Q4 Earnings Season: What Lies Ahead

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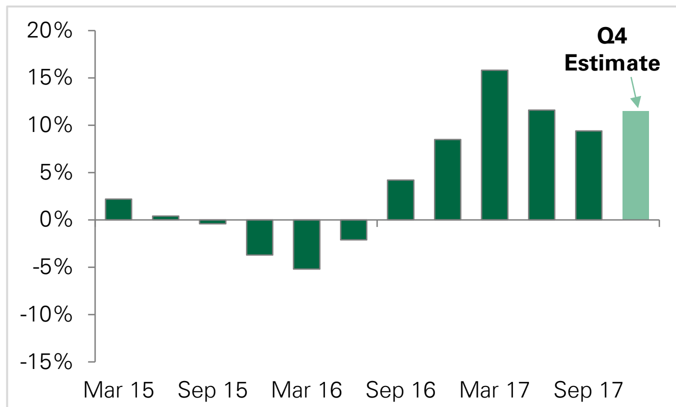
Highlights

- We expect operating earnings to come in strong overall, helped by strong profit margins and share repurchases.
- Beyond earnings, the focus for this reporting period is guidance for the year ahead, particularly regarding the tax changes. How much will the tax overhaul boost profitability? How will firms use their tax savings? How conservative is guidance likely to be?
- We remain constructive on the equity markets. Our base case is for another year of solid economic growth, modestly rising inflation, and still-accommodative monetary policy.
- That said, we acknowledge a number of risks to our outlook and, as a result, remain comfortable maintaining our neutral equity exposure with a tilt toward the U.S. region.

The coming weeks will see investors increasingly focus on the quarterly U.S. corporate earnings season. While earnings are always critical to gauge how firms are doing and what executives are thinking and planning, both for our security selection as well as for macroeconomic implications that impact asset allocation, this time will be especially important because firms will be commenting on the recently passed tax bill (the Tax Cuts and Jobs Act, or TCJA).

Overall, we believe operating earnings (business profits before one-off adjustments) will look strong for the fourth quarter. Indeed, consensus is calling for 11.5% year-over-year earnings-per-share (EPS) growth for the S&P 500, compared to 9.4% in the third quarter (Exhibit 1). Assuming the historical beat rate of 2%-3% is repeated, we could be looking at even bigger reported earnings.

Exhibit 1: Earnings Per Share Growth
Year-over-Year

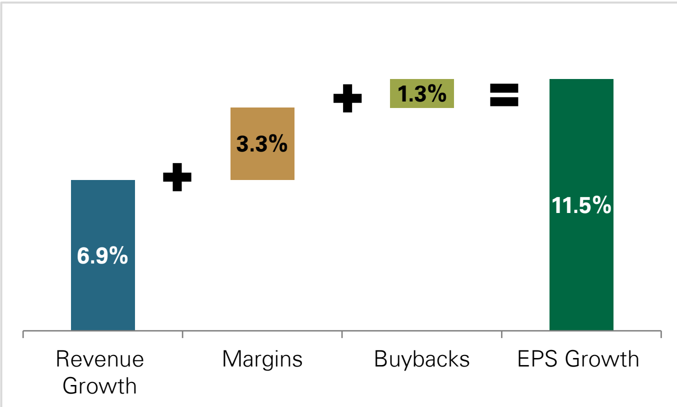


As of January 10, 2018
Source: Standard & Poor's, FactSet, Credit Suisse

Breaking down the 11.5% expected EPS growth, the energy sector —helped by higher oil prices —is expected to stand out, contributing about 2.4 percentage points to the overall results. Other sectors seen doing quite well last quarter include materials and technology.

Profit margins are also expected to remain elevated and positively contribute to the quarter's results. Despite hovering near expansion-record levels at 9.2% (Bloomberg data), expectations are for margins to contribute roughly 3.3 percentage points to overall year-over-year earnings growth. Share buybacks should continue to help the trend, adding an additional 1.3 percentage points to the bottom line (Exhibit 2).

Exhibit 2: Decomposition of EPS Growth



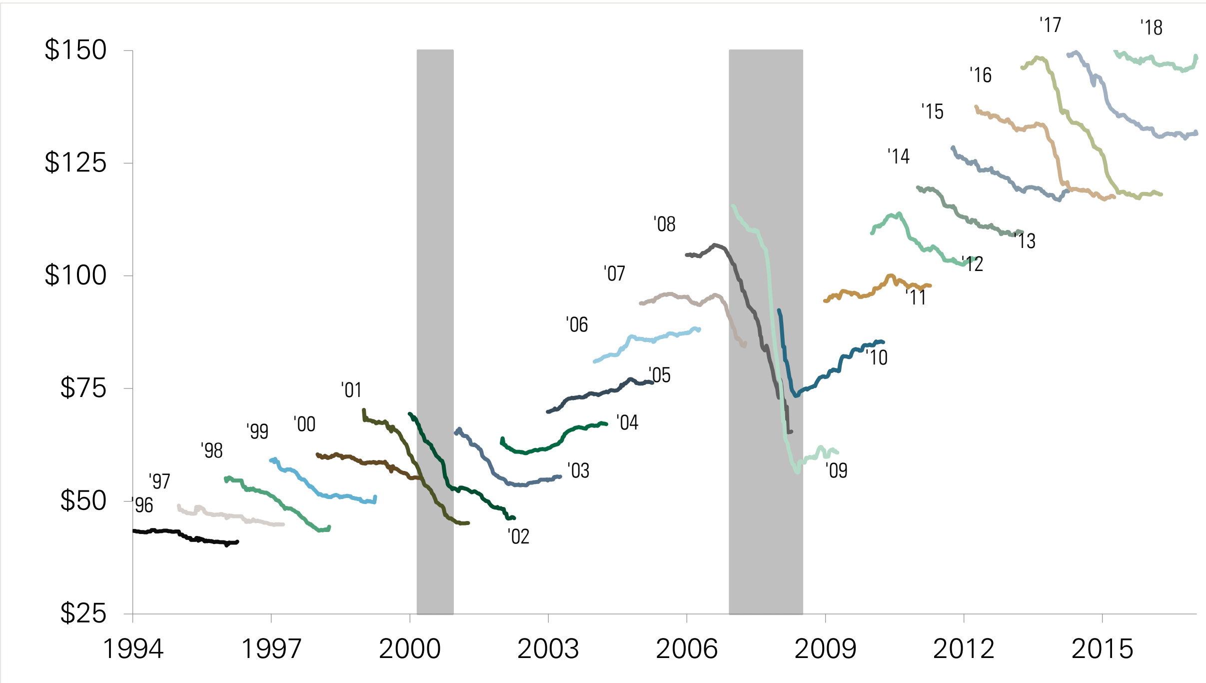
As of January 11, 2018
Source: Standard & Poor's, FactSet, Credit Suisse

Beyond details around earnings, the focus for this season will be guidance for the year ahead —and particularly guidance tied to tax policy changes. For instance, how much will the tax overhaul boost corporate profitability? The effective tax rate for the S&P 500 is likely to fall from approximately 25% to something closer to 20%. Using some back-of-the-envelope math, we can calculate the potential impact of this tax legislation if the entire tax savings were passed through to earnings. Today, consensus is pricing in approximately 11% EPS growth for 2018 before the tax change. Adding this 5% tax savings could bring EPS growth up to 18% if none of it were spent. While we do not expect the entire tax savings to make its way down to earnings, there is upside risk to consensus forecasts for 2018. (We note that geographic source of revenues, debt levels, and deductions, among other factors, will impact each company's respective tax rate.)

Investors will also be looking for clues on how firms will use tax savings. In the example above, we assumed that all tax savings would be passed through to earnings, but we know this will not be the case. Companies may choose to reinvest some or all of that savings into the business. Whether it's an increase in capital expenditures, M&A activity, or paying higher wages, the additional tax dollars should prove to be a net positive. (For more on investment implications of the TCJA, please see our recent *Investment Insights*, "Unwrapping Tax Reform: Implications for Markets"). Anecdotally, Walmart recently announced it will use a portion of its tax savings to increase minimum wages to $11 per hour in an effort to better compete with its rival, Target. Understanding how much of this tax saving will be spent on the business or how much will trickle down to shareholders is key in accurately forecasting corporate profits. The breakdown will also guide our thinking on macroeconomic and equity-sector-related implications of the tax bill.

A third question on our minds: Will corporate guidance be conservative despite the tax changes and current momentum in the global economy? Historically, executives have frequently managed analysts' and investors' expectations enough so that they can easily be beat during earnings season. This time around, management might want to "trickle" out the good news to have some positive surprises to share with the market in the quarters to come. That approach, if it happens, could help create positive earnings surprises throughout the year ahead. This would obviously be a support for equities and a contrast to the historical trend in which Wall Street's earnings estimates start high and get revised lower over the course of the year (Exhibit 3). The exception to that rule tends to be in the years following a recession (2004, 2005, 2006, and 2011), where analyst estimates are anchored and corporate guidance is conservative, each allowing actual results to surprise positively. 2018 has the potential to be one of those years.

Exhibit 3: S&P 500 Annual Earnings Estimates: Beginning of Year to End of Year



As of January 12, 2018. Weekly consensus estimates are charted above. Gray area indicates a recession.

Source: Strategas Research Partners

As we think about the year ahead, we maintain a constructive but not euphoric view on the equity markets. As is outlined in our latest *Quarterly Investment Perspective*, "Goldilocks or the Three Bears," our base case is for another year of solid economic growth, modestly rising inflation, and still-accommodative monetary policy. That said, we see risk in the form of more-hawkish-than-expected central banks, a more pronounced slowdown in China, and geopolitics. For these reasons, we remain comfortable maintaining our neutral equity exposure with a tilt toward the U.S. region. We believe our positioning will allow us to participate in a strong domestic market while guarding against potential risks.

Our Recent Insights

Goldilocks or the Three Bears — Quarterly Investment Perspective (First Quarter 2018, Video Available)

Unwrapping Tax Reform: Implications for Markets — Investment Insights (December 2017)

The Dollar Under President Trump Revisited — A Closer Look (November 2017)

The Fed's Next Chapter — Investment Insights (November 2017)

Alternative Investments and Wealth Planning Opportunities — A Closer Look (October 2017, Video Available)

How America Shops and Why It Matters — Quarterly Investment Perspective (Fourth Quarter 2017)

Japan's Abe Gets a Second Wind — Investment Insights (September 2017)

The Fed's Plans for Balance Sheet Normalization — Video (September 2017)

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