What Will Q3 2022 Earnings Look Like?

Presented by Christopher Phelps

When you look at expectations for corporate earnings for the third quarter, you get a bunch of mixed messages. On one hand, the economy is (supposedly) sinking fast, hit by rate hikes and inflation. More, companies are struggling with the labor shortage, with wages rising sharply and, in many cases, labor simply not available. Between a slower economy and a labor shortage—not to mention the problems created by the strong dollar—you would expect earnings to take a sharp hit. Indeed, we have seen a number of downward revisions to analyst expectations. On the other hand, despite the lower expectations, earnings are in fact still expected to grow, which doesn't seem consistent with the narrative at the economic level. What's going on?

Not So Great Expectations

Let's start with what the expectations actually are. According to FactSet, as of last Friday, the estimated earnings growth rate for the S&P 500 was 2.4 percent. That's not great and, as noted, it is down from the 9.9 percent expected growth as of June 30. This is the lowest expected growth we have seen since the third quarter of 2020, in the depths of the pandemic, when it was –5.7 percent. If we do get a growth rate this low (or even negative, as there are all sorts of headlines suggesting analysts are going to keep revising their estimates down), that would suggest things are indeed very, very bad. And that would likely point to a further downturn for markets.

Those expectations come from what companies are saying. As of last Friday, 10 of the 11 S&P 500 sectors had lower expectations now than at the start of the quarter. This is a widespread deterioration, and it says that the entire market is under stress as the economy deteriorates. Yet, looking at the details, I don't think things will be that bad, as the evidence simply doesn't point that way.

The Macro Economy

Let's start with the basic, macro economy. The consumer is about 70 percent of the economy, and consumer spending is determined by two things: job growth and confidence. Job growth, as we saw last week, remains strong and the labor market is still tight. Consumer confidence, perhaps as a result, has recovered over the past several months and, despite everything, remains at healthy levels. Consumer spending growth, likewise, bottomed in May and has been on an upward trend since then. We see the same trend in business spending, where durable goods orders (a proxy for business investment) continue to improve. In other words, the biggest part of the economy is likely to grow, which should help both sales and profits. So, from the macro perspective, that 2 percent looks more likely to be on the low side than the high.

Company Data

If we look at the company data we have so far, which admittedly is not all that much, we see that the individual companies are more positive than the headline numbers would suggest. As of last Friday, out of 96 companies, 65 reported negative guidance and 41 issued positive guidance. Not great, you could argue, but that is a much more even split than the 10/11 decline at the sector levels. The spread gets even better when you look at the 20 companies that have reported so far, with 14 of those reporting a positive earnings surprise and 13 reporting a positive revenue surprise. Yes, these are early days. Nonetheless, the spread has improved from 10/11 down at the sector level, to 7/10 down on the guidance level, to only 3/10 down on the actual reported data. That's a pretty good trend so far.

Historical Perspective

That is also consistent with history. Actual reported earnings have historically come out above expectations. Putting numbers to that, according to FactSet, reported earnings have beaten expectations in 39 of 40 quarters in the past 10 years. On average, almost three-quarters of companies beat expectations, by an average amount of between 5 percent and 7 percent. Looking at history, we could reasonably see earnings growth of between 5 percent and 10 percent, which would be very good all things considered.

Will We See a Win for Earnings?

Although the economy isn't as bad as expected, it is slowing in many ways. And even though we can expect earnings to do better than expected, the inflation and labor drag is very real, as is the foreign exchange effect. All of these will weigh on earnings, although likely not as much as currently estimated. We will get a win here, but probably not that big of a win.

But that's okay, as a win is indeed a win. Overall, I expect earnings growth for the S&P 500 to come out at around 6 percent to 7 percent when all is said and done. This is a very healthy growth rate, given current conditions, and should help act as a cushion for markets going forward. It is not the growth we have gotten used to, but slow growth is better than no growth.

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