Market Bulletin

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1Q15 Earnings season recap: The value of a dollar

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In Brief

- We estimate that first quarter 2015 earnings-per-share (EPS) declined by 5.0% on a year-over-year (y/y) basis. Similar to the prior quarter, this was primarily due to lower oil prices and the stronger U.S. dollar (USD).
- Excluding the energy sector, S&P 500 EPS grew by 9.1%, in-line with historical trends. We also estimate that the stronger U.S. dollar resulted in an average EPS decline of 5% for the most multinational non-energy companies.
- We continue to favor U.S. equities, despite slightly higher valuation levels. The base case for the S&P 500 total return in 2015 is in the single digit range, which we believe is still attractive for most portfolios in this market environment.
- In addition, macroeconomic shocks (lower oil prices, stronger dollar) have led to widening dispersion across and within sectors, potentially benefiting active managers who can take advantage of attractive opportunities.

Summary

The first quarter of 2015 continued the marked slowdown in EPS growth that began at the end of last year. These declines are not due to a general slowdown in the U.S. economy. Rather, they are a result of two broad macroeconomic headwinds: lower oil prices and the strengthening USD. Stock market valuations, such as the forward price-to-earnings (P/E) ratio, remain modestly elevated for this reason.

To the extent that recent weakness is driven by these macroeconomic effects, we expect the drag on earnings to subside by the end of the year. In fact, bottom-up estimates imply that earnings will stabilize by the third quarter and rebound by the fourth. Analysts are already looking through these short-term factors toward future earnings growth.

As a result, we continue to recommend an overweight to U.S. equities. On one hand, stronger earnings data is needed to justify current valuation levels. On the other hand, P/E multiples are far from stretched and short-term earnings hiccups have not historically predicted bear markets. Instead, investors should lower their return expectations for the S&P 500. We believe a solid single-digit return is the base case for 2015, which should still be attractive for most portfolios. This also means that finding opportunities *within* the market is more important than ever.

EARNINGS RECAP

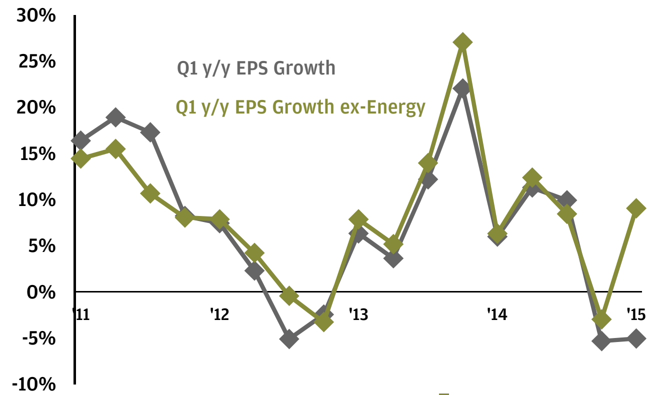
With 92% of the market capitalization of the S&P 500 having reported earnings, we estimate that first quarter EPS shrank by 5% on a y/y basis to $25.94. This is an extremely weak earnings season: Not only will this be the first time since 2012 that EPS declined in two consecutive quarters, but the earnings season one year ago was weak to begin with. We estimate that revenues fell 4.0% on a y/y basis, the largest decline since 2009. This reflects the power of the two macroeconomic headwinds, since lower oil prices and the stronger U.S. dollar impact the top line directly.

The oil price headwind is easy to quantify. Excluding the energy sector, EPS increased by 9.1% y/y and is on-trend with historical growth rates, as shown in **Exhibit 1**. This does not imply that the price of oil was the only headwind in the first quarter, but only that this is the easiest effect to measure.

The USD effect, on the other hand, is difficult to gauge due to its more dispersed impact, and thus we will explore it in detail in the next section.

Excluding energy, 1Q EPS rose 9.1%

EXHIBIT 1: YEAR-OVER-YEAR EPS GROWTH

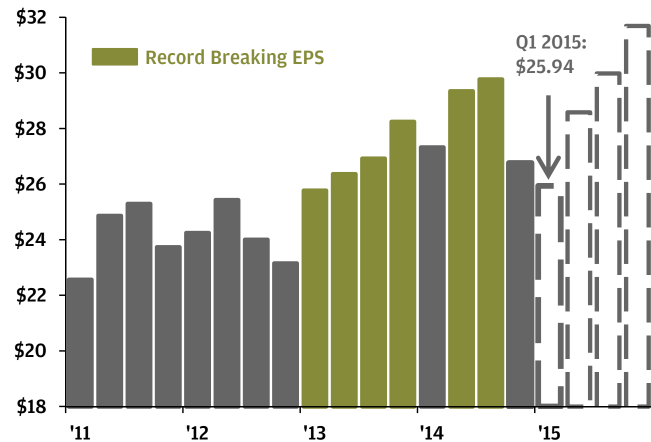


Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of May 13, 2015.

For full-year 2015, S&P 500 EPS is only expected to grow by 2.9% to a level of $116. EPS growth is expected to be less negative in the second quarter, slightly positive in the third quarter and rebound in the fourth quarter as these macro headwinds stabilize and earnings rebound from the prior year (**Exhibit 2**).

As macro headwinds abate, earnings should stabilize and rebound

EXHIBIT 2: S&P 500 EARNINGS PER SHARE

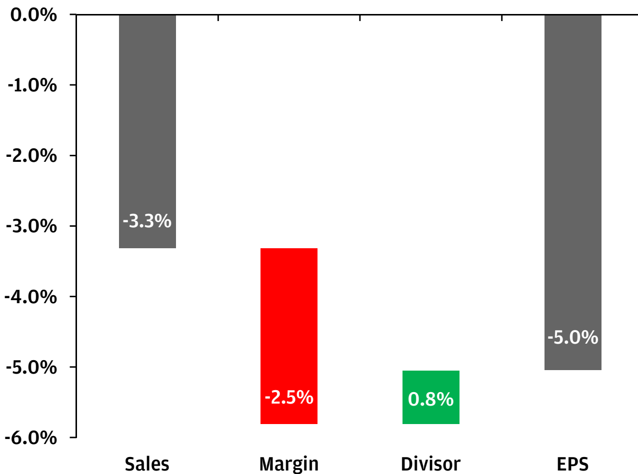


Sources: Standard & Poor's, J.P. Morgan Asset Management. First quarter earnings per share is an estimate from J.P. Morgan Asset Management while the remaining 2015 quarters are estimates from Standard & Poor's. For illustrative purposes only. Data are as of May 13, 2015.

Approximately 69% of companies have beaten their depressed expectations, in line with historical averages, while 22% met expectations and 8% missed. This is positive, but only in the way that a student who expected to fail a class scrapes by with a D. Even worse, only 36% of companies are beating revenue estimates which, as explained, is consistent with the macroeconomic drivers. The silver lining, then, is that better earnings "beats" than revenue "beats" means that companies adjusted to this environment and had better-than-expected margins.

Revenue and margin declines both detracted from EPS growth

EXHIBIT 3: Q1 EPS GROWTH BROKEN DOWN Y/Y

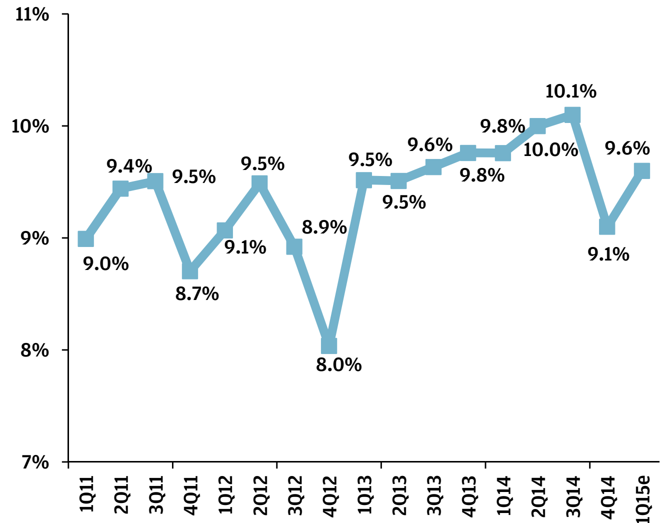


Sources: Standard & Poor's, J.P. Morgan Asset Management. First quarter profit margin is a J.P. Morgan Asset Management estimate. For illustrative purposes only. Data are as of May 13, 2015.

Our current estimate for the S&P 500's first quarter profit margin is 9.6%, a decline from 9.8% one year ago (**Exhibit 4**). Downward pressure on profit margins is expected to continue as the cycle progresses due to higher labor costs and diminishing marginal returns to globalization and automation, making it unlikely that they will return to their prior peaks of over 10%.

Pressure on profit margins

EXHIBIT 4: S&P 500 PROFIT MARGINS



Sources: Standard & Poor's, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of May 13, 2015.

Next we'll discuss the effect of the stronger U.S. dollar on earnings growth and the sector dispersion that has resulted from the slowdown in profitability (please see last quarter's earnings bulletin for a discussion of the oil price effect). Both have created potential for those actively searching for market opportunities.

A KING DOLLAR'S RANSOM

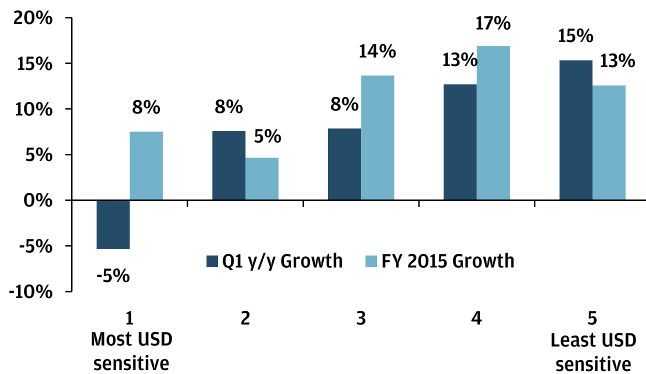
The USD, which strengthened by 8.1% in the first quarter of 2015 after a 12.4% rise in the second half of 2014,[1] impacts corporate earnings in at least two ways. First, it reduces global demand for U.S.-produced goods, which become more expensive for international consumers and corporations. Second, it impacts accounting revenues for U.S. multinational companies through foreign currency translation effects on their financial statements. Specifically, when the USD is rising, corporations experience smaller sales gains on their income statements for the same quantity of international units sold.

[1]Measured using the trade-weighted U.S. dollar against major currencies

It's difficult to precisely quantify the impact of a rising USD on corporate earnings due to data availability. However, we can approximate the magnitude by identifying companies that are more sensitive to currency movements and compare them to those that are more domestically focused. We can then rank stocks according to this sensitivity to measure various effects.[2]

Multinational firms 1Q EPS shrank by 5% y/y vs. 17% growth for domestically focused countries

EXHIBIT 5: S&P 500 Y/Y EPS GROWTH BY DOLLAR SENSITIVITY EX-ENERGY*



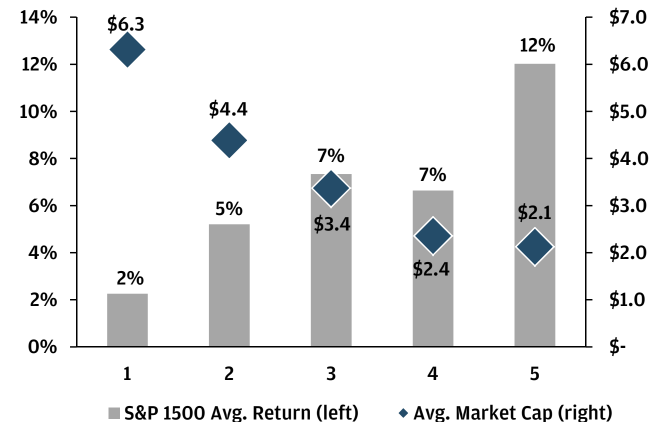
Source: Standard & Poor's, Federal Reserve, FactSet, J.P. Morgan Asset Management. *1 = Most USD Sensitive, 5 = Least USD Sensitive. For illustrative purposes only. Data are as of May 13, 2015.

Exhibit 5 shows S&P 500 EPS growth across quintiles of USD-sensitivity, excluding the energy sector.[3] Let's refer to quintiles 1 and 5 as "multinational" and "domestically focused" stocks, respectively. First quarter EPS shrank by an average of 5% for multinational companies, in stark contrast to the 17% increase for domestically focused ones (ex-energy). However, with the USD expected to stabilize later this year and corporations poised to respond to these challenges constructively, full-year 2015 EPS should accelerate to 8% for multinationals.

[2]More precisely, we regress the percentage change in stock returns against the USD from January 2010 to June 2014. We then rank and quintile stocks on the resulting R-squared. Intuitively, if the variation in a stock's return over time is largely explained by USD movements, then it is more likely to be a multinational company with a significant portion of international sales, or a company whose prices are USD-sensitive.

The USD surge has hurt stocks of multinationals vs. domestically focused companies

EXHIBIT 6: S&P 1500 AVG. RETURN SINCE JULY 2014 AND MARKET CAPITALIZATION BY USD SENSITIVITY EX ENERGY*



Source: Standard & Poor's, Federal Reserve, FactSet, J.P. Morgan Asset Management. *1 = Most USD Sensitive, 5 = Least USD Sensitive. For illustrative purposes only. Data are as of May 13, 2015.

Exhibit 6 shows these quintiles for S&P 1500 companies[4], also excluding the energy sector. As expected, stock performance since July 2014, when the USD surge began, is clearly related to USD sensitivity. The most multinational stocks are up only 2% on average compared to domestic ones which have seen a median gain of 13%. This is a significant difference in performance and the pattern is nearly monotonic across quintiles.

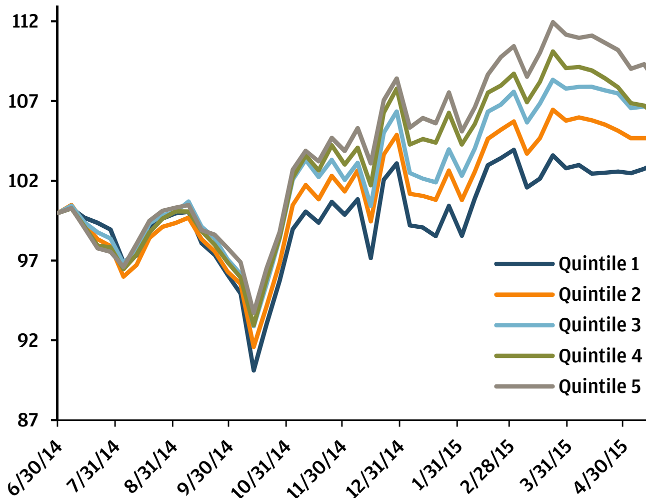
Exhibit 6 also shows that, the median market capitalization for multinationals is much larger than domestic stocks. Indeed, favoring less USD-sensitive stocks, such as small caps, was a consensus trade going into 2015, one that we believe was overdone. **Exhibit 7** shows the performance of portfolios constructed from these five quintiles over time. The effect on returns was strongest late in 2014 and has reversed recently as the USD has retreated. A similar reversal has recently occurred with large cap stocks, which are now leading small caps.

[3]We exclude the energy sector to reduce the impact of lower oil prices on this analysis. Energy stocks tend to be dollar-sensitive and exaggerate the results of quintile 1.

[4]The S&P 1500 is a composite that includes the S&P 500, S&P MidCap 400 and S&P SmallCap 600 and covers approximately 90% of U.S. equity market capitalization

USD impact on portfolios based on USD sensitivity was strongest in late 2014 and has recently retreated

EXHIBIT 7: AVG. STOCK PERFORMANCE BY USD SENSITIVITY EX ENERGY



Source: Standard & Poor's, Federal Reserve, FactSet, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of May 13, 2015.

We continue to favor large caps and would not suggest broadly shying away from USD-sensitive stocks. The USD may strengthen further for a number of reasons, including a move by the Federal Reserve to increase interest rates. However, there are numerous other factors that still favor large caps and USD-sensitive stocks. These include stronger growth in regions such as Europe, lower overall volatility and lower valuation levels for large cap stocks than mid and small caps. At the very least, the shake-up caused by the stronger USD creates an attractive environment for stock-pickers.

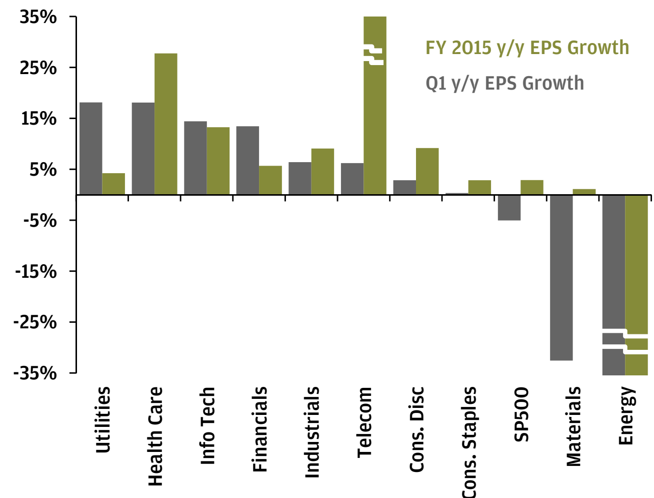
INVESTMENT IMPLICATIONS

Because the S&P 500 is expected to generate only modest returns, it is more important than ever to find opportunities *within* the market. **Exhibit 8** shows that dispersion in EPS across sectors is significant, even though EPS declined for the S&P 500 overall. **Exhibit 9** underscores this point by showing the dispersion in forward P/Es across sectors. There are clearly over- and undervalued areas of the market, leading to sector-rotation opportunities.

What's more, **Exhibit 9** also shows that there are individual stocks that are cheap relative to their historical averages even in the most expensive sectors. Active managers who are able to identify these stocks are in a position to find potential investment opportunities.

Even though 1Q EPS declined overall, the dispersion in EPS across sectors is significant

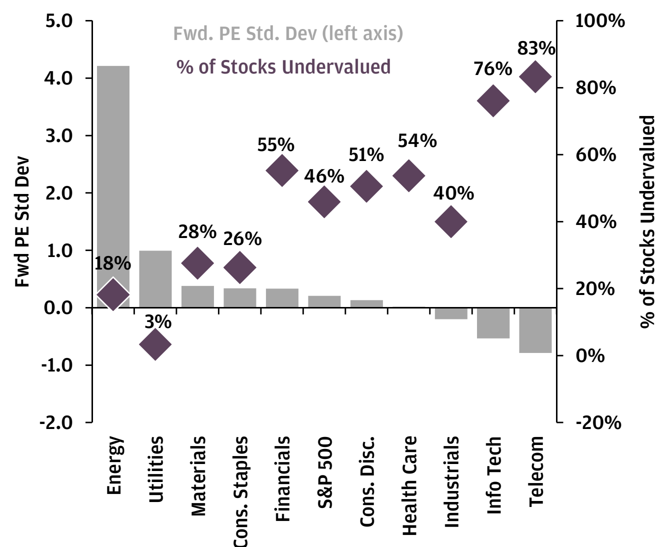
EXHIBIT 8: SECTOR Q1 Y/Y GROWTH, FY2015 Y/Y EPS GROWTH



Sources: Standard & Poor's, Factset, J.P. Morgan Asset Management. Q1 2015 EPS are J.P. Morgan Asset Management estimates while full year 2015 are Standard & Poor's estimates. For illustrative purposes only. Data are as of May 13, 2015.

High sector dispersion creates opportunities for active management

EXHIBIT 9: VALUATIONS AND STOCK PICKING OPPORTUNITIES



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. For illustrative purposes only. Data are as of May 13, 2015.

Investors should also focus on favorable long-term sector themes. For example, consumer discretionary stocks should continue to benefit from improving consumer net worth, lower oil prices, attractive EPS growth trends and favorable valuation levels. Information technology is also attractive with a valuation level that is below its long-run average. Despite concerns over the sector's international exposure, revenue growth increased by 7% y/y with profit margins of 18%. EPS growth for the sector could continue to look attractive as many technological trends unfold.

One final example is the energy sector, which is over four standard deviations expensive due to the significant decline in earnings expectations. However, we estimate that 18% of stocks within the sector are cheap relative to their own historical valuations. Active managers can potentially find promising opportunities given the significant dislocation in the sector.

CONCLUSION

The S&P 500 experienced weak earnings growth in the first quarter, but this was primarily due to the effects of lower oil prices and the stronger USD. The energy sector saw significant downward EPS revisions, while multinational companies experienced significantly lower EPS growth than domestically focused ones. These macroeconomic shocks have led to widening dispersion between stocks, creating potential opportunities for active managers. This will be increasingly important in a year when the S&P 500 should be expected to generate only single digit returns.

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