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Daily Observations

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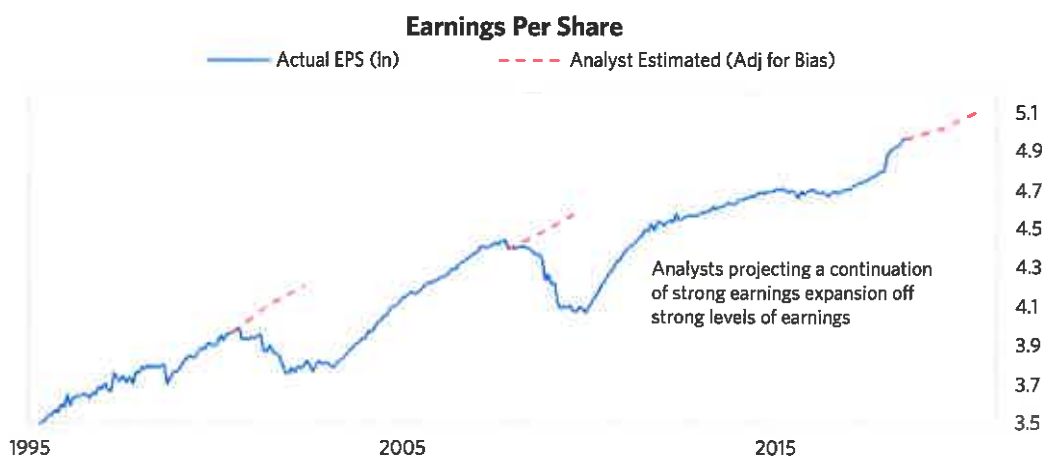
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An Unlikely Confluence of Events Is Required for Companies to Beat High Expectations Priced Into the US Equity Market

What's discounted in the US equity market today looks to be an extrapolation of the recent strength in corporate profits. Expectations are most often for a continuation of the norm, such that after periods of strength, it is more strength that's expected. Returns then reflect how cash flows come in against expectations and how the discounting of those cash flows changes through time. In previous *Observations*, we have discussed the building pressures on discount rates; in today's *Observations*, we focus more on the outlook for future cash flows. Looking back over the past couple of years, US corporate profitability consistently beat priced-in expectations, leading to rising future expectations, leading in turn to high returns. But after years of outperforming, the expectations priced in have gotten stretched. Beating expectations going forward would require an optimistic outcome at almost every layer of what drives earnings. Demand would need to continue to accelerate from already strong levels. Despite continued tightening in conditions, wage growth would need to remain contained to enable margins to keep rising from already secular highs. And corporates would need to continue or accelerate their financial engineering from today's breakneck pace. Moreover, all of this would need to occur at the same time that monetary tightening is continuing and many of the fiscally driven supports to profit growth (tax cuts supporting spending, the repatriation tax change freeing up cash to finance financial purchases) are fading. Adding it up, while what's priced in is not impossible, there is lots of room for disappointment.

The chart below shows the level of earnings per share and what is expected going forward today and at a few peaks in history. Today's level of earnings has been a reflection of the impact of strong monetary and fiscal stimulation, which has supported corporate profitability. These strong earnings are being extrapolated going forward, as is often the case, even just before turning points. Expectations are not as extreme as at some past points (note the tech bubble), but they're still notable after a period of strength when many of the supports are beginning to fade.



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Forward expectations were extremely weak coming out of the financial crisis in 2009 and remained weak until about three years ago. In recent years, market performance began to exceed the impact of actual earnings growth or lower discount rates and began to price in improved future profitability. After a few years of this market action, expectations for future earnings growth are as high as they've been since the tech bubble burst, though much lower than at its peak. Earnings expectations are strong across most sectors, especially those with already high levels of profitability today.

Long-Term Analyst Estimations



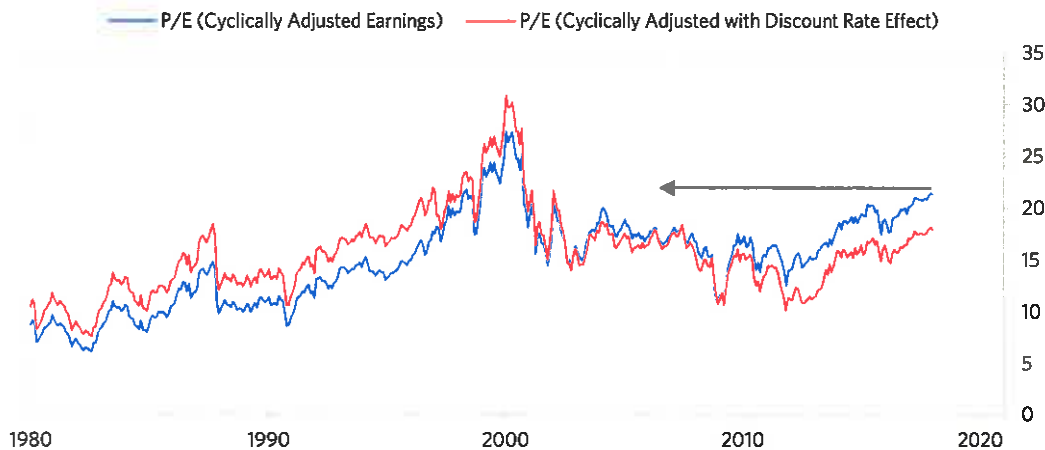
Analyst 3-Year Earnings Est By Sector

Adjusted for Bias

Sector	Estimated Growth, Ann	Relative to History
Total Market	8%	4%
Consumer Discretionary	13%	5%
Materials	11%	-1%
Financials	11%	6%
Info Tech	11%	1%
Industrials	11%	7%
Healthcare	8%	2%
Consumer Staples	6%	0%
Utilities	3%	3%
Telecom	2%	-4%
Real Estate	1%	0%

Expectations are high fairly consistently across sectors, with most above historical averages

As another perspective on what expected earnings are priced into the market, the chart below shows the current level of P/Es as well as a measure of P/E that takes out the effect of today's low level of discount rates. Both measures are on the high side relative to history, though not close to past bubbles.



With high expectations priced in, there is lots of room for disappointment. Market action last week around earnings releases was a good example of this dynamic. On average, companies that reported positive surprises were up on the days surrounding the announcement by about 2%, whereas companies that surprised on the downside were down around 9%. This is consistent with what we would expect given expectations for strong earnings for many years to come: small downside surprises in actual earnings can lead to meaningful repricing of expectations into the future, whereas positive surprises are likely to have less impact given how strong long-term expectations already are. Facebook was a notable example where the price reaction was particularly extreme, as the earnings announcement was accompanied by commentary about revenues and costs explicitly aimed at bringing down expectations for the future.

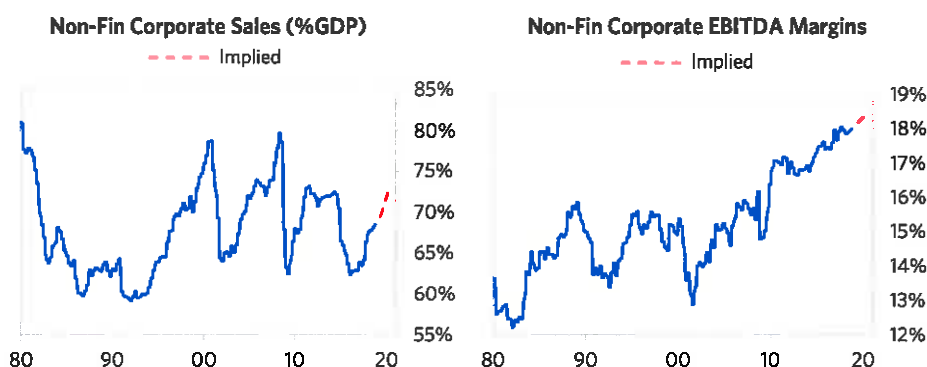
Market Action for Major Companies with EPS Surprises

Reporting July 25 for Q2 2018

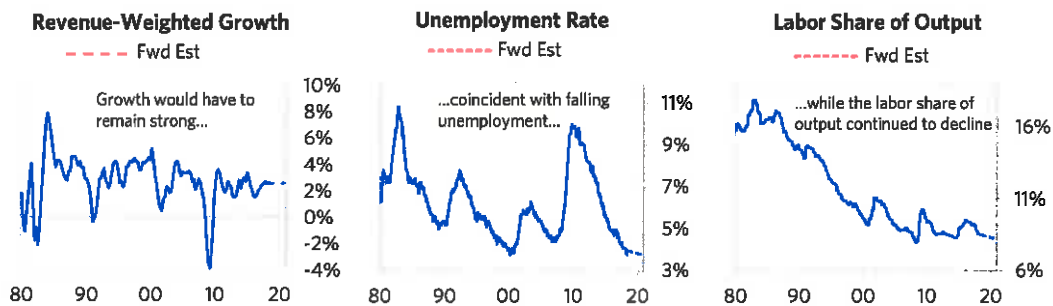
	Companies with Positive Surprises	Change in Price	Companies with Negative Surprises	Change in Price	
Positive earnings surprises led, on average, to an increase in price	Market Cap Weighted Average	2.4%	Market Cap Weighted Average	-8.8%	Prices moved the most for companies that disappointed
	Visa, Inc	2%	Facebook, Inc	-18%	
	Coca-Cola Company	2%	Boeing Company	0%	
	PayPal Holdings, Inc	-2%	Las Vegas Sands Corp	-4%	
	Gilead Sciences, Inc	1%	General Motors Company	-7%	
	GlaxoSmithKline plc	-2%	Ford Motor Company	-6%	
	Thermo Fisher Scientific, Inc	6%	ServiceNow, Inc	4%	
	Qualcomm Incorporated	8%	Fiat Chrysler Automobiles NV	-13%	
	United Parcel Service, Inc	6%	STMicroelectronics NV	-6%	
	NextEra Energy, Inc	-1%	CitrixSystems, Inc	5%	
	Anthem, Inc	0%	TechnipFMC plc	4%	

Beating High Priced-In Earnings Growth Will Require an Unlikely Confluence of Events

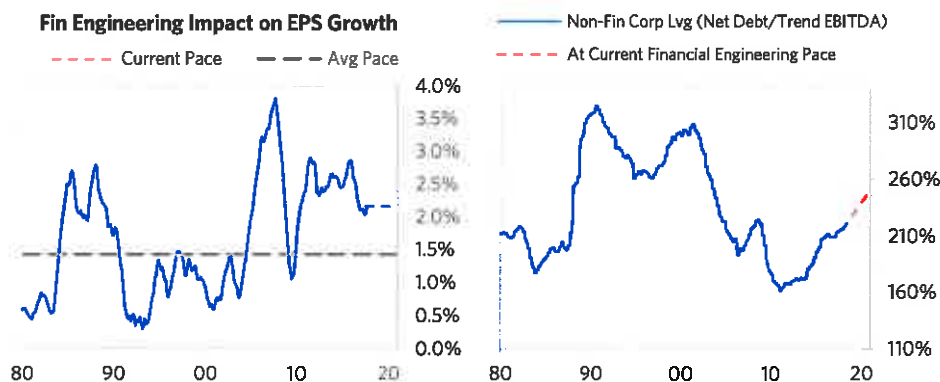
The charts below break down what would be required to achieve the strong continued earnings growth that is priced into the markets. Sales would need to continue to run faster than potential for a long period of time, at a point when levels of demand are already high. And margins would need to expand further from secular highs, which seems particularly unlikely at a point so late in the cycle, when cost pressures are likely to become a drag.



For sales to grow as shown above, growth would have to remain strong and above potential. Stronger production would result in more people getting employed, pushing the unemployment rate down further from today's already tight levels. But at the same time, for margins to expand as shown above, we couldn't see much in the way of wage pressure. Any one of these scenarios seems potentially plausible, but in combination it would be particularly difficult to see this world play out.



Corporates' financial purchases have been another support to earnings-per-share growth, adding around 2-3% in recent years. Recently, much of this spending has been supported by the change in tax policy on earnings held abroad, which led many companies to repatriate cash stored abroad and deploy it to shareholders. This repatriation dynamic only has so far to run and should be petering out heading into next year. Keeping financial purchases steady as this impulse fades will require more corporate borrowing at a time when corporate debt levels are already moderate and borrowing costs continue to rise as the Fed tightens.



So, meeting expectations would require strong growth off of already high levels of demand, the further tightening of labor markets but little pressure on wages, and corporates leveraging up to maintain a breakneck pace of financial purchases. This would all be at a time when the Fed continues to tighten and fiscal stimulus rolls off, putting pressure both on household and corporate demand. While any one of these things could be possible, in coordination the scenario required looks unlikely to us.

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