AEGON Asset Management

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SPECIAL REPORT: Q2 2019 EARNINGS WRAP UP

By US Credit Research Team

Broad Results

Despite year-over-year growth slowing to slightly less than 2%, S&P 500 earnings relative to expectations were positively skewed for yet another quarter, surprising by 5% while revenues were in line with consensus. Similar to the first quarter, the earnings growth rate, while positive, remains well below levels observed throughout 2017 and 2018. Looking ahead to the third quarter, high growth levels from the same period in 2018 will make for another tough comparison. Combining this with the continued uncertainty around tariffs, global growth and interest rates, the third quarter is at increasing risk of providing a negative EPS growth rate.

Exhibit 1: Our thoughts from a fixed income perspective: sector results relative to expectations

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

Source: Aegon AM US.

Interesting takeaways

Evolving impact of Chinese tariffs. China continued to be referenced with high frequency on earning calls during the quarter—picking up later in the quarter after the US announced additional tariffs on approximately $300 billion of goods coming from China starting in September. A number of management teams cited the US and China trade tensions (i.e. Huawei) as the main reason for guiding cautiously, stating lack of visibility and uncertainty regarding near-term demand. A leading communication equipment company that sells infrastructure to larger carriers in China has seen sales slowly declining and during their earnings call explained, "We saw [sales] decline more rapidly last quarter. And then what we've seen is in the state-owned enterprises—we're just being uninvited to bid. We're not being allowed to even participate anymore."

As a result of the growing uncertainty, the Chinese consumer appears to be pulling back on larger purchases and discretionary spending, such as leisure travel, appliances, and autos. As reported previously, numerous companies continue to work on moving portions of their supply chains outside of China to reduce future risks related to tariffs. Some of the more aggressive management teams are taking action now and not waiting for trade tensions to abate. Malaysia, India, and Vietnam appear to be receiving a good portion of the relocated supply chain.

Another worry for China—the Hong Kong protests—was also mentioned several times with management teams calling attention to disruption of travel in the city and the possible impact to consumer spending in the coming quarters. One of the world's leading media and entertainment companies commented, "In Hong Kong, we have seen an impact from the protests, obviously, they are significant in nature. And while the impact is not reflected in the results that we just announced, you can expect that we will feel it in the quarter that we're currently in and we'll see how long the protest go on, but there's definitely been disruption."

Despite the negative headlines generated by the Hong Kong protests and the US and China trade talks, a number of management teams continue to report year-over-year revenue growth in China, but the rate of growth has slowed versus prior quarters. Several management teams continue to be bullish on China long-term, but the trade war combined with a slowing Chinese economy has created uncertainty over the near-term. The recent escalation between the US and China reduces the likelihood of a stronger second half.

A closer look at Europe. Results of S&P 500 companies, European divisions were mixed, with underperformance primarily occurring in the industrial space. Consumer companies noted solid European results, highlighting the important role the consumer continues to play in supporting global growth. A large travel company performed well on the continent, continuing "its run of impressive pricing growth", but noted a revamped value offering helped drive performance, which may indicate trading down or the increased need for value. Other non-consumer companies that performed well in Europe include a payments company, a storage company and a consulting company.

The most consistent theme in earnings calls was industrial weakness. A packaged gas company reliant on manufacturing, noted, "weakness across the Eurozone" and observed, "industrial production has been trending down...on the continent…that is what we are facing going forward." A provider of high-performance liquid chromatography products and services, is cautious on the back half, saying they expect a "solid and healthy US environment…a balanced view on China and…more caution on the European environment overall...if there's any kind of conservatism built into our overall second half outlook, it's really around the challenging European environment, particularly in the industrial category." An automotive products and services company, stated, "Europe has seen many of its economies slowing" and they "anticipate the soft industry conditions will continue through the balance of 2019." A tools company posted positive results but indicated, "Europe overall was challenged." Finally, a packaging and materials company attributed overall volume declines to "industrial weakness in Europe and Asia."

When thinking through the drivers of the industrial weakness, a major shipping company summed it up nicely, attributing the weak European outlook to "a number of sector- and country-specific factors, such as disruptions in the auto manufacturing sector, social tensions, policy uncertainty, as well as uncertainty related to Brexit." This indicates that as long as political and policy uncertainty remains elevated, it may be difficult for the industrial sector to rebound in a healthy manner, and places even more importance on the pace of consumer spending to drive growth.

Domestically falling rates. The recent interest rate declines were noted frequently during the quarter and the financial sector referenced the topic with the highest frequency. Bank comments reflected some deterioration in net interest margins due to the decline in longer-term interest rates, and the outlooks seem to indicate the risk of further pressure going forward. Insurance company commentary reflected a higher level of concern due to the negative impact on spread margin, lower reinvestment rates as maturities occur over time and the negative impact on product demand.

Companies outside of the finance industry noted that they have been opportunistically refinancing higher coupon debt or moving out of floating rate debt into fixed rate debt. These moves should lead to lower interest costs, which will provide support for earnings going forward. If interest rates remain low, this positive trend would be expected to continue as debt maturities increase over time.

Interestingly, rates were referenced by several companies in the context of asset values and the potential for acquisitions. Various REITS noted that a lower cost of capital will be a tailwind for commercial real estate demand. In more cautious commentary, it was noted that the low interest rate environment has led the markets to be very accommodating to highly levered transactions and that acquisition multiples are increasing.

It should also be noted that lower interest rates are driving higher residential housing demand and mortgage refinancing activity. In addition, while comments were limited this quarter, lower interest rates normally have a negative impact when calculating pension funding and this could be a growing topic into year-end.

Summary

The China/US trade war remained the focus for companies this quarter and one of the main macro variables that management teams are anticipating will continue to affect growth. While results were better than expected, the real story this second quarter was looking at results on a year-over-year basis which came in well below the double-digit numbers we had this time last year. The weakening growth rate indicates what we have anticipated: the third quarter is at increasing risk of providing a negative EPS growth rate.

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