Rathbones
Look forward

Review of the week

24 April 2023

Markets on edge as earnings season picks up pace

Investors are fearful of an earnings recession as reporting season steams ahead. Meanwhile, China's first-quarter GDP estimate suggests its recovery is proving uneven

Earnings season really picks up pace this week: around a third of S&P 500 companies will be reporting their first quarter earnings– and how they expect to do from here. These numbers – and whether or not they meet or miss analysts' expectations – can be major drivers of equity market performance.

Analysts were far from optimistic heading into the current earnings season. In fact, most are expecting an earnings recession (when earnings fall year-on-year for two quarters in a row). According to data company FactSet, analysts expect first-quarter earnings to slump by 6.6% on an annualised basis following a 5.8% fall last quarter. That would represent the biggest quarterly decline since the early days of the pandemic.

We believe that the consensus is still too optimistic, however. In the US, strong earnings growth is expected over the calendar year from the financials, industrials and consumer discretionary sectors. Only the energy, materials, real estate and healthcare sectors are expected to see earnings contract meaningfully. This is inconsistent with our top-down quantitative models, as well as our belief that an economic recession will begin in the second half of 2023.

Shrinking profit margins are the main reason for the expected decline in earnings. Inflation is still pushing costs up, and higher interest rates are making it more expensive for businesses to borrow. The result is that companies could makes less profits – even if their revenues are still growing. That's bad news for stock prices.

The most notable companies reporting this week include several of the US technology giants like Microsoft, Apple, Google parent Alphabet and Meta Platforms (Facebook). Technology stocks took a real battering last year, but have performed much more strongly over the last few months. Decent news - particularly in terms of the guidance these big companies provide on their future prospects - could help equity markets find a firmer footing from here. But, equally, any high-profile setbacks could ignite investor unease. Stocks have rallied quite a bit since the last batch of earnings reports and any big disappointments could risk shattering the current edgy calm. We're braced for a potentially bumpy week ahead.

Given the banking system stresses in March, all eyes were firmly focused on the financials sector last week when earnings season kicked off in earnest. Around 18% of S&P 500 companies, including several big banks, reported their first quarter earnings. Most showed few signs of severe strain in the wake of the tumult, helping to ease fears about big deposit outflows and sharp declines in their net interest margins (NIMs). NIMs are a key profit metric for banks as they reveal the amount they're earning on interest on loans compared with the amount they're paying in interest on deposits. NIMs have benefited from higher interest rates as these enable banks to charge more for lending, but they're expected to come under pressure as depositors get more selective in search of higher interest and a slowing economy weighs on demand for new loans.

We were already seeing bank lending to households and businesses slowing down and banks tightening their lending standards before the March panic set in. Further belt tightening from the banks raises the already high probability of a mild US and global recession as the delayed effects of higher interest rates and less bank lending filter through the economy. But while conditions will likely worsen ahead, we're not expecting a deep or prolonged downturn.

That said, we still think current equity market pricing is at odds with the probability we place on a global recession (as well as sticky inflation). And this downward skew to the risks is keeping us defensive. Even before the banking sector's travails, we felt that global equity valuations were too high relative to what the historic, tight relationship with inflation-adjusted (real) bond yields suggests they should be.

To put it another way, the better the real yield available from safer assets like bonds, the less investors are willing to pay for potential future returns from riskier equities. And there's still a big disconnect in these valuations. Most global stock markets are still in positive territory for this year, but government bond markets have been trading as if a recession is looming

Last week saw an important milestone for UK 10-year gilt yields, which soared above 3.85% , their highest level in more than 10 years if we exclude the crisis triggered by the ill-fated mini-budget last October.

The immediate trigger was March's higher-than-expected consumer price inflation. To recap briefly, consumer inflation dropped by a mere 0.3 percentage points to 10.1% year-on-year in March.

The Bank of England (BoE) had expected the rate to be 9.2% by this point so it was big upside surprise, led by worryingly high food and core inflation (19.1% and 6.2%, respectively). The BoE has warned that high inflation is "a bigger risk than over-tightening" and markets are fully pricing in another quarter point rate hike at the BoE's next policy meeting in May. We weren't in the camp that thought the BoE had already reached peak rates and have long thought the risk that inflation gets stuck is higher in the UK than elsewhere.

China past its peak

China released its estimate of first quarter GDP last week. The general picture seems to be that consumers have been quick to return to the streets and public transit in the wake of the 'great reopening'. Indeed, the recovery in everyday spending has been very strong. But people have been slower to step up discretionary spending on big ticket items or on long-distance travel. Construction activity was weaker than the consensus expected: we believe weak banks and developers will curtail this driver of growth from some time.

We think China's recovery will be slower from here and, moreover, slower than the market bulls expect. There seems to be a lot of optimism around high pandemic-accrued savings translating into high consumption throughout the year, much like the West's post-COVID rebounds. But China's propensity to save has stayed around a 20-year high, in part due to the first-ever negative wealth effects from property since records began over 20 years ago, and damage to China's household balance sheets from so-called wealth management products failing to deliver. The distribution of pandemic-related excess savings is also skewed towards the rich, who have a lower marginal propensity to spend - more skewed than in the West it seems.

If current cyclical tailwinds fade, then investors will have to confront some profound structural headwinds again. We've written about them in our new Investment Report - China past its peak. You can read the full report here.

If you have any questions or comments, or if there's anything you would like to see covered, please get in touch by emailing review@rathbones.com. We'd love to hear from you.

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