Heartwood
Investment Management

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Investment Insight

Weekly Insight

As US corporates face more headwinds, expect more performance dispersion

Corporate earnings season is in full force and forecasts suggest that we are likely to see the third consecutive quarter of negative earnings growth, the first time since 2009, which would technically count as an earnings recession. It is worth making the point, however, that earnings pressure is heavily concentrated within the energy, materials and industrials sectors. Broadly, US corporates are contending with slowing growth in China, lower oil prices, a stronger US dollar and limited pricing power in this disinflationary environment.

Approximately 20% of S&P 500 companies have so far reported results for the fourth quarter. Due to the significant reduction already made to earnings expectations, early indications show that approximately half of those companies have announced better than expected sales growth with around 80% reporting better than expected earnings growth. The trend of earnings growth being derived more from cost cutting, corporate restructuring and share buybacks has continued, but with US equity valuations remaining above their long-term averages across a range of measures, some investors are questioning how long this trend can continue.

While recognising the headwinds faced by corporate US, the effect of strong cash generation and continued low interest rates are likely, in our opinion, to support share buybacks; after recording a total volume of $615 billion in 2015 [Source: JP Morgan], which was one of the strongest years on record, already this year we have seen $15 billion in authorised buybacks.

Expect increasing sector and stock dispersion

We are expecting to see increasing dispersion in performance between sectors and stocks. Defensive sectors such as health care and consumer discretionary, as well as innovative growth industries, such as software and biotech, should be better positioned to outperform in a moderate growth environment. Elsewhere, US banks are showing improvements in revenues, although earnings are mixed. Bank of America and Citigroup results have been weaker, while those banks that have successfully restructured, like Morgan Stanley, have been standouts with 10% earnings growth. On the whole, banks appear to be weathering oil losses reasonably well given much stronger balance sheets, although the building of loan loss reserves may pressure earnings in coming months.

Within industries we are seeing more dispersion as well. In software, which continues to benefit from the secular drivers of cloud computing, applications and cyber security, headlines have been dominated by concerns about Apple's ability to grow its product offerings, particularly as demand in China slows. Some forecasts suggest that full year revenues for the fiscal year 2016 will decline, which would be the first time since 2001. It is not all bad news though, as Apple sits on a $200 billion cash pile. Other software companies have surprised above expectations, such as Citrix, the enterprise software provider, and Facebook, which announced 50% earnings growth over the previous year.

Look outside of the US to markets further behind in the corporate earnings cycle

Investors might also look outside of the US to other markets which are further behind in the corporate earnings recovery cycle, such as Europe and Japan; and Heartwood has reallocated some capital in this way. In the case of Europe, profit margins in aggregate on the Euro Stoxx index are significantly below 2007 pre-crisis levels. Corporate Japan, meanwhile, has seen stronger profit margins as a result of business restructuring and a greater focus on growing return on capital.

The UK equity market has made little progress over the last two years, its significant exposure to the energy and material sectors being much of the reason for this. Questions around the risk to future dividend pay outs and the likely overhang of the coming EU referendum are likely to weigh on returns in the short term. Further afield, equity markets in Asia and emerging economies are continuing to fall, which in time should provide interesting opportunities for the patient investor.

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Risk Warnings:
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