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CORPORATE EARNINGS OUTLOOK

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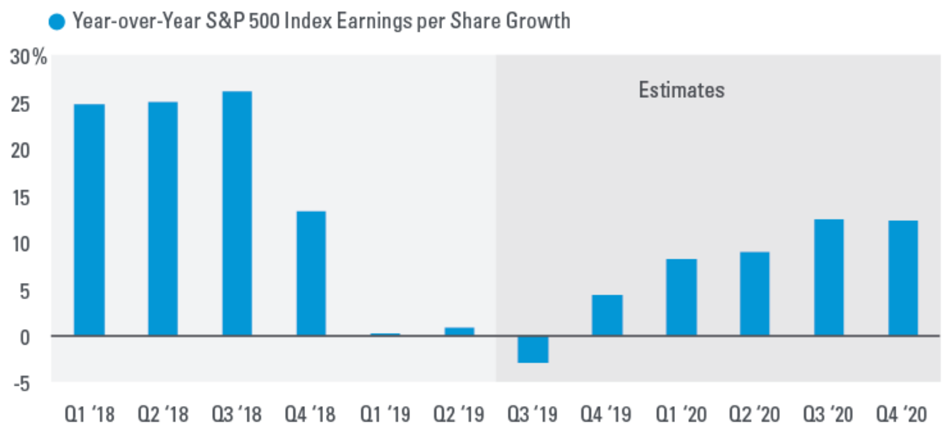
We lowered our 2019 earnings growth forecast for the S&P 500 Index on August 19 due to increased risk to economic growth and corporate profits from the ongoing trade conflict between the United States and China. Until we get clarity on trade, we believe earnings will likely continue to grow but only modestly [Figure 1].

1 EARNINGS LULL REFLECTS TARIFF IMPACTS



Source: LPL Research, FactSet 09/04/19
Estimates reflect FactSet consensus.

We recently lowered our 2019 S&P 500 Index earnings growth forecast. In our August 19 *Weekly Market Commentary*, "Tweaking Forecasts," we lowered our 2019 expectations for growth domestic product (GDP), the 10-year Treasury yield, and S&P 500 earnings per share (EPS). Our revised S&P 500 EPS forecast is now $165 for 2019, and we initiated a 2020 forecast of $175. Importantly, we have maintained our year-end fair value target on the S&P 500 of 3,000, as we expect lower interest rates and inflation to support higher valuations. Here we provide more background on our reduced earnings outlook.

BACKGROUND

We lowered our 2019 S&P 500 EPS forecast last month, from $170 to $165, due to the impact of tariffs, lower business investment, and trade uncertainty. The revised figure, which is in line with consensus estimates (source: FactSet), represents 2-3% growth compared with 2018. We had been above consensus before tariffs offset much of the benefits of fiscal stimulus. Earnings upside from a surprise trade agreement has become increasingly unlikely after the latest escalation, although we are encouraged by China's willingness to meet face-to-face in early October.

The trade conflict is weighing on earnings in several ways. Slower economic growth hampers revenue, while paying tariffs and dealing with supply chain disruptions hurt profit margins. In addition, business uncertainty around future trade actions weighs on capital investments, which limits opportunities for companies to grow revenue, particularly industrial and technology companies, and caps gains in productivity (output per hour worked) that could boost profit margins (more output per hour means companies can do more with fewer resources and contain wage increases). On top of that, slower growth in international developed economies has added to near-term pressure on the U.S. economy and therefore on companies' revenue.

PRELIMINARY 2020 FORECASTS

In August we also initiated preliminary S&P 500 EPS forecasts for 2020 of $175. At this point, we expect modest 1.75% GDP growth, 2–2.25% on the 10-year Treasury yield, $175 in S&P 500 EPS, and a range of 3,150–3,200 for S&P 500 fair value at year-end 2020. Our forecasts for GDP and the 10-year yield are near consensus while our EPS projection is currently $8 below the consensus ($183) estimate (source for consensus estimates is FactSet). These forecasts reflect increasing odds of a prolonged trade conflict odds of recession in the latter half of 2020.

TAKEAWAYS FROM SECOND QUARTER EARNINGS SEASON

We would say the most important takeaway from the now-completed second quarter earnings season is that earnings are still growing and an earnings recession appears to be off the table for now. While FactSet's math said the S&P 500 Index overall produced flat EPS year over year, other sources such as Refinitiv (former Thomson Reuters) reported operating earnings growth of over 3%. Boeing's multi-billion charge during the quarter detracted 1.5% from S&P 500 EPS by itself, which appears to be a unique event that shouldn't recur.

Overall, we think corporate America has done a good job delivering modest earnings gains amid significant headwinds, including tariffs and trade uncertainty, slowing growth in Europe and Japan, and a strong U.S. dollar. Roughly 40% of S&P 500 profits are generated overseas and are therefore sensitive to global trade, international economies, and foreign exchange markets. Over the past two months, EPS estimates for the next four quarters fell about 2%, in line with historical averages and an impressive feat given the various headwinds.

MAINTAINING S&P 500 FAIR VALUE TARGET

After exceeding our fair value target in July, stocks have struggled with trade uncertainty and recession fears related to the inverted yield curve. Long-term interest rates have dipped below short-term rates, historically a leading indicator of recession, though with varied and relatively long lead times. Although we have lowered our earnings forecasts, we believe potential Federal Reserve rate cuts, mild inflation, and lower market interest rates support higher price-to-earnings ratios (P/E) for stocks. We look for a price-to-earnings multiple (P/E) of slightly over 18 on $165 in S&P EPS to get us back to the 3,000 range on the S&P 500 by year-end.

CONCLUSION

We reduced our 2019 S&P 500 EPS forecast in August to reflect increased risk to economic growth and corporate profits from the ongoing trade conflict between the United States and China. Although we continue to expect resolution later this year or in early 2020, the odds of a more prolonged dispute have risen. As a result, we believe it is prudent to be somewhat conservative in our forecasts until we get more clarity on trade.

NEW WEEKLY MARKET PERFORMANCE REPORT

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DEFINITIONS

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The price-to-earnings ratio (P/E ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The modern design of the S&P 500 stock index was first launched in 1957. Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

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