September 2023 | Market Perspective

American Century Investments®

Earnings Watch
Resilient U.S. Consumers Soften Earnings Slide

Demand weakness elsewhere hasn't hit the U.S. as hard — yet.

GLOBAL GROWTH EQUITY

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KEY TAKEAWAYS

- Second-quarter U.S. earnings fell twice as much as the prior quarter but easily surpassed expectations.
- Persistent consumer spending remains a linchpin for the U.S. economy, especially compared with Europe and China.
- A U.S. earnings recovery appears on tap for the year's second half, even as company guidance drifts lower.

U.S. Consumer Stocks Buck Sluggish Trend

Corporate earnings in the U.S. declined for the third consecutive quarter, reflecting the ongoing impact of the Federal Reserve's inflation-fighting campaign. But thanks to resilient U.S. consumers, they didn't fall as far as expected.

In the second quarter of 2023, earnings for U.S. companies in the S&P 500® Index dropped 4.6%, more than double the first quarter's 2.2% decline. Revenues rose just 0.8%, the weakest growth since they fell 1.1% in the third quarter of 2020, during the height of the Covid-19 pandemic.

Still, earnings easily surpassed the consensus 7% decline analysts had expected heading into the second-quarter reporting period. Moreover, 79% of companies exceeded consensus expectations, slightly more than the five-year average, according to FactSet. Finally, overall sales and earnings would have risen 2.4% and 2.1%, respectively, if not for dramatic declines in the energy sector.

For the second straight quarter, strong results from broadline retailers (led by Amazon.com) and the travel and restaurant industries propelled significant profit growth in the consumer discretionary sector. Without retailers, travel and leisure, earnings in the sector would have fallen 3%; instead, they surged 53%. That's almost three times the growth of the second-highest performing sector, communications, which benefited from soaring growth in video game and concert sales. The industrials sector ranked third, mostly thanks to airlines riding the wave in travel spending.

Only five of the S&P 500's 12 sectors recorded earnings growth of more than 10%. Conversely, three suffered outright earnings declines, with profits for each dropping by more than a quarter. Profits in the energy sector totaled just half of last year, when oil and gas prices soared in the wake of Russia's invasion of Ukraine, and earnings in the materials sector fell 29%. A 27% drop in health care primarily reflected plunging coronavirus vaccine sales at Pfizer and Moderna.

Weakness in Europe

Outside the U.S., consumer discretionary and health care companies drove sales and earnings 6% and 2% higher, respectively, for companies in Japan's TOPIX Index. But in Europe, like the U.S., the energy and materials sector dragged overall sales and earnings for Europe's STOXX 600 down 8% and 9%, respectively. That happened despite growth in several other areas of the economy – namely banks, automakers, parts suppliers, airlines and hotels.

Though 59% of STOXX 600 firms beat earnings expectations, shares of those that didn't fell an average of 1.7% in the trading session after they reported earnings. That compared with an average gain of just 0.8% for companies with profit beats.

Overall, corporate profit margins fell slightly but remained high. However, high inventory levels suggest companies will face headwinds trying to raise prices as higher interest rates further challenge profitability. Combined with a weakening credit cycle and the fading impact from U.S. fiscal stimulus, growth could get more difficult.

Four Earnings Season Themes We're Watching

1. Despite Some Stress, Consumers Remain Resilient

Signs of stress on American consumers have increased, potentially exacerbating the bifurcation between higher- and lower-income levels. Federal government stimulus has ended, inflation has reduced purchasing power and student loan payments will resume Aug. 31 for 44 million people. With food and shelter soaking up a larger portion of their budgets, lower-income families experience greater impacts from these factors.

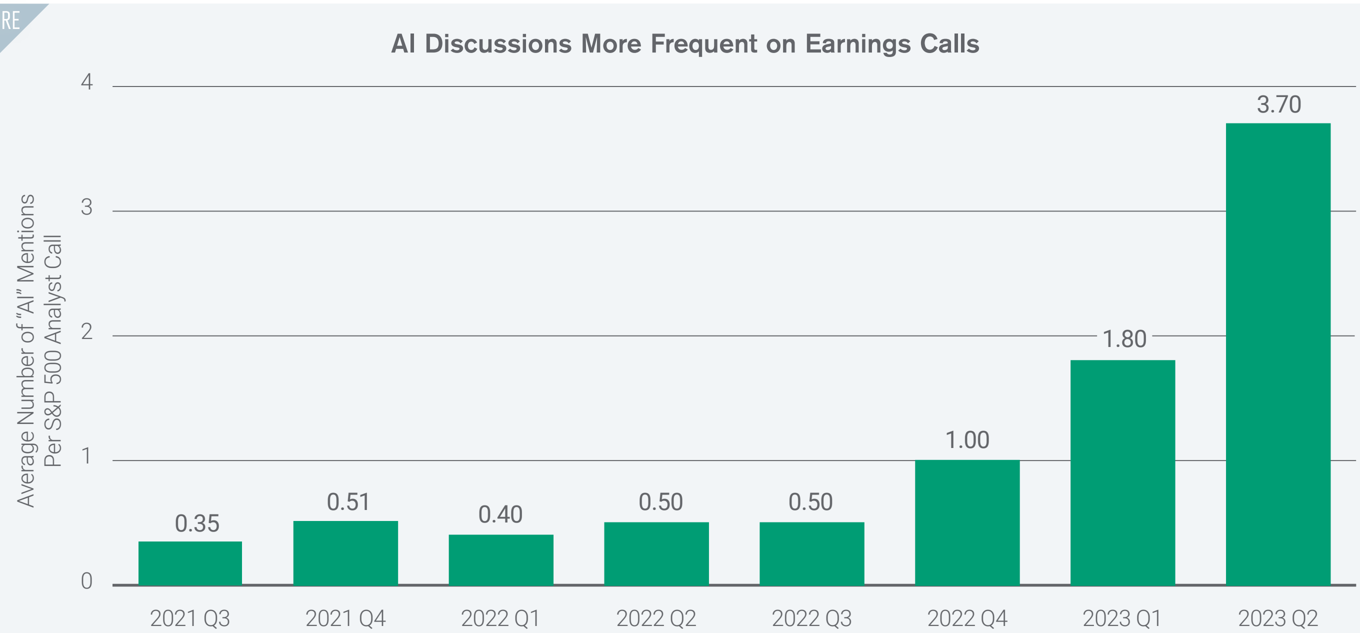
Nevertheless, consumers overall remain more resilient than most market observers expected heading into 2023.

Visa, for instance, reported higher-than-expected quarterly earnings, with its payments volume rising 6% compared with the same period last year – and up 54% compared with 2019, before the pandemic. The company said its data indicate consumer spending, regardless of wealth level, has remained stable since March, and that has persisted into the current quarter. Meanwhile, its average sales transaction price fell 2%, signaling easing inflation pressure.

Consumer product giants expressed similar sentiments. Procter & Gamble and PepsiCo both said they retain substantial ability to raise prices, though slowing sales volume means that may not last much longer. PepsiCo's sales increased 13%, but higher prices accounted for the entire increase as its sales volume fell 2.5%.

> "We're seeing consumers shopping in more stores than before. They're looking for better deals. They're starting to look for optimization. They are going into channels that have better-perceived value. They're buying more in dollar stores, or they're buying more in mass or in clubs. So, every segment of the consumer is making adjustments. Overall, we're seeing very positive, and I think it has to do with the levels of unemployment that we're seeing all around the world."
>
> Ramon Laguarta, Chairman & CEO, PepsiCo

FIGURE 1



Data from 9/30/2021 – 6/30/2023. Source: Refinitiv call transcripts. The bars compare conference calls held by companies so far in 2023 Q2 to calls held by the same companies in previous quarters.

2. The AI Boom Accelerates

The focus on artificial intelligence intensified in the latest quarter. More than a third of S&P 500 companies mentioned AI at least once on their quarterly conference calls with investors. Moreover, as shown in **Figure 1** above, the average number of times they referred to it more than doubled to 3.7 from 1.8 in the first quarter.

> "Every single one of our businesses inside of Amazon, every single one, has multiple generative AI initiatives going right now. And they range from things that help us be more cost-effective and streamlined in how we run operations in various businesses to the absolute heart of every customer experience in which we offer. And so it's true in our stores business. It's true in our AWS business. It's true in our Advertising business. It's true in all our devices. And you're going to just imagine what we're working on with respect to Alexa there. It's true in our entertainment businesses. Every single one. It is going to be at the heart of what we do. It's a significant investment and focus for us."
>
> Andrew Jassy, President & CEO, Amazon.com

3. Declining Demand Could Slow Inventory Drawdowns

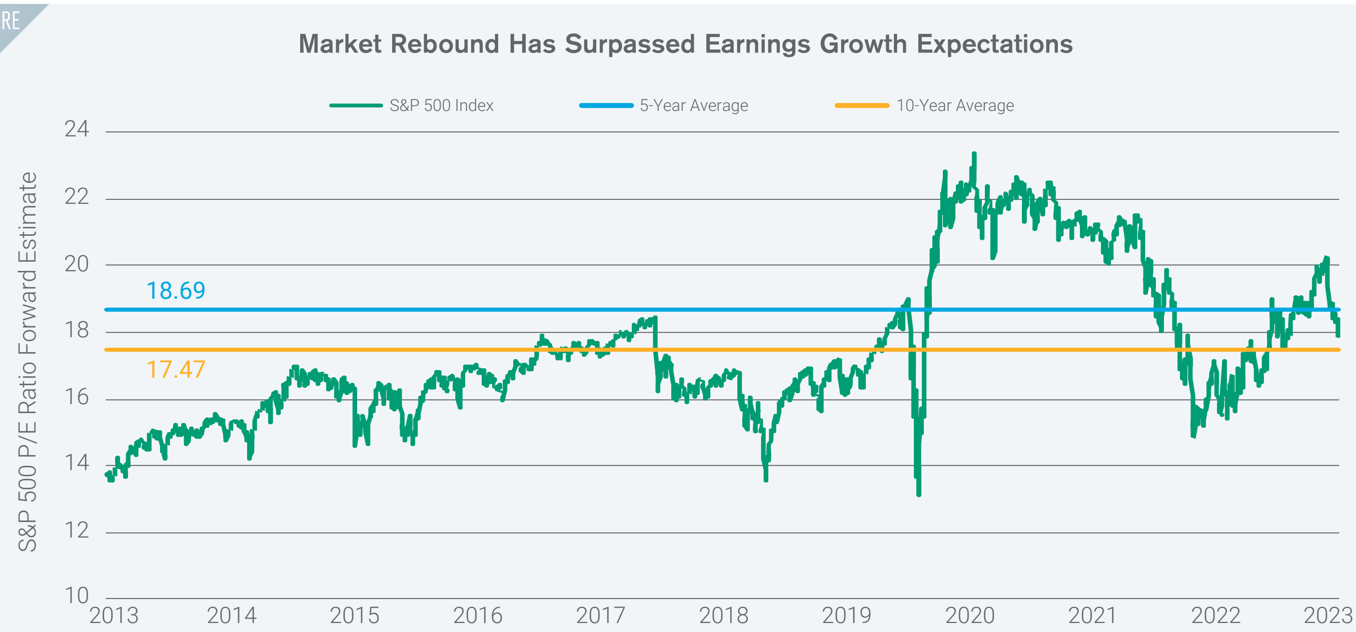
This quarter, conference calls generally exhibited a less optimistic tone, particularly for European companies. They routinely referenced weakening demand and declining sales volume. That could slow the inventory destocking on which companies in developed markets recently have focused.

> "Needless to say, you know this, there is still a lot of inventory in the market -- not only ours, but also ours. And the problem is, of course, some of that inventory is not great. That means that the sell-through is slow, and we have to work through that for a while. And because of that, the discounts also are high, in general."
>
> Bjørn Gulden, CEO ADS GR, adidas AG

4. China's Challenges

Companies contend the operating environment has worsened in China, portending a difficult second half of the year for the world's second-largest economy. Weak consumption in the industrial and manufacturing sectors has hurt export-oriented companies. Add increased geopolitical concerns to the mix, and foreign companies may increasingly choose to migrate away from China and establish operations elsewhere to satisfy global customers. If that happens, it will diminish China's medium and long-term investment opportunities.

FIGURE 2



Data from 8/16/2013 – 8/18/2023. Source: FactSet.

Looking Ahead: Earnings Forecasts Suggest Expensive Valuations

The U.S. economy has yet to encounter a widely predicted recession in the wake of rising interest rates. That has emboldened investors – perhaps a little too much. Although, equity market declines in recent weeks have brought valuations back toward more typical levels.

The S&P 500's 12-month forward price-to-earnings (P/E) ratio remains elevated compared to the 10-year average (see **Figure 2** above). That's because the stock market's strong rebound since mid-October 2022 has surpassed the modest increase in earnings growth expectations.

According to FactSet, current estimates project U.S. earnings will rise 11.4% in 2024. But that forecast has engendered some skepticism. The aging business cycle, the Fed's ongoing inflation fight and the lack of economic growth in key markets, especially China and Germany, may make it tough to clear that earnings hurdle.

Near term, consensus expectations from FactSet predict flat S&P 500 earnings in the third quarter compared with a year ago. In reporting their latest quarterly results, slightly more companies than usual provided earnings guidance below existing forecasts for the quarter. In addition, 62% of companies that provided earnings projections issued guidance lower than existing forecasts, an increase from 59% that pushed guidance lower the prior quarter.

Much weaker earnings appear likely in Europe. Weaker demand and global growth are expected to push profits down 15% for the STOXX 600. That would represent the biggest slide since the pandemic-plagued third quarter of 2020.

Looking further ahead, fourth-quarter S&P 500 earnings are expected to increase 7.9% amid more favorable year-to-year comparisons and moderating input costs.

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