

David Bianco  
Chief Investment Officer &  
Strategist, Americas



### In a nutshell

- Half way through fourth quarter 2018 EPS reports: Decent results, constructive outlooks
- Early 2019 outlooks by sector: The only sector slashing estimates is Energy
- S&P 500 target 2850, 16.75 trailing P/E: Next 5% plus S&P 500 move has balanced risk

## Americas CIO View

### Company outlooks suggest that a profit recession is unlikely

#### Half way through fourth quarter 2018 EPS reports: Decent results, constructive outlooks

About 60% of the fourth quarter S&P 500 earnings per share (EPS) has been reported. So far the results are decent with a 3% weighted-average beat. However, this 3% beat is measured from the estimate of the previous day of reporting and because estimates were reduced in the weeks before reporting season, this 3% beat is not the same quality as the typical 3% beat delivered in past reporting seasons. Beat metrics can be deceiving, it is best to assess year-over-year (y/y) EPS growth.

Because the window for lowering estimates is behind, a 3% beat from the remaining half of earnings – yet to report on top of the current 40.31 U.S. dollar (USD) bottom-up estimate suggests that fourth-quarter EPS will finalize at about 41 USD or about 14% y/y growth. This is a bit lower than what we expected two to three months ago, but this is mostly because of the Energy sector. We still expect full 2018 non-GAAP S&P 500 EPS to be about 163 USD.

Excluding the Energy sector, S&P 500 fourth-quarter EPS results and 2019 outlooks suggest that 5% EPS growth (ex. Energy) is a reasonable estimate for 2019. Managers attached many macroeconomic caveats to their outlooks. Caveats are ranging from no recession, a patient U.S. Federal Reserve Board (Fed), no further tariffs and no disorderly Brexit. These are the same conditions for our 2019E S&P EPS, all of which we consider likely to be satisfied.

#### Early 2019 outlooks by sector: The only sector slashing estimates is Energy

In assessing estimate trends, remember that companies usually guide estimates down 3 to 5% at this time of the year to help put those estimates for the new calendar year at levels likely to be beaten by 3% when reporting time comes. That is why we focus more on the y/y growth rates than beat metrics or ratios. The seasonal trend in 2019E EPS estimates has not been more negative than usual, excluding Energy.

Banks lowered their expectations of Fed hikes to one or none in 2019, but their earnings estimates have not been materially reduced. Healthcare estimates are stable with a slight upward trend. Consumer Discretionary is mixed by industry, but stable overall. Technology was cut, mostly at handsets and semiconductors. Technology EPS growth is now at a low to mid-single-digit rate for 2019, which should allow beats. Industrials are most sensitive to weak commodity prices, slower trade and growth, but estimates remain above ours given good trends at Aerospace and Defense and many Transports. The year still has eleven more months to go, but if oil prices stay at current levels through 2019,

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then Energy earnings are likely down by 15% vs. 2018. Because we are uncertain when West Texas Intermediate (WTI) oil prices rally to 60 USD / barrel (b) we cut our 2019E Energy earnings from 80 billion USD to 65 billion USD. This reduces our 2019E S&P 500 EPS by 2 USD from 172 USD to 170 USD. This is up 4% vs. 2018 or 5.5% ex. Energy.

Because oil prices and Energy earnings are volatile, investors will focus on the sector's normalized earnings; which we still estimate at 80 billion USD. For S&P 500 EPS overall, we think investors will evaluate growth on an ex. Energy basis. This was the case in late 2015 and early 2016. Because the oil price decline is not as severe as in late 2015, and because Energy companies substantially reduced their operating expenses and investment spending from levels then, we think Energy profits will be higher in 2019 than what the sector generated in past quarters with oil prices near these levels. And domestic-centric oil producers have increased their unit volume production. The drop in oil prices should be less of a shock to Materials and Industrials sector earnings in 2019 vs. 2015-2016. Thus, the benefits of lower oil prices to the consumer sectors might produce a net benefit to S&P 500 EPS ex. Energy.

**S&P target 2850, 16.75 trailing P/E: Next 5% plus S&P 500 move has balanced risk**

The average S&P 500 price-to-earnings ratio (P/E) since 1960 is 16.1 and since 1985 is 17.7. One way to evaluate an observed P/E is to compare it to a fair steady-state P/E estimate. A steady-state PE is estimated as: one divided by a fair long-term real return on S&P ownership. Since 1960 or 1985, the S&P 500 generally traded with a 15 to 20% premium to its steady-state P/E, which was generally 14 to 16. This premium represents long-term economic-profit growth potential. Right now, the S&P 500 is trading at a 15.9 P/E vs. our fair steady-state P/E estimate of about 18, which is a 12% discount. Our 16.75 P/E target implies a 5 to 10% discount. This discount should close if the risk of recession falls as 2019 unfolds. This would most benefit the P/Es at growth -oriented sectors. Given the recent strong rally, we lower the equity allocation to 65% from 68% and favor growth stocks.

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R-0500029-80 (1/19)

## Glossary

### Barrel (bbl)

A **barrel (bbl)** is the commonly used unit to measure crude oil. One barrel is about 159 liters.

### Brexit

**Brexit** is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

### Earnings per share (EPS)

**Earnings per share (EPS)** is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

### Generally accepted accounting principles (GAAP)

**Generally accepted accounting principles**, or **GAAP**, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

### Growth strategy

A **growth strategy** is an investment style that is focused on an investor's capital appreciation through capital gains. Investors following this strategy seek to invest in companies whose earnings are expected to grow at an above-average rate compared to the industry or the overall market.

### Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

### S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

### U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

### U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

### Volatility

**Volatility** is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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**West Texas Intermediate (WTI)**

**West Texas Intermediate (WTI)** is a grade of crude oil used as a benchmark in oil pricing.

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R-0500029-80 (1/19)

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by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request.

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