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RICHARDSON Wealth

Market Ethos

The latest market insights from Richardson Wealth

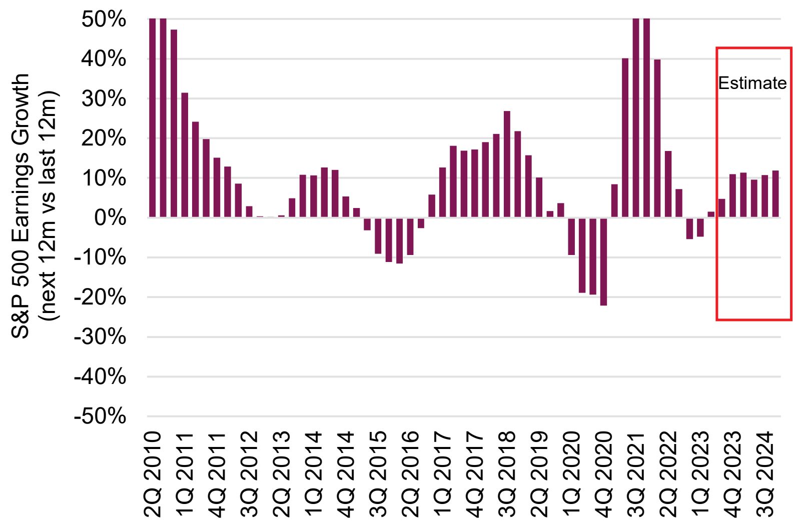
Craig Basinger

Earnings, trick or treat?

We are about halfway through the U.S. earnings season, with 245 of the S&P 500 companies having already reported. Earnings are backward-looking, kind of like GDP reports, since the quarter started in July and ended in September. Nonetheless, companies offer a direct look at what is happening on the ground and deliver their expectations for the coming quarters via guidance. We would include Canadian earnings as well, but only 14% of the TSX has reported. Things move a little slower up here. So, let's dive into U.S. earnings.

There is some good news: earnings growth has returned. After three quarters of negative or no earnings growth, Q3 2023 earnings appear to be coming in at about +5% compared to the same quarter last year. Based on current bottom-up analyst estimates, earnings growth is expected to continue to improve up to about 10% or so.

S&P 500 earnings growth has started to improve



Source: S&P, Purpose Investments

Continuing on a positive note, about 80% of companies have so far surprised to the upside, in keeping with historical norms. Impressively, this was widespread across all sectors except energy. Growth, too, was widespread, with all sectors except energy, materials and real estate showing positive earnings improvement over last year. With commodity prices lower than a year ago, that is what drives the earnings in energy and materials, so it is not surprising. And, of course, real estate continues to struggle. Margins have also remained resilient. Yes, costs are up, but so too is top-line revenue growth for most firms. Overall, it has been a decent earnings season so far.

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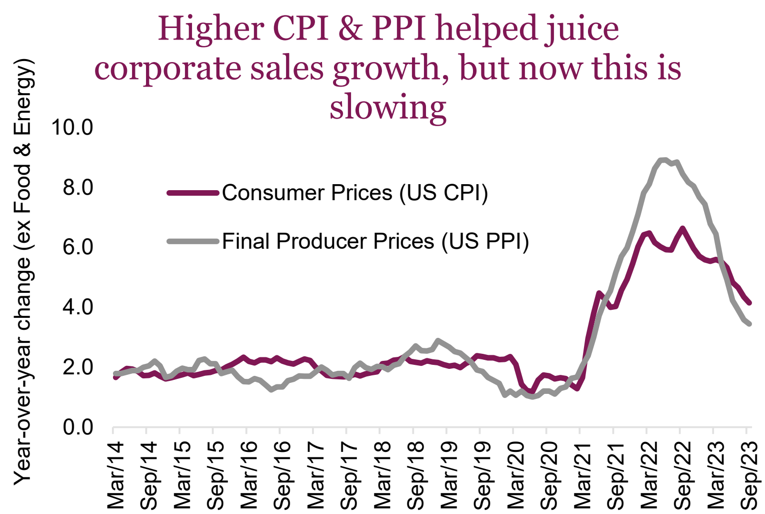
On aggregate, it does appear that things are holding up or even improving from an earnings perspective. But it is important to remember that periods of higher inflation create a great deal of confusion, not just for people making decisions but for businesses and even for economists. Inflation churns up the water, making it hard to see what is really happening in the economy.

There is no denying higher inflation helped offset higher input costs to maintain margins and help restore earnings growth. Now the question is, what happens as prices and producer prices come back down? Without the ability to raise prices, either input costs have to reverse as well, or margins suffer.

So, will input costs come down? Ford appears to have resolved the strike and, as a result, removed profit forecasts. Sure sounds like input costs may keep going up even as inflation comes down. This may put labour-intensive industry margins at greater risk in the coming quarters.

There is another cost that is starting to bite: interest expense. In 2022, when yields started to rise, there was much talk about how great a job corporate America did on extending the terms of their debt when yields were so low. Absolutely true, and this has helped. But as time goes by, it starts to show up more and more as rising interest expense.



Source: Bloomberg, Purpose Investments

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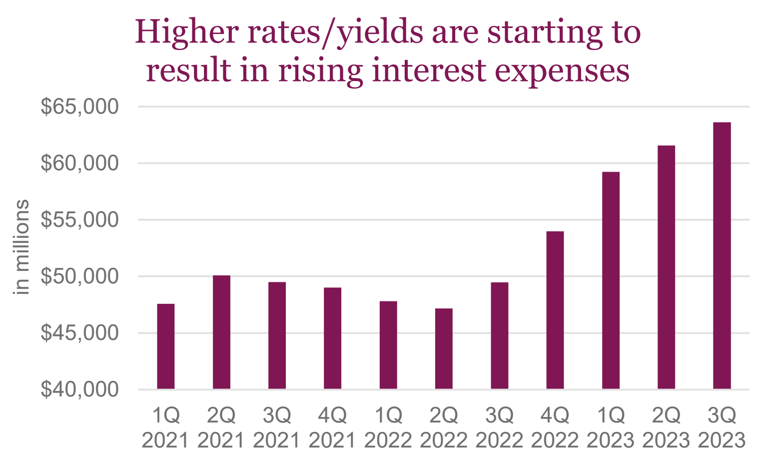
Final thoughts

We are encouraged so far by this earnings season, but we also are starting to see forward estimates come under a bit of pressure. It is important to focus on the composition of companies, their ability to pass through costs, how labour-intensive their operations are, and what the debt situation looks like.



Source: S&P 1500, Bloomberg, Purpose Investments

S&P estimates for 2024 remain too high in our opinion, and we believe this adds to risk. Canada and most international markets have already seen a rapid decline in estimates, which does provide a margin of safety. U.S. earnings appear the most at risk, but it really depends on the industry and the company.

Sorry, there is no quick and easy shortcut here, just the conclusion that digging deeper into fundamentals is becoming increasingly important in this challenging market.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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