charles SCHWAB Asset Management

Don't Let Me Down: An Earnings Season Update

Earnings season has thus far been a mixed bag, and despite a notable increase in the beat rate, the market is rightfully shifting focus to guidance for the rest of the year.

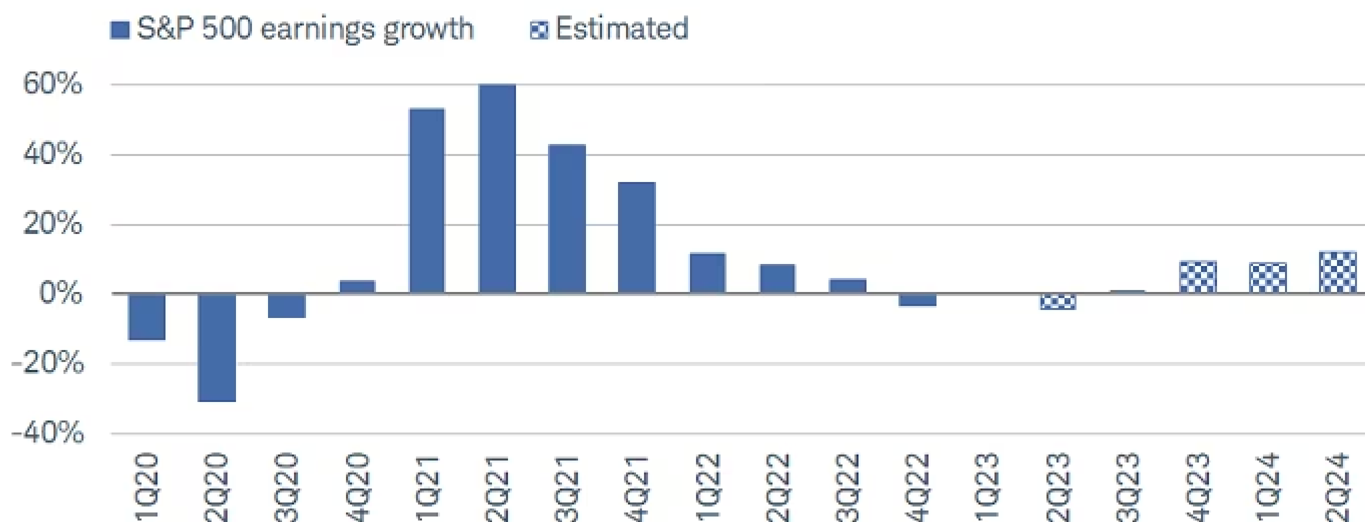
August 07, 2023

With nearly 85% of S&P 500® companies having reported results for second-quarter earnings season (as of August 4th), it's time for an update on how the profits picture has unfolded thus far—as well as a peek into what expectations are for the back half of the year. The simplest way to sum up performance in the second quarter is "mixed." On the one hand, earnings are contracting, revenue growth is virtually flat, and guidance has weakened. On the other hand, the beat rate has climbed, earnings estimates are up from their worst points, and the percentage by which companies are beating estimates has moved higher (all to be explained below).

On the right path?

Starting with a broad overview, you can see in the chart below that the "blended" estimate for earnings growth—which combines results from companies that have already reported with estimates for those that have yet to report—is in negative territory. At -4.2% year-over-year, it's the worst decline since the third quarter of 2020 and is sandwiched between a zero-growth quarter (the first quarter of this year) and what is expected to be a rebound into positive territory (starting in the third quarter).

Growing pains still here



Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 8/4/2023.

Y-axis truncated for visual purposes. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data. **Past performance is no guarantee of future results.**

Putting results under the microscope yields an interesting reason as to why growth is negative for the quarter. As you can see in the table below, the drag is entirely due to the energy sector. You can see that if one were to exclude energy's -41.2% contraction, the S&P 500's earnings growth rate jumps to 2%. This dynamic won't last in perpetuity, but energy will face tougher base effects in the near future, given the sector's profits were growing by triple-digit percentage points this time last year (which had the opposite effect of boosting the overall market's earnings).

Worth pointing out is that earnings growth is expected to rebound at a steep pace in the back half of this year, then climb to a double-digit pace into 2024. In the face of leading indicators that continue to weaken, tightening lending standards, and the climb in interest rates, it seems rather lofty (for now) to assume that growth will hold at that pace. Plus, we like to consistently remind investors that estimates further out should be taken with several grains of salt. A year ago, the consensus estimate for earnings in the second quarter of 2023 was nearly 11%; that has clearly been chopped considerably.

Energy a considerable drag

S&P 500 y/y earnings by sector										
Sector	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24	4Q24	FY23	FY24
Consumer Discretionary	56.2%	52.1%	18.5%	24.7%	14.7%	3.6%	16.2%	19.2%	32.7%	16.3%
Consumer Staples	0.4%	7.4%	4.4%	7.0%	7.5%	8.2%	9.8%	8.7%	4.0%	8.9%
Energy	21.0%	-47.7%	-41.2%	-27.8%	-17.3%	13.0%	10.9%	9.9%	-28.7%	2.0%
Financials	7.7%	7.3%	13.3%	9.7%	6.0%	8.2%	9.6%	12.3%	9.0%	9.4%
Health Care	-14.8%	-26.6%	-9.8%	1.0%	5.1%	26.7%	11.1%	10.5%	-13.3%	13.2%
Industrials	27.1%	13.9%	14.5%	7.7%	15.0%	10.3%	13.9%	13.1%	14.7%	12.7%
Materials	-22.2%	-26.1%	-15.7%	-4.4%	-3.1%	4.8%	14.2%	11.8%	-19.0%	6.2%
Real Estate	-6.2%	-2.1%	-6.1%	15.2%	6.1%	1.2%	8.5%	8.2%	1.0%	6.0%
Technology	-8.3%	1.9%	1.7%	11.6%	14.8%	13.7%	18.5%	17.6%	1.8%	16.3%
Communication Services	-8.9%	15.5%	35.3%	49.4%	27.2%	18.1%	14.0%	15.1%	22.5%	18.1%
Utilities	-21.8%	3.7%	14.5%	58.1%	20.3%	3.4%	4.4%	-6.7%	6.2%	8.9%
S&P 500	**0.1%**	**-4.2%**	**0.9%**	**9.2%**	**8.7%**	**12.3%**	**12.8%**	**13.0%**	**1.2%**	**12.2%**
S&P 500 ex-Energy	**-1.6%**	**2.0%**	**6.7%**	**13.4%**	**11.3%**	**12.2%**	**13.0%**	**13.2%**	**4.7%**	**13.0%**

Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 8/4/2023.

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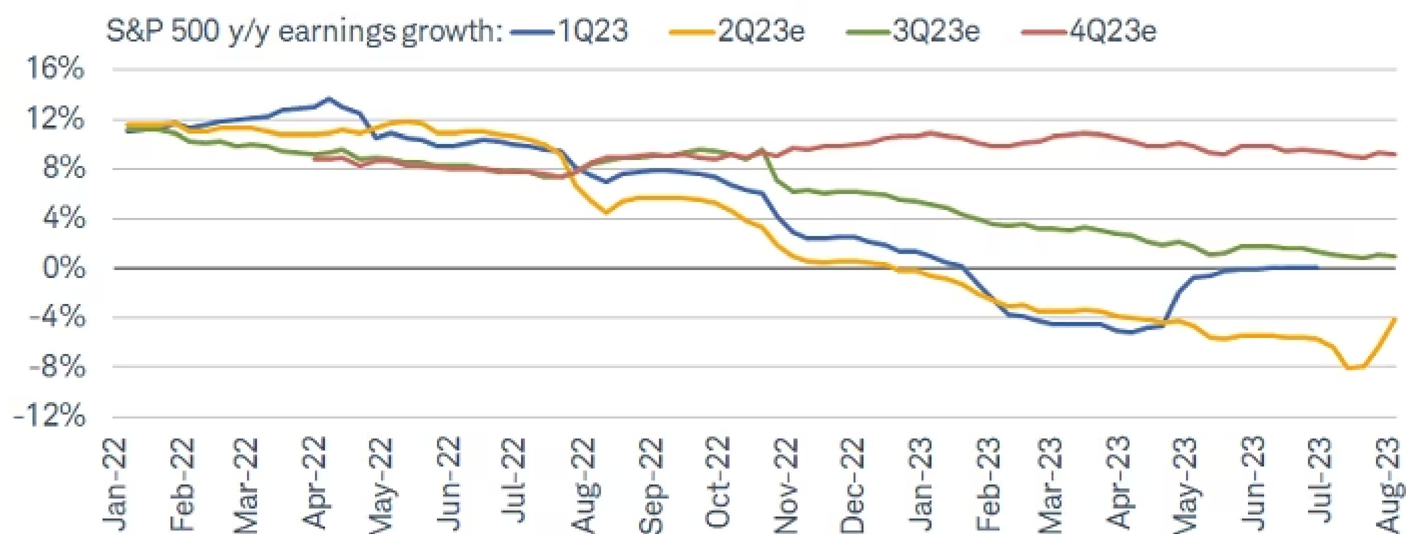
You can see that chopping-down process more clearly in the next chart, which plots out the path of estimates over time for this year. At certain points last year, analysts had expected first- and second-quarter earnings growth to jump above 12%. Yet, earnings didn't grow at all in the first quarter (the blue line) and they are contracting in the second quarter (the yellow line). Not only that, but despite the expectation for stronger results in the third quarter, estimates have continued to move down.

One development worth watching is if the "hook" pattern seen year-to-date continues. Even though there was no earnings growth in the first quarter, that was a significant improvement from the low point, which had baked in a nearly 5% decline. Admittedly, analysts lowered the bar too far, too fast at the beginning of the year, which made results look less terrible. You can see earnings starting to replay that pattern in the second quarter, but given reporting season is close to wrapping up, it would take a heavy lift from a small number of companies to get earnings back to breaking even.

Getting the hook again?



Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 8/4/2023.

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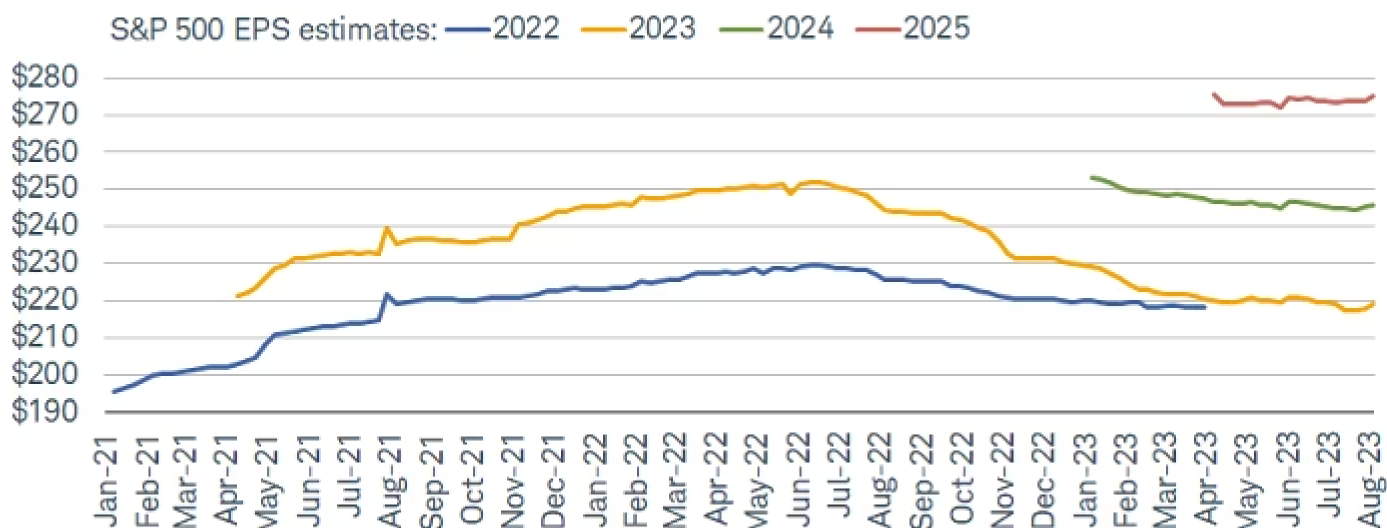
The hook in the first quarter is virtually the entire reason that earnings estimates for the full year have stabilized. Shown in the chart below are dollar estimates for the S&P 500, broken down by year. With the yellow and blue lines right near the $220 level, the expectation (as of now) is that earnings will see almost no growth this year compared to last year. Yet, as we alluded to earlier, the expectation is for a miraculous jump in growth as we enter 2024 (the green line). Again, we'd be careful in extrapolating for several reasons, not least being some notable cuts to guidance of late.

2022, meet 2023



Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 8/4/2023.

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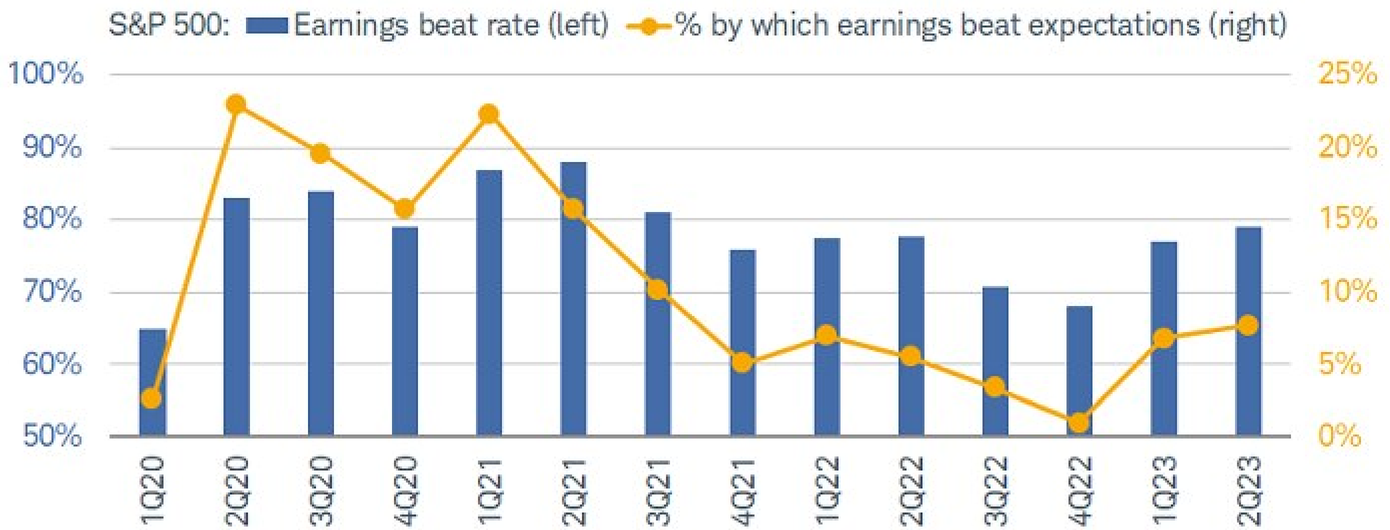
Better-than-expected doesn't cut it

There has been a lot of enthusiasm stemming from the impressive beat rate this season, given nearly 80% of companies have reported earnings results above analysts' expectations (the highest since the third quarter of 2021). Additionally, as you can see below, the percentage by which companies are beating (shown via the yellow line) has jumped to 7.7%, which is also the highest since the third quarter of 2021. Undoubtedly, both are great statistics for which to cheer, but we would encourage investors to look at growth and revisions, since it's easy to clear a low bar if analysts drop it significantly—which was the case starting last quarter.

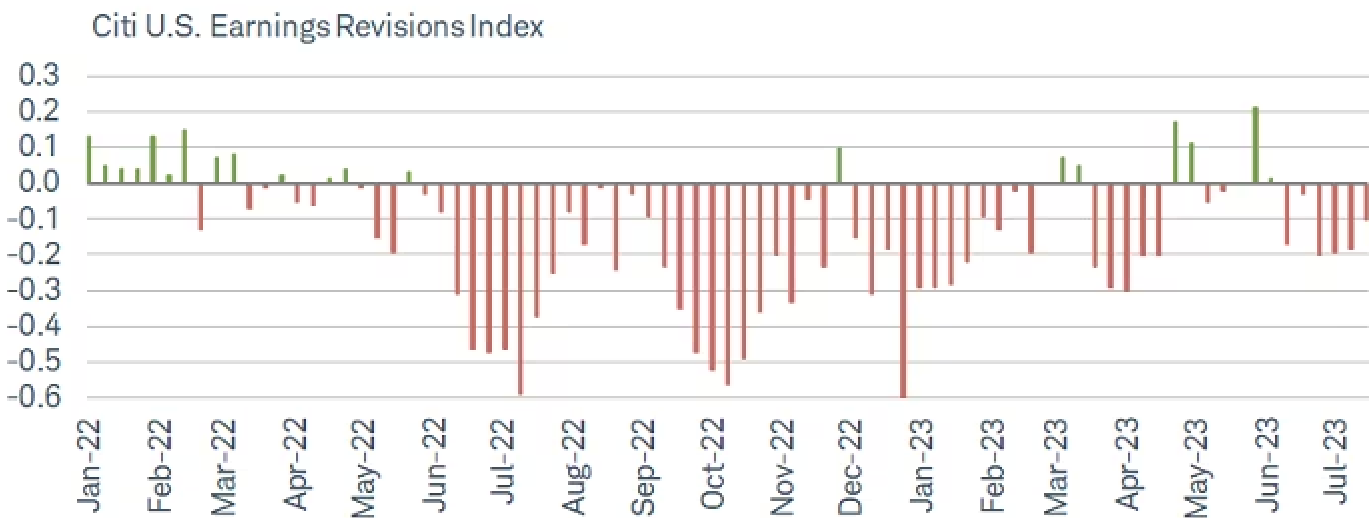
Beating the odds



Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 8/4/2023.

As such, you can see that there has been much less enthusiasm for the market when looking at revisions. The number of negative revisions has outpaced the number of positive revisions for the past six weeks, the longest streak since the end of 2022 into 2023. To be sure, the spread is less severe this time around. That, along with the fact that we have seen some notable pops higher (like in early June), suggests that the direst expectations are being rescinded.

Downgrades outpacing upgrades

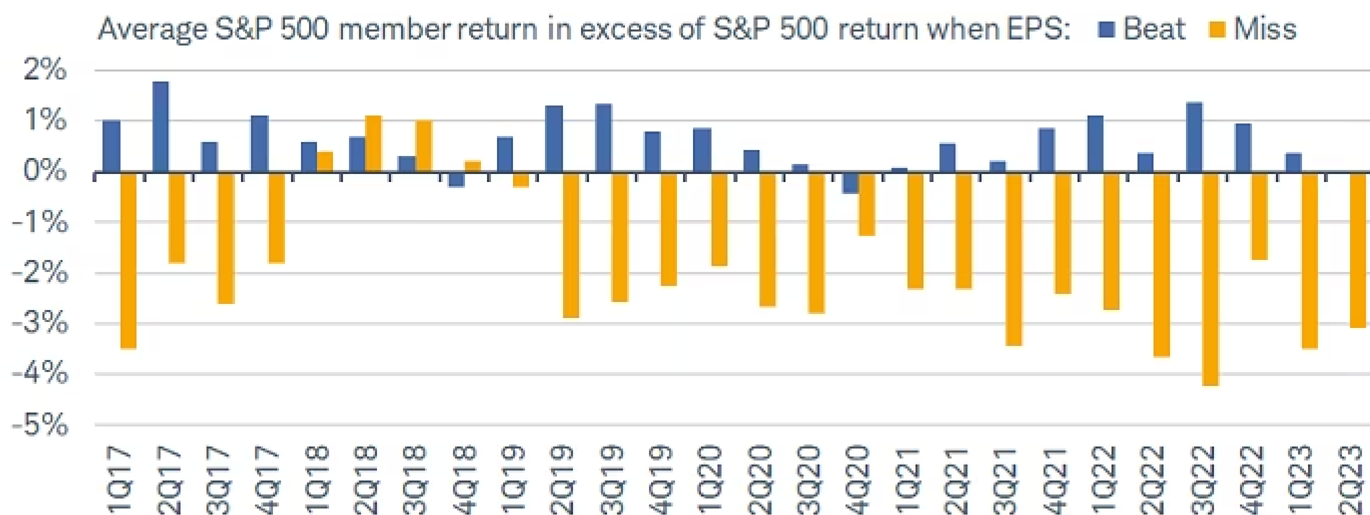


Source: Charles Schwab, Bloomberg, as of 7/21/2023.

The Citi U.S. Earnings Revisions Index is calculated as the ratio of analysts' earnings per share revisions to listed companies tracking equity analyst revisions upgrades (positive) vs. downgrades (negative).

The chief reason we'd look to revisions and actual growth results (as opposed to the beat rate) is because companies' stock prices haven't been rewarded for outpacing analysts' estimates. The chart below plots out the average S&P 500 member's return in excess of the broader market's return when earnings beat and miss expectations. Conventional wisdom says a company should outperform when beating estimates, which has been the case most of the time. Yet, this quarter, there has been zero outperformance despite some notable earnings beats, making this (so far) the worst quarter for the average S&P 500 member's reaction since the fourth quarter of 2020. We view this as the market both having fully priced in better results and putting more emphasis on what guidance companies are giving.

An unenthusiastic response



Source: Charles Schwab, Bloomberg, as of 8/4/2023.

Past performance is no guarantee of future results.

In sum

There's something for everyone in earnings results for the second quarter. Our main takeaway is that the market is (rightfully) growing stricter in its assessment of companies' forward guidance, which is crucial given inflation-adjusted revenue growth for the broader economy is now contracting. As we turn to the second half

of the year, earnings have to step up to the plate to justify the market's strong run, especially because the entire rally since the trough last October has been driven by multiple (price-to-earnings ratio, or P/E) expansion. It is true that multiples tend to rebound before earnings; but it's also true that for a rally to be sustainable, earnings need to start showing material signs of strength and contributing to the upside.

We are approaching critical moments of truth for the economy in the back half of the year. If earnings and revenue growth hold up (and rebound) as monetary policy continues to tighten and cracks in the labor market remain, resilience will have taken on a new, stronger meaning. For now, though, we're not yet out of the woods.

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(0823-3R20)

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