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SPECIAL REPORT: 2Q 2018 EARNINGS WRAP UP

By Jennifer Moore, CFA, Director of US Credit Research

Earnings strength continued into the second quarter as companies benefited from a robust economy and tax reform. For S&P 500 companies overall, year over year, revenue grew 10% and earnings per share improved by 26%. Similar to the first quarter, growth was broad based with nearly all sectors experiencing double-digit earnings improvement. Much of this strong growth was included in expectations, resulting in revenue that was relatively aligned with estimates, however, earnings still surprised by about 5%. Additional information can be found in Appendix I and II.

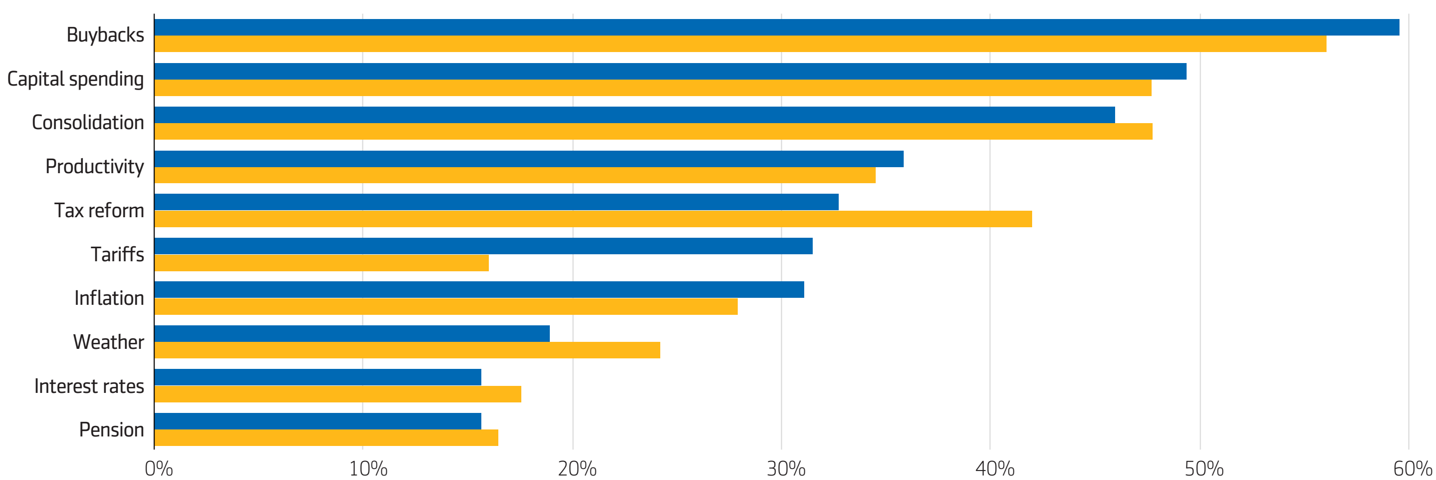
Exhibit 1: Sector results relative to expectations—a fixed income perspective

Negative	Modest negative	Neutral/mixed	Modest positive	Positive
		Communications	Consumer Non-Cyclical	Basic Materials
		Entertainment	Manufacturing	Consumer Cyclical
		Energy	Construction	Technology
		Insurance	Transportation	Non-US Banks
			Healthcare	Other Finance
			Utilities	
			US Banks	

Interesting takeaways

Exhibit 2 shows how frequently select topics were referenced on this season's calls. In the following text, we take a look at of few of these key topics.

Exhibit 2: Percent of S&P 500 companies referencing topic on earnings calls



Source: Aegon AM US Credit Research Team, Bloomberg   2Q 18 Date Range: 7/1/2018-8/10/2018   1Q 18 Date Range: 4/1/2018-5/14/2018

Key earnings call topics

Tariffs. While this was an increasingly popular topic early in the year, the discussion around tariffs gained additional steam this quarter with nearly a third of the companies in the S&P 500 Index mentioning it. Discussions took on a variety of angles, ranging from a few expecting a positive effect, to no expected change in their operations, to companies running recession scenarios on their businesses. Despite another quarter of information, "uncertainty," "caution" and "nervous" were terms frequently mentioned when discussing the topic. The businesses most directly affected include the downstream users of steel and aluminum from the first round of tariff announcements. Many companies are still trying to understand the potential outcome of additional tariffs that have either recently gone into effect or are under consideration.

Overall, it appears that firms are evaluating a few options to deal with current or proposed tariffs:

- Increase prices;
- Take offsetting cost reductions elsewhere;
- Evaluate possible exemptions;
- Modify supply chains; and
- Adjust manufacturing locations.

Companies affected by the tariffs but unable to take action will likely see their margins suffer. Increasing product or service prices appears the most straightforward near-term approach to accommodate the tariffs, but it is too early to tell how successful these attempts will be. Depending upon the degree of these potential increases as well as if it ultimately reaches the end consumer, the next ripple could be higher inflation. In terms of cost reductions elsewhere, this could be challenging given the many years of cost reductions that have already occurred and the relatively lean operations of many firms.

The option of exemptions is also possible, however, the plan on achieving these remains uncertain. Several companies did note that they are currently evaluating supply chain adjustments and are considering alternative suppliers in case the tariffs are expanded. This will take time to evolve and could also be inflationary given that several firms may do so at the same time.

Finally, the longest-term approach is for companies to adjust their manufacturing footprint to better align production with the sale of the respective product. This was not a major source of discussion during the current quarter but we will watch for it in future quarters, especially given the potential impact on capital spending.

Inflation. Broadening the discussion from tariffs, which was commonly referenced as a source of current or expected inflation for several firms, to the broader topic of inflation itself, highlights another interesting area to investigate.

As we discussed in last quarter's earnings wrap up, during the first quarter references to inflation had increased at the early stages of the product pipeline, such as in the energy, utilities and industrials sectors. This quarter, inflation references continued to increase at this early stage, partially due to the tariffs, and has also spread further down the production process, getting closer to the end consumer.

Overall, about 31% of companies in the S&P 500 Index referenced the topic, up from 28% in the first quarter. At the sector level, financial and consumer staple firms had fewer references quarter over quarter, but this was more than offset by double digit percentage increases in the consumer discretionary, health care, real estate, materials and energy sectors. In addition to the increased number of references, the breadth of products experiencing inflation has also increased.

The primary sources of inflation mentioned, in addition to tariff-related ones, included commodities, such as oil, metals, resins, various chemical and agriculture products; wages in the form of regular pay, higher benefit-related costs, and an increased need for overtime; transportation-related costs such as freight, fuel and logistics; and other items such as batteries and rent. This list remains somewhat similar to the prior quarter, however, the breadth of the affected products has increased and the sentiment regarding the topic has intensified, which appears to be taking a greater toll on companies.

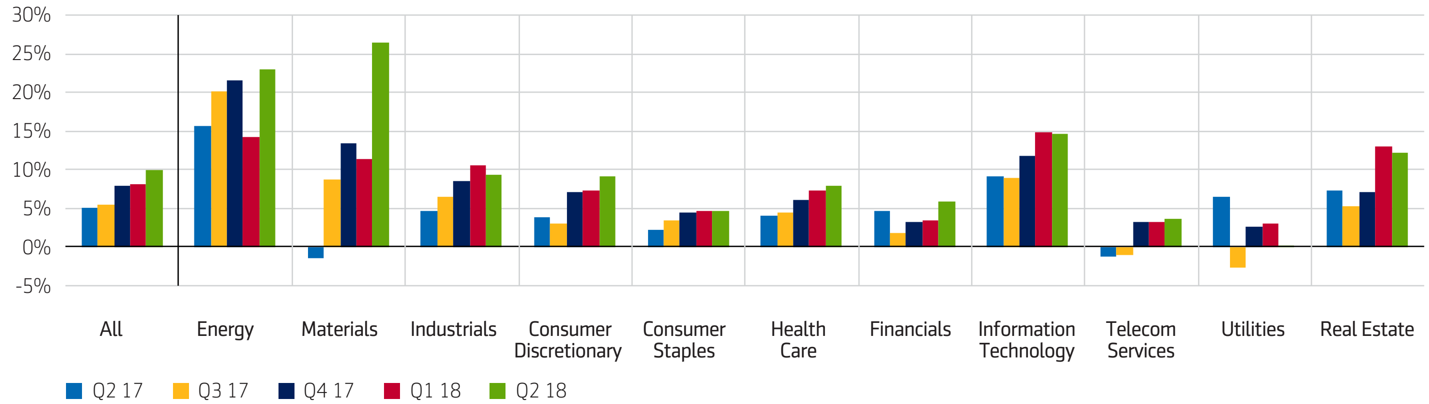
Capital spending. With the announcement of the new tax plan in late 2017 and continued economic strength, investors have been watching the capital spending plans of companies closely. Overall, more companies discussed their capital spending plans this quarter than in the year-ago period.

Looking closer into the details, while some mentioned plans to reduce capital spending, most references were in relation to higher spending anticipated in the second half of the year and, to some degree, during the quarter. For a few companies, capex spending during the current period may have been reduced by those electing to use cash flow to make voluntary contributions to their pension plans given the tax deadlines. The capital spending that is being discussed appears disciplined and targeted to specific opportunities such as technology, real estate, and businesses or geographies experiencing above average growth, and is well aligned with existing or expected demand or opportunities where cost savings can be achieved.

Finally, while most companies did not commit to specific expenditure plans, with tariffs focusing attention on the benefits of aligning product production with their sale, it is possible that this could also result in higher capital needs down the road. This remains uncertain, however, given the lack of clarity with the existing and potential tariff efforts. We will continue to watch how this evolves in the second half of the year.

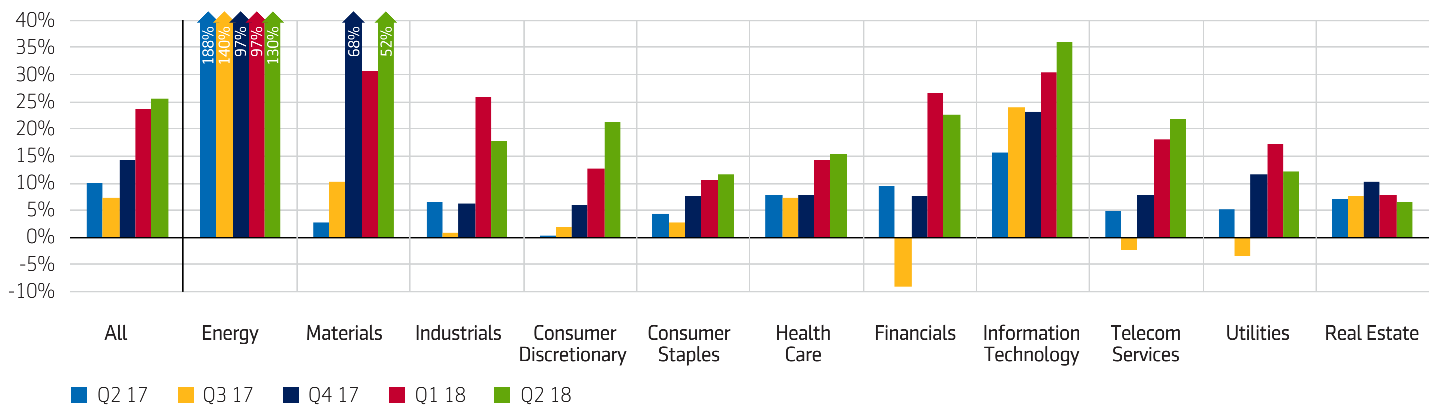
Appendix I

Exhibit 3: S&P 500 Y/Y revenue growth by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 8/15/2018

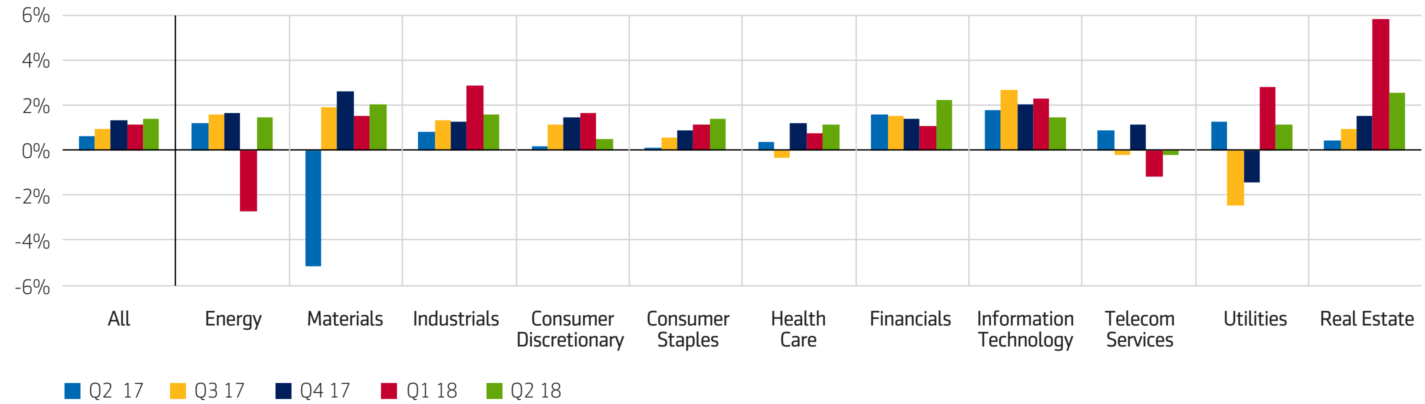
Exhibit 4: S&P 500 Y/Y EPS growth by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 8/15/2018

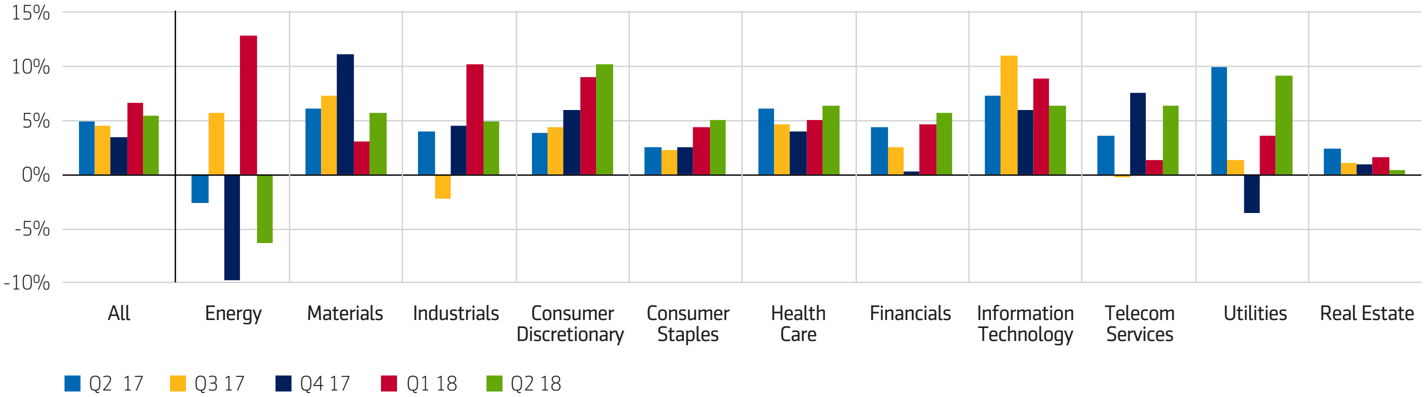
Appendix II

Exhibit 5: S&P 500 Y/Y revenue surprise by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 8/15/2018

Exhibit 6: S&P 500 Y/Y EPS surprise by quarter



Source: Aegon AM US Credit Research Team, Bloomberg
As of 8/15/2018

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