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MARKET SIGHT LINES

A Positive Earnings Season

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As our readers know, we keep a close eye on earnings reports as we manage equity portfolios. The quarterly "earnings season" also provides important insights for the stock market as a whole, and it also provides us a window into how companies are wrestling with two of our macro topics, the optimism around artificial intelligence (AI) and worries about a consumer slowdown. In this Sight|Lines, we review the second quarter "earnings season," unpacking the quarter's results so far, as well as implications for the future, including AI and the potential for a consumer slowdown.

THE TAKEAWAY: EARNINGS GROWTH BETTER THAN EXPECTED, BUT…

The majority of S&P 500 companies beat expectations. Investors remain focused on two topics: 1) the elevated capital expenditures (capex) on AI by technology companies, and 2) the slowdown in consumer spending. In summary:

- 91% of the companies in the S&P 500 have reported second quarter results.
- Many companies posted positive earnings surprises, but by smaller than average amounts.
- Combined earnings were better than expected, with most sectors reporting earnings growth.
- Investors appear to be punishing earnings misses more than rewarding positive surprises.
- Consensus views for third quarter 2024 and full year 2024 are declining modestly, influenced likely by an increase in unemployment and a slowdown in the still very positive earnings growth of the Magnificent Seven stocks (Apple, Google parent Alphabet, Amazon, Meta Platforms, Microsoft, Nvidia, and Tesla).
- Consensus views on 2025 earnings growth are more optimistic.
- The stock performance in the consumer discretionary sector has been muted year to date, reflecting a more discerning and price-conscious consumer.
- Capital spending for four of the Magnificent Seven – Alphabet, Amazon, Microsoft, and Meta Platforms – went toward data centers and Nvidia's artificial intelligence systems.
- Together, capital spending for these companies totaled $58.5 billion in the second quarter.
- As we analyze the transcripts of earnings calls, we see continued focus on headwinds, inflation, and labor costs, albeit perhaps less so than a year ago.
    - Generative AI continues to be a topic of focus for many companies.

IN-DEPTH: EARNINGS GROWTH WAS BETTER THAN EXPECTED AND FORECASTS ARE HIGHER, BUT COMPANIES MUST EVENTUALLY DELIVER ON SUBSTANTIVE AI CAPEX, EVEN WHILE THE CONSUMER MAY BE SLOWING

S&P 500 companies have produced better-than-expected second quarter results, but technology companies must deliver on AI investments long-term while the consumer is now more discerning and may be slowing. Going deeper:

- 91% of the companies in the S&P 500 have reported earnings second quarter results:
  - 78% of those companies reported better-than-expected earnings, while 59% reported sales that exceed expectations.
  - Earnings are now forecast to have grown 10.8% in the second quarter, compared to a year ago, bettering analysts' consensus forecast of 8.9% as of June 30.
  - Nine of 11 sectors reported positive earnings growth, with industrials and materials posting declines.
- Investors appear to be punishing earnings misses more than rewarding positive surprises:
  - Companies who announced earnings misses declined an average of 3.8% in the two days before and after the earnings release.
- Consensus views for third quarter 2024 and full year 2024 are declining, while consensus views on 2025 earnings growth are more optimistic:
  - The growth forecast for third quarter now sits at 5.4%, down from 7.7% on June 30.
    - Earnings growth over this period for the Magnificent Seven is expected to be 16.6%, slowing from the second quarter rate of 33.9%.
  - The forecast for 2024 growth is now 10.2%, down from 10.9% on June 30.
  - The forecast for 2025 earnings growth is now 15.2%, up from 14.5% on June 30.
- The results in the consumer discretionary sector have been muted:
  - Excluding Amazon, earnings for this sector declined 3.1% compared to last year. Year-to-date through August 14, this sector is the worst performing in the S&P 500, up just 0.3%.
  - McDonald's CEO, Chris Kempczinski, said the pressures on the consumer have "deepened and broadened," while travel companies like Airbnb and Marriott are forecasting a leisure travel slowdown.
- Capital spending for four of the Magnificent Seven– Alphabet, Amazon, Microsoft, and Meta Platforms – went toward data centers and Nvidia's artificial intelligence systems, totaling $58.5 billion in the second quarter.
  - There will be increasing focus on how this capex spending translates to future earnings.
- Here are some meaningful learnings from the transcripts of earnings calls held by company management:
  - Inflation and labor costs remain a headwind, albeit less so than a year ago.
  - Generative AI continues to be a growing topic of focus for many companies, with 320 mentions this quarter compared to just nine in 2021.

CONCLUSION

My team and I keep a close eye on earnings reports as we manage equity portfolios, but also evaluate each quarterly "earnings season" to develop important insights for the stock market overall. Lately, this process has helped us better understand how companies are wrestling with two of our macro topics, AI optimism and a possible consumer slowdown. While second quarter 2024 earnings results were better than expected, analysts are a little less positive about the second half of 2024, even while be a bit more optimistic about the potential earnings in 2025.

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