Sector Intellect

Trend Analysis – Q4 S&P 500 Earnings

February 16, 2017

Lindsey Bell
Investment Strategist
lindsey.bell@cfraresearch.com

Q4 Earnings Average, At Best

Plus, Despite Typically Downbeat Guidance, FY17 Earnings Growth Is Stable

One might assume it was an exceptional fourth-quarter reporting period given the 4.9% advance the S&P 500 index recorded year-to-date. However, we would describe the fourth quarter earnings season only as average, at best. The number of companies beating consensus estimates is in line with the historic average of 66%. Growth has trended better than initial projections, which is standard, but the 157 basis point (bps) improvement is much weaker than the historic increase of 300 to 400 bps. It's also weaker than the 350 bps and 490 bps of outperformance recorded in the respective second and third quarters of 2016. Revenue growth is slightly better than expectations, but not as many companies beat as is typical.

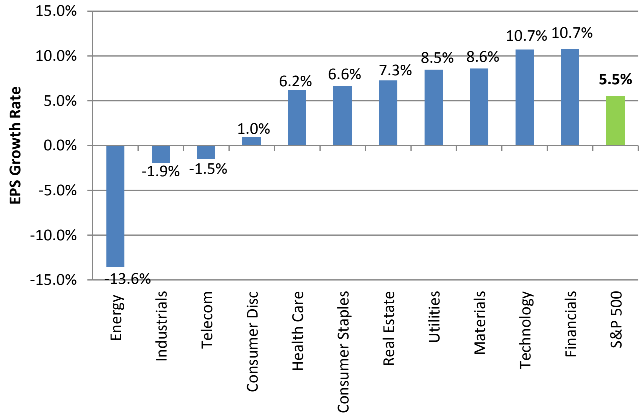
Just over 75% of the index has reported to date. Notably, this is the second consecutive quarter the S&P 500 has reported an increase in growth, after four quarters of declines. Additionally, growth of 5.5% is the highest rate of earnings growth since the fourth quarter of 2014, but only 150 bps better than the 4.0% of Q3.

Cyclical sectors, including financials, information technology, and materials lead earnings growth. It's clear the technology sector, which has increased 8.6% since the start of the year, is benefiting from a very strong quarter. Earnings growth of 10.71% year-over-year is the second quarter in a row for double-digit growth from the sector, an event that hasn't been recorded since 2012. Only financials have slightly better growth at 10.72%. Materials have the third best growth at 8.6%.

Telecommunications and financials are the only sectors with growth tracking lower than initial estimates. Telecommunication companies are at war for subscribers and Verizon is losing share, which affected its own earnings and guidance, as well as the sector's, because of its significant weight in the group. The financials were expected to have close to 16% growth before AIG announced an increase in reserves related to the commercial insurance segment. Again, the weight of the company had a significant impact on the sector and index.

Energy once again is weighing on the index with a 13.6% decline year-over-year, the worst of all eleven sectors. Despite West Texas Intermediate (WTI) oil prices remaining steadily above $50 per barrel since the start of the year, earnings results from some of the majors have not been very strong. That being said, the growth decline is in an improvement from the 67.5% decline in Q3 and the 86.1% decline in Q2.

Chart 1: S&P 500 Q4 EPS Growth by Sector



Source: S&P Capital IQ. Q4 2016 data is based on a blended growth rate.

Chart 2: Q4 EPS and Revenue Beats / Misses by Sector

Sectors	% with EPS & Revenue Beats	4Q'16 EPS Mix: Beat	4Q'16 EPS Mix: Inline	4Q'16 EPS Mix: Miss	4Q'16 Revenue Mix: Beat	4Q'16 Revenue Mix: Inline	4Q'16 Revenue Mix: Miss	% of Sector Reported
Consumer Discretionary	38%	36	5	12	26		27	61.6%
Consumer Staples	21%	16	3	10	9		20	78.4%
Energy	14%	6	13	2	11		10	58.3%
Financials	37%	48	5	7	27	1	32	95.2%
Healthcare	48%	35	5	6	25		21	76.7%
Industrials	35%	36	7	17	31		29	87.0%
Information Technology	57%	46	7	3	36		20	83.6%
Materials	35%	12	3	5	10		10	80.0%
Telecommunication Services	0%	1	1	2	1		3	80.0%
Utilities	20%	5	1	4	3		7	35.7%
Real Estate	**40%**	**11**	**1**	**8**	**10**		**10**	69.0%
S&P 500	38%	252	51	76	189	1	189	75.0%

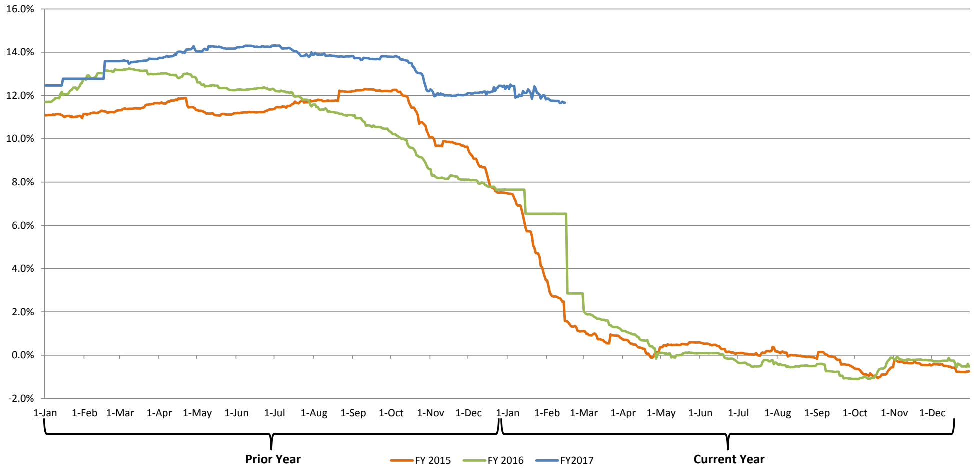
Source: S&P Capital IQ.

Looking forward to 2017, earnings growth estimates have contracted slightly to 10.9% from 11.8% at the start of the year. We find this trend a bit concerning considering historical patterns and the risks that remain in the market. In the last two years, growth was reduced by about 3 percentage points from the start of the year until now and by nearly 7 percentage points from the start of December to now. That's much higher than the approximate one percentage point reduction for FY17 thus far. Additionally, guidance for the first quarter has been consistent with the pessimistic historical average – 66% of those companies offering first quarter guidance have provided guidance below the consensus estimate.

The largest risk likely resides in the third and fourth quarter estimates as the consensus for those quarters hasn't moved much. The market and analysts are seemingly pricing in lofty benefits from President Trump's potential policies on tax reform, infrastructure spending, repatriation and deregulation, which has prevented analysts from adjusting estimates further downward. We are also concerned the market may be ignoring any negative consequences that could come from immigration, trade or protectionist policies.

Trading at 18.0x the forward twelve month's earnings, the S&P 500 is already priced at a premium valuation. This is especially true when considering that inflation is rising (January CPI increased 2.3% year-over-year, excluding food and auto), a trend that is expected to continue to rise throughout the year. As such, it will be important to follow the trajectory of earnings growth over the course of the year.

Chart 3: Trajectories of Annual EPS Growth Estimates for 2015, 2016 and 2017



Source: CFRA Research.

Disclosure