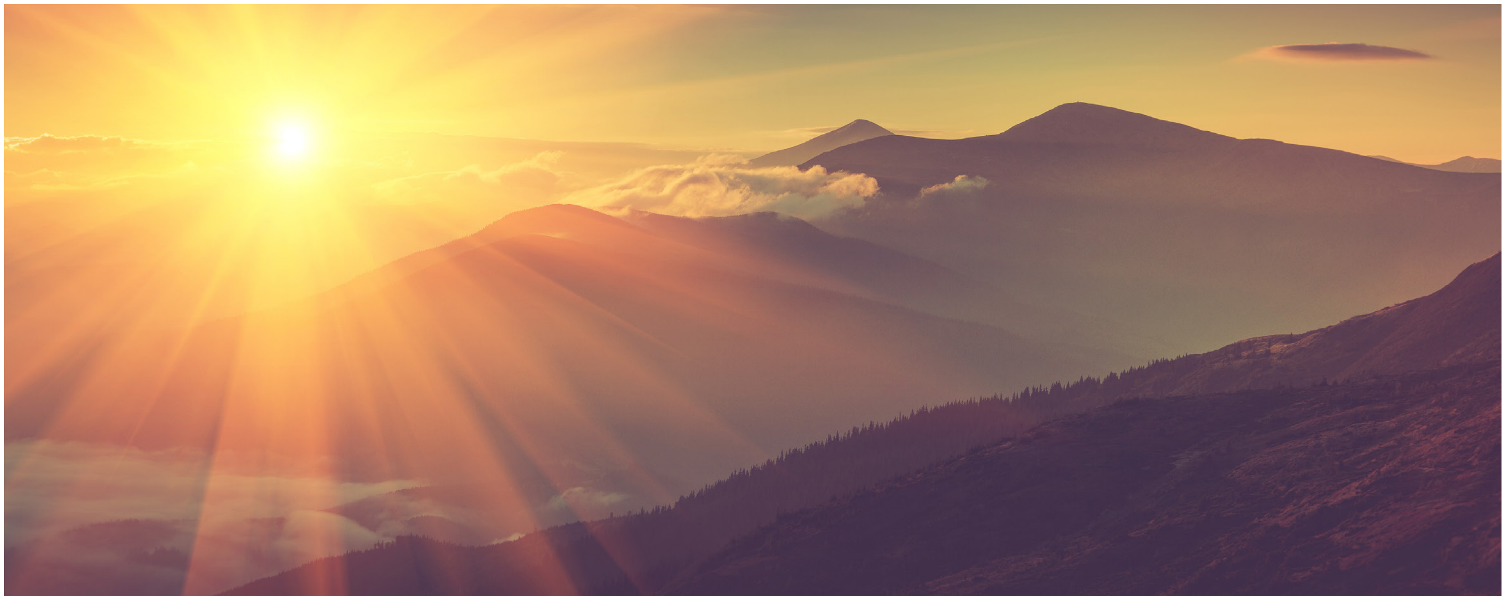

March 2023 | Market Perspective

Earnings Watch

Lowered Profit Forecasts Are Too Optimistic

Q4 earnings revealed analysts are underestimating the impact of deteriorating business conditions on corporate profits.

GLOBAL GROWTH EQUITY

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KEY TAKEAWAYS

- Profit margins narrowed, suggesting companies may be nearing the limit on their ability to pass through higher costs.
- Management comments reflected slowing business conditions and maneuvering to adapt to rising costs and softening demand.
- Elevated valuations could spur volatility if companies underperform expectations or events sow doubt about future earnings.

The latest round of earnings reports reflected worsening business conditions as 2022 wound down. Profit growth in the U.S. decelerated for the third consecutive quarter and turned negative for the first time since 2020. Overall, U.S. earnings fell -4.7%, while European profit growth slowed but finished in positive territory at 1%.[1]

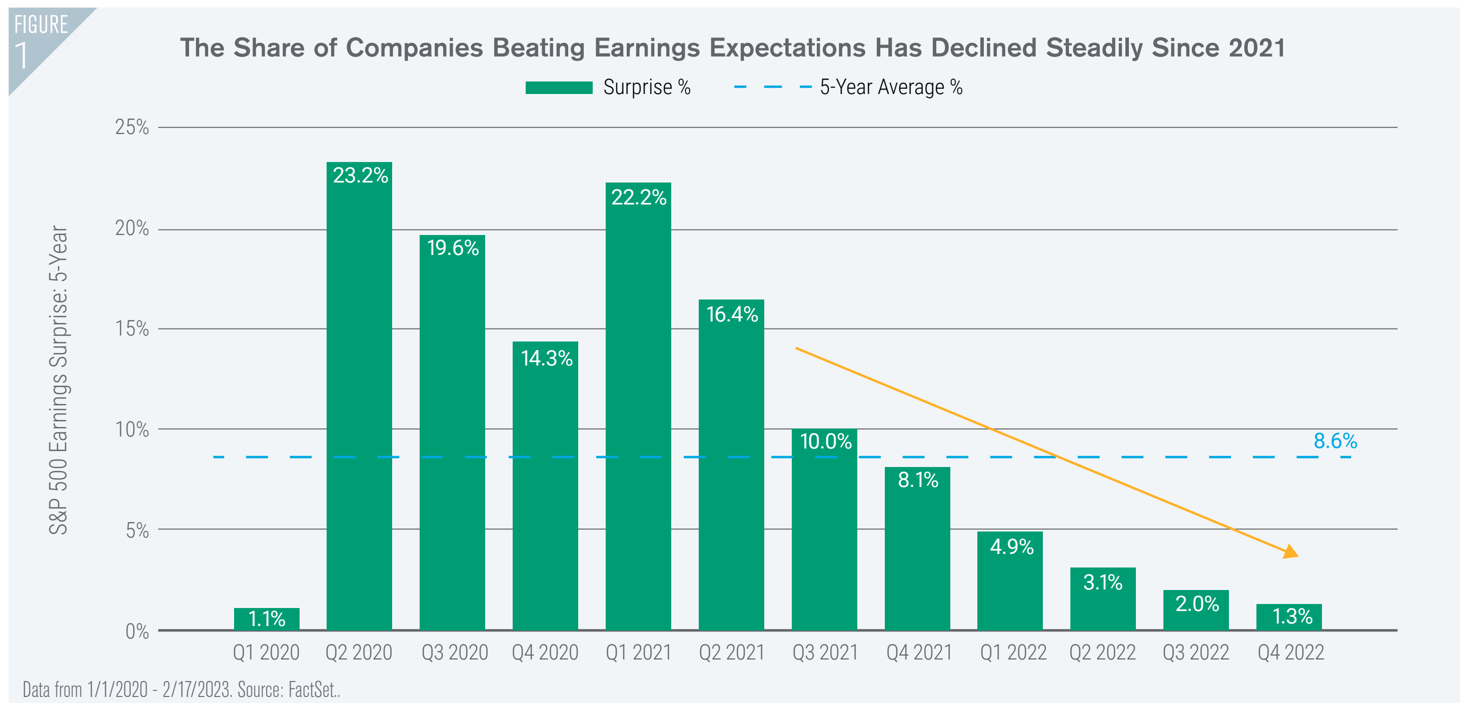
Fewer Companies Are Winning the Expectations Game

Coming out of COVID-19 lockdowns, analysts tended to underestimate how quickly businesses were regaining their footing. We see this in data showing 85% of companies outperformed Wall Street estimates during the first three quarters of 2021.[2]

With inflation high and the risk of recession rising, we now see the opposite situation unfolding. Analysts have been steadily lowering their estimates but haven't been aggressive enough. As shown in **Figure 1**, the share of companies beating earnings estimates has declined steadily since late 2021. Even for the companies that exceeded expectations, the magnitude of their outperformance was below average.[3]

FIGURE 1

The Share of Companies Beating Earnings Expectations Has Declined Steadily Since 2021



Data from 1/1/2020 - 2/17/2023. Source: FactSet..

Energy Sector Profits Again Masked Broader Weakness

The energy sector continued to skew top-level profit readings. With supplies tight and commodity prices high due to Russia's war on Ukraine, year-over-year energy sector profits grew nearly 58% in the U.S. Excluding energy, fourth-quarter earnings growth fell from -4.7% to -8.8%.[4]

Similarly, Europe's profit growth, excluding energy, was -6% compared to an overall reading of 1%. In contrast with the U.S., however, energy was not the continent's top-performing sector from a profit growth perspective. Instead, utilities delivered the strongest results due to higher pricing amid the energy crisis. During the quarter, 50% of utilities beat earnings estimates, and 50% beat sales estimates.[5]

On the downside, the materials and consumer discretionary sectors were among the U.S. and Europe's bottom performers.

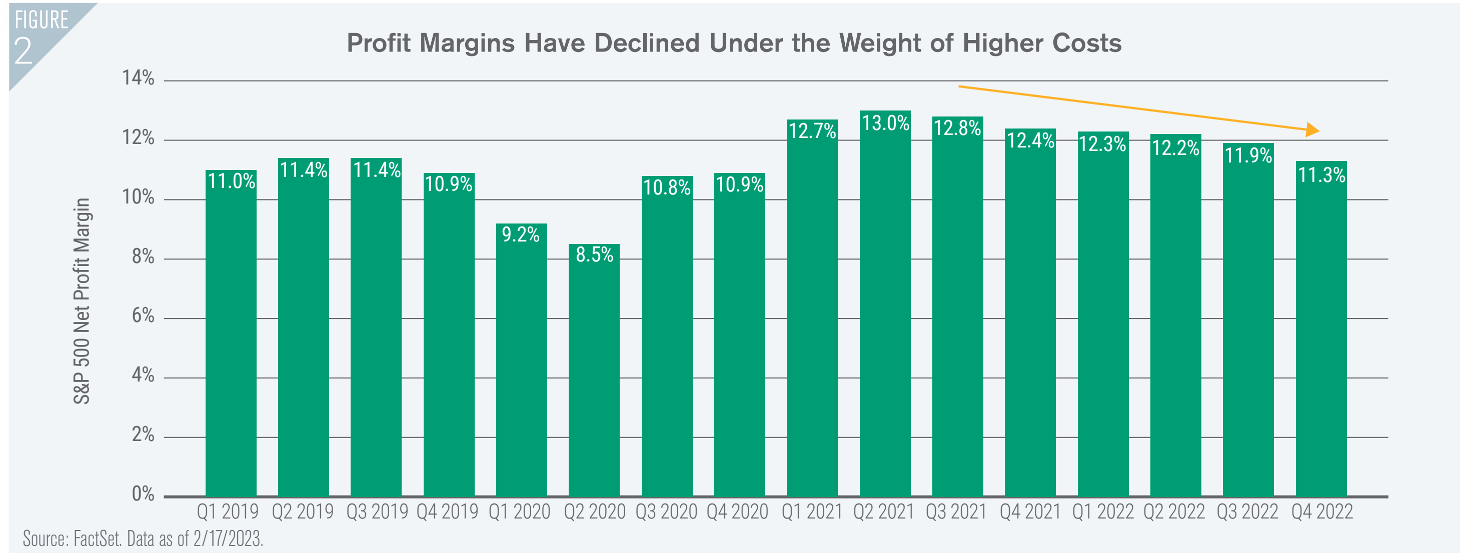
Another notable trend was the relative weakness in sales and earnings growth from U.S. companies with significant international exposure. While we would have expected the easing of COVID restrictions in China and the weaker U.S. dollar to benefit companies with more global exposure, the opposite was true.

Information technology and communications services profits suffered, with large companies such as Intel, Alphabet, Meta Platforms and Apple accounting for a significant portion of the decline. These companies were among the tech-oriented businesses that built up the capacity to meet pandemic demand only to find themselves with cost structures that are too high for today's more normal demand environment.

Profit Margins Squeezed as Sales Cool

Despite the tailwind of inflation, U.S. revenue growth moderated to 5.1%, snapping a seven-quarter streak of double-digit growth. Meanwhile, European companies posted 16% sales growth, with 60% of companies beating sales estimates.[6] We attribute Europe's more robust revenue growth rate to its greater exposure to energy and industrials, two of the strongest sectors for sales growth during the quarter.

Slowing U.S. revenue growth coupled with higher input costs pressured profit margins. Slimmer margins could indicate that companies are approaching the limit of their ability to pass through higher costs. As shown in **Figure 2**, margins remain elevated at 11.3% and above pre-pandemic levels. However, they've declined steadily since peaking at 13% in the second quarter of 2021.[7]



Source: FactSet. Data as of 2/17/2023.

3 Earnings Season Trends We're Watching

1. Companies "Rightsize" as Demand Slows

With demand softening and the economic outlook getting cloudier, management teams are focused on controlling costs by streamlining their product lines and reducing headcount. This trend is especially notable in technology, e-commerce and home goods, where companies scaled up operations to meet peak pandemic demand that's now returning to normal.

"The slower-than-expected growth was due to rapid declines in consumer-facing markets such as consumer electronics and retail — a dynamic that accelerated in December as consumers sharply cut discretionary spending and retailers adjusted inventory levels."

Michael Roman, CEO, 3M

"We are going to take a really hard look at the cost for everything that we make both across television and film because things in the very competitive world have just simply gotten more expensive. And that's something that is already underway here. In addition, we're going to look at the volume of what we make. And with that in mind, we're going to be fairly aggressive at better curation when it comes to general entertainment."

Bob Iger, CEO, Disney

2. Lower-Income Consumers Bear the Brunt of Inflation and the Slowing Economy

Signs of stress on consumers are emerging. Stimulus checks have been spent, and inflation has eaten away at purchasing power. Further, weaker equity market returns and a slowing housing market have lessened the "wealth effect." This impact is felt mainly at lower income levels where food, shelter and gasoline represent a more significant portion of household budgets, and higher prices are changing spending habits.

"We are seeing some increase in our higher-frequency customers — or higher-income customers coming more frequently. And some of that is no doubt due to trade down into our brands. On the lower end, we're not seeing the low-income consumer drop out of our business. What we're seeing is they're probably a little bit more focused on value, and that's been the trend."

David Gibbs, CEO, YUM Brands

3. Supply Chain Problems Ease

While challenges remain in some manufacturing areas, the supply chain headaches that plagued businesses throughout the pandemic are easing. Ocean shipping times are decreasing, ports are keeping up, and the labor supply has improved. We've also seen a steady rise in efforts to shorten supply lines through reshoring or nearshoring.

> "Inventory levels have increased from about six months pre-pandemic to seven months today to ensure we can deliver the products to our customers despite the more unreliable supply chains. However, we are now confident to bring supplies down closer to pre-pandemic levels, and we plan to consume excess inventories over the next 12 to 18 months."
>
> Philippe Deecke, CFO, Lonza Group

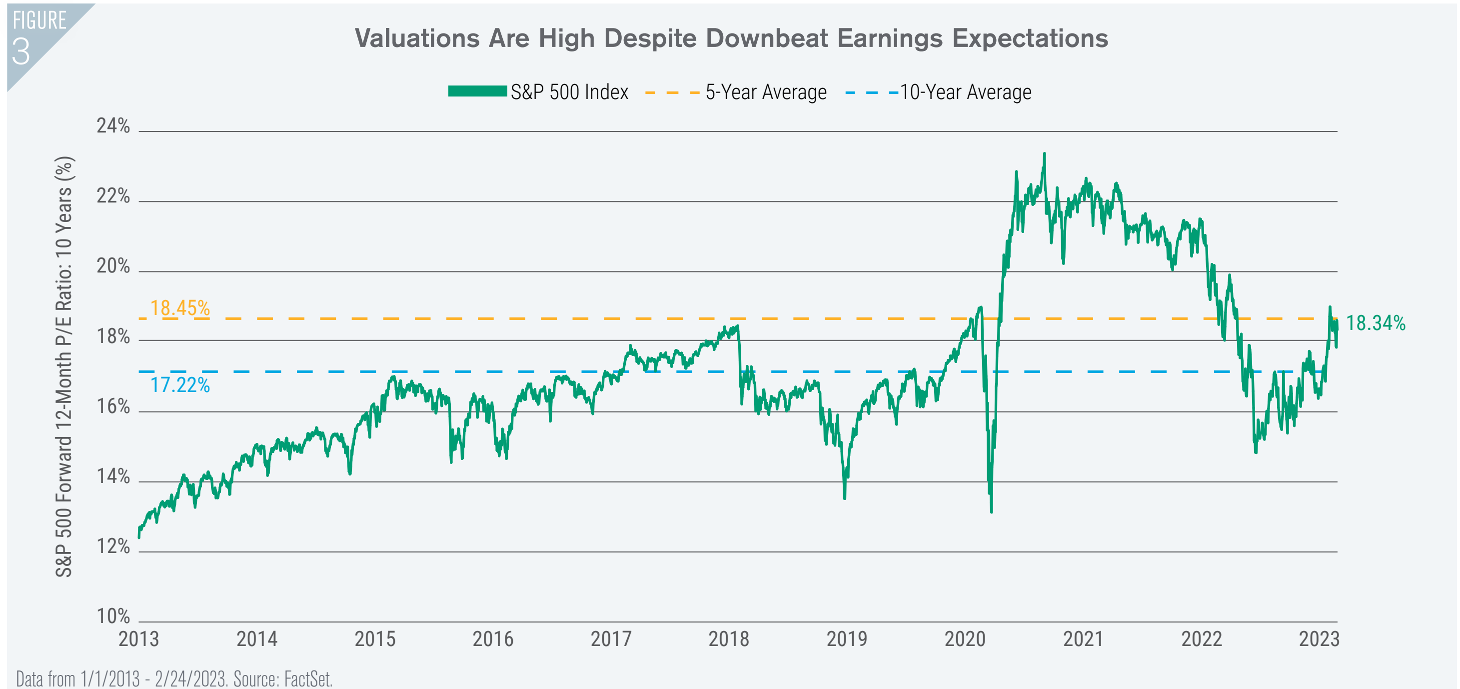
Are Stock Market Valuations Too High?

A more significant percentage of companies are issuing negative forward guidance as the economic outlook grows dimmer. Not every company provides a forward-looking perspective, but 76% of companies that have issued guidance provided lower-than-expected forecasts compared to a five-year average of 59%.

For this year, analysts expect S&P 500® earnings to decline -5.4% in the first quarter and -3.4% in the second. They're calling for a rebound in the year's second half based on expectations that input costs will normalize and comparisons in the second half of 2022 will become easier. For the full year, the forecast is for 2.3% earnings growth compared to last year.

The decline in earnings estimates combined with the market's fourth-quarter advance and continued strength early this year have added to market risk. As shown in **Figure 3** on the next page, the S&P 500's valuation coming into 2023 was at its highest point since April 2022, in line with the five-year average and above the 10-year average. These elevated valuations suggest more market turbulence may occur if companies miss lowered guidance or events create doubt about future earnings.

American Century's most recent macro strategy outlook reiterates our view that a recession is the most likely economic outcome in the next six months. Considering this expectation and the downward trend in earnings, it may be appropriate to adopt a defensive posture emphasizing quality in equity portfolios.



Data from 1/1/2013 - 2/24/2023. Source: FactSet.

[1] FactSet.

[2] FactSet.

[3] FactSet.

[4] FactSet.

[5] J.P. Morgan.

[6] FactSet, J.P. Morgan.

[7] FactSet.

[8] FactSet.

[9] FactSet.

[10] FactSet.

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