AEGON Asset Management

SPECIAL REPORT: 4Q 2018 EARNINGS WRAP UP

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Growth slowed in the fourth quarter with overall revenue at 6% year over year and earnings per share improving by a mere 12%, compared to 26% in the third quarter, for companies in the S&P 500. While these numbers indicate growth, the rate has slowed in relation to earlier periods in 2018. At an industry level, utilities and materials saw the lowest growth rates. Similarly, while still better than expected, earnings per share results only beat consensus by 4% this quarter, the lowest rate in several quarters. From a fixed income perspective, fourth quarter sector results relative to expectations have a less positive bend (Exhibit 1).

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	Consumer cyclical	Manufacturing	
		Consumer non-cyclical	Transportation	
		Entertainment	Healthcare	
		Technology	Communications	
		Energy		
		Utilities		
		US banks		
		Non-US banks		
		Insurance		

Source: Aegon AM US.

Interesting takeaways

The cost environment. Higher costs from a variety of sources continued to pressure the underlying results of some companies in the fourth quarter. The sources are similar to prior quarters: raw materials, labor, freight and tariff related. While some companies have been able to pass through the costs in the form of higher prices, more often than not, they are relying on past activities such as restructuring and cost saving efforts to mitigate the impact—although not all have been successful in this pursuit. They are also carefully monitoring additional pressure related to the US/Chinese tariff situation. In addition to evaluating higher selling prices, some are considering divesting underperforming units, attempting to shift the mix of products, and/or implementing further efficiency efforts to mitigate this risk. Several companies have noted an expectation that inflation is likely to continue in 2019, but anticipated at a lower rate. However, companies who had favorable hedges in place in 2018 are likely to see greater pressure as these roll off.

Uncertainty surrounding China. While it seems like China has been a focus of concern nearly every quarter, taking a break this quarter would ignore a key topic of discussion during the season. Daily news reports would lead many to assume that China is under material pressure. While ongoing trade disputes/discussions carry on, economic uncertainty in the region continues and volatility remains high, some companies are more optimistic on the region than the headlines would imply. During their quarterly earnings call, Phillips 66, a company within the energy industry, remarked, "So we did probably see some slowdown activity in the fourth quarter around China, but as we look into China through to the base demand in China, it's still pretty healthy." Walmart also commented on China during their recent earnings call, stating, "If you just read the headlines, you might imagine things are pretty tough, but that's not really what we're seeing."

That said, several companies did experience challenges in the region during the quarter, especially chemical and automotive companies, and were a bit more cautious. Albemarle, a company in the chemical industry stated, "[The] Chinese automotive market has been choppy," adding, "Chinese accounts customers have been reluctant for some time to commit to longer-term agreements." When remarking about construction growth within China, Caterpillar observed, "Within China, the industry is very dynamic and there are a variety of forecasts. We will continue to monitor the situation but as of now, we are forecasting the overall China market to be roughly flat in 2019 following two years of significant growth."

A deeper dive on autos. The auto industry has experienced an overall slowdown during the quarter, particularly in China and Europe. This was largely due to weaker consumer spending in China as well as emission bottlenecks from new environmental regulations in Europe. The Chinese sluggishness is multi-faceted: weakness in the Chinese stock market (wealth effect); issues with consumer lending in the region; destocking of inventory; the 10% auto purchase tax that was re-instituted in 2018; and the continued transition to electric and hybrid vehicles (EV) were all contributors. These challenges not only impacted the direct automotive manufacturers, but also several suppliers including those outside of the traditional auto space, such as chemical and semiconductor producers.

Looking forward, numerous management teams noted a belief that auto production will improve during the second half of 2019 in anticipation of a US/China trade agreement, as well as improved throughput related to European emission testing. It should also be noted that despite the slowdown of overall auto production, EV production continues to expand and the pace is projected to increase dramatically over the coming years, as the number of EV models scheduled to be released over next three years has grown significantly.

Additional observations

Several companies across various industries are noting difficulties in finding skilled labor. This isn't surprising given low unemployment rates, but is worth noting due to the cost pressure this may create, as well as the risk of reduced growth and innovation that may occur in the future as companies are unable to fill key roles.

Volatility in the stock market and with interest rates created uncertainty within the US construction markets, causing disappointing results and lack of visibility into the key spring selling season.

As the business cycle continues to age, debt levels remain in focus. While a few sizable issuers discussed debt reduction efforts, the number of companies referencing the topic and the combined debt levels of those firms remains similar to that of the fourth quarter in 2017.

In summary

For the fourth quarter 2018, results were decidedly mixed across sectors. Though still positive overall, global economic and political risks tempered 2019 guidance. We observed slowing growth with effects from foreign headwinds, namely from China and Europe, leaving companies cautiously optimistic heading into 2019.