CANACCORD Genuity
Wealth Management

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Weekly Note

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You Get What You Give

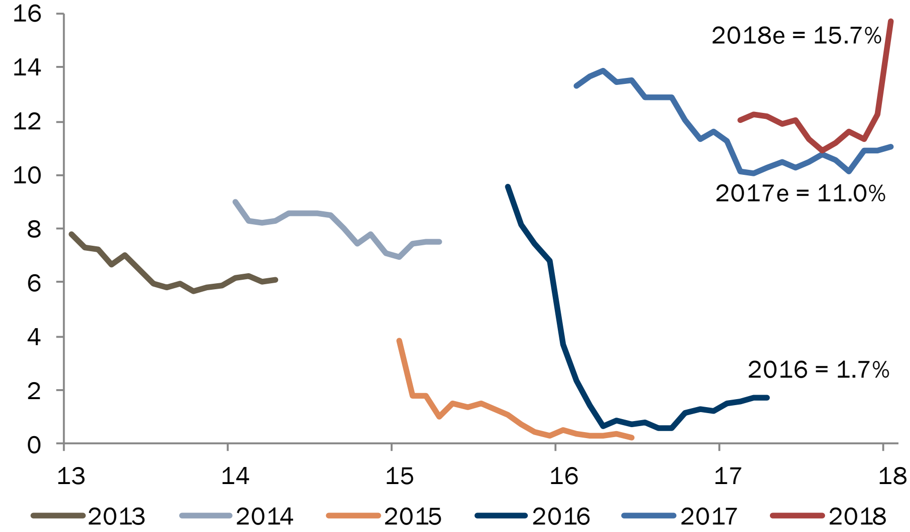
The latest forecast for US real GDP growth is 3.4% (on a seasonally adjusted annual rate) for the fourth quarter of 2017 according to the Atlanta Federal Reserve Bank's GDPNow model. The first official estimate is due to be reported at the time of writing with the consensus from Bloomberg, estimating an annualised growth rate of 3.0% for the final quarter of last year. If the GDPNow model final estimate is correct then this would represent the fastest quarterly growth in the US economy in three years. Last year the US economy grew by 1.2% in Q1, 3.1% in Q2 and 3.2% in Q3. Moreover, the strong US economic growth is set against the backdrop of a robust synchronised global growth with major leading economic indicators pointing to an ongoing positive activity.

The other key piece of information for investors is the current earnings season and the earnings growth prospect for 2018 in particular. So far, 128 out of the 500 S&P companies have reported earnings for Q4 2017. Earnings growth is up 10.8% year-on-year (YoY) in the final quarter of last year according to Bloomberg. This is on the back of revenue growth of 7.8% YoY over the same period. If the current reported corporate earnings growth is maintained, this would be in-line with the bottom-up IBES consensus forecast for the S&P 500 Index of 11.0% in 2017.

Looking forward, a key determinant of this year's stock market return in our view is earnings growth in 2018. Figure 1 highlights the momentum in the IBES consensus earnings growth forecasts for the S&P 500 companies. Currently, earning is forecast to grow by some 15.7% in 2018. The latest forecast has increased dramatically from 12.3% at the end of December last year. This is on the back of the IBES consensus revenue growth of 6.0% in 2018 which is marginally below the expected 6.4% growth for 2017 (please see Figure 2).

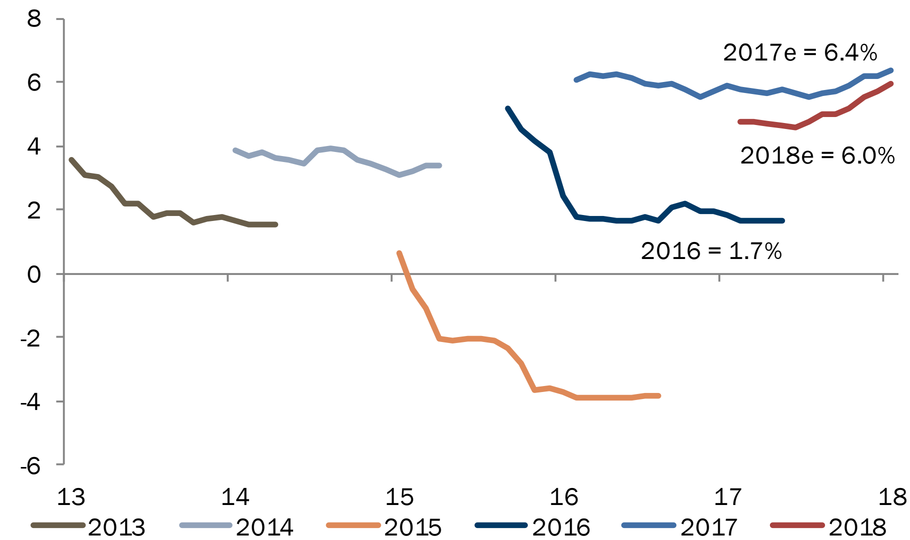
A significant driver of the rebound in the earnings growth expectations is a sharp recovery for the energy sector. Corporate earnings in the energy sector are expected to grow by 51% in 2018. However, even if we strip out the effect of the energy sector, earnings growth for the S&P 500 companies (ex-energy) is forecast to grow by 15.0% this year. All ten major sectors are expected to see positive earnings growth. Following on from energy, financials and materials are also expected to see impressive growth of 27% and 20% in 2018 respectively. We are cautious of these levels of earnings expectation given the overall economic growth prospect and the already high corporate profit margins.

Figure 1: Consensus EPS growth forecasts for the S&P 500 Index



Source: Datastream, Canaccord Genuity Wealth Management

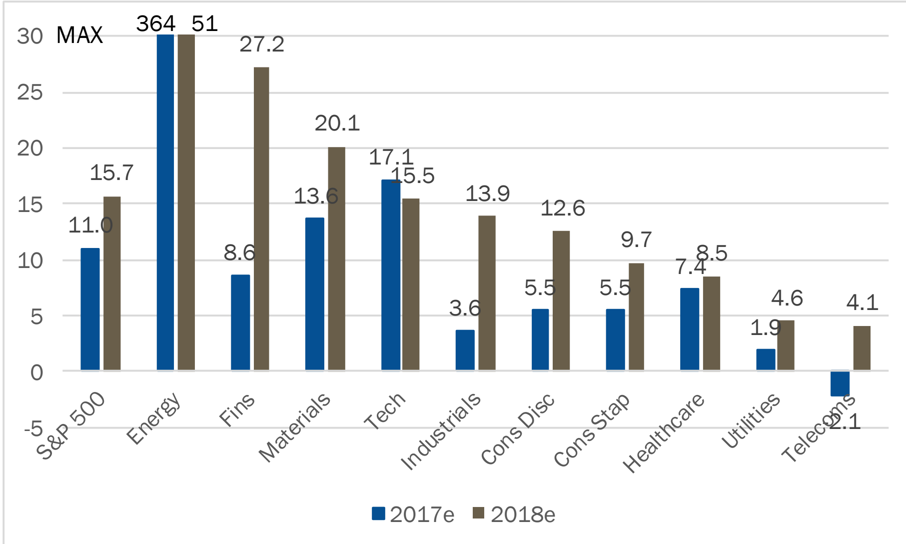
Figure 2: Consensus revenue growth forecasts for the S&P 500 Index



Source: Datastream, Canaccord Genuity Wealth Management

As a rough rule of thumb, we should expect corporate earnings growth to match nominal GDP plus margin growth. For 2018, nominal GDP growth for the US economy is expected to be 4.2% (based on real GDP growth of 2.5% and 1.7% inflation rate) according to the latest US Federal Reserve projection. Using that as a close proxy for corporate revenue growth this year and allowing for the fact that the S&P 500 companies also derive sales from outside of the US and the ability of firms to control for costs in recent times, the current earnings growth forecast (ex oil) would appear to be too optimistic in our view. We would look for EPS growth in the region of 9-10% next year.

Figure 3: Consensus EPS growth forecasts for the S&P 500 sectors



Source: Datastream, Canaccord Genuity Wealth Management

Global stock markets have remained resilient with the S&P 500 Index trending higher since the start of the year and volatility as measured by the VIX remaining low. Whilst we remain positive on equities for this year given positive economic and earnings growth and the still accommodative monetary policies, the prospect of downward revisions to the consensus earnings growth forecasts is likely to lead to an increase in market volatility, you always get what you give. That is something we expect to see in the second half of this year.

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