FINANCIAL LIFE CONCEPTS

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All Eyes on Earnings Season: What to Expect for Q1 2023
Presented by Christopher Phelps

We are at the start of the period when companies release their results for the first quarter of 2023, known as earnings season. With everything going on—inflation, rate hikes, a labor shortage, the weakness of the dollar, a pending recession, the list goes on and on—the results are unusually uncertain this time around. Analysts are struggling to figure out exactly what all this means.

Low Expectations Abound

That may explain why those expectations are as pessimistic as they have become. As of last week, FactSet noted that the expected year-on-year change in the earnings of the S&P 500 was a decline of 6.7 percent, which would be the second quarterly decline in a row. Given the uncertainty, that decline seems reasonable. But it is inconsistent with the strong job and spending growth we saw during that quarter. What's going on here?

Let's keep in mind that we are at the very start of earnings season. As of last Friday, per FactSet, only 30 companies (6 percent of the index) had reported. So, we should take the data with a grain of salt. At the same time, the numbers are much better than expected so far, which suggests that current estimates might be too pessimistic.

Data Reveals Beats

So far, 90 percent of the companies reporting beat the expected earnings number. On average, over the past 5 to 10 years, 77 percent to 73 percent of companies, respectively, beat on earnings. As of now, we are doing better than usual. In terms of how much they beat by, we are at a 7.9 percent beat (or the reported earnings are 7.9 percent above the expected numbers). Again, this is consistent with the historical averages, below the 5-year average of 8.4 percent but above the 10-year average of 6.4 percent.

The effect of the reports so far is that the quarterly earnings were initially expected to decline by 6.9 percent, but now that decline has been reduced to 6.5 percent. Still not good, but an improvement. And if the remaining companies do better to a similar degree, the final number will likely be much improved.

If we assume the remainder of the reports play out like the 10-year average earnings would suggest, we would get a decline of 1.4 percent. If we use the 5-year average numbers, we would actually get a small gain, of 0.8 percent. As noted, we are running somewhere between the 5- and 10-year numbers. As such, flat earnings are a real possibility, which is much better than current expectations.

Does a Decline Make Sense?

Current estimates reflect a significant shift in analyst expectations in the past two quarters. Last quarter's drop in expectations was the third largest in recent history, after the second quarter of 2020 and the second quarter of 2022. Analysts almost never change their minds that much, that fast. Expected earnings for the first quarter of this year are similarly depressed. But the question we have to ask ourselves is, does that decline make sense. I don't think it does.

Looking at the fundamentals, we can draw the same conclusion. In 2020, we were in lockdown. Layoffs were through the roof, and no one was going out and spending. The economy was in freefall, and earnings reflected that—the decline made sense. As we look at the expected decline for the last quarter, while there are things to worry about, the situation is very different than it was then. Job growth is still healthy, and unemployment is still low. While there is a slowdown underway, during the past quarter itself, spending growth was healthy, as was business investment. We are looking at growth for last quarter, not a significant decline like in 2020. Given that, why would we see a big decline in earnings?

The markets are telling us the same thing. Most sectors have rallied since the start of the year. Since markets look ahead, that can reasonably be interpreted as a positive signal for earnings during that time period. The fact that the market has held those gains in recent weeks says that signal holds.

The Big Picture

We see two things when looking at the big picture. First, the analyst community is struggling to characterize extreme uncertainty in multiple areas and is suddenly becoming much more pessimistic, on top of the normal pessimism we see almost every quarter. That change occurred, mind you, even as the economy continued to perform strongly and even as the market started to rally. Normally, history suggests earnings will come in about 5 percent better than expected. If so, we could be looking at more or less flat earnings, which would not be great—but still much better than a decline.

Beyond the analyst pessimism, the second thing we see is the relatively strong fundamentals still in place. With people shopping and spending and with businesses investing, the top-line growth should be healthy. With margins expected to largely hold, so should the bottom line. Given the strength of the economy, I suspect the actual earnings will be better than analyst expectations by at least the usual amount of 5 percent or so.

Risks to the Upside

All of this is preliminary of course, as only about 5 percent of companies have reported. While the 5- and 10-year averages look good, the past couple of quarters have been weaker. So, we may not see results as strong as we think. But overall, the risks are very much to the upside, not the downside.

As more earnings come in, expect more good news. Overall, we can look for a small decline rather than a moderate one, and possibly even a gain, in earnings. It may very well turn out that the world didn't end last quarter after all.

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