Zacks INVESTMENT MANAGEMENT

Market Insights by Mitch Zacks

Earnings Unexpectedly Down – Hmm…

By Mitch Zacks
Senior Portfolio Manager

As of this writing, 399 of the S&P 500 companies have reported and total earnings in aggregate are down -2.3% from the same period last year on -4.2% lower revenues – not the picture we want to see.

This is especially true in a year in which we expected the market to move more in-line with earnings than anything else. With the "quantitative easing" programs long gone in the U.S., and the Federal Reserve set to raise interest rates toward the end of the year, excess liquidity is leaving the marketplace. And, until now, this 'easy money' has arguably flowed into risk assets (there's nowhere else to get yield) driving up P/E ratios and leading to favorable returns in the equity markets.

I think those days are behind us now and believe the market needs real earnings growth to push it higher. But with earnings growth negative, does that mean the market is headed for decline?

3 Reasons the Earnings Picture Isn't as Dismal as It May Appear

I don't think there's a need to get too worried and, in fact, I think there are three compelling reasons to remain optimistic.

1) An Investor's Three Favorite Words: "Better than Expected" – of the 399 companies that have reported, 69% of them beat their earnings per share estimates and 50% of them have reported higher than expected top-line revenues. The stock market loves positive surprises – it means that the state of a company, and perhaps the economy, is better than what's already priced. It can give stocks a positive boost.

2) Strip Away "Energy," and Earnings Are Positive – If a sector is as notable a drag on aggregate S&P 500 earnings as Energy, for analysis purposes it makes sense to strip it away to see how the other sectors are truly performing. And, when you do that, you discover things aren't as bad as they may seem:

total earnings for the Energy sector in the S&P 500 index are down -60% from the same period last year on -30% lower revenues. So, when you take the Energy sector out of the equation, total earnings for the rest of the S&P 500 are up +5% on +2% revenues. That's reasonable growth.

As active investors, we might consider underweighting Energy in our portfolio if we think the sector will continue struggling in an environment of moderate growth and falling commodity prices.

3) Consumer-Related Sectors Are Strong – consumer spending represents about two-thirds of the U.S. economy and it rose +0.2% in June after a +0.7% uptick in May. This growth shows up in the Consumer Discretionary, Retail/Wholesale and Autos sectors; three of the best performing sectors in Q2 demonstrating consumer spending strength.

The auto industry is on pace for its best year in a decade and the Consumer Discretionary and Retail/Wholesale sectors saw some of the most robust year-over-year revenue growth in Q2. This, I think, should give investors some reassurance about the real state of the economy.

Bottom Line for Investors

Earnings should be a key strategy driver for investors at this stage of the bull market. I think that the era of rapid P/E growth is fading as the U.S. enters a monetary tightening cycle. This means that a company's share price should be more closely tied to its merits as a growth machine.

-Best Regards, and Better Returns!
Mitch

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

ZACKS INVESTMENT MANAGEMENT, INC.
One South Wacker Drive
Suite 2700
Chicago, IL 60606
Toll Free: 888.600.2783
www.zacksim.com

Disclosure:
Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice.

Any views or opinions expressed may not reflect those of the firm as a whole. Third-party economic or market estimates discussed herein may or may not be realized and no opinion or representation is being given regarding such estimates. This material has been prepared by Zacks Investment Research (ZIR) an affiliate of Zacks Investment Management, Inc. (ZIM) on the basis of publicly available information, Internally developed data and other third party sources believed to be reliable. Neither ZIR nor ZIM has sought to independently verify information taken from public and third party sources and does not make any representation or warranty as to the accuracy, completeness or reliability of the information contained herein. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal.

Indexes:
The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. The volatility of the index is materially different from the individual performance obtained by a specific investor. An investor cannot invest directly iIndex.