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2Q Earnings Season Review: Strong numbers, but underlying trend is negative

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We are almost at the end of the US 2Q earnings season with 350+ companies reported earnings and the results have been impressive as we expected; 77% surprised to upside with an average earnings per share (EPS) surprise of 10.7% vs. a historical average of 3.7% - so clearly a solid earnings season in terms of EPS. However if we look at sales development there is reason for concern. 61% surprised to the upside, while the average surprise has been -0.83%. With margins almost at prior peak levels and a sales growth outlook that is bleak we expect revisions to the downside in earnings. This should in combination with a deteriorating macroeconomic environment lead equity prices lower.

We have now had 350+ earnings reports out from S&P500 and the result has turned out quite as we expected. We expected expectations of 4 out of 5 beating estimates to the upside, but so far 77% has surprised to the upside, while 23% missing the streets estimates. The average positive surprise in terms of EPS growth has so far been 10.7% which is decent given a historical average of 3.7%.
So far, so good. But if we turn to sales development the story is somewhat less cheerful. Only 61% has surprised to the upside, but the average surprise has so far been negative at -0.83%. The takeaway from this is that sales are still having trouble picking up and this is clearly our main concern going forward as we do not expect margins to continue improving at current pace into 2011.

If we take a closer look at the drivers of earnings growth we are left with sales and margins. Breaking down both consensus sales growth estimates and forecasted margin changes clearly reveals that the increase in consensus earnings growth has been mostly driven by expected margin improvements. Consensus sales growth has largely been unchanged since the beginning of 2009, but during the last two years we have seen consensus strongly revise up expectations for margin improvement. Consensus is currently expecting margins to improve less in 2011 (90 bp) than in 2010 (150 bp). We are aligned with consensus here and do not expect to see margins test their prior peak in 2011. This leaves sales as the component that should drive earnings further up from current levels and when looking at the macro picture we find it increasingly difficult to buy into this story.

Corporate earnings are somewhat lagging macroeconomic indicators, whereas equity markets tend to react more quickly especially to changes in the macroeconomic environment. On a global basis PMI's are still in expansionary territory, but they have started retracing. Similarly leading indicators have long been heading south again and this usually points towards a deteriorating macroeconomic environment. But this should already a part of the sales growth expectations that lately have been starting to drop. However the upcoming severe cuts in public spending in Europe and possibly also the US (when they realize the state of their economy) are neither a part of GDP expectations, nor the sales growth expectations.
In other words this is clearly bad news for sales growth expectations and in the end for earnings growth expectations which for S&P500 is currently 20% for 2011. Given our expectation of sales growth that will be sluggish at best and margins that are close to their prior peak we expect earnings growth around 5% for 2011 in S&P500. The two most important questions in this regard are obviously: 1) Will earnings growth revisions affect equity prices and 2) if, when should we expect it to happen?

Equity markets have clearly started to anticipate this, so if negative earnings revisions should be less than 15% from current levels equity markets should not react because it is already a part of the current pricing. However if we should end up with 2011 earnings growth expectations in single digit territory in S&P500 as we expect equity prices will come down. For sure – but as with most things in here in life it is all about timing – so when do we expect this to happen? We expect downward earnings revisions to start after the 2Q earnings season, because downward revisions always take place between earnings seasons, but the major revisions to the downside will first take place after the 3Q earnings season. Why? Simply because this is when CEO's will start to reveal their sales forecasts for 2011 and analysts will then be forced to follow suit.

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