Welcome earnings season: 1Q S&P EPS growth likely 20%+

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Next week begins an earnings season that should put the recent worry season aside

A good 1Q earnings season tends to support good springtime stock market performance and we expect this earnings season to be great. This should help investors set aside some of their worst inflation and protectionist fears of late and help the market regain its footing for a decent ascent in 2018. While we believe US stocks climbed too high in January, we also think that the twice tested correction lows of February were an overshoot to the downside. The S&P 500 has essentially restarted 2018, with Feb-March washing out January, but S&P price levels in late January show the type of upside that is likely for full 2018 if S&P earnings per share (EPS) delivers upon expectations.

Many clear and quantifiable reasons why 1Q18 S&P EPS growth should exceed 20%

We maintain a quantitative S&P 500 profit indicator model to help us forecast near-term S&P EPS and the signals from this model for 1Q S&P EPS y/y growth are essentially the strongest they've been this cycle and clearly the strongest since the early recovery years this cycle. Our indicators suggest that even before the benefits of the US corporate tax rate cut to 21%, that S&P EPS growth should exceed the 12% y/y pace achieved in 4Q17. Thus, with the 7% boost to S&P EPS that we expect from the tax cut, 1Q S&P EPS growth should exceed 20%. We expect the aggregate effective tax rate of the S&P 500 to fall from about 26% to 19%, thus S&P companies will keep 81% of their pretax profits in 2018 vs. 74% in 2017, this is a 10% tax boost, but we think roughly 25% of this lower tax cost benefit is passed on to customers.

A closer look at our S&P 500 profit indicator signals

Our profit indicator consists of 23 signals in 6 categories. These categories are: 1) manufacturing activity, 2) industrial production, 3) exports, 4) jobs, 5) loan growth, 6) and commodity prices. For 1Q18, the aggregate signal of each category is in positive territory with the exception being loan growth. Although loan growth remains sluggish, it is positive and recent U.S. Federal Reserve (Fed) rate hikes help to boost the net interest margins at banks vs. last year and also sequentially vs last quarter. The strongest contributors to the positive 1Q S&P EPS growth signal are manufacturing activity, industrial production and exports. Manufacturing and industrial activity, which are strongly related to investment spending and exports, have a large influence on S&P EPS. The S&P is more sensitive to these segments of gross domestic product (GDP) than consumption. We believe that this investment activity is strongest on new information technology related hardware, software and services. Heavy industry is also in good shape with good growth, but tech industries are stronger. Energy and other materials related industries are doing decently as these industries slowly recover from excess supply and weak pricing. Energy profit growth should be strong from depressed levels.

An important S&P EPS driver that our quantitative profit indicator doesn't capture is FX

Our profit indicator doesn't capture changes in foreign exchange rates (FX). But we know that this is an important driver of S&P EPS, because roughly a third of S&P revenue and 40% of S&P profit comes from abroad. About 25% of S&P profits are earned in foreign currencies. Thus, every 10% decline in the dollar vs. developed currency indices boosts S&P EPS by about 2.5% or $3.50-$4.00 a year. Average dollar exchange rates in 1Q18 suggest an S&P EPS boost of about 3% y/y and 1.5% sequentially versus 4Q17. Our 2018E S&P EPS of $155 assumes that some of this FX benefit reverses later in 2018, but if not then 2018 S&P EPS is likely to be $155-160. We assume that West Texas Intermediate (WTI) oil prices will be about $60/bbl for the rest of 2018.

We expect 1Q 2018 S&P EPS to finalize between $38 to $38.50, supports $155 for year

Given our profit indicator signals, our additional consideration of foreign exchange rates, and Fed hikes over the past 12-months – which boosts bank profits – and the potential for significant buybacks at attractive share prices during February and March, we believe that 1Q S&P EPS will exceed $38. Because the first quarter is seasonally lighter than the rest, this suggests that our 2018E S&P EPS of $155 is well within reach even if these profit indicators slow over the course of the year, which is what we do expect and reflect in our full 2018 S&P EPS estimate.

We stay constructive on US and global equities and expect an earnings season led rally

We expect the heightened equity volatility experienced so far this year, which has not been seen in rates, currency or commodity markets or in the economic data reports, will fade back to more normal levels soon as lower stock prices and the 1Q demonstration of higher earnings power will prove valuations reasonable and point to attractive upside for weathering the risks.

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Definitions:

Earnings per share (EPS) is calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The **U.S. Federal Reserve Board (Fed)** implements U.S. monetary policy.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing.

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