AEGON Asset Management

SPECIAL REPORT: Q1 2019 EARNINGS WRAP UP

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S&P 500 earnings were positively skewed for the first quarter, surprising by 7% with revenues in line with expectations. Exhibit 1 illustrates our rating of the first quarter results of sectors within fixed income. If one simply looks at this measure, however, you would miss an important change relative to prior periods: on a year-over-year basis, earnings-per-share (EPS) only grew by 2%, well below the double digit growth rates achieved throughout 2018. Many factors are behind this shift, with the primary drivers being the anniversary of the major tax changes that boosted results throughout 2018 as well as material year-over-year drops in several commodity prices. That said, 2% growth is also well below the growth experienced throughout 2017 (ranging from 7-15%) indicating that taxes are not the only reason for the slowing rate. Overall, slowing growth combined with an evolving tariff situation creates a generally less certain earnings picture than we have recently experienced.

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

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

Source: Aegon AM US.

Interesting takeaways

The Latest on China. China remains top of mind for the majority of companies and was referenced with high frequency during the quarter. As the release cycle began in April, several management teams were cautiously optimistic and referenced signs of improving Chinese demand as a result of stimulus activities, which included both a reduction of value-added tax (VAT) and an increase in consumer lending. Several companies also highlighted modest supply chain actions taken over prior quarters like moving certain operations outside of China, but the majority thought trade negotiations were heading in a positive direction and decided against making more sizable supply-chain modifications given further disruptions such actions may create. For example, a clothing and accessory maker discussing higher inventory levels explained, “The increase was primarily driven by a higher level of in-transits related to port congestion in Asia. Specifically as companies have migrated production outside of China, infrastructure investments in key Asian ports, including the Philippines, Vietnam and Cambodia have simply not kept pace. And while this has not resulted in higher freight costs, it has resulted in longer lead times with more inventory on the water at any given time."

The tone in regards to China changed when President Trump surprised the markets and reignited the tariff discussion in a tweet on May 5. When discussing the topic, many companies provided more cautious commentary and some lowered guidance as a result. Several management teams also began expressing concern about the administration moving forward with tariffs on an additional $300 billion of Chinese imports as well.

Outside of tariffs, other notable items discussed with regards to China included a breakout of African swine fever which has crippled the pork industry within China, continued softening in automotive demand (excluding electric vehicles), and further smartphone weakness. Despite this, several firms referenced positive momentum regarding Chinese infrastructure buildout, solid demand within healthcare, and the belief that inventory destocking had more or less been completed.

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Outlook

The Second Half: Looking ahead to the remaining quarters of 2019, current consensus indicates relatively flat EPS growth rates for both the second and third quarter; however, this increases to approximately 7% growth in the final period of the year. Although largely a reflection of easing comps in the fourth quarter, a back-end loaded growth rate may create greater risk to the downside as we progress throughout the year if the uncertainty continues. In addition, some of the reasons companies have provided on how growth is anticipated to occur throughout the year, such as restocking and improving macro sentiment, tend to rely upon some type of macro event occurring outside of the control of management teams. Combining this with the tariff news occurring after many companies had already released results, creates greater risk of revisions as we look ahead. While this does seem to be concentrated in certain industries at this point, it is something to watch as the year progresses.

Domestic Results Remain Strong: Domestically focused businesses generally outperformed those operating in a broader marketplace. Excluding financials, the first quarter saw one of the largest gaps in earnings growth rates since 2016 between domestically focused US firms and export focused US companies. This was generally driven by a relatively strong US economy, healthy consumers, attractive interest rates and increased dialogue around tariffs.

Summary

The impending outcome of the China/US trade war remained the focus for companies this quarter and one of the macro variables that management teams are anticipating that will affect growth as we enter the second half of the year. While results were better than expected, the real story this first 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: we are likely approaching the end of this growth cycle.

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