SPECIAL REPORT: 3Q 2018 EARNINGS WRAP UP

By Jennifer Moore, CFA, Director of US Credit Research

Earnings this quarter remained strong. Overall, revenue grew 8% year over year and earnings per share improved by 26% on the same basis for companies in the S&P 500. Similar to earlier this year, growth remains broad based across major sectors with no significant pockets of weakness. Also in line with what we have seen throughout 2018, revenue remains relatively aligned with expectations, with earnings slightly exceeding estimates this quarter by nearly 7%.

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

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

Interesting takeaways

Lack of new themes. While the overall results remain reasonably healthy, this quarter lacked major new themes that materially drove results. Companies continued to talk about several consistent themes we have discussed in previous quarters, such as cost pressures and tariffs, but there were not clear underlying takeaways.

Guidance. While results came in rather strong again this quarter, market sentiment during the period was soft. Given the forward looking nature of markets, this type of disconnect can occur due to a weakening in guidance rather than anything in particular with the quarter's results. During the third quarter reporting period, nearly 35% of the companies in the S&P 500 Index discussed full-year earnings guidance. Of those firms, about 30% affirmed full-year 2018 guidance and half of them raised guidance. For those who lowered expectations, a common cause was inflation, not necessarily that cost pressures had intensified relative to prior periods, but rather continued for longer than expected. In addition, several companies who lowered guidance made references to the negative impact of foreign exchange rates.

At an industry level, Utilities and Healthcare had a large number of companies raising (40-50%) or affirming (10-30%) and only a small portion lowering guidance (0-10%). Relative to the broader market, these industries have some of the lowest exposure to areas experiencing cost pressures and they tend to have a greater domestic presence. On the other hand, Materials and Industrials were more likely to lower (15-20%) and less likely to raise (10-20%). Industrials also experienced larger changes in guidance when lowered (5%) than when raised (3%). These industries have some of the most direct exposure to rising costs (including tariffs) and international markets.

Around the globe

Overall, results in the US remain robust, however results and commentary did reflect some differences in major markets. Additionally, as we noted in relation to company guidance, foreign exchange rates continue to create various challenges for domestic firms.

Europe. The European markets were lackluster during the quarter with relatively low growth rates. Larger overhangs such as Brexit, Italy, various political issues and unusual weather, as well as softness in certain key industries such as autos, which is partially related to new emission standards going into effect, all contributed a general sense of uncertainty.

China. While growth remained rather strong, some companies experienced deceleration in the growth rate as well as some general softness that was difficult to measure. Tariffs continue to create some uncertainty in more industrial-based companies, but slight caution on the consumer side was also noted. It is also difficult to judge the overall health of the region given it appears that anticipation of tariffs has resulted in pulling forward demand, possibly masking true underlying trends. Despite this, it appears that the region continues to grow and many companies remain optimistic on the region for 2019.

Other countries. While not major end markets for US companies, some businesses experienced volatility in Turkey, Argentina, South Africa and portions of the Middle East as various events occurred.

Additional observations

Discussion around inflation remained consistent from last quarter and remains around transportation, labor and certain raw materials. The most notable new takeaway on this topic is that a few companies confirmed that the expected waning of inflation the second half of the year has not occurred, but rather, remains as it did in the first half of the year.

Also, after gaining steam last quarter and causing some uncertainty on its effect, talk on tariffs, while remaining an important topic, declined somewhat this quarter.

Finally, discussion around interest rates increased this quarter, but comments remained very similar to prior quarters, as we discussed in the first quarter earnings piece.

While still relatively low, there was an uptick in references to destocking this quarter. A closer look did not reveal material concerns about broad economic weakness, but did hint at pockets of uncertainty within the industrial space as well as within China, although some of this is related to the tariff situation rather than just demand based.

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