3Q Earnings Off to Surprisingly Strong Start

By Robert Landry, CFA, Portfolio Manager of USAA Investment Solutions

While we are still early in the third-quarter earnings season, there have been some pleasant surprises that hint at the possibility that the reality may not be as rough as the forecast.

The forecast is that the U.S. earnings recession will continue for a sixth straight quarter; the Standard & Poor's 500 is expected to post earnings growth of -1.8% for the three months ended in September, according to the financial data firm FactSet. This is nothing to crow about, but it is trending in the right direction, given that expectations were even more negative as the quarter ended.

Only a tenth of the S&P have reported their 3Q numbers so far, and a higher-than-usual percentage of them are exceeding analyst estimates on both revenue and profits. On top of that, the extent to which they are surpassing those estimates is also significantly above the long-term average.

If this trend keeps up, overall earnings growth will beat Wall Street's weak outlook, and it may even be able to push into positive territory. Thomson Reuters, in fact, said Wednesday that its data shows 3Q earnings moving into the black.

Financial stocks are generating the biggest boost to earnings growth. The largest banks, which used gains from trading activity to counter the drag of ultra-low interest rates, saw their share prices jump by as much as 2% on the news. Also faring well in early reporting are health care providers and technology companies, including online media.

At the other end of the expectations spectrum is the energy sector, which is still dealing with a tough oil market. The forecast predicts that S&P energy companies will see a 72% drop in earnings and a 13% decline in revenue compared to the third quarter of 2015. Industrials are also expected to lag, in large part due to struggling airlines.

KEY TAKEAWAYS

- It's still early in third-quarter earnings season, but so far the trend is good — more companies than usual are beating expectations and by a wider margin than the long-term average. Big banks are leading the way.
- The economic growth outlook is less exciting. The Atlanta Fed's GDPNow estimate has been nearly halved from 3.8% GDP growth to 2% since August due to a proliferation of soft data reports.
- Given the Fed's reliance on data in determining its course of action on interest rates, the recent lackluster reports raise questions about whether policymakers will end up hiking rates in December.

Stocks overall are on the expensive side, based on both forward and trailing earnings, so in our view, there's not much room for price multiple expansion. Valuations for dividend-paying stocks like utilities, telecom and consumer staples are particularly rich, as they've been driven up by income-seeking investors. Opportunities are still out there, though selectivity is key. Our research is turning up promising dividend growers in health care, tech and even among certain financials.

It's a challenge for companies to grow their top and bottom lines in a slow-growth economy like the one we've endured for the past several years. So when the Federal Reserve Bank of Atlanta estimated in early August that the U.S. economy would expand by 3.8% in the third quarter, markets did a little dance. Finally, the economy was taking off.

Alas, it was all too good to be true. The Atlanta Fed's GDPNow number has since been in steep decline due to a long string of uninspiring economic data. Its latest estimate came out Wednesday at 2%, little more than half what it was just a couple of months ago. Reports from other data compilers reinforce the weakening growth outlook. We'll know soon enough, as the Commerce Department's first print on 3Q GDP comes out next week.

This softening trend makes the anti-trade talk from the major presidential candidates a greater concern. Global trade represents a substantial chunk of the U.S. economy and, on the whole, American companies and American consumers have greatly benefited from globalization in recent decades. Candidates' promises that existing trade deals will be renegotiated or that tariffs will be imposed make for good populist sound bites, but history clearly shows that no one wins in a trade war.

Slowing growth may also have a bearing on the Fed's course of action on interest rates. The market is pricing in a 0.25% increase for December, but in light of the subpar economic data of late, we don't think it's a lock that there will be a hike before 2017.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are best suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

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