PORTFOLIO INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

January 21, 2019

IN BRIEF

- Recent equity market volatility reflects, in part, investor concern about the impact of slowing growth and tariffs on corporate earnings as well as the possibility of an earnings recession. The U.S. reporting season underway will be closely scrutinized for any clues on these issues, while results should in any case confirm that earnings growth peaked in Q3 in 2018.
- Earnings growth expectations for 2019 have begun to decline across regions, with U.S. equities now expected to deliver around 6.5% growth, down from 10.5% in October. Declines have been broad-based and, unusually, driven by margin downgrades in the face of rising top line growth rates.
- It is too early to tell whether current earnings downgrades represent the start of a material earnings downturn, but they make us more cautious on the equity market outlook.
- We have recently reduced risk levels in our multi-asset portfolios, initiating a small underweight in stock-bond at our November Strategy Summit. We prefer defensive regions, with the U.S. our most preferred equity market and emerging markets (EM) and Europe our least preferred.

IS THE GLOBAL EARNINGS CYCLE ABOUT TO TURN?

Concern about the outlook for corporate profits, amidst a global growth slowdown and a U.S.-China trade battle, was one of the key drivers behind the recent volatility in global risk assets. As the Q4 U.S. earnings season gets underway, investors will be scouring the data for any hints about how growth and trade issues might impact profits. In the rearview mirror the picture should still look pretty good. Bottom-up consensus for the S&P 500 currently expects about 14% earnings per share (EPS) growth year-over-year for the fourth quarter (12% ex-energy). This is down from the 20% growth rate analysts were expecting at the beginning of Q4. The magnitude of this downgrade is only marginally worse than the norm of recent years, so it tells us little about the scope for upside surprises. A 17%-18% Q4 growth rate, which is implied by the usual size of upside surprises, would be a clear slowdown from the 25%-plus rate of the first three quarters of 2018. Should that be the outcome, it would confirm that earnings growth peaked in Q3. Still, a 17%-18% growth rate would be a solid result and, as ever, investors will be far more concerned with companies' guidance for the coming quarters.

AUTHOR

Patrick Schöwitz, CFA
Managing Director
Global Strategist
Multi-Asset Solutions

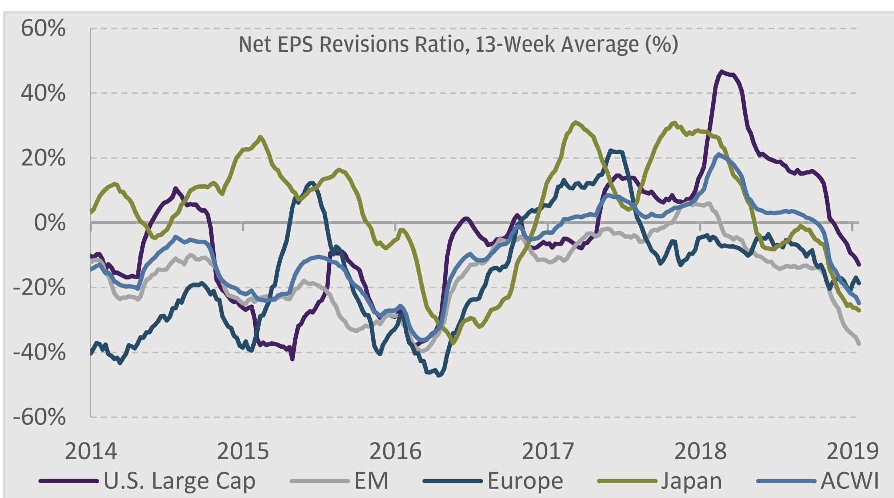
The recent sell-off in risk assets and sudden slowing in global growth have already raised fears that a so-called earnings recession—a fall in corporate earnings outside of an economic recession—might lie ahead. But to put these worries into context, earnings recessions are fairly rare in the U.S. equity market, where material declines in profits are usually associated with economic downturns or recession. When earnings recessions do occur, they are usually associated with a big drop in commodity prices, which sends energy and materials sector earnings lower by enough to drive overall market growth negative. The most recent examples: the 2015-16 period, when S&P 500 index earnings fell some 15% while energy earnings dropped 70%; 1998, when index-level earnings barely dropped while energy sector earnings fell nearly 30%; and 1985-86, when index-level earnings were down about 10%, while energy earnings were off about 33% and materials by about 66%. Of course, these historical drops in commodity prices were often associated with other economic problems elsewhere in the world—such as the Chinese slowdown in 2015-16.

The current situation shows some similarities to those non-recession episodes, but also some concerning differences. So far, 2019 growth expectations for U.S. equities have fallen to around 6.5% currently, from 10.5% in October. Consistent with past earnings recessions, the decline has been most pronounced in the energy sector. The fall in the oil price has hit the sector's growth estimates, which are now roughly flat vs. 26% as recently as October. The energy sector's share of S&P 500 earnings has roughly halved since 2014, to around 6% currently, so its impact on the overall market is much less serious than in past episodes. However, the decline in earnings expectations has not been confined to energy. In every other sector except utilities, EPS growth expectations have declined as well, dragging the ex-energy growth rate from 9.5% to about 7%. Most of the drop so far reflects diminished margin expectations, which have now declined by about 30 basis points (bps) in total and hit most sectors in the S&P 500, even as top line growth expectations in aggregate are still on the rise. That confluence presents a concerning contrast with earlier non-recession periods.

How much worse might the earnings outlook get? Looking first at the energy sector, if the current crude oil price is sustained it would be consistent with 2019 profits expectations falling by roughly another third. That would, in turn, pull S&P 500 earnings growth down to the 4%-5%

EXHIBIT 1: GLOBAL EARNINGS REVISIONS ARE DECLINING FAST

Earnings revisions ratios (defined as number of analyst upgrades relative to downgrades) have begun to fall precipitously across all major markets since the equity market peak in October. This suggests the downturn in the earnings cycle is global in nature and may have further to run.



Source: Refinitiv, J.P. Morgan Asset Management Multi-Asset Solutions; data as of January 17, 2019. U.S. large cap: S&P 500; EM: MSCI EM; Europe: EURO STOXX 50; Japan: TOPIX; ACWI: MSCI All Country World. For illustrative purposes only.

range. This would not be disastrous and it is certainly not inevitable, given the uncertainty around the oil price. In the unlikely event that energy sector profit growth plunges to zero, it would drag overall market EPS growth to zero. Even in 2015-16, the energy profit picture did not get that bleak.

Margin downgrades, rising top line expectations

Nevertheless, the fact that S&P 500 margin expectations are falling while top line expectations are still rising does give us pause. First, the two are usually highly correlated; and given the large impact of operational gearing on profits, the impact of changes in top lines tends to dominate the impact of changes in costs. It is rare to see a situation in which increasing costs overwhelm rising revenues and thus lead to falling margins. When it does happen, it tends to precede significant economic slowdowns or recessions. Second, the fact that top line expectations are still rising while many signs point to slowing economic growth suggests a high risk of earnings downgrades, which would, in turn, likely also lead to further margin downgrades. Put it all together, and it is easy to see 2019 growth expectations falling to the low single digits or even into negative territory.

Of course, the current margin downdraft could possibly have less to do with macroeconomic conditions and more to do with the impact of tariffs. If that is the case, the margin deterioration may not extend much beyond the initial tariff impact. However, adding to investor unease is the fact that downward earnings revisions in the U.S. are part of a global trend. Indeed, earnings revisions have declined precipitously across markets (**Exhibit 1**) and earnings growth expectations are falling everywhere. Admittedly, among the major indices the worst declines have been in the U.S. and emerging markets.

This perhaps lends weight to the explanation that tariffs are the most significant driver behind the decline in the profits cycle. But even if that is so, it also makes clear that the effects of tariffs are being felt by companies worldwide, rather than just in the U.S. and China.

Investors analyzing earnings trends are therefore faced with the same signal extraction problem that is evident across markets: A growth slowdown is clearly underway, but as of yet it is difficult to say whether it is the start of a more serious downdraft or even the beginning of a recession. There are many examples of years in which equity markets delivered solid positive returns in the face of persistent earnings downgrades. But there are few instances of positive equity market returns when profit downgrades proved to be a precursor to a material economic downturn. Given the late stage of the economic cycle, a heightened level of concern seems appropriate.

ASSET CLASS IMPLICATIONS

In recent months we have reduced the level of risk in our multi-asset portfolios and are modestly underweight equities relative to bonds. This reflects our concern about the late stage of the cycle and waning growth momentum across the global economy, but also our conviction that an economic recession is not imminent (otherwise we would contemplate a more aggressive underweight stance in equities). Our increasing concerns over the earnings outlook further strengthen our medium-term caution on equities and risk assets in general. Within equity regions, we continue to prefer a defensive tilt, with the U.S. the most preferred market, given its large share of defensive and high quality stocks. Our least favored markets remain the cyclical European and emerging equity markets.

Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Michael Hood
Global Strategist
New York

Benjamin Mandel
Global Strategist
New York

Michael Albrecht
Global Strategist
New York

Tim Lintern
Global Strategist
London

Patrik Schöwitz
Global Strategist, Editor
Hong Kong

Thushka Maharaj
Global Strategist
London

Sylvia Sheng
Global Strategist
Hong Kong

Diego Gilsanz
Global Strategist
New York

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