CURRENT MARKET NEWS

Q3 Earnings Review: Jumping over the low bar

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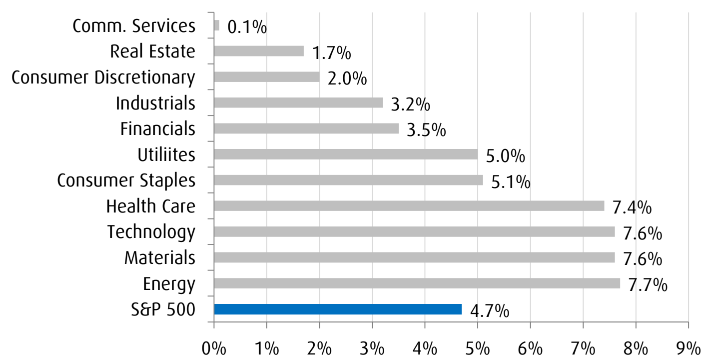
Third quarter earnings season is wrapping up and results were strong enough to provide a positive catalyst for the stock market. In total, earnings exceeded consensus by a greater magnitude than average and a larger percentage of companies beat estimates than is typical. Stock price reactions were mixed; companies that exceeded consensus increased 1.1% over the following two days in aggregate.

Earnings reports have been better than expected each quarter this year, which fits with the typical pattern of analysts' expectations being lowered and then exceeded. As of November 4, 2019, 72% of the companies in the S&P 500 have reported earnings. This group of companies exceeded consensus by 4.7% which is well above the 3.3% average since 1994. Yet this is a modest deceleration compared to the last few quarters, as seen in ***Chart 1***. At 76.1%, the percent of companies exceeding consensus also compares favorably to the 64.8% long term average.

For 2020, Wall Street analysts are anticipating a much more robust level of earnings growth at 10.5% following the modest 0.5% forecasted for 2019. Even in stable economic environments, however, earnings expectations tend to come down as the year progresses. Tariffs are also a risk for 2020 guidance as tariffs only applied for part of 2019. In many cases, they were offset by concessions from vendors and currency appreciation.

Earnings strength was broad based with four sectors exceeding consensus by 7.5%-7.7% ***(see Chart 2)***. This is an overall metric where larger companies are more impactful on the result. Health Care was notable as it outperformed expectations by 7.4%, its best performance in at least two years. The major pharmacy companies delivered core product sales ahead of expectations and nearly all companies raised 2019 guidance.

Chart 2: Strong earnings beats across multiple sectors - Total Earnings Surprise



Source: Refinitiv, BMO Wealth Management

Chart 1: Third Quarter 2018 growth provides a tough comparison

	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19 Estimates
3Q EOS Growth	26.60%	24.90%	28.40%	16.90%	1.60%	3.20%	-0.60%
S&P 500 EPS Surprise %	6.60%	5.30%	6.40%	3.40%	6.00%	5.60%	4.70%
% Companies Exceeding	78.20%	80.20%	77.40%	69.30%	75.70%	73.90%	76.10%

Source: Refinitiv, BMO Wealth Management

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Consumer Staples earnings were especially strong relative to their recent history. So far 91.7% of the companies exceeded consensus by 5.1% in total. Sales exceeded expectations in a reversal from recent disappointments as companies are having more success passing through pricing.

On the other end of the spectrum, earnings beats for Consumer Discretionary and Communication Services companies decelerated this quarter. Over the last two years, discretionary companies beat by between 4% and 13%, only to slow to a 2% beat this quarter. Five companies missed consensus by 8% or more, including industry behemoth Amazon which is investing in one-day shipping.

Communication Services earnings were about in line with consensus. Alphabet's 13% miss was primarily due to a French tax settlement and write down of the value of investments in recent IPOs. This offset double digit beats by Netflix and Facebook.

Conclusion

While we believe that the economy is slowing, we do not see the conditions for a recession developing. The consumer is supporting the economy due to low unemployment and healthy wage increases. The Fed has signaled that its intentions are to remain accommodative. While the S&P 500 remains at peak levels, the valuation is supported by low interest rates. We remain comfortable with our neutral position in U.S. equities.

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