# Weekly Market Flash

## Earnings Kabuki and Valuation Math

***November 8, 2019***

In this space last week we presented the case for smooth sailing through the remainder of 2019. If anything, that case would seem even more compelling today, with investors tossing away their safe haven stockpiles of gold, Treasury notes and Japanese yen while pouring into equities. US stocks are set to close with gains for the fifth week in a row, for the first time since February. The trade war, the market's favorite fetish object, seems to be receding further now, with concrete talk of phased eliminations of currently in place tariffs (though there is still no set date for that signing ceremony of a "phase one" deal).

Lest anyone become too complacent about the general state of things, however, we will use this week's platform to examine another data point that could be a key influencing factor in 2020: corporate earnings. Estimates have been coming in for fourth quarter earnings (which will start to be released come January) and the picture they paint is not a healthy one.

### The Dance of the Analysts

"Corporate earnings" sounds like the most sober and rational of processes – it's just a bunch of numbers, after all, painstakingly presented to be in compliance with precise accounting standards. In reality, though, the earnings exercise is more like the kabuki theater popular in Japan: ritualistic, highly stylized, and ultimately more about image than reality. Analysts at major investment firms routinely present their estimates about what they expect earnings to be for the companies they cover in the months ahead, usually up to a 12 month window (called "next twelve months" or NTM in Wall Street parlance). They update these expectations from quarter to quarter as the actual release dates for the numbers approach.

For example, back in June of this year, at the end of 2019's second quarter, the average consensus estimate by analysts for S&P 500 companies in the fourth quarter of this year was a growth rate of 5.64 percent. In other words they expected that earnings would grow year-on-year from December 31 2018 to December 31 2019 by that percentage rate.

By September, this Q4 consensus estimate had fallen from 5.64 percent to 2.19 percent. As of this week – less than two months after the September estimate – that number had fallen further still to minus 1.43 percent (these estimates are all courtesy of FactSet LLC, a data research firm). Yes – earnings that were expected to grow by almost six percent are now, according to the analysts, on track to actually fall by more than one percent.

### Clearing the Low, Low Bar

Here's where the kabuki element really kicks in. Whereas that 5.64 percent number back in June was apparently too high, the minus 1.43 percent number (if history serves as a guide) is almost invariably too low. In other words, when S&P 500 companies actually do start releasing their Q4 earnings numbers come January, it is likely that they will come out a bit ahead of what the analysts think. This then becomes the "positive surprise" to which grinning financial news anchors will refer when they explain why Company ABC's stock price is up. Earnings beat! It's an elaborate performance, this earnings dance, and everyone is in on it. On average, from earnings season to earnings season, anywhere from 60 to 80 percent of all companies experience these "positive surprise" events. It's optics, but it usually works.

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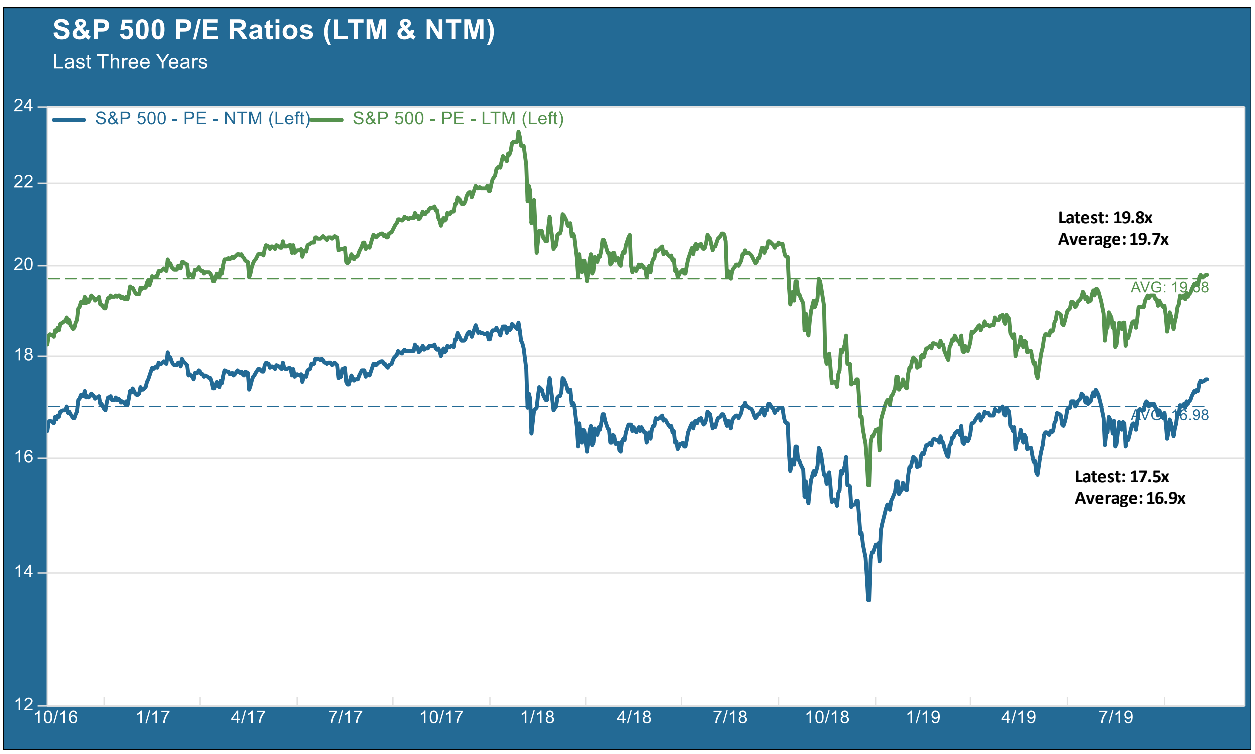
## Reality Bites Back

But Earnings Kabuki can only go so far, and now is where we turn to the real math of valuation. Whatever the final number turns out to be for Q4, it is fairly likely to be closer to minus 1.4 percent than to 5.6 percent. Moreover, Q4 will come on the heels of three weak earnings seasons already this year, so that the final growth number for calendar year 2019 is likely to be somewhere close to zero – as in, zero earnings growth.

The earnings number matters because the relationship of a stock price to the underlying earnings of the company is one of the most widely used metrics – the P/E ratio – to assess whether a stock is relatively cheap or expensive. The chart below shows the trend of the P/E ratio over the past three years. We show here both the last twelve months (LTM) P/E which reflects actual historical earnings over the four prior quarters, as well as the next twelve months (NTM) P/E where the denominator consists of those analyst projections for earnings in the next four quarters.




*Source: MVF Research, FactSet*

So what does this chart tell us? At first glance it doesn't seem so bad. Both P/E ratios shown here are well below the high point reached at the height of the last go-go phase of the bull market in late 2017. The LTM P/E ratio (in green), in fact, is right around its three year average. Not a screaming bargain by any means, but not outrageously expensive either.

The NTM number (blue) tells us something a bit different, though, and it relates back to our lead-up exposition of Earnings Kabuki. Note how the NTM P/E has gone up in the past couple weeks so that it is now meaningfully above its three year average. Why is that? Partly because stock prices have been going up (numerator) but also because analyst estimates (denominator) have been going down. The effect of reduced earnings expectations, all else being equal, is to make valuation measures go up, and therefore become more expensive.

## Earnings in 2020

Here is where we see some cause for concern in 2020. While that Q4 2019 estimate has come down, the numbers for 2020 are only just coming onto the kabuki stage. Right now the estimate for Q1 2020 is growth of 5.3 percent, while the same Q1 estimate back in September was 6.9 percent. Expect those numbers to start creeping lower as the time approaches.

Now stand back and think about what it all means in an environment of slowing global growth. US GDP growth is expected to have a hard time getting north of two percent, while Europe and Japan will be fortunate to have any growth at all. Companies are going to have a hard time generating robust earnings in the high single digit or low double digit range (where the expectations for 2020 have largely been) unless some organic growth driver unleashes a new wave of demand. This, in our opinion, could be one of the most significant headwinds to market performance next year.

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