Baird Market and Investment Strategy

Macro Update

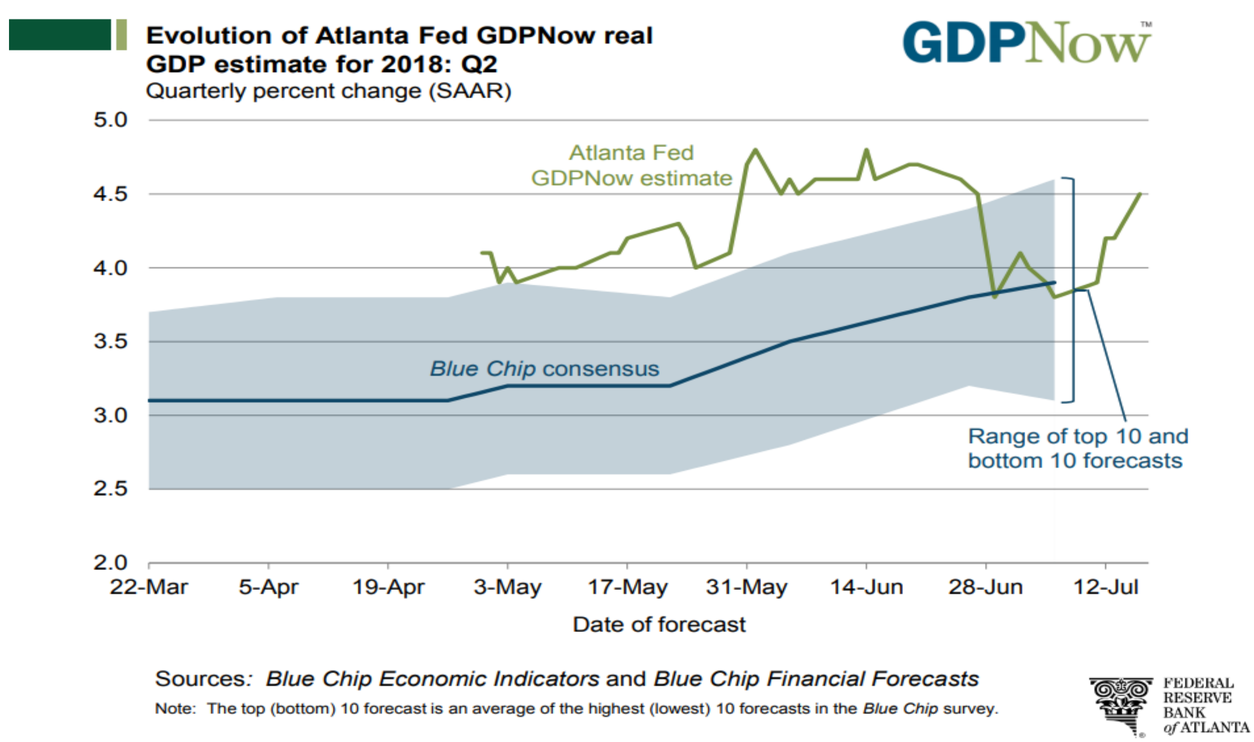
July 17, 2018

Please refer to Appendix – Important Disclosures.

Robust Earnings Expectations Relying on Second Quarter Growth Surge

Key Takeaways: Economic growth appears to have surged in the second quarter, providing support for elevated earnings expectations. Earnings growth is being fueled by improving sales growth and expanding profit margins, both of which could face headwinds. The market reaction to earnings surprises and forward guidance will be important as earnings season progresses.

Economic growth appears to have surged in the second quarter. The Atlanta Fed's GDPNow model indicates we could see GDP growth of 4.5%, which would be the strongest quarter of growth in nearly four years. The initial look at Q2 GDP will be published by the BEA on July 27. Before seeing that number, however, we will have gotten the bulk of the Q2 earnings reports. Nearly 2/3 of the S&P 500 (in terms of market capitalization) will have reported Q2 earnings by that time. Expectations are that revenue for the S&P 500 was up close to 9% in the quarter, with earnings growth of nearly 20%. As earnings season has gotten underway, the number of companies issuing positive earnings guidance has dipped from the level seen in Q1, but it is still high enough to be the second best level seen since FactSet started collecting this data in 2006. That being said, currency fluctuations and potential margin pressures could weigh on results, and already elevated expectations leave little room for error (or opportunity for reward).



Source: Federal Reserve Bank of Atlanta

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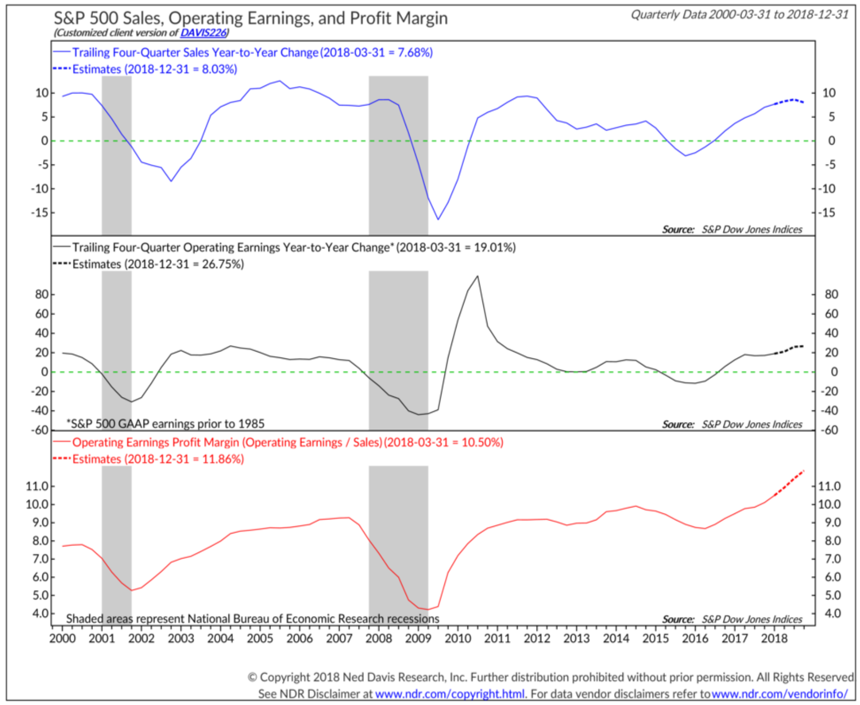
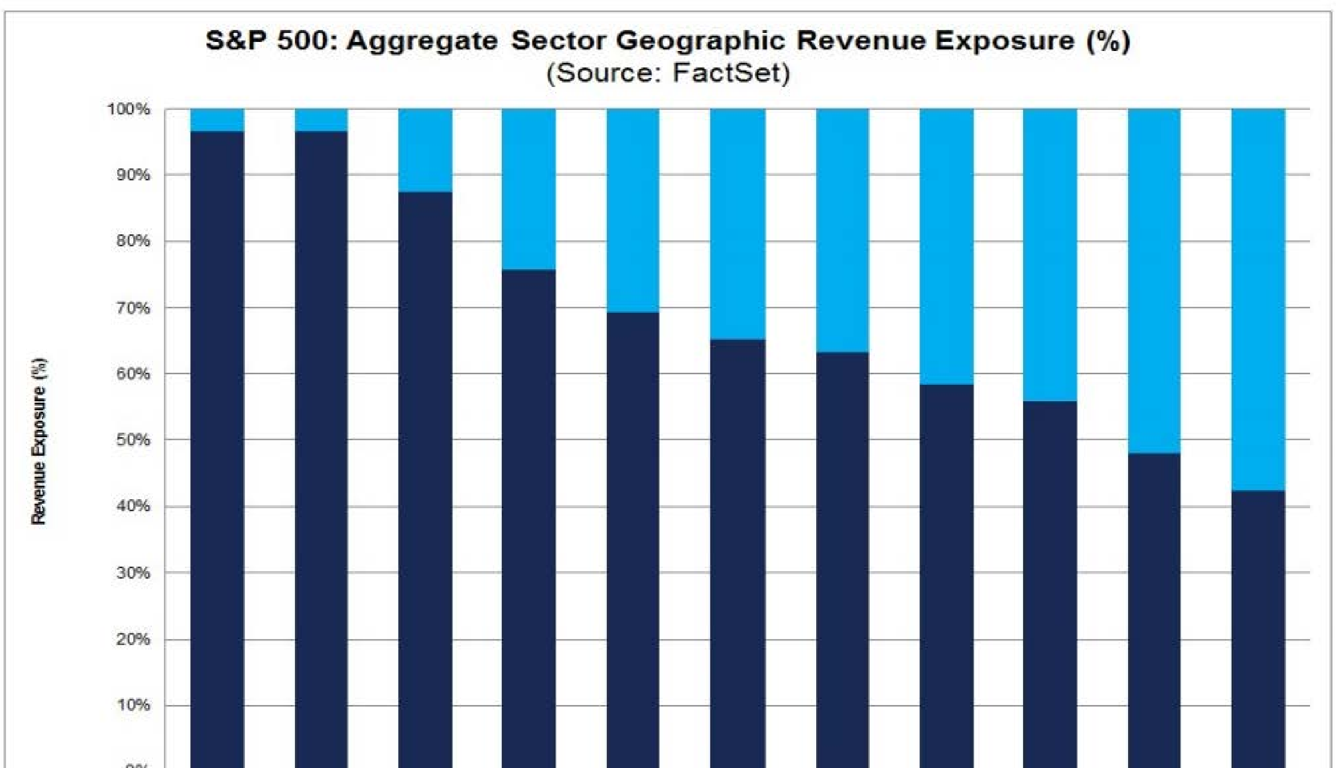
Earnings growth expectations are being fueled by both accelerating sales growth and expanding margins. Higher costs (e.g., energy prices or wage pressures) could put pressure on margins that are expected to move further in record territory. While earnings season has just begun, currency fluctuations are already getting mentioned (by half of the 23 S&P 500 companies that have reported Q2 results) as a negative impact on results. With more than one-third (38%) of total revenue from the S&P 500 coming from abroad, currency moves can have a meaningful impact on results. Both the Materials sector (52%) and Information Technology sector (58%) generate more than half of their revenue internationally.



Source: Ned Davis Research

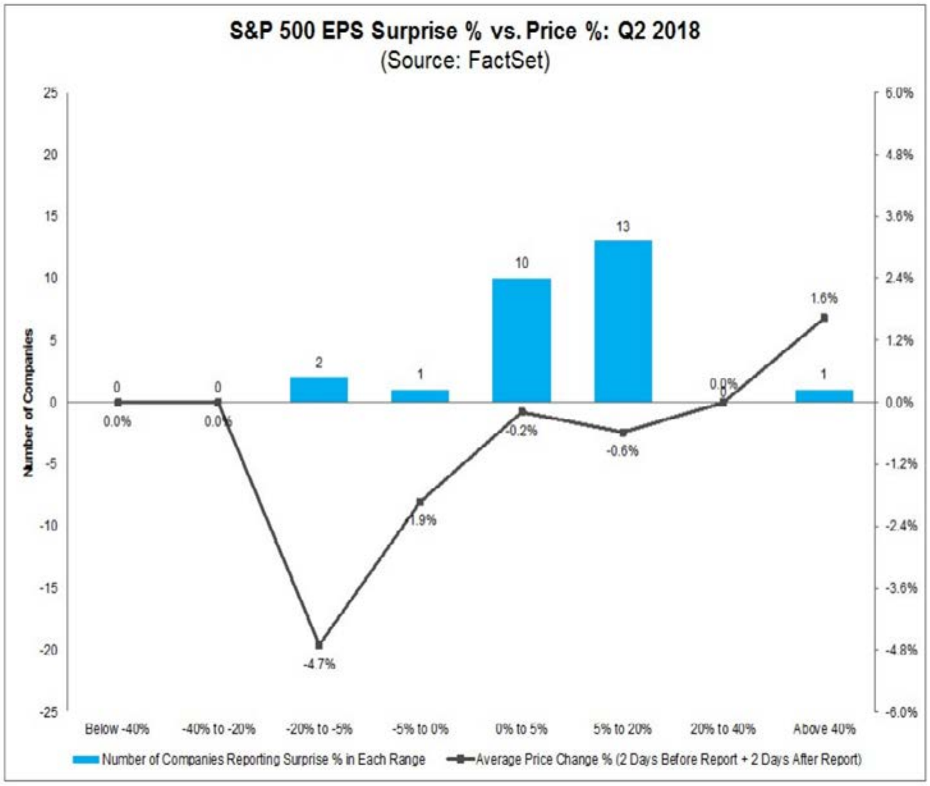


	Utilities	Telecom Services	Real Estate	Financials	Consumer Disc.	Health Care	Industrials	Energy	Consumer Staples	Materials	Info. Technology
International	3%	3%	12%	24%	31%	35%	37%	42%	44%	52%	58%
United States	97%	97%	88%	76%	69%	65%	63%	58%	56%	48%	42%

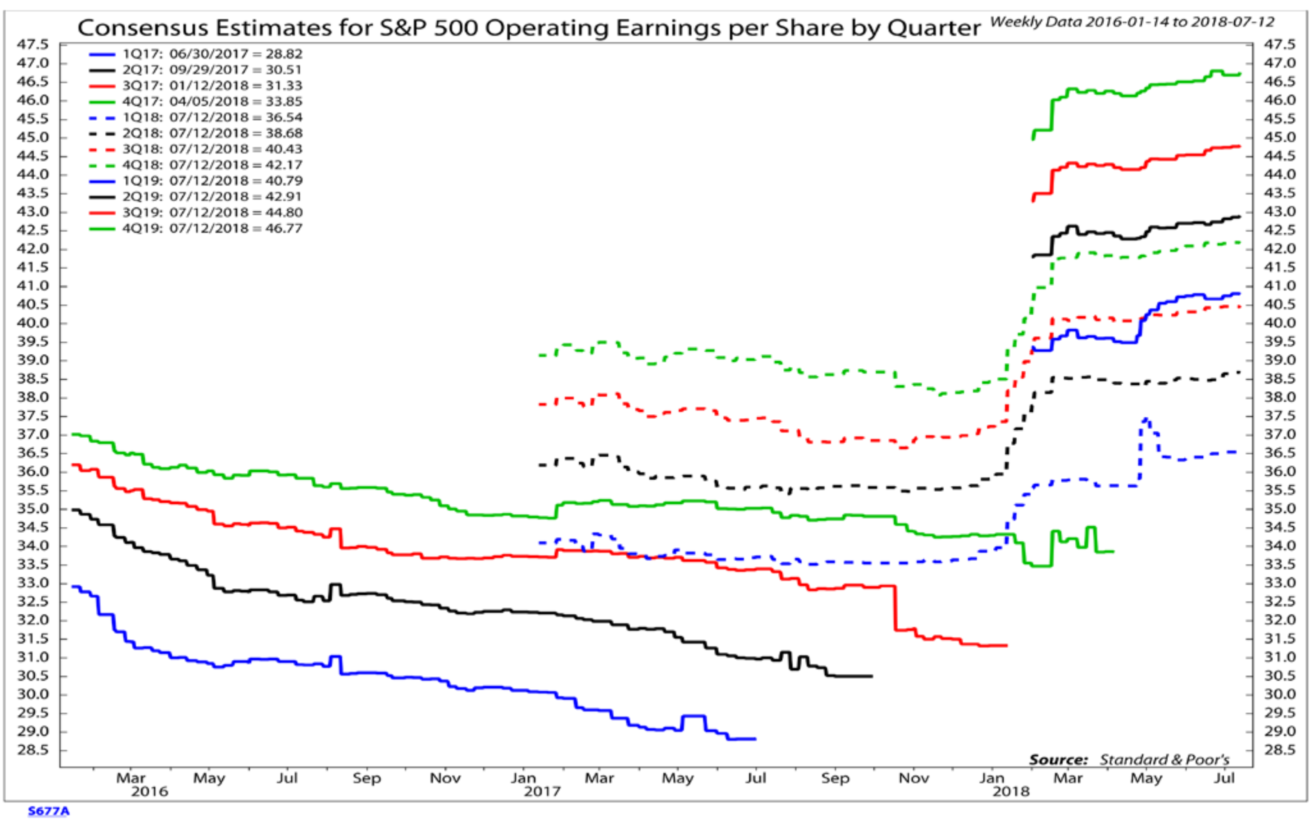
Source: FactSet

With expectations elevated as earnings season begins, there is plenty of risk of disappointing. It is early yet – but companies with negative earnings surprises have been more severely punished than has been the trend in previous quarters, and those with positive earnings surprises have not been rewarded to the same degree as in the past.

In addition to watching results for the second quarter, the market will also be looking for guidance about the path of earnings for the second half of 2018 and into 2019. Current expectations are that earnings growth will remain elevated. The good news is that pattern of estimates fading over time appears to have been broken. The bad news is that stocks have historically struggled to rally when expectations have been elevated.



Source: FactSet



Source: Ned Davis Research

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