Weeden&Co. LP

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SPX Earnings – Aligning Expectations With Economic Reality

Summary

We are reducing our 2017 SPX earnings estimates from $127 to $116. While earnings momentum in Q1 was reasonably strong, we do not expect the trajectory of economic growth to support our initial estimate for the balance of the year. We were too optimistic in December, and we think the rest of the sell side is as well. Consensus bottoms up estimates per Bloomberg are currently $130 (the mean of the top down strategists surveyed by Bloomberg is $129) and imply record margin expansion and sales growth coming late into the cycle. As Q2 earnings begin to unfold, we think the prospect for a series of earnings/forecasts downgrades is likely.

There is of course the prospect for major legislation (infrastructure, substantial de-regulation, corporate tax reform) later in the year. However, it is increasingly obvious that any major legislation will not be implemented until well into 2018 and may well end up substantially watered down relative to initial expectations. We will address 2018 earnings and market valuation in a separate note. For now, we are leaving our 2,350 year end SPX price target intact at this point.

It is important to recognize that the Street has had a history of excessive optimism on corporate earnings. Consensus bottoms up forecasts have seen their beginning of year estimates exceed the actual results every single year since 2012 – by anywhere from 4% to 13% with a mean miss of nearly 9%. For that matter, top down strategists have done worse, with a mean earnings estimate miss of nearly 10% (see details on the Street and Weeden's forecasting history in the Appendix). With this in mind, a 10% reduction in expectations does not seem to be a stretch for this year, especially given the initial excitement for loose fiscal policy following the Trump election.

Section 1. Great Expectations

For all the excitement regarding the first quarter's earnings, we think there is mounting risk that overall 2017 earnings will be downgraded, a process which will likely start in mid July as corporate CEO's weigh in. Consider the following:

- **Two Years At 16%?** After the election, overall bottoms up and top down (ours included) consensus earnings estimates jumped following the election. These estimates have remained elevated since the election (Chart 1). Bottoms up consensus estimates for 2017 are at $130, implying a nearly 20% y/o/y growth from 2016's $108 in EPS. The two year CAGR to reach consensus $145 in 2018 is nearly 16% and imply a 12% growth from 2017 to 2018.

- **<u>Late Cycle Optimism</u>**? To put these expected growth rates in perspective, consider that the average y/o/y EPS growth rates since 2011 have been a mere 5.0% (2009 to 2010 posted a massive 40% y/o/y earnings expansion but that of course was coming out of a very steep recession). The 2017-18 estimates are aggressive numbers, all the more so this far into a cycle. When we consider prior later cycle periods, we see lower numbers. For example, the late cycle 2005-7 EPS growth averaged 8.9% (with a high of 15.6% in 2005-6) and the 1996-2000 period had an average growth of 9.8% (high of 14.8%).

  Clearly the arrival of fiscal stimulus, particularly lower tax rates, would justify higher earnings growth. However, we are nearly half way through the year and still have minimal visibility of tangible progress with legislation. Trump's low approval ratings reduces the White House's leverage in any legislation, which in turn lengthens the legislative process and increases the potential for watering down and complicating the economic/earnings friendly aspects of his stated loose fiscal agenda.

- **<u>The Hope Factor Has a Lot of Hope In It</u>**. While the earnings recession of 2015 and H1 2016 was significant, the acceleration out of that trough has been less than spectacular. Estimates for full year 2016 earnings began at $124 and as noted above, finished the year at a paltry $108 (2015-16 growth ended up being flat, despite a more benign rate/dollar environment).

  Chart 2 shows that forward 12 month estimates are nearly 22% above trailing EPS (a metric we might call the "Hope Factor"), putting it in the top 5% of all readings going back to 2010. When we consider the 2005-7 and 1996-1998 mid/late cycle periods, we see that these spreads declined as we got deeper into the cycle. We think it is important to distinguish between an earnings recession (driven primarily by unusually low oil prices) and an economic recession in terms of understanding what types of growth rates are reasonable. Charts 2, 3 and 4.

Chart 1.

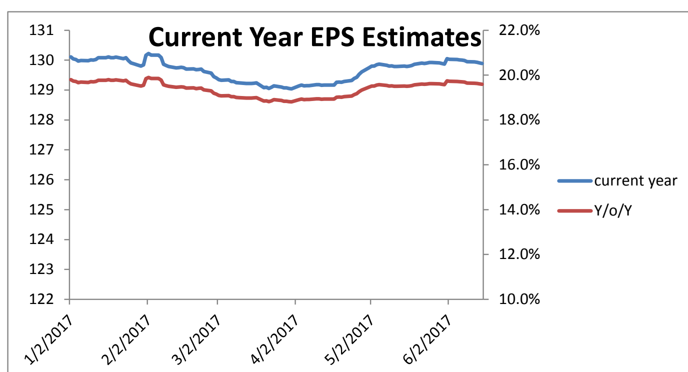


Chart 2.

Chart 3.

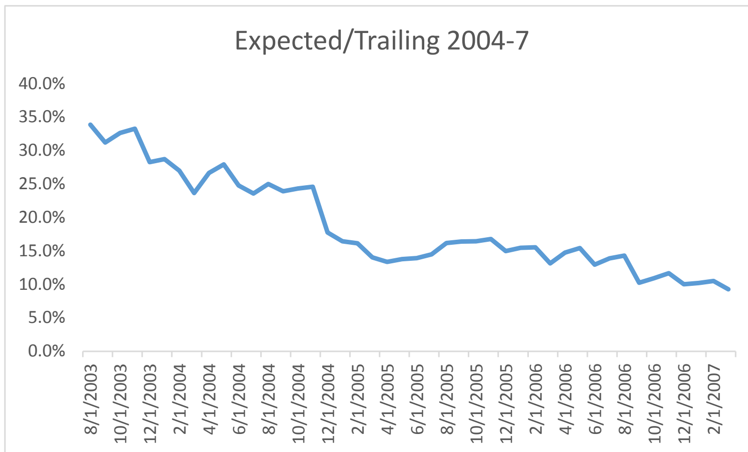
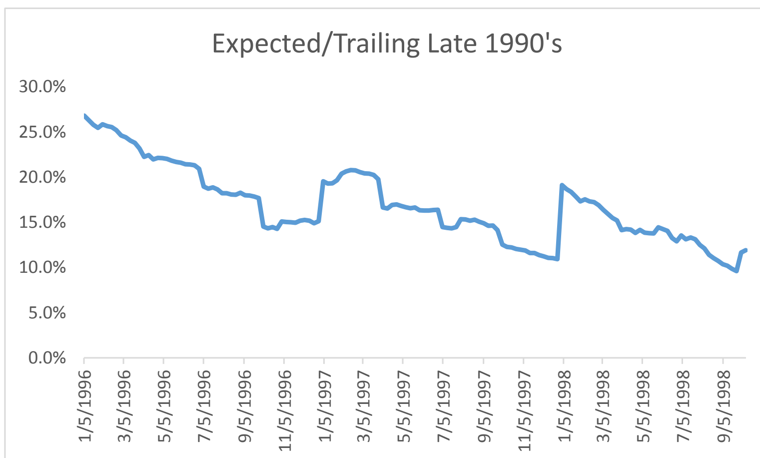


Chart 4.



Section 2: Margins and Revenue Growth Will Come Down

- As is obvious in Chart 5, Gross, EBIT, and Net Income Margins per bottoms up Bloomberg consensus for SPX (ex financials) are all substantially elevated when compared with actual results over the past few years. Net income margins in particular are expected to expand over 100 basis points in 2017 to 10.7% and to 11.4% in 2018. As we can see in Chart 6, if these prospective margins were realized, these would be setting multi-decade records.

  We acknowledge that if nominal GDP accelerates, that would drive incremental revenue which, in theory should fall cleanly to the bottom line and support margin expansion. However, an increase in nominal GDP would also likely erode operating margins (in the form of higher labor and other input costs). Further, higher nominal GDP would likely mean higher interest rates, which would put further pressure on net income margins.

  - First quarter margins came in at 9.8% for the SPX overall, levels consistent with the last several quarters but far below the 10.7% expected for this year. In other words, the next three quarters have to average over 11% just to reach the year end expectation. Consensus estimates are for a 10.7% net income margin in 2017.

  - It is important to recognize that, all other things being equal, if net income margins were to underperform by just 1%, that would decrease overall earnings from $130 to $120 this year, cutting y/o/y growth in half.

Chart 5.

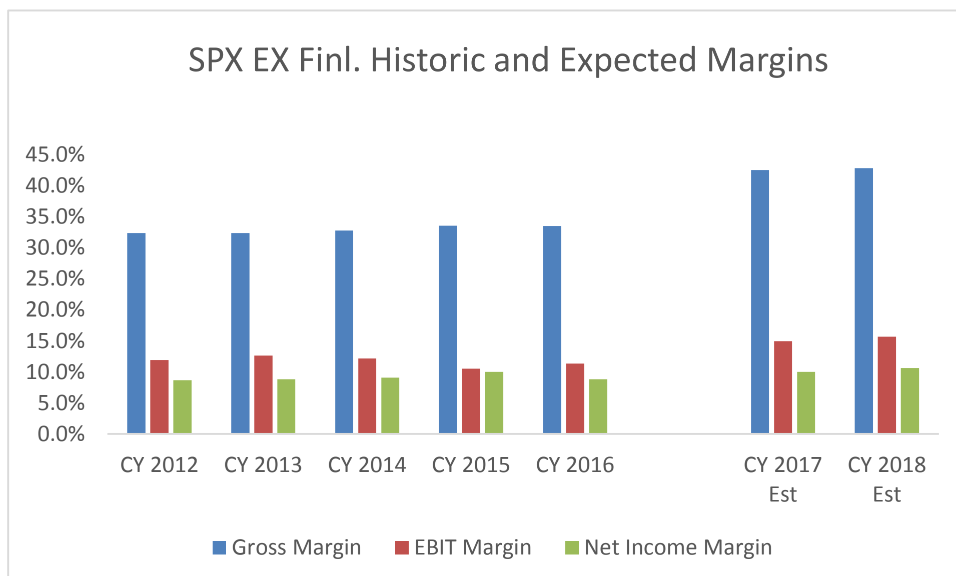
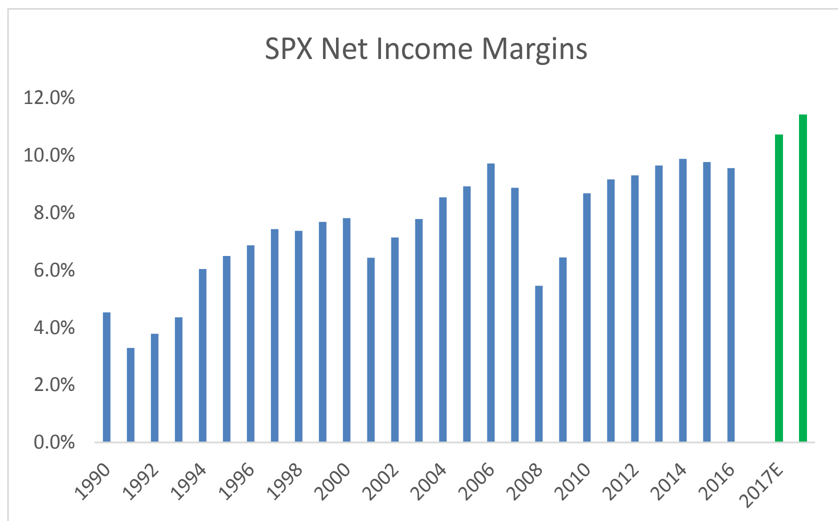
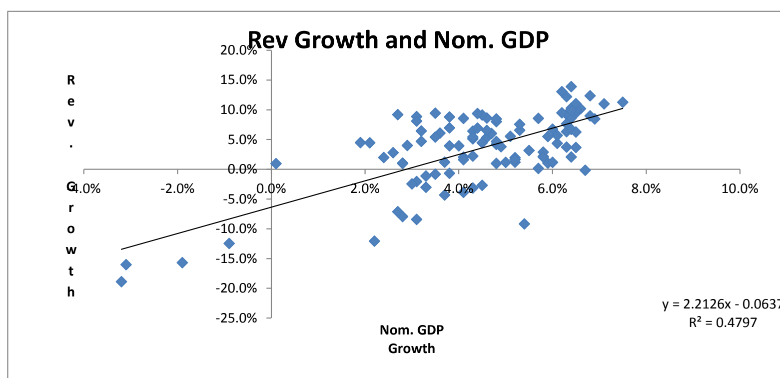


Chart 6. SPX Net Income Margins



<u>Revenue Growth – Nominal Growth Disconnect.</u> Chart 7 shows a longer term relationship of nominal GDP growth with SPX revenue growth (quarterly going back to 1990). The R2 of .48 is not stunning, and we acknowledge the increasing dependence on foreign revenues has weakened this relationship recently in the past few years. Still, the overall relationship is pretty straightforward and helpful for providing a top down context for revenue expectations.

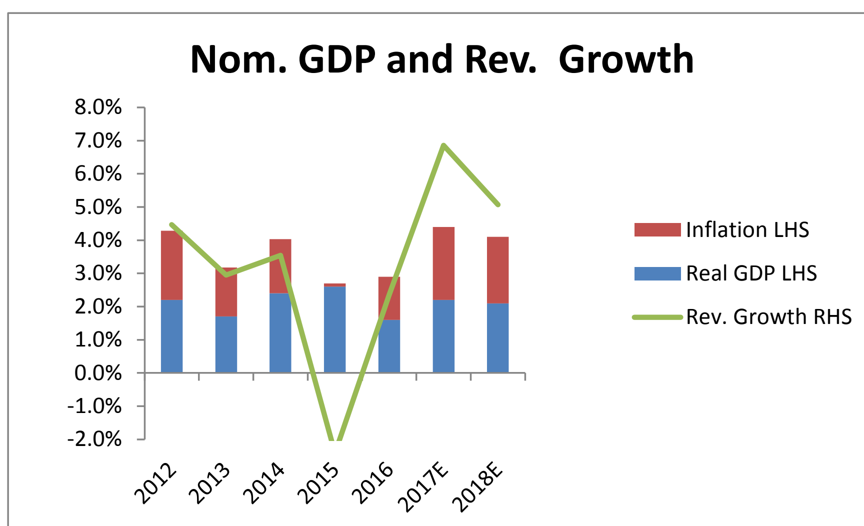
Chart 7.



If we assume that current market economic forecasts are conservative, we still have trouble understanding the revenue growth implicit in current SPX bottom's up forecasts given the likely

trajectory of nominal GDP. As we can see in Chart 8, current bottoms up y/o/y revenue growth is expected to be 6.9%. This is markedly higher than the highest post 2011 growth of 4.8% (achieved in 2012 when the economy was still in the early stages of healing from the 2009 recession). What is also apparent in Chart 8 is that the presumed revenue growth, which tends to (roughly) track nominal GDP 1 for 1, is simply much higher than that which would be implied by the nominal GDP estimates (4.4% this year relative to 4.3% in 2012).

Chart 8.



If we are to assume that revenue this year will be more in line with what would be suggested by nominal GDP, we would expect to shave at least $3 off this year's earnings (assuming no change in margins, an aggressive assumption).

- **Triangulating on More Probable Earnings Outcomes.** In Chart 9 we sensitize SPX earnings for margin and revenue growth. We can see that with revenue growth and margins more in line with the recent past, we derive EPS for the SPX in the $114 - $120 range. These EPS figures reflect a revenue growth and margin scenario more associated with the actual results of the recent past.

Chart 9.

		Implied 2016-2017 EPS As a Function of Top Line Growth and Margin								
		2016-2017 Revenue Growth								
		4.50%	**4.80%**	**5.10%**	**5.40%**	**5.70%**	**6.00%**	**6.30%**	**6.60%**	**6.90%**
	8.7%	$103.22	$103.51	$103.81	$104.10	$104.40	$104.70	$104.99	$105.29	$105.59
Presumed	**8.9%**	$105.59	$105.89	$106.19	$106.50	$106.80	$107.10	$107.41	$107.71	$108.01
Net Income	**9.1%**	$107.96	$108.27	$108.58	$108.89	$109.20	$109.51	$109.82	$110.13	$110.44
Margin	**9.3%**	$110.33	$110.65	$110.97	$111.28	$111.60	$111.92	$112.23	$112.55	$112.87
	9.5%	$112.71	$113.03	$113.35	$113.68	$114.00	$114.32	$114.65	$114.97	$115.30
	9.7%	$115.08	$115.41	$115.74	$116.07	$116.40	$116.73	$117.06	$117.39	$117.72
	9.9%	$117.45	$117.79	$118.13	$118.46	$118.80	$119.14	$119.48	$119.81	$120.15
	10.1%	$119.83	$120.17	$120.51	$120.86	$121.20	$121.55	$121.89	$122.23	$122.58
	10.3%	$122.20	$122.55	$122.90	$123.25	$123.60	$123.95	$124.30	$124.65	$125.00
	10.5%	$124.57	$124.93	$125.29	$125.64	$126.00	$126.36	$126.72	$127.07	$127.43
	10.7%	$126.94	$127.31	$127.67	$128.04	$128.40	$128.77	$129.13	$129.49	$129.86
	10.9%	$129.32	$129.69	$130.06	$130.43	$130.80	$131.17	$131.54	$131.92	$132.29

Current levels

Estimated Levels

		Implied 2016-2017 EPS As a Function of Top Line Growth and Margin								
		2016-2017 Revenue Growth								
		4.50%	**4.80%**	**5.10%**	**5.40%**	**5.70%**	**6.00%**	**6.30%**	**6.60%**	**6.90%**
	8.8%	4.50%	4.80%	5.10%	5.40%	5.70%	6.00%	6.30%	6.60%	6.90%
	8.7%	-4.9%	-4.6%	-4.4%	-4.1%	-3.8%	-3.5%	-3.3%	-3.0%	-2.7%
Presumed	8.9%	-2.7%	-2.4%	-2.2%	-1.9%	-1.6%	-1.3%	-1.0%	-0.8%	-0.5%
Net Income	9.1%	-0.5%	-0.2%	0.0%	0.3%	0.6%	0.9%	1.2%	1.5%	1.8%
Margin	9.3%	1.7%	1.9%	2.2%	2.5%	2.8%	3.1%	3.4%	3.7%	4.0%
	9.5%	3.8%	4.1%	4.4%	4.7%	5.0%	5.3%	5.6%	5.9%	6.2%
	9.7%	6.0%	6.3%	6.6%	6.9%	7.2%	7.5%	7.9%	8.2%	8.5%
	9.9%	8.2%	8.5%	8.8%	9.1%	9.5%	9.8%	10.1%	10.4%	10.7%
	10.1%	10.4%	10.7%	11.0%	11.3%	11.7%	12.0%	12.3%	12.6%	12.9%
	10.3%	12.6%	12.9%	13.2%	13.6%	13.9%	14.2%	14.5%	14.8%	15.2%
	10.5%	14.8%	15.1%	15.4%	15.8%	16.1%	16.4%	16.7%	17.1%	17.4%
	10.7%	17.0%	17.3%	17.6%	18.0%	18.3%	18.6%	19.0%	19.3%	19.6%

Current levels

Estimated Levels

- While we are not addressing valuation in this note, Chart 10 shows that implied consensus P/E's are about 2 P/E points higher if our revised earnings assumptions are correct.

Chart 10.

		Implied 2017 P/E As a Function of Top Line Growth and Margin								
		2016-2017 Revenue Growth								
		4.50%	**4.80%**	**5.10%**	**5.40%**	**5.70%**	**6.00%**	**6.30%**	**6.60%**	**6.90%**
	8.8%	23.5	23.4	23.4	23.3	23.2	23.2	23.1	23.1	23.0
	8.7%	23.7	23.7	23.6	23.5	23.5	23.4	23.3	23.3	23.2
Presumed	**8.9%**	23.2	23.1	23.1	23.0	22.9	22.9	22.8	22.7	22.7
Net Income	**9.1%**	22.7	22.6	22.6	22.5	22.4	22.4	22.3	22.2	22.2
Margin	**9.3%**	22.2	22.1	22.1	22.0	22.0	21.9	21.8	21.8	21.7
	9.5%	21.7	21.7	21.6	21.6	21.5	21.4	21.4	21.3	21.2
	9.7%	21.3	21.2	21.2	21.1	21.0	21.0	20.9	20.9	20.8
	9.9%	20.9	20.8	20.7	20.7	20.6	20.6	20.5	20.4	20.4
	10.1%	20.4	20.4	20.3	20.3	20.2	20.2	20.1	20.0	20.0
	10.3%	20.0	20.0	19.9	19.9	19.8	19.8	19.7	19.7	19.6
	10.5%	19.7	19.6	19.6	19.5	19.4	19.4	19.3	19.3	19.2
	10.7%	19.3	19.2	19.2	19.1	19.1	19.0	19.0	18.9	18.9
			Current levels							
			Estimated Levels							

<u>Sector Considerations.</u>

- **Energy.** In our April 2016 note, we reviewed our top down work which suggested that consensus bottoms up analysis implied the Street was pricing in ~$45/bbl for the then forecasted 2016 and ~$65 for 2017 (this may explain in part the large underperformance of energy equities this year).

  As we dust off our models from a year ago, we can learn a few interesting things. The first of which is that actual sector revenues for 2016 came in at $276 (note we are using SPX GICS level 1 sector definitions and WTI for oil in this analysis). Given that the average price of oil last year ended up at $43.44, this suggests our regression model held together quite well (the model predicted revenues would have been $285, quite close to the actual $276). This also tells us that the bottoms up equity analysts arguably had a better read on oil prices for the balance of the year then the futures market did (which at that time was predicting $37/bbl for the average price for the year). Charts 11 and 12.

  Net income for 2016 came in at $4.5 for the sector, the problem being the minimal 1.6% margins (we discussed at length the correlation of margins with oil prices in our April 2016 note – please contact us for a copy of this report). This weaker than expected margin was due to the financial distress in the sector last year.

Current forecasts for 2017 and 2018 revenue and net income seem aggressive. **Current bottoms up revenue forecasts imply a ~$62/average price for crude in 2017 and ~$68/average price for crude in 2018.** These figures are notably higher than the year-to-date average of $51/bbl. Expected net income margins are not wildly optimistic, but once again seem on the optimistic side at 4.4% this year and 5.8% in 2018. While there is less financial stress in the sector today than a year ago, we would expect both top line and margins to compress soon barring a jarring uptick in crude prices. Chart 11, 12.

If we assume an average price for the year of $50/bbl and a net income margin of 4% (estimates we don't consider especially conservative), this would imply a 20% reduction to sector bottoms up net income estimates. **Adjusting for the energy sector's weight, this in turn would suggest SPX earnings would be reduced by about $1.5 if these oil/net income expectations are realized**.

Chart 11.

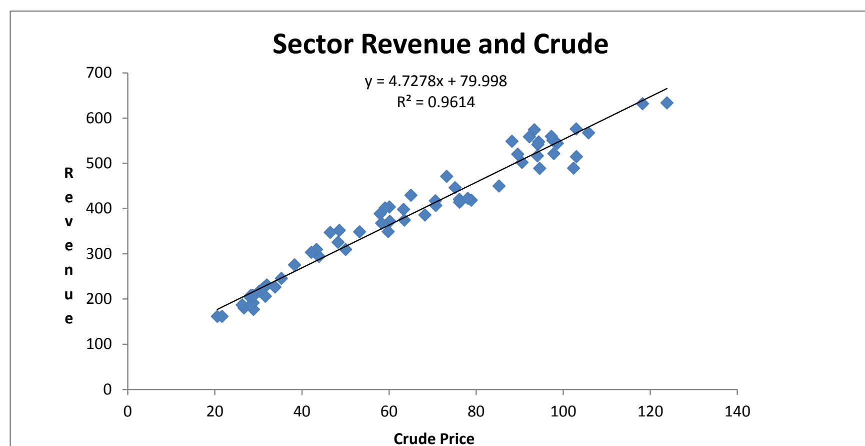
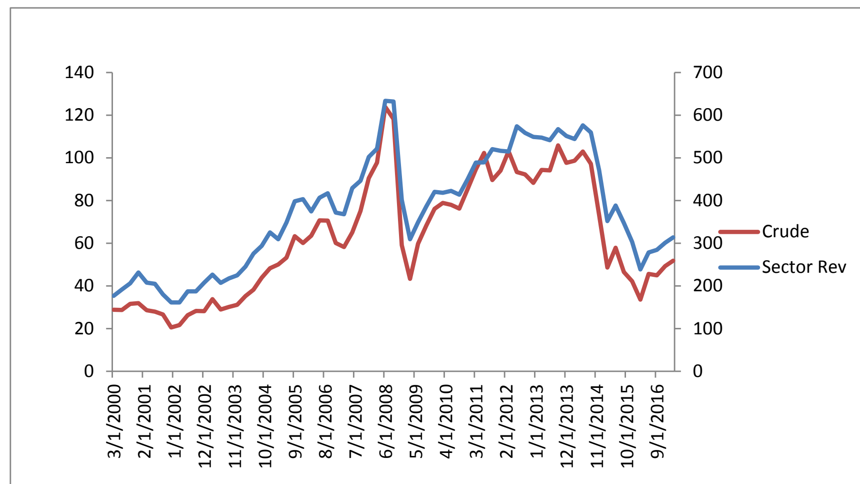


Chart 12.



- **Financials.** In our original forecast we estimated that the Trump loose fiscal agenda would drive the yield curve higher. This in turn would drive up the earnings generated by the financial sector (the second largest sector in the SPX). As conservative as we were in our yield curve enhancement (10%), we are now looking at a yield curve more in line with pre-election levels. With a 2-10 yield curve increasingly looking like a pre-election <100 level, this would subtract about $1.0 from our overall earnings forecast.

Section 3. Economic Growth – Yet Another Failed Breakout?

- Consensus forecasts for 2017 increased 20 basis points to 2.30% after the election but have since given back half of that gain as economic data has underperformed. It is nominal GDP, however, which drives corporate revenues, and therefore inflation is a critical component to our analysis as well. And on this point, CPI forecasts increased from 2.20% just prior to the election to 2.5%. Thus nominal GDP forecasts increased by 50 basis points right after the election to 4.8%, but have given back much of this to settle at 4.5%. We can see that this ~4.5% level for nominal GDP squares with what you would get to if the Atlanta Fed real GDP and inflation were used to generate a proxy for year-to-date nominal GDP. 2018 estimates imply a slightly higher nominal GDP of about 4.6%. Chart 13.

  These implied nominal GDP estimates are certainly better than last year's, but essentially fall within the band of where nominal GDP has actually come to over the past several years – essentially the 3% to 5% range as we can see in Chart 14. Putting aside a broader discussion on the prospects for a H2 economic lift off and the actual delivery of a loose fiscal policy (e.g. tax reform, infrastructure) in D.C., there are few suggestions of escape velocity in these figures.

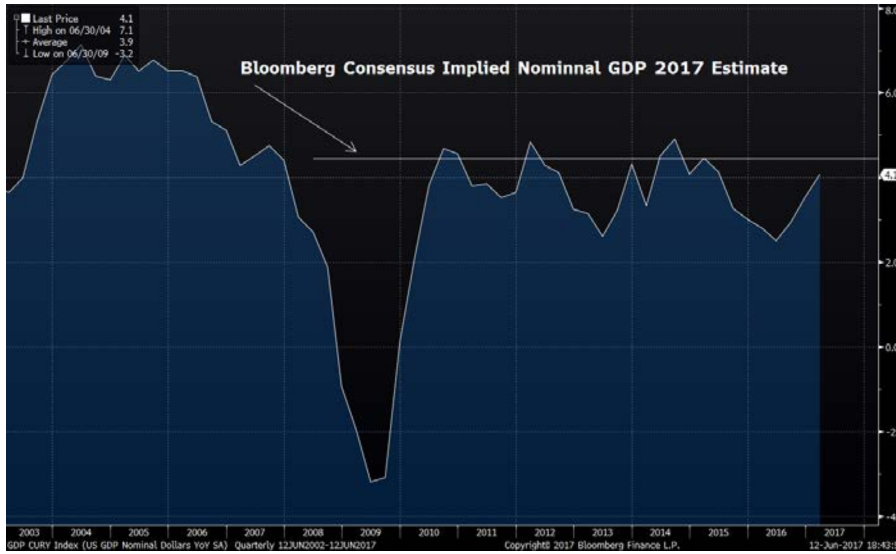
Chart 13. Economic Forecast and Actual History since Election

	2017E Bloomberg Consensus				
	Oct. 2016	Post Election Peak	Current	YTD Avg. Atlanta Fed(1)	Q1 Reported
Real GDP	2.1%	2.3%	2.2%	2.3%	2.0%
Inflation	2.2%	2.5%	2.3%	2.2%	2.0%
Nominal GDP	4.3%	4.8%	4.5%	4.4%	4.0%

	2018E Bloomberg Consensus		
	Oct. 2016	Post Election Peak	Current
Real GDP	2.1%	2.4%	2.3%
Inflation	2.2%	2.4%	2.3%
Nominal GDP	4.3%	4.8%	4.6%

Note: YTD is the average of daily values for GDP and PCE; Atlanta Fed does not publish a nominal GDP (we are adding the #'s to establish an Atlanta Fed proxy)

Chart 14. Nominal GDP Quarterly Y/o/Y



Most Recent Data Confirms Growth is Weakening

Since February, the Citi Economic Surprise index has had one of its most aggressive declines in years and has just made fresh seven year lows (-78 as of time of this writing). These dashed expectations can be understood by significant weakness in several key segments of the economy:

1. **Consumer**. Despite still strong soft data, hard consumer data has been weakening:
   - Retail & Food services growth ex autos has contracted steadily since last summer (last print at -0.3%). Chart 15.
   - Auto sales have continued to deteriorate while auto delinquencies have been climbing. Chart 16.
   - Personal consumption expenditures have been steadily weakening and the 12 month moving average has started to roll over. Chart 17.

2. **Manufacturing/Investment**. Manufacturing appears to be in relatively better shape than the consumer, and industrial production data has been one of the consistently stronger trends in the economy. Nonetheless, the data is suggesting more stability than acceleration:
   - PMI's are still reasonable, but have fallen from 58 to under 55 in a straight line just since the February print.
   - Capital Goods have climbed from their trough but are still short of where you might expect in a mid/late cycle. Durables new orders have continued to trend sideways and have shown recent weakness. Chart 18.
   - C&I loan growth has come out of its trough on the recent print but is still unusually low at this point in the cycle.

3. **Housing**. Housing had been one of the brighter lights but again we see the uptrend in housing starts, permits and home builder sentiment weakening over the past three months. Chart 19.

4. **Employment**. The recent weakness in the jobs gains may or may not represent a pivot to a weaker trend or just a pause before renewed gains. Nonetheless, the fact that the 12 month moving average in wage gains has started to contract is a worrisome trend, especially this late in the employment cycle with U-3 at 4.3% and U-6 trending towards 8.0%. Chart 20.

5. **International Revenue Considerations**. A subject of a longer discussion, but there is mounting evidence that other economies are starting to slow down in concert with the U.S. as we can see in Chart 21. International revenue/earnings may well be at risk as well.

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Chart 15. Retail Sales Less Autos SA

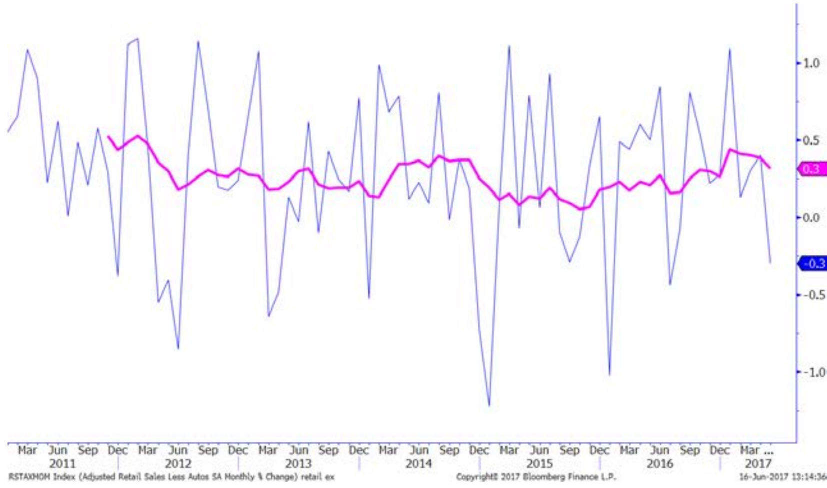


Chart 16.

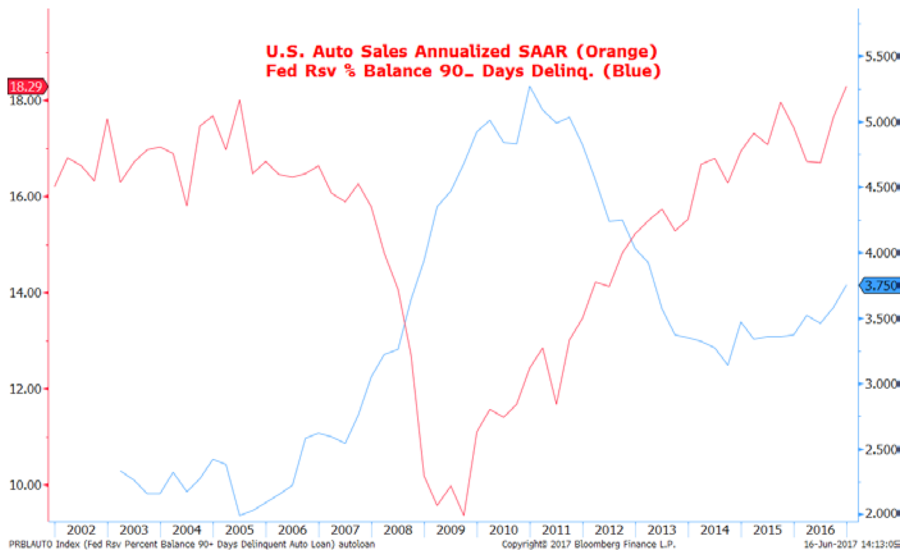


Chart 17. BEA Personal Consumption

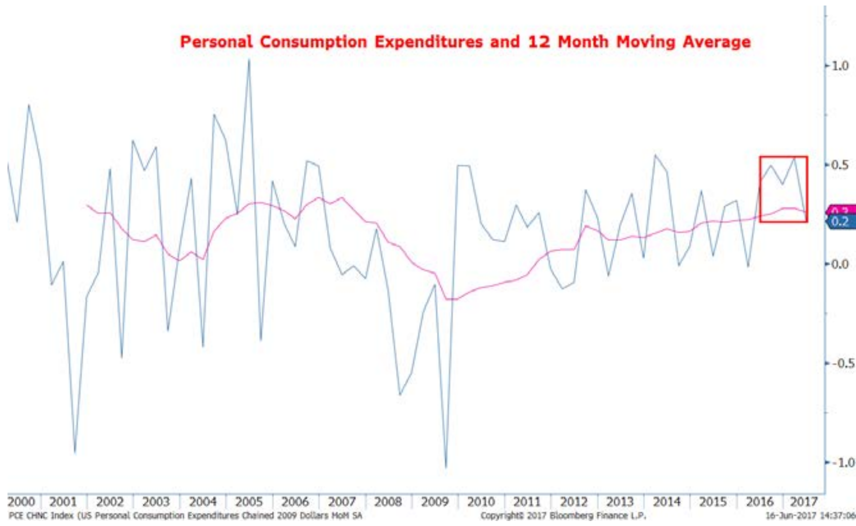


Chart 18.

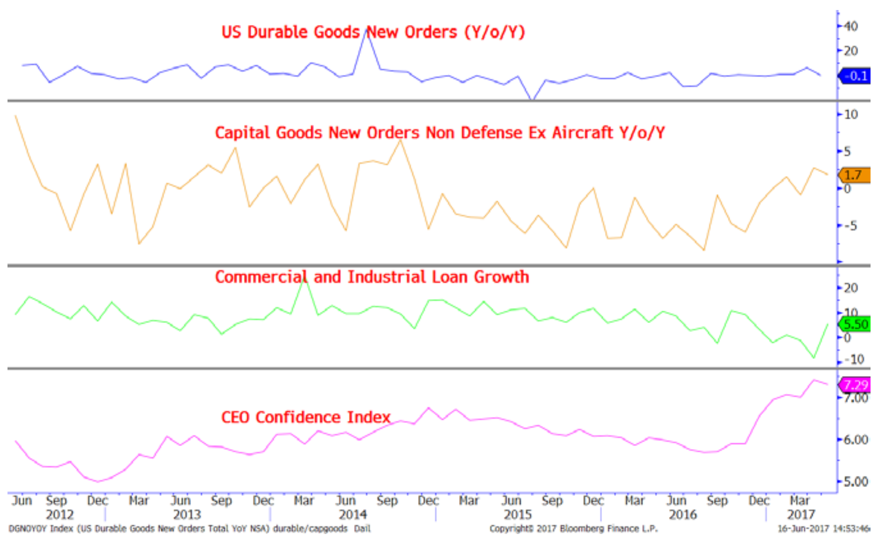


Chart 19.

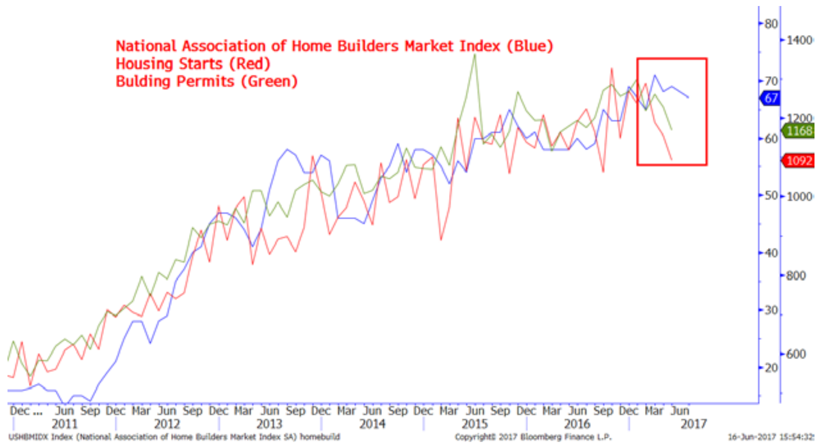


Chart 20.

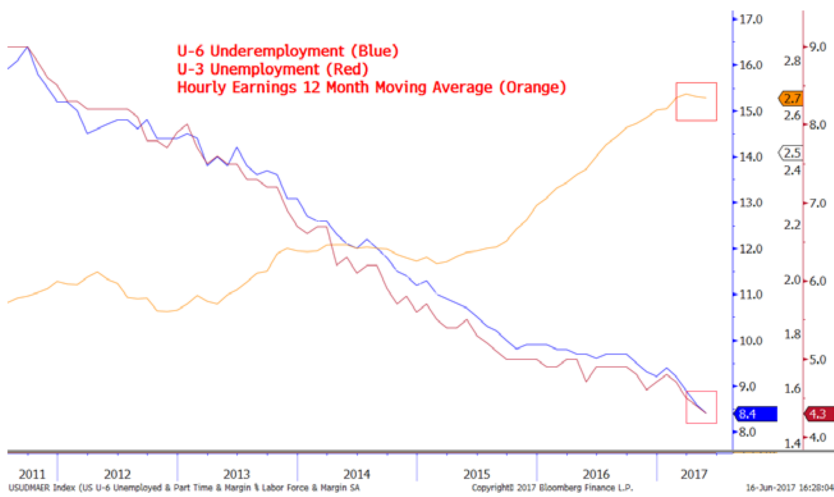
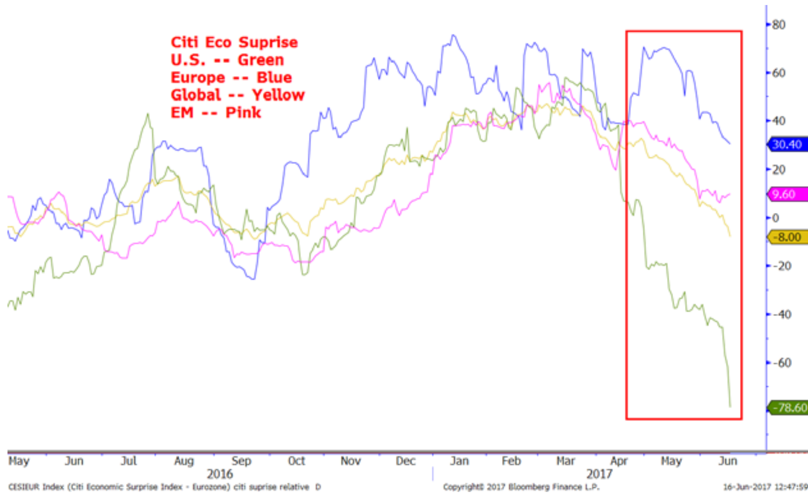


Chart 21.



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APPENDIX

A-1.

Bottoms Up Consensus Vs. Actual Results	2012	2013	2014	2015	2016	2017	Mean
Beg of Year Estimate	105.1	110.9	123.8	124.2	122.7	130.0	
Actual	99.2	106.0	112.4	108.5	108.6	?	
Beat/(Miss) - Abs.	(5.9)	(4.9)	(11.5)	(15.8)	(14.2)	?	
Beat/(Miss) - Relative	-5.6%	-4.4%	-9.3%	-12.7%	-11.5%	?	-8.7%

Top Down Consensus Vs. Actual Results	2014	2015	2016	2017	Mean
Beg. Of Year Mean Estimate	116.9	124.6	123.3	128.0	
Actual	112.4	108.5	108.6	?	
Beat/(Miss) - Abs.	(4.5)	(16.2)	(14.7)	?	
Beat/(Miss) - Relative	-3.9%	-13.0%	-11.9%	?	-9.6%

Estimates per Bloomberg consensus forecasts at beginning of the year.

A -2

SPX Earnings and Implied P/E Expansion/Contract	2014		2015		2016	
Weeden Estimates	EPS	EPS Growth	EPS	EPS Growth	EPS	EPS Growth
Initial Earnings Estimate	115.0	8.6%	120.0	6.6%	120.0	10.2%
Revised Earnings Estimate	NA		115.0	2.2%	115.0	5.6%
Initial Estimated Earnings Growth						
Revised Estimated Earnings Growth	NA					
Actual EPS	112.6	6.3%	108.9	-3.3%	107.3	-1.5%
Street Consensus Mean Earnings Estimates						
At time of initial report	116.9	10.3%	124.6	10.7%	123.3	13.3%
At time of revised report	NA		121.2	7.6%	120.3	10.5%
Weeden Estimated P/E Expansion (1)						
Estimated at Initial Report	**5.1%**		**7.5%**		**-5.1%**	
Estimated at Revised Report	NA		-2.6%		**4.4%**	
Actual P/E expansion	**5.1%**		**2.6%**		**11.0%**	
Street Mean Consensus Estimated P/E Expansion						
Estimated at Initial Report	-5.3%		-2.3%		-6.1%	
Estimated at Revised Report	NA		-2.5%		-5.4%	

(1)P/E expansion is anticipated return less antipated earnings growth. Street consensus per Bloomberg.

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A-3.

SPX Price Target (Cash)	2014 SPX Level	2014 Expected Return	2015 SPX Level	2015 Expected Return	2016 SPX Level	2016 Expected Return
Weeden						
Initial Year End Price Target/Expected Return	**2,100**	13.6%	2,350	14.1%	2,150	5.2%
Revised Year End Price Target	NA	NA	**2,050**	-0.4%	**2,250**	10.1%
Date of Revision	NA	NA	10/5/2015		7/28/2016	
Actual Year End SPX Level	**2,059**	11.4%	**2,044**	-0.7%	**2,238**	9.5%
Average of Last Five Closes of Year	**2,080**	12.5%	**2,061**	0.1%	**2,254**	10.3%
Average of Last 10 Closes of Year	**2,078**	12.4%	**2,048**	-0.6%	**2,259**	10.5%
Street						
Mean of Street Strategists						
At beginning of year	1,940	5.0%	2,232	8.4%	2,191	7.2%
At time of revised Weeden report	NA	NA	2,164	5.1%	2,149	5.1%
Weeden Above/Below Actual (to last close of yea	**SPX Points**	**Return %**	**SPX Points**	**Return %**	**SPX Points**	**Return %**
Initial Report	**41**	**2.2%**	**306**	**14.9%**	**(88)**	**-4.3%**
Revised Report	**NA**	**NA**	**6**	**0.3%**	**12**	**0.6%**
Street Mean Above/Below Actual						
At beginning of year	(119)	-6.4%	188	9.2%	(47)	-2.3%
At time of revised Weeden report	NA	NA	120	5.8%	(89)	-4.4%

Note: Expected returns exclude dividends. Street means per Bloomberg consensus.

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