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# High Expectations Meet High Earnings

## Key Takeaways

**Earnings Matter:** Corporate earnings periods are full of news about companies that exceeded, met, or disappointed relative to expectations. On a macro basis, we expect "good news" for earnings. Listening to CEOs, we hear that more large US firms are optimistic about their 2024 outlook. We find the confidence measure to be correlated with EPS surprises. This might not please investors in some highly valued and interest-rate sensitive shares. However, we see improving earnings "breadth" as a key market dynamic in 2024.

**First Quarter Earnings Matter**: Earnings season is back in full swing, and we expect Q1 S&P 500 earnings per share (EPS) to beat current estimates by 6%. We had earlier revised our full year EPS estimates upward to 8% from 6% previously and we remain convinced that there will be improved earnings breadth this year.

**Banks Take the Lead:** Banks have outperformed the S&P 500 over a trailing 1-, 3-, 6-, and 12-month basis. On a top-down basis, an improving economic picture typically bodes well for this economically sensitive sector. Financials have historically been the best performing sector in the 12 months after ISM Manufacturing tops 50, which it did on April 1st. The highest quality banks are, for now, likely to maintain their steady cadence of dividend increases while boosting buybacks.

## Potential Portfolio Implications

When markets have rallied hard, as they have over the last six months (the S&P 500 is +25% since the October 2023 lows ), it is natural to wonder if the good news is sustainable. While it is unlikely such heady gains are repeatable, we believe there is good earnings data ahead. When fundamentals live up to expectations, markets can maintain and grow value.

**AI Broadens Out:** Listen for a continuation of AI-related hype. With leading AI winners in the tech sector posting parabolic gains, investors have been looking for other ways to play the AI theme. Expect executives at leading energy, utilities, and electrical equipment companies to reference their own AI strategies. AI topics have evolved from chips to drive demand for computational power to power itself. The energy and electricity capacity needed to power data centers that enable AI computing will receive great attention.

[1] Source: Bloomberg, data representing performance between October 31, 2023, through April 5, 2024.

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# High Expectations Meet High Earnings

The first week of April was a choppy one for markets as investors contended with a deluge of macro data, geopolitical headlines and too many Fed speakers. Stocks ended the week roughly 1% lower while 10-year Treasury yields rose 19 basis points and West Texas Intermediate (WTI) crude oil prices rallied almost 5%.

This week's US economic data confirmed the improving manufacturing picture, culminating with a stronger-than-expected jobs report on Friday. March employment grew by 303,000, well above consensus expectations for 214,000. Q1 2024 employment gains have averaged 276,000, a re-acceleration relative to the second half of 2023. The strong payrolls numbers coupled with a slight up-tick in average hours worked should modestly accelerate consumption growth in the current quarter and beyond. The unemployment rate ticked down slightly to 3.8% in the month, as a sizable swing higher in the household survey helped bring the two metrics in alignment.

With sustained employment growth, the entire decision about when to begin easing will focus on the inflation rate, economic growth, and productivity. Markets have currently priced in a 60% probability of a rate cut by the June meeting, but that will likely be updated next week with the release of March CPI data. We will be listening closely to Chair Powell, who continues to reiterate the view that a resumption of disinflation this Spring should keep rate cuts on track later this year.

Investors are also contending with ongoing geopolitical risks and events. Presumed Israeli strikes on the Iranian consulate in Syria have also sparked concerns over a response by Iran or one of its proxies, driving oil prices higher amid a heightened geopolitical risk premium. Meanwhile, an earthquake in Taiwan reminded investors that China is not the only major risk facing the island.

## Earning Matters

When markets have rallied hard, as they have over the last six months (+25% since the October 2023 lows), it is natural to wonder if the good news is sustainable. While it is unlikely such heady gains are repeatable, we believe there is good earnings data ahead. When fundamentals live up to expectations, markets can maintain and grow value.

Corporate earnings periods are full of news about companies that exceeded, met, or disappointed relative to expectations. On a macro basis, we expect "good news" for earnings. Since 1997, the net positive results from first quarter earnings have been sequentially better than fourth quarter results 81% of the time. For this quarter, we **expect S&P 500 EPS to beat current estimates by more than 6%.** That is after a 4.2% beat in Q42023.

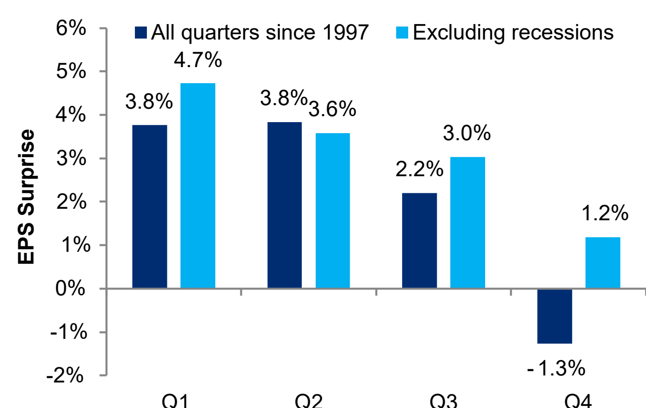
We believe many companies have embedded weakness in the final quarters of calendar years. This keeps investors focused on future growth opportunities (see **FIGURE 1**). The bar for earnings, in general, is not high. Since 1997, the overall S&P 500 has posted a stronger level of EPS than consensus estimates in 81% of all quarters.

Analysts are the proverbial "easy graders" when it comes to setting quarterly expectations. Individual firms beat research analyst estimates in about 70% of all cases. And *"amazingly,"* since 2009, the S&P 500 has seen EPS fall short of consensus in only two quarters (3% of cases).

Listening to CEOs, we hear that more large US firms are optimistic about their 2024 outlook. The Business Roundtable CEO Confidence Index jumped 11 percentage points in the '24 first quarter (see **FIGURE 2**). Survey data for 1Q shows an improving breadth of industrial activity with US manufacturing in expansion for the first time since late 2022.

We find the confidence measure to be correlated with EPS surprises. This might not please investors in some highly valued and interest-rate sensitive shares. However, we see improving earnings "breadth" as a key market dynamic in 2024.

**FIGURE 1**: Strong Upward Bias in S&P 500 1Q EPS Surprises (Aggregate EPS vs End-of-Quarter Consensus)




Source: LSEG I/B/E/S, Factset as of April 5, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results**. Real results may vary.

**FIGURE 2**: Business Roundtable CEO Confidence Index

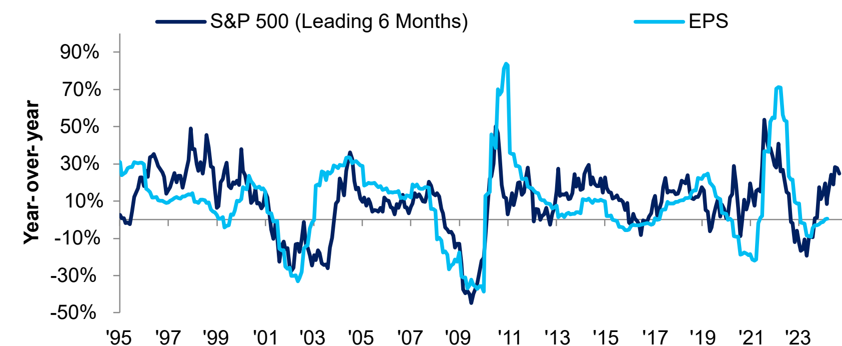
Source: Haver as of April 5, 2024

## Of Course, Future Equity Performance is Not Guaranteed

The US equity market is signaling a strong gain in EPS in the coming six months. As we wrote in our Wealth Outlook 2024, the slowing we expect in 2024 is for *employment gains*, not profits. Yet after a 23.5% total return for the S&P 500 over the course of 6 months, short-term gains for the S&P 500 may require even greater positives surprises (please see our latest bulletin).

Trying to support US managements' usually ambitious multi-year guidance, analysts tend to inflate future EPS growth projections even as they mark down their near-term ones. Analysts now forecast a 9.7% EPS gain for the S&P 500 in 2024, higher that our +7.7% estimate of a 7.7%. Their forecasts for the second half 2024 look like a stretch to us (see **FIGURE 3**).

**FIGURE 3**: S&P 500 (Leading 6 months) vs EPS Year over Year %



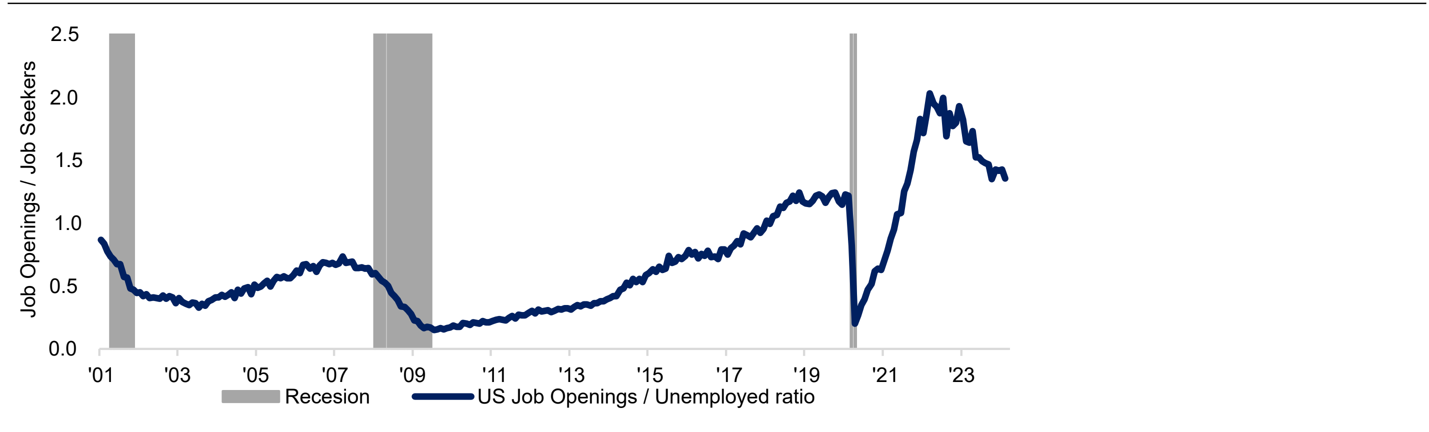

Source: Factset as of April 5, 2024. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results**. Real results may vary.

## Watch Inflation Data, Not Jobs

Strong manufacturing data in the US has generated concerns that the Fed will not pivot from its restrictive monetary policy. At one point this year, US interest rate markets embedded about 7 rate cuts of 25 basis points during 2024. Today, short-term interest rate products price in just 2-3 easing steps.

We would expect core inflation measures to moderate again in coming quarters. There has been a 3.4 million drop in unfilled job openings since a peak in early 2022 (see **FIGURE 4**). In short, we think higher employment and lower inflation are possible, though there is more risk for Treasuries given the hotter employment data from Q1.

**FIGURE 4:** Powell's "Rebalancing" - Falling Job Openings Per Job Seeker




Source: Haver as of April 5, 2024.

# The Insider's Guide to Q1 Earnings Season

## First, the Big Banks

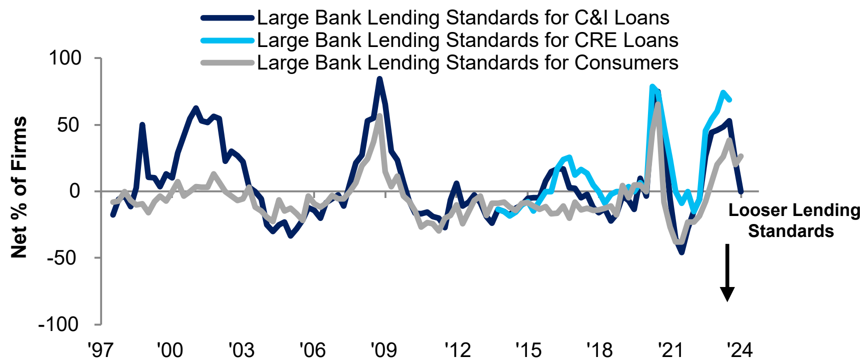
Big banks in the US kick-off earnings season this coming week (April 12th). Banks have outperformed the S&P 500 over a trailing 1-, 3-, 6-, and 12-month basis. Investors will be looking for evidence of a fundamental improvement in bank profitability. Initial indications point to a more upbeat tone from the big banks (we, of course, make no comment on our own firm).

In February, senior loan officers at large banks signaled some accommodation in lending standards for corporate loans after several quarters of net tightening (see **FIGURE 5)**. Loans to consumers and commercial real estate, however, remain constrained. Regional banks, many of whom are managing more challenging loan books, have also kept tight reigns on additional lending. While bank analysts look at interest rates and the yield curve to assess net interest margins, a pickup in aggregate lending is foundational if the recent bank rally is to be sustained.

On a top-down basis, an improving economic picture typically bodes well for this economically sensitive sector. Financials have historically been the best performing sector in the 12 months after ISM Manufacturing tops 50, which it did on April 1st.

Even though more onerous capital requirements are likely after the elections, the highest quality banks are likely to sustain their cadence of dividend increases while boosting share buybacks.

**FIGURE 5**: Early signs large banks are easing lending standards




Source: Haver as of April 5, 2024. C&I stands for commercial & industrial businesses. CRE stands for commercial real estate. **Past performance is no guarantee of future results**. Real results may vary.

## Health Care Runs a Political Fever

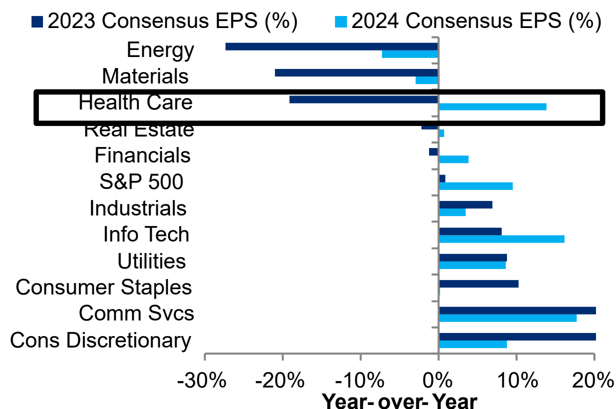
Among the 11 major market sectors, Health Care is likely to demonstrate the strongest improvement in EPS growth this year (see **FIGURE 6**). Earnings revisions relative to poor 2023 results are optimistic (see **FIGURE 7**).

But there are political headwinds. The annual final rate announcement for Medicare Advantage plans is usually a sleepy affair for all but the most in-the-weeds health care analysts. But this year's release, on April 1st, came as a big disappointment to managed care stocks as final rates were not revised higher despite rising costs and heightening utilization of medical insurance. Few investors expected this outcome, but it is a sign of the politics surrounding the 2024 elections.

As we recently highlighted in our latest equity piece on Healthcare, presidential years bring heightened uncertainty for big pharma and health care providers. In contrast, MedTech and biotech have historically outperformed in election years. While political noise is surely going to grow in '24, we expect Q1 reporting season will refocus investors on fundamentals, where a broad recovery is healthcare is likely to be supported by earnings.

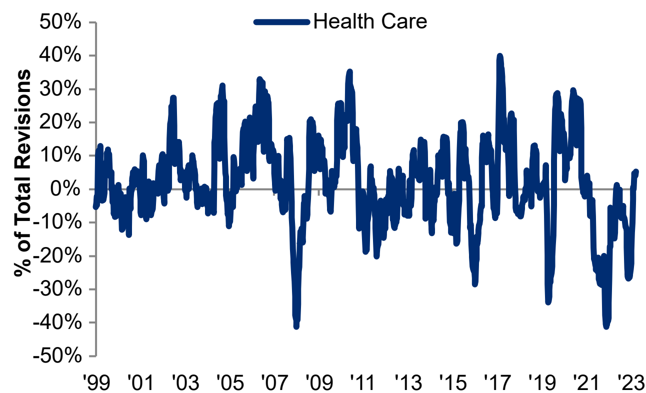
We remain in favor of MedTech stocks which should benefit from receding concerns associated with anti-obesity drugs (GLP-1s), greater medical procedure volumes as well as an upcycle in new product pipelines.

**FIGURE 6**: Big swing expected for Health Care EPS




Source: Bloomberg as of April 5, 2024. Sectors proxied using S&P 500 Sectors (Level 2). Box highlights Health Care sector, which is expected to see the biggest change in growth from 2023 to 2024.

**FIGURE 7**: Health care analysts have upgraded their EPS estimates




Source: Factset as of April 5, 2024. Health Care proxied using S&P 500 Health Care Index.

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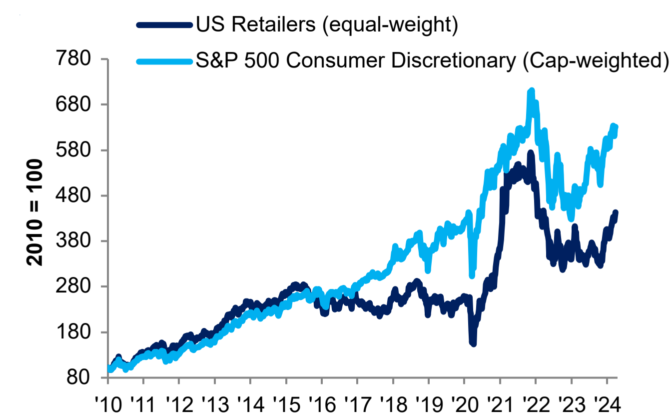
## A Look at the Consumer

Major retailers will round out Q1 earnings season in mid-May, providing investors with a real look at consumer spending patterns after a choppy start to the year. Even though an equal-weight index of US retailers looks ready to test 2021 highs if earnings and guidance beat expectations (see **FIGURE 8)**, there have been warnings issued by brand-name luxury and apparel firms suggesting that challenging consumer pockets exist.

Other challenges include firms who have strong ties to Chinese consumption. The way retail is evolving relative to consumer preferences will also be on display. Striking the right balance between direct-to-consumer and in-store sales has been a difficult tightrope to walk for many firms.

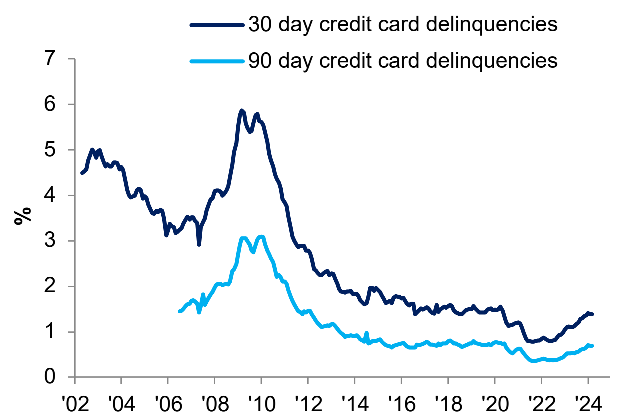
Bulls and bears have debated the macro data on consumption. In a recent CIO bulletin, we noted that household debt has *declined* as a share of GDP since 2010. While we expect job growth to slow, unemployment still remains low, supporting consumption. More pessimistic commentators have highlighted rising credit card delinquencies and falling savings rates, but a longer lookback suggests that delinquency rates remain in line with 2010-2020 averages (see **FIGURE 9**).

**FIGURE 8**: Average retailers are well off post-COVID highs




Source: Bloomberg as of April 5, 2024. Equal-weight US Retail index proxied using S&P Retail Select Industry Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results**. Real results may vary.

**FIGURE 9**: Credit card delinquencies are in line with pre-COVID levels

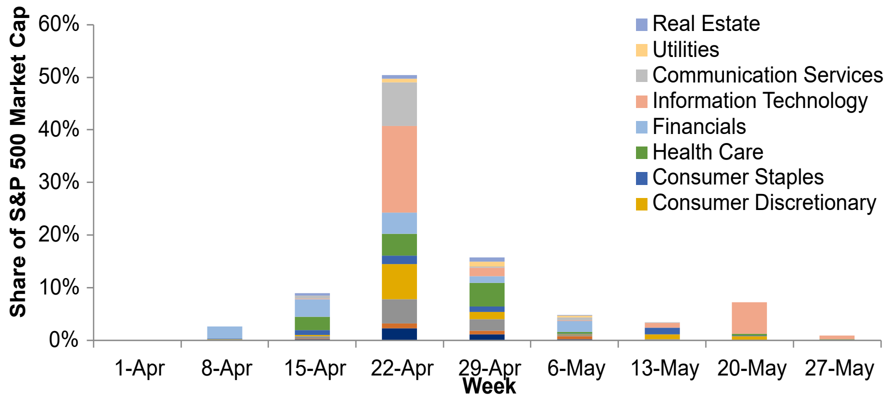



Source: Bloomberg as of April 5, 2024

## Everything, Everywhere, All the Time: Artificial Intelligence (AI)

Eighty percent of S&P 500 companies report between April 22nd and May 3rd. Over 50% of the "market cap" reports the week of April 22nd, including most mega-cap tech names (see **FIGURE 10**).

**FIGURE 10:** S&P 500 Q1 Earnings Season Calendar



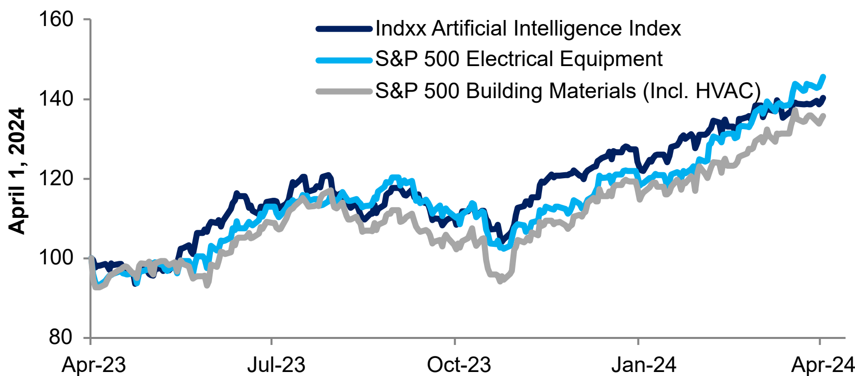

Source: Factset as of April 4, 2024. Indices are unmanaged. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. No assurances can be given that the future results indicated, whether expressed or implied, will be achieved. While sometimes presented with numerical specificity, any projections and estimates are based upon a variety of assumptions that may not be realized, and which are highly variable. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results**. Real results may vary.

Listen for a continuation of AI-related hype. With leading AI winners in the tech sector posting parabolic gains, investors have been looking for other ways to play the AI theme. Expect executives at leading energy, utilities, and electrical equipment companies to reference their own AI strategies.

AI topics have evolved from chips to drive demand for computational power to power itself. The energy and electricity capacity needed to power data centers that enable AI computing will receive great attention. The International Energy Agency (IEA) estimates that electricity consumption from data centers could double by 2026, fueled by growth in AI and cryptocurrency mining demand. (Electricity 2024 - Analysis and forecast to 2026 (windows.net)). This demand is real and apparent. The near-term increase in data center capacity has forced utilities to buy more natural gas to meet these needs.

The two main drivers of data center electricity demand are computing and cooling. Indeed, electrical and HVAC equipment manufacturers with ties to data center buildout have seen their share prices surge this year, keeping pace with AI tech leaders (see **FIGURE 11**). This is why we will hear much more about AI's earnings impact from electrical equipment, utilities, and oil & gas companies talking about beneficial tailwinds.

**FIGURE 11**: Electrical equipment and HVAC shares have kept pace with AI tech




Source: Bloomberg as of April 5, 2024. Electrical Equipment proxied using S&P 500 Electrical Equipment Index. Building Materials proxied using S&P 500 Building Materials Index. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees, or sales charges, which would lower performance. **Past performance is no guarantee of future results**. Real results may vary.

**Note to our readers**: there is a correction to last week's **FIGURE 2** which improperly sorted asset class returns for the 2020 decade to date. This has been corrected in the pdf link here.

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| Bond credit quality ratings | Rating agencies | | |
|---|---|---|---|
| **Credit risk** | **Moody's[1]** | **Standard and Poor's[2]** | **Fitch Rating[2]** |
| **Investment Grade** | | | |
| Highest quality | Aaa | AAA | AAA |
| High quality (very strong) | Aa | AA | AA |
| Upper medium grade (Strong) | A | A | A |
| Medium grade | Baa | BBB | BBB |
| **Not Investment Grade** | | | |
| Lower medium grade (somewhat speculative) | Ba | BB | BB |
| Low grade (speculative) | B | B | B |
| Poor quality (may default) | Caa | CCC | CCC |
| Most speculative | Ca | CC | CC |
| No interest being paid or bankruptcy petition filed | C | D | C |
| In default | C | D | D |

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
2 The rating from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standings within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

An investment in alternative investments can be highly illiquid, is speculative and not suitable for all investors. Investing in alternative investments is for experienced and sophisticated investors who are willing to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks may include:

- loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices;
- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
- complex tax structures and delays in tax reporting;
- less regulation and higher fees than mutual funds; and
- manager risk.

Individual funds will have specific risks related to their investment programs that will vary from fund to fund.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

Past performance is no guarantee of future results.

International investing entails greater risk, as well as greater potential rewards compared to US investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Factors affecting commodities generally, index components composed of futures contracts on nickel or copper, which are industrial metals, may be subject to a number of additional factors specific to industrial metals that might cause price volatility. These include changes in the level of industrial activity using industrial metals (including the availability of substitutes such as manmade or synthetic substitutes); disruptions in the supply chain, from mining to storage to smelting or refining; adjustments to inventory; variations in production costs, including storage, labor and energy costs; costs associated with regulatory compliance, including environmental regulations; and changes in industrial, government and consumer demand, both in individual consuming nations and internationally. Index components concentrated in futures contracts on agricultural products, including grains, may be subject to a number of additional factors specific to agricultural products that might cause price volatility. These include weather conditions, including floods, drought and freezing conditions; changes in government policies; planting decisions; and changes in demand for agricultural products, both with end users and as inputs into various industries.

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Diversification does not guarantee a profit or protect against loss. Different asset classes present different risks.

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