Heartwood
Investment Management

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Investment Insight

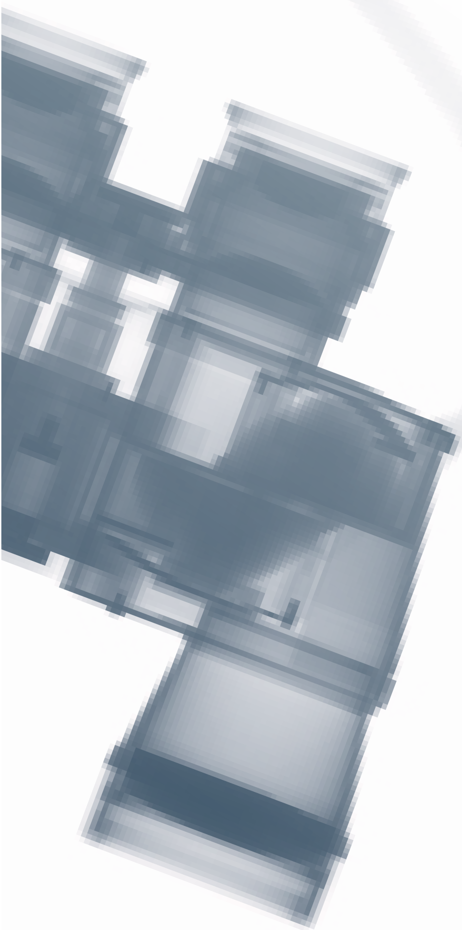
Weekly Insight

A record quarter for corporate profits

Earnings season is almost over and is on course to set new records. According to FactSet, 80% of S&P 500 companies have reported results for the fourth quarter of 2017 so far. Of those companies, 75% have reported positive earnings surprises (on an earnings-per-share basis), which is above the five-year average. In addition, 78% of S&P 500 companies have also reported positive sales surprises - the highest percentage since FactSet began tracking this metric.

Improved corporate earnings growth is not just a US phenomenon. In Europe and Japan, which are both at earlier stages of the corporate earnings cycle versus the US, corporate profitability has been even stronger. Across the US, Europe and Japan, the blended earnings-per-share growth is between 15% and 17% year-on-year.

Drilling down into the sectors, the strongest results have been reported in energy, materials and technology. In the case of energy and materials, the high growth rates in these sectors have been driven by favourable year ago comparisons. In technology, results have been boosted by double-digit earnings growth among semiconductor companies (such as Nvidia and Intel). In contrast, earnings results have been generally weaker among defensives and sectors most sensitive to higher interest rates, including telecommunications, utilities and real estate.



Can the positive earnings momentum continue?

There has been a tendency over the last few years for companies to lower their start-of-the-year guidance as a way of managing the market's expectations. However, this year appears to be different and corporates seem to be exuding more confidence. For example, the number of S&P 500 companies issuing positive guidance for 2018 is more than double the ten-year average. Overall, the market is now looking for 18.1% S&P 500 earnings per share growth in 2018, up from 10.3% in January.

Stronger forward guidance is being fuelled by optimism around the US tax windfall, an additional $300 billion in US government spending and stronger global growth. As interest rates and cyclical inflation pressures rise, however, there will be stumbling blocks, especially if higher wage inflation begins to reduce profit margins. However, the additional boost of increased capital expenditure could lead to improved productivity, something we have not seen for many years. Improved productivity would partly negate the effects of increased wage growth and further boost expected earnings for corporates. In the near term, a strong corporate profit environment is a key component of the positive fundamental narrative, and this should continue to be a tailwind for equity markets.

Benjamin Matthews
Investment Manager

Clear Thinking

Contact

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