Key Questions

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What Do 2Q Earnings Tell Us About the Rest of the Year?

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Some Key Themes Are Emerging as Analysts Seem Cautious but Optimistic for the Second Half of 2023 and Beyond

The halfway point for the 2023 second-quarter earnings season has passed. That makes it a good time to reflect on what we have learned from earnings calls and our conversations with analysts and other investors.

Following a strong first-half performance for equities, three key themes have emerged about the current sentiments of investors and what they will be watching in the back half of the year and beyond.

1) The number of "beats" (i.e., the number of companies that have exceeded analysts' forecasts) has been above average yet the stock price reaction has been below average.

2) Mentions of key topics from recent quarters like layoffs, supply chain, and recession appear to have peaked, while mentions of artificial intelligence (AI) have continued to rise.

3) Investor focus is beginning to shift to next year, and bottoms-up consensus earnings growth is currently 11% year-over-year for 2024, a rebound in profit growth from 2023.

Let's take a closer look at each of those themes.

Beating Earnings Estimates Not Rewarded as Much

With sell-side estimates being revised lower coming into second-quarter earnings and with a still relatively healthy macro backdrop, the bar to beat estimates seemed to be low. According to Factset, bottom-up earnings estimates for the S&P 500 (those constructed at the company level versus at the index level) called for a 9% decline year-over-year.

So far 80% of companies have beat their earnings estimates, which is above the 10-year average of 73%. The earnings surprise percentage (the magnitude by which a company beat estimates) is 5.9%, which is roughly in-line with the 10-year average of 6.4% and well above the one-year average of 3.2%. Despite the stronger than average beats, the stock price reaction has been more negative than historical averages. Of the companies that beat, the price reaction around earnings (two days prior through two days after) has been -0.2%, compared to the historical average of +1%. In other words, investors are not rewarding companies for exceeding analysts' estimates as they have done in the past.

One explanation: Investor expectations are much higher than those of analysts which can simply be expressed by the ~15% positive move in the S&P 500 in the past three months.

The Topics Discussed on Earnings Calls Have Shifted

This past year's earnings-call conversations have centered around topics including supply-chain disruptions, inflation, and labor issues. Using Bloomberg's transcript analyzer, we can observe a trend shift for management commentary and analyst questioning this quarter.

These previously mentioned topics appear to have peaked while emerging topics like AI are more top of mind for management teams and the investor community. Outside of the large tech companies directly involved with AI-related software and hardware, most companies still seemed to be in the early stages of figuring out how to best implement the technology.

A positive this quarter has been commentary around labor – there have been fewer mentions of layoffs and staffing shortages. This is corroborated by macro-economic data that shows that the labor market is gradually returning to normal.

Overall, we would sum up the tone of this quarter's earnings calls as cautiously optimistic. The recession that companies were planning for at the beginning of the year does not seem imminent, yet outlooks remain measured as we have not yet seen the full impact of higher interest rates.

Focus Shifting to the Anticipation of a Strong Rebound in 2024

Investors tend to be a very forward-looking group. While we are just past the halfway point of 2023 and management teams don't typically complete the upcoming year's budget until late in the fourth quarter, the emphasis on next year is beginning to matter more.

So far this year the equity market has been able to climb while 2023 earnings estimates have steadily declined. Estimates for 2024 have not seen the same type of downward pressure, and consensus currently expects year-over-year earnings-per-share (EPS) growth of 11%. This appears to be a fairly optimistic growth rate in the face of recession predictions that keep getting pushed out.

We will be watching a few key items, namely revenue growth and margins, to see if this current earnings growth forecast can hold.

Over the past few years, price increases have become a larger component of revenue growth for most companies. However, against the backdrop of slowing inflation we expect price increases will be harder to implement and companies will need increased volumes or an improved mix of the products/services sold to keep revenues growing at a healthy rate.

Inflation slowing also means that input costs are going down and could be a source of upside for margins next year. Conversely, higher interest expenses could be a downside for net profit margins next year. Like most homeowners, companies refinanced debt at low rates in recent years; however, instead of a 30-year term, a 3-to 5-year term is much more likely. This debt will likely be refinanced at much higher rates and therefore reduce cash flows and earnings.

Key Takeaways

This earnings season has told us that the economy is on better footing than most management teams expected coming into the year. These three themes have emerged from what we've heard:

- Earnings beats are more frequent, but they aren't being rewarded as much as usual.
- Analysts are talking more about AI than inflation and supply shortages.
- Many are already looking ahead to a strong rebound next year.

With no growth in 2023 earnings, the market's valuation multiple is beginning to look elevated relative to history. The market can continue to climb from here, but investors will be looking to 2024 and beyond to see if growth can hold or improve beyond current expectations.

For more information, please contact your advisor.

About the Author

Connor Cloetingh is a Senior Lead Research Analyst responsible for the Materials and Healthcare sectors within the Equity and Fixed Income Research team. Connor has 7 years of experience in Equity Research, most recently on the buy side at Ancora Advisors as a generalist equity analyst on the $1.5 billion AUM Ancora/Thelen small and mid cap funds. Prior to joining Ancora, Connor was a Sr. Equity Research Associate at KeyBanc Capital Markets covering the Chemicals industry. He began his investment career at Northcoast Research covering the medical device and healthcare distribution industries. Connor holds a Bachelor of Arts in Finance with a Minor in Economics from Michigan State University and is currently studying for an MBA at the University of Michigan’s Ross School of Business.