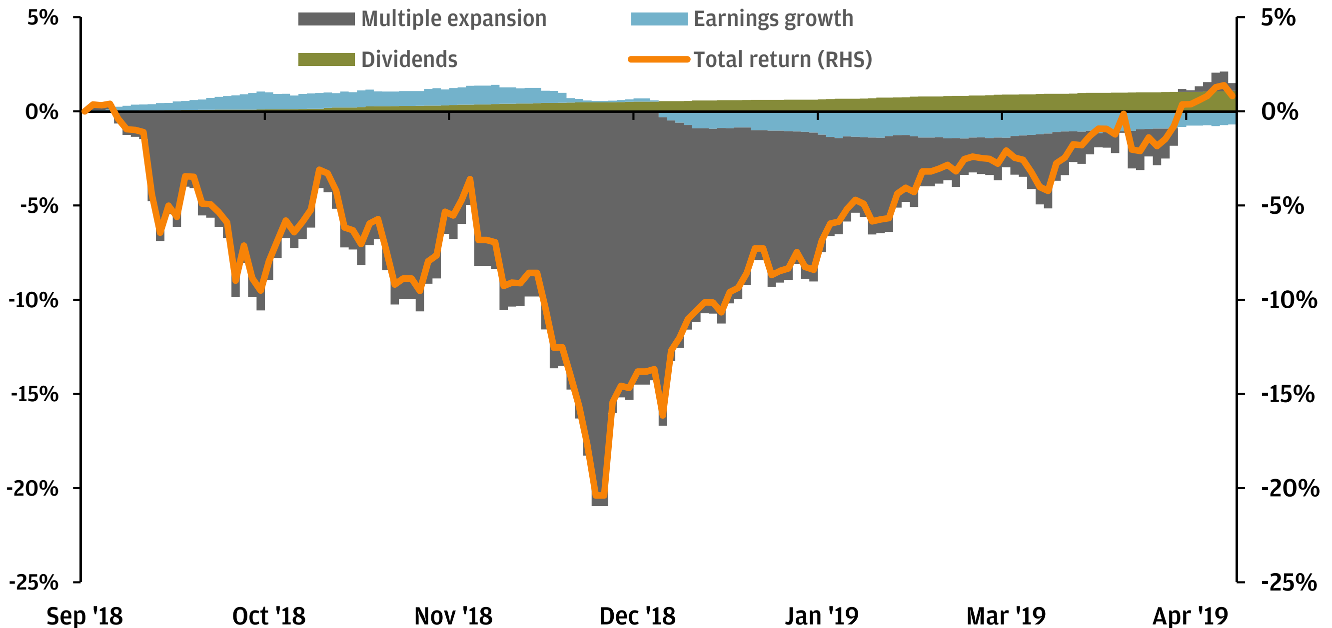
The round-trip flight

The S&P 500 has risen 15.9% so far this year, putting the index on pace to return 70.1% in 2019. While solid returns to start the year were expected given the sell-off in December, trees do not grow to the sky, and it seems unlikely that this annualized return will be achieved. Furthermore, despite the fact that the Federal Reserve (Fed) has paused its interest rate hiking campaign, better data out of China (in the form of the March PMIs) suggests that global growth may accelerate in the coming months, allowing long-term interest rates to move higher. If this is the case, it will limit the extent to which multiples can rise.

The reason why this is important is highlighted in **Exhibit 1**, which decomposes the S&P 500's return from the end of 3Q18 through the end of 1Q19 into earnings

growth, multiple expansion and dividends. Valuations led the market lower in December, and then rebounded back to average levels earlier this year as concerns over the trajectory of global growth began to fade.

EXHIBIT 1: THE BOOM AND THE BUST WERE DRIVEN BY VALUATIONS
Cumulative total return since 9/30/18 broken into earnings, multiples and dividends



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

However, the extreme pessimism that took over markets at the end of last year was not entirely unwarranted, as U.S. economic growth was softening at a time when growth in the rest of the world was already subpar. This dynamic led earnings estimates to move lower over the course of the first quarter; not only have these revisions been negative and broad-based, but also there has been a clear downward trend in corporate guidance during the past few months.

While any extended period of negative earnings growth would pose a threat to the current expansion, declining earnings estimates can actually help the stock market move higher, as lowering expectations makes beating those expectations that much easier. At the current juncture it seems like earnings estimates may have declined too far, and while consensus is looking for negative earnings growth from a year prior, our view is not quite as downbeat.

That said, earnings will be key in determining where we go from here. Lingering uncertainty around the trajectory of policy and growth will weigh on multiples over the long run, even if a temporary pause at the Fed allows them to move higher in the near term. As such, any sustainable upside in markets from current levels will need to be driven by earnings, which look set to grow between 3% and 5% for 2019 as a whole.

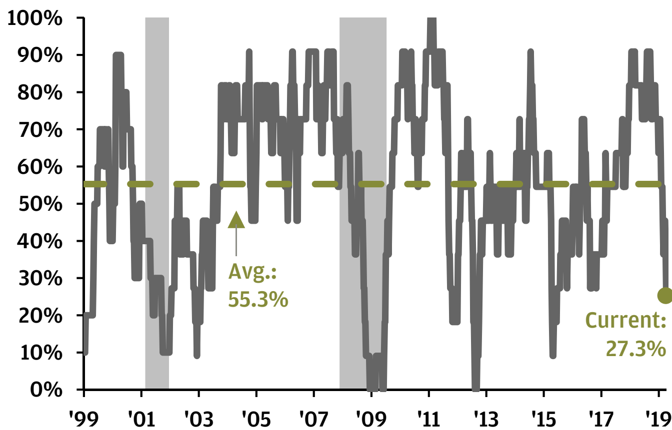
The earnings party takes a pause

One characteristic of the current earnings season has been the unrelenting downward bias to estimates and guidance over the past few weeks. 1Q19 revisions have moved sharply lower since the beginning of the year,

falling roughly -7.8% compared to the typical path of revisions falling -3.3% over the same time period during this cycle **(Exhibit 3)**. Furthermore, and as shown in **Exhibit 2**, the share of S&P 500 sectors with positive net earnings revisions is just below 30%, a level that has historically coincided with periods of economic stress or recession.

EXHIBIT 2: EARNINGS REVISIONS HAVE HAD A CLEAR DOWNWARD BIAS

% of GICS sectors with positive net earnings revisions



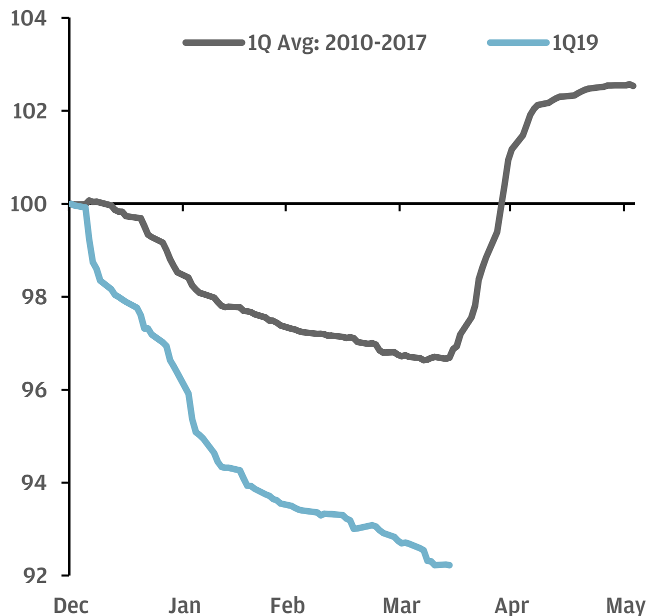
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

Consensus estimates for negative earnings growth against a backdrop of dwindling positive revisions suggests that the current earnings season may prove to be challenging for investors. Indeed, only two sectors – health care and financials – are expected to see meaningful earnings growth; estimates across the other nine sectors are flat or negative. That said, given that analysts tend to be overly pessimistic on quarterly profits by the time an earnings season begins, we believe that aggregate 1Q19 S&P 500 earnings growth will finish in positive territory when all is said and done.

Despite the sharp drop in yields over the past few months, it appears financials still saw positive earnings growth in the first quarter. Continued tightening in the labor market has allowed consumer finance companies to hold up relatively well, but a flatter yield curve and extreme volatility in capital markets at the end of last year likely offset some of this strength. Furthermore, health care companies are expected to see positive earnings growth due to solid revenue growth and margin expansion, with health care providers and biotech firms projected to see the best results. To an extent, this is a function of robust mergers and acquisitions activity in the sector, which has led to favorable year-over-year comparisons.

EXHIBIT 3: FIRST QUARTER ESTIMATES FEEL OVERLY PESSIMISTIC

Indexed to 100 on 12/31 of the prior year



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

The more globally exposed sectors look set to struggle, as a slower pace of global economic expansion and a 6.1% y/y increase in the U.S. dollar during the first quarter weighed on revenue growth across the board. Profits in the technology sector were hampered by weakness in semiconductors and hardware, a trend that is validated by the softer economic growth seen in emerging market Asia during 1Q. That said, software, communications equipment and IT services are all expected to see positive earnings growth,

reflecting a shift in capital spending toward smaller-ticket items given broader policy uncertainty.

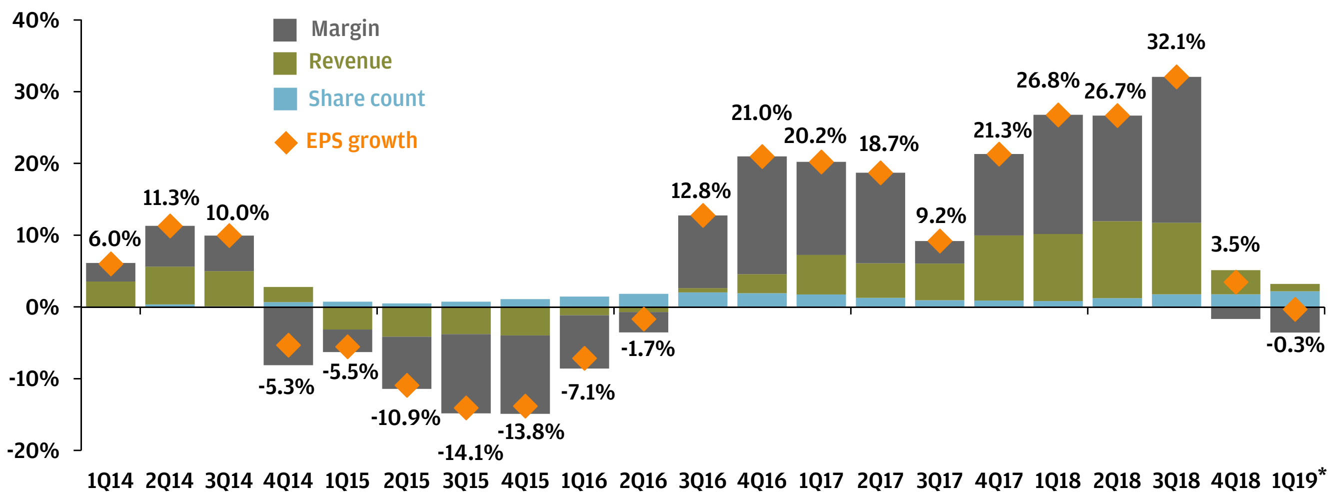
Energy sector profits look set to come in lower than a year ago, as 1Q18 was a particularly good quarter for energy companies and average WTI prices are down 13.1% y/y in the first quarter. Specifically, exploration and production, refining and oilfield services companies look set to struggle, but storage and transportation – businesses that are more agnostic to oil prices – should be a bright spot.

Much ado about margins

Although 1Q19 earnings growth looks set to be a bit tepid, margins should show some signs of improvement following the accounting issues that led to a 2%-pt decline during the fourth quarter. That said, we still expect margins to decline on a year-over-year basis, and believe that they will remain under pressure for the better part of 2019. Wages and other input costs continue to rise and, at the same time, pricing power remains muted, thereby limiting the ability for margins to expand. It is also important to note, as shown in **Exhibit 4**, that the majority of the benefit from tax reform showed up in margins last year; with comparisons now apples-to-apples in terms of the effective tax rate, this tailwind has become nothing more than a light breeze.

EXHIBIT 4: THE BENEFIT FROM TAX REFORM SHOWED UP IN MARGINS

Quarterly growth broken into revenue, changes in profit margin and changes in share count



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
EPS levels are based on quarterly operating earnings per share. Percentages may not sum due to rounding. Past performance is not indicative of future returns.
.*1Q19 earnings are calculated using actual earnings for 4.5% of S&P 500 market cap and earnings estimates for the remaining companies. Data are as of April 12, 2019.

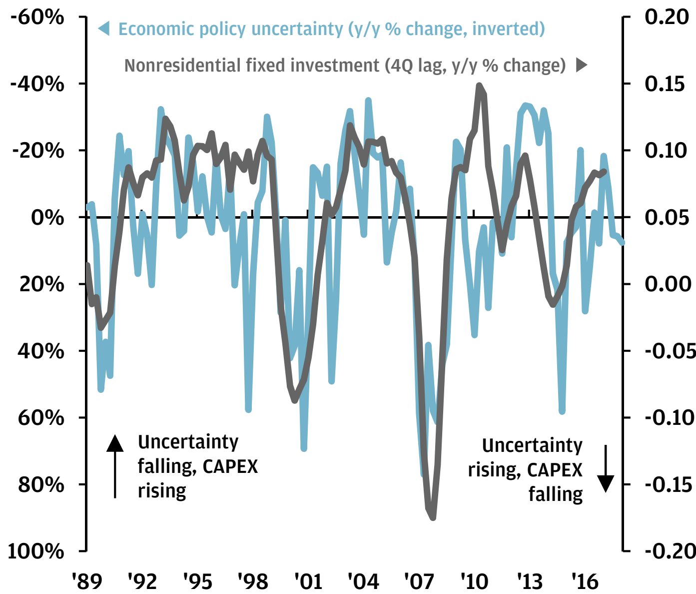
A lack of pricing power and slowdown in revenue growth during the first quarter is directly related to broader issues facing the global economy. There has been a significant divergence between manufacturing and services, with the former deteriorating much more than the latter; using purchasing manager index (PMI) data as a proxy, the spread between the two is nearly 2 standard deviations away from its long-term average.

This weakness in manufacturing has been driven by a combination of short-term headwinds and longer-term uncertainty. The majority of the deceleration in manufacturing activity has stemmed from Europe, as auto plants were forced to retool their emissions equipment and adhere to new emissions standards in 2018. That said, recent data on eurozone industrial production suggest that some of these headwinds may be beginning to fade, and

better numbers out of China could help provide an additional short-term boost. On the other hand, however, uncertainty remains elevated, which will continue to hold back a broader rebound in business spending and manufacturing.

EXHIBIT 5: MANUFACTURING IS BEING HELD BACK BY UNCERTAINTY

Economic policy uncertainty index, nonresidential fixed investment, year-over-year % change



Source: Baker, Bloom & Davis, BEA, FactSet, J.P. Morgan Asset Management. Data are as of April 12, 2019.

While it feels like progress is being made on U.S.-China trade, and a clearer timetable for Brexit has evolved, uncertainty around the broader trajectory of global growth will continue to weigh on capital spending **(Exhibit 5)**.

Resolution on some of these issues could ignite animal spirits, but that seems a bit unlikely at the current juncture. Rather, the gap between manufacturing and services should gradually close, leading global growth to realign with its longer-term trend. While this would be a positive development, it would not materially change the outlook for pricing power or margins.

Investment implications

With the S&P 500 up over 15% so far this year, but risks to earnings tilted to the downside and multiples unlikely to sustainably expand beyond their current levels, the medium-term outlook for equities has darkened. That said, equities continue to look attractive relative to fixed income, and could very well move higher in the short-term given firmer economic data and a Fed on hold. In the current environment, we maintain a preference for large caps over small caps, and value over growth.

Within value, we are hesitant to fully embrace defensive sectors like consumer staples and utilities. Although both of these sectors generate healthy streams of income, the 10-year Treasury yield looks set to grind higher over the coming months; this should be a headwind for these sectors given their negative interest rate sensitivity, leading us to maintain our preference for financials, industrials, energy and materials. These sectors offer some incremental yield above and beyond that of the S&P 500, but do not have the same negative relationship with changes in interest rates. Thus, given our expectation that volatility will pick up over the remainder of the year, we believe that focusing on cyclical value and "bubble wrapping" portfolios remains the best approach for long-term investors.

For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own professional advisers, if any investment mentioned herein is believed to be suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not reliable indicators of current and future results.

J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide.

To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our Company's Privacy Policy. For further information regarding our regional privacy policies please refer to the EMEA Privacy Policy; for locational Asia Pacific privacy policies, please click on the respective links: Hong Kong Privacy Policy, Australia Privacy Policy, Taiwan Privacy Policy, Japan Privacy Policy and Singapore Privacy Policy.

This communication is issued by the following entities: in the United Kingdom by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions by JPMorgan Asset Management (Europe) S.à r.l.; in Hong Kong by JF Asset Management Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited; in Singapore by JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), or JPMorgan Asset Management Real Assets (Singapore) Pte Ltd (Co. Reg. No. 201120355E); in Taiwan by JPMorgan Asset Management (Taiwan) Limited; in Japan by JPMorgan Asset Management (Japan) Limited which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Cth) by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919); in Brazil by Banco J.P. Morgan S.A.; in Canada for institutional clients' use only by JPMorgan Asset Management (Canada) Inc., and in the United States by JPMorgan Distribution Services Inc. and J.P. Morgan Institutional Investments, Inc., both members of FINRA; and J.P. Morgan Investment Management Inc.

In APAC, distribution is for Hong Kong, Taiwan, Japan and Singapore. For all other countries in APAC, to intended recipients only.

Copyright 2019 JPMorgan Chase & Co. All rights reserved.

MI-MB_1Q19 EarningsBulletin
0903c02a825727f1

J.P.Morgan
Asset Management