April 20, 2018 — There are two ways to beat expectations: you can excel at your task or you can set low hurdles. This makes evaluating corporate earnings very difficult. Analysts are forced to use some pretty convoluted logic to explain market reaction to announcements. They will say how disappointing it is that a company only slightly exceeded expectations. It makes you wonder what the word “expectations” means. So earnings season can be confusing for everyone except maybe UN Ambassadors. However, once in a while you get a quarter in which the results are driven by some simple intuitive macro factors. This quarter fits that description. Expectations have been for very strong earnings growth, and so far a lot of companies have been meeting or exceeding the estimates. It could be the result of a rare situation in which almost all of the macro factors are lined up in favor of earnings growth.

Global growth has been good over the past year. It should not be a surprise that growth is one of the most important macro drivers of earnings. When growth is good, companies can sell more of their products and services. Over the past generation, earnings growth has been generally steady during economic expansions and has had some sharp contractions during recessions.

U.S. Nominal GDP vs. Corporate Profits

Economic growth isn’t the only macro driver. Nominal GDP growth was 4.5% last year while year-on-year earnings growth for the S&P 500 will likely come in at around triple that number. A lot of factors, such as companies’ capital structures, affect the relationship between earnings and GDP in the short run, but there are two main macro trade-offs which can drive it the long run. The first is the relationship between the government and the private sector, and the second is how profits are distributed between companies and workers. An economist might say overall growth determines the size of the earnings pie, while these other factors determine how it is split among the different parts of society. But no one would listen.

In the past year, government policy has been friendly to earnings for one big reason: the Tax Cuts and Jobs Act. Some of the effect of the cut in corporate taxes is already benefitting earnings. A cut in corporate tax can be viewed simply as a transfer from the government to companies (or perhaps more accurately as a reduction in the transfer from companies to the government). The government, of course, makes a lot of other transfers to companies and individuals, but it does not seem as though they are being reduced to compensate for the tax cuts. In other words, the government is going to run larger deficits. There has been some talk about how corporate earnings have been rising despite the increase in deficits, but that gets it backwards. The government deficit is another way of saying the private sector has a surplus, so the deficit is one of the reasons that earnings have been so good this quarter.

At the same time, wage growth has been moderate. This helps keep corporate margins high as companies don’t have to pay extraordinary amounts to workers. Low wage growth has also been cited as a potential threat to corporate profits, because it means that workers have less money to spend. This is a potential problem, but any lost consumption may be offset by the fiscal stimulus provided by the tax cuts, as well as by low interest rates. It is this trifecta of fiscal stimulus, moderate wage growth, and decent real growth that is providing such a friendly macro backdrop to corporate earnings.

For the rest of the year, there are some things that could make this environment less friendly. The global economy could start to slow, and U.S. companies make a material amount of their earnings abroad. Last week we argued U.S. data is holding up, but it is still a risk. It is unlikely that the government will reverse the tax plan any time soon, but we may have seen the largest effect this quarter. Still, government policy should remain friendly to earnings. A bigger risk probably comes from wages. There are some signs that wages are starting to pick up. If this continues it will start to hurt margins and could lead
What We Are Watching

European Central Bank Meeting (Thursday)

Eurozone growth has strengthened over the last couple of years, but inflation has remained subdued. As a result, the European Central Bank (ECB) has been signaling only a very gradual exit from its current stimulus program. The ECB is currently purchasing €30 billion of (mostly government) bonds each month, and has indicated that this pace is "intended to run until the end of September 2018, or beyond, if necessary." Short term interest rates, including the negative deposit rate of -0.4%, are "expect[ed]...to remain at their present levels for an extended period of time, and well past the horizon of...net asset purchases." At present, markets price a meaningful chance of ECB rate hikes starting in early to mid-2019, which would be consistent with the central bank concluding its bond-buying at the end of September, then waiting around six months before making any changes to policy rates. However, data released over the last month has suggested a possible deceleration in eurozone growth as well as lower than expected inflation. If this month's ECB statement and post-meeting press conference acknowledge these negative surprises, it could be a first step towards extending the timeline of asset purchases beyond September. Such a move could generate weakness in the euro and gains in domestic fixed income markets.

U.S. Employment Cost Index (Friday)

With U.S. unemployment at a multi-decade low, policymakers and market participants have been focused on the question of when a tighter labor market will begin to generate meaningful increases in wage growth. Readings on average hourly earnings (AHE) growth in the monthly employment report have pointed to a modest pickup in compensation, but volatility in the data has made it difficult to pin down the exact magnitude of the shift. The Employment Cost Index (ECI) is published only once per quarter but otherwise may be a more useful indicator than AHE. The ECI is adjusted for changes in the composition of the workforce and also accounts for changes in employee benefits, a key part of overall compensation. A firm first quarter reading for the ECI would add to evidence that the labor market is finally beginning to generate some degree of inflationary pressure.

U.S. GDP (Friday)

U.S. GDP accelerated last year, with the YoY growth rate rising from 1.8% in the fourth quarter of 2016 to 2.6% in the fourth quarter of 2017. While economists have been optimistic that positive trends will be sustained in 2018, data released since the start of the year has painted a mixed picture. While business spending on capex has continued to pick up, consumer spending has looked disappointing and the U.S. trade deficit has widened. As a result, the BEA's initial estimate of GDP growth in the first quarter could look sluggish relative to recent readings. Market reaction to a lower than expected GDP figure may be tempered somewhat by a persistent (and somewhat mysterious) pattern of softer first quarter GDP numbers in recent years.

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