



Solid But In-Line Earnings Unlikely To Dispel Trade Cloud

We expect a modest deceleration in headline S&P 500 EPS growth, with rising consensus estimates pointing to an in-line quarter:

- **Despite the well-known overhang of concerns about peak earnings and the escalation of trade frictions, consensus earnings estimates have continued to be upgraded in sharp contrast to typical behavior going into reporting season.** The bottom-up consensus has moved up by 0.7% since early June (end of Q1 reporting). This marks the second quarter in a row of upgrades going into earnings season but it is very unusual and only the 2nd time in 7 years. It contrasts with a typical cut of -3.1% from the end of the prior season. It is also noteworthy that upgrades going into the last quarter were largely driven by the cut in the corporate tax rate, whereas this time they reflect other factors.
- **The upgrades have been broad based across sectors.** Indeed Utilities were the only exception. They were led by the cyclical sectors: Materials, Consumer Discretionary, Financials, Energy and Tech.
- **The bottom-up consensus points to 24% growth in Q2, which would mark a modest deceleration from the 26.6% reported in Q1.** The bottom-up consensus estimates are for EPS growth of 20.2% in Q2. But historically earnings have beat on average by 3.4%, which implies headline growth of 24%. Median earnings growth (including a typical beat) is for a somewhat slower 20%, indicating the impact of outliers. In particular Energy earnings are expected to show very strong growth (+149%) on the back of higher oil prices. Ex Energy the consensus is for 20% (median 19%). Apart from Energy, several sectors are expected to post very strong growth: Tech (30%), Materials (29%), Telecom (28%), Financials (24%), Consumer Staples (18%) and Consumer Discretionary (18%).
- **Sales growth is expected to be a robust 8.7% and margins 11.6%, both slightly below that in Q1 before factoring in beats.** A realization of the consensus would put sales growth modestly below the 9.1% growth seen in Q1. Sales beats have been running around 1% in the last few quarters and a similar beat this quarter would put it at a new 7-year high. A typical beat on margins would take them to a new record. Survey data (NFIB) points to the share of firms raising selling prices rising sharply, with the gap to those raising wages continuing to shrink, and is supportive of a further increase in margins.

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- **The top-down drivers point to an in-line quarter with typical beats: stronger US growth and higher oil prices offset by slower global growth and a smaller tailwind from the dollar.** We model S&P 500 earnings growth as driven by US growth, global ex-US growth (PMIs) and by changes in the US dollar. US growth accelerated in Q2 versus Q1, boosting EPS growth (+2pp), global growth decelerated (-3.5pp), while the dollar continued to help but less so (-1.5pp). On net the 3 key top-down drivers point to a modest deceleration (-3pp). Energy earnings are expected to provide a boost to headline (+1pp) but Financials a drag (-2pp) relative to Q1. Our model points to EPS growth of 24% in Q2. So the earnings season should deliver beats in line with the historical average. Early reporters have shown very strong growth (32%) with somewhat above average beats (4.5%).
- **In sum we expect solid double-digit underlying earnings growth excluding the impact of the tax cut and higher oil prices.** Excluding the tax cut benefit (+10pp), Q2 results point to underlying growth (i.e., ex-taxes, ex-Energy) in the double digits which, as we have noted previously, is the norm during cyclical expansions ([Settling Into A Historically Typical Double Digit Range—Q2 Earnings Preview, July 2017](#)).

On the escalation of trade frictions, companies seem more concerned about a lack of clarity on the rules of the game rather than actual tariff hikes:

- **Robust demand and pricing initiatives.** Early reporters so far have continued to point to robust demand conditions, with pricing initiatives helping to offset rising cost pressures;
- **Wait and watch mode.** Companies have pointed to limited impacts from the tariffs that have been enacted so far but are obviously concerned about further escalation. With clarity being very limited, they are in a wait and watch mode;
- **Robust demand conditions mean that companies are arguably more concerned about the lack of clarity than the actual tariff hikes.** As Ingersoll Rand put it “I don't know what the rules of the game are going forward. I think, what you need is certainty around the rules. And one certainty we expect, I think, companies will make decisions about getting off the fence on where to locate capacity. If they need capacity, they're going to put it in the world where they need it; the fact is, they're going to need capacity. It's just a matter of where they're going to locate it And companies aren't dealing with this in a political way, they are dealing with it with the economics of the rules. And if you tell us what the rules are, we'll determine the best way to position the capacity and to go about the investment.”
- **Buybacks and dividends are ramping up.** With very strong earnings and cash flows, companies have been ramping up payouts in the form of both buybacks and dividends. Buyback announcements year to date are running at \$600bn, almost double the pace over the same period last year. Dividend announcements are also up 13% ytd, well above the 8% rate of last year.

Strategy: [Three reasons to buy domestic- versus foreign-sales firms](#)

Even as the S&P 500 has remained range bound since early February, as we have pointed out previously, two strategies have worked well: DB's Alpha Buybacks basket (DBUSALBBK), which benefits from surging buybacks ([Capturing The](#)

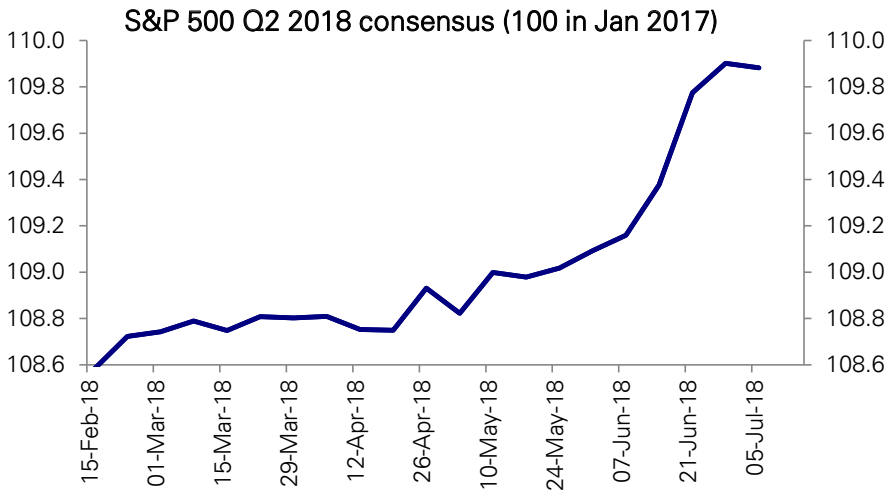


[Alpha In Buybacks, Feb 2016](#)); and DB's value basket (DBUSVALU) ([What Value Conundrum, June 2018](#)). We highlight a third: a sector-neutral basket of companies with a high share of declared domestic sales has steadily outperformed those with a high share of foreign sales since March (+5.7%). We see this trend continuing on the back of a rising dollar, US growth outperformance and persistent concerns around trade:

- **The relative performance of domestic- versus foreign-sales exposure companies has been tightly correlated (86%) to the US dollar.** Indeed it is notable that domestic firms started outperforming as soon as the dollar stopped falling. With the Fed indicating steady rate hikes while other central banks, in particular the ECB, remaining committed to keeping rates on hold for an extended period, the rate differential will continue to widen in favor of the US dollar while positioning has moved from short earlier this year back only to neutral. We see prospective moves in rate differentials as continuing to support if not pressure the dollar higher;
- **US growth continues to outpace growth in the rest of the world.** We see plenty of further upside from previously announced US stimulus (lower taxes, higher fiscal spending, higher capex and higher rates);
- **Concerns around trade frictions.** The cloud from the trade war is unlikely to fade away anytime soon and inherently impacts internationally focused companies rather than domestic ones.

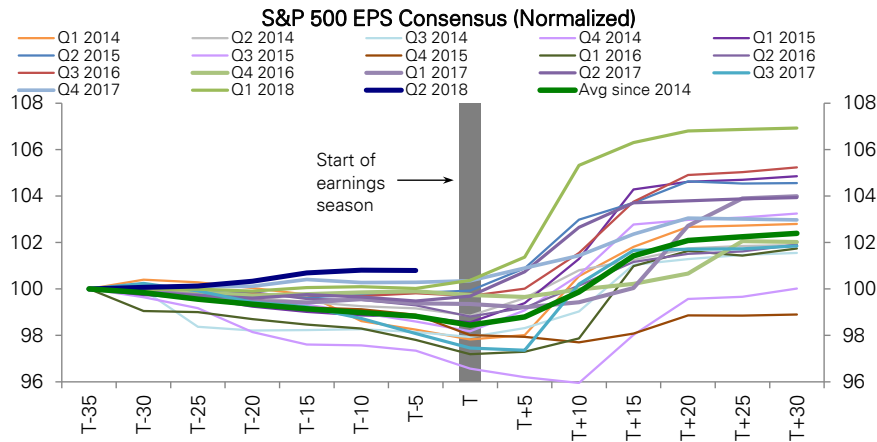


Figure 1: Consensus estimates for Q2 earnings have been rising going into the reporting season



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

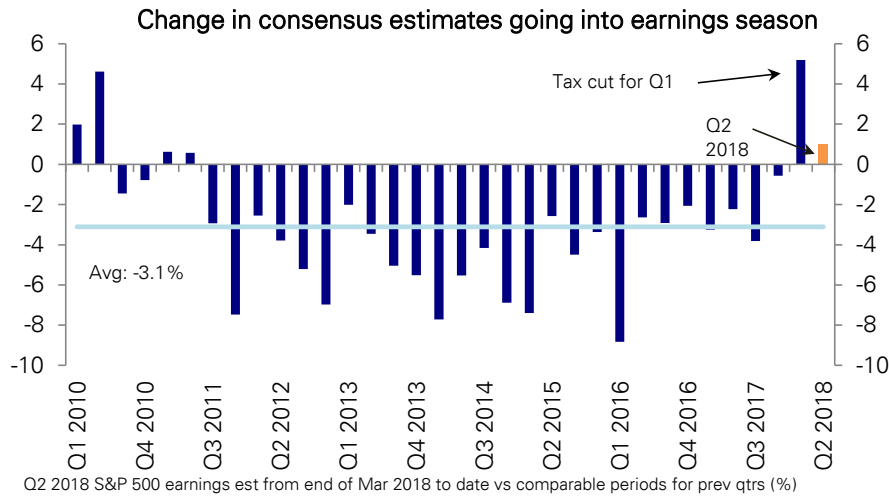
Figure 2: The norm is for consensus estimates to fall going into earnings season



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

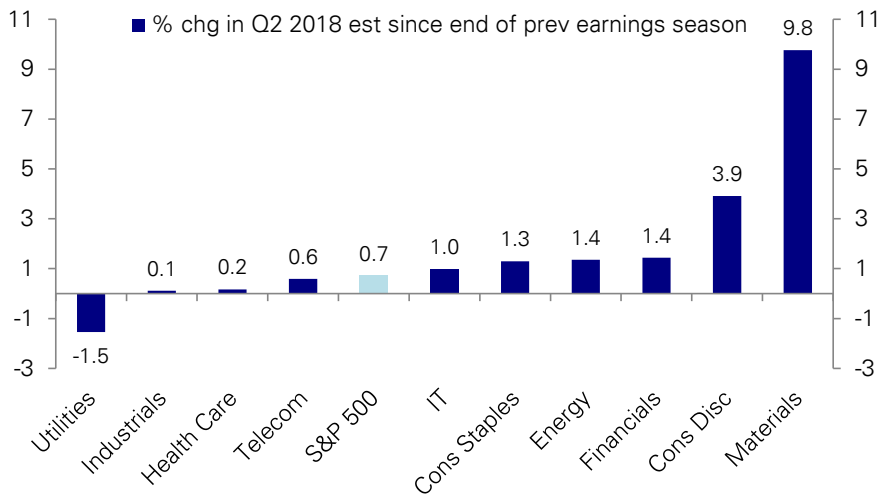


Figure 3: This is only the second time in 7 years that consensus estimates have gone up going into earnings season



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

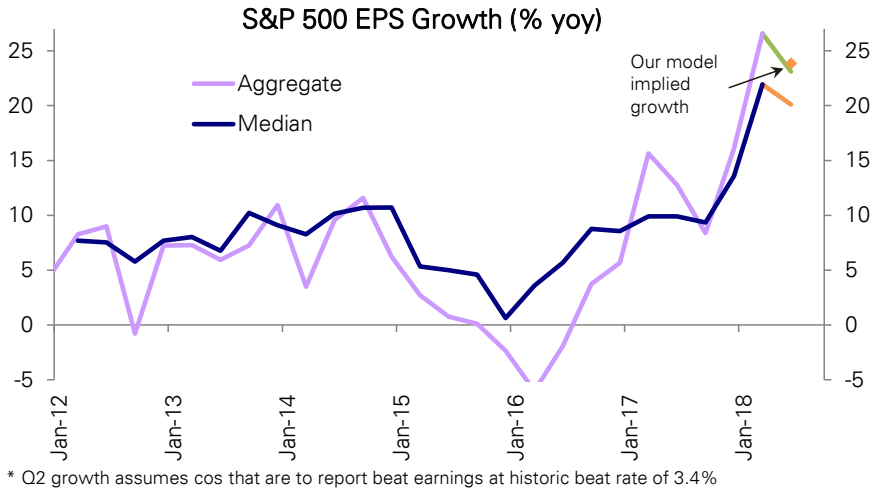
Figure 4: Upgrades have been broad based across sectors



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

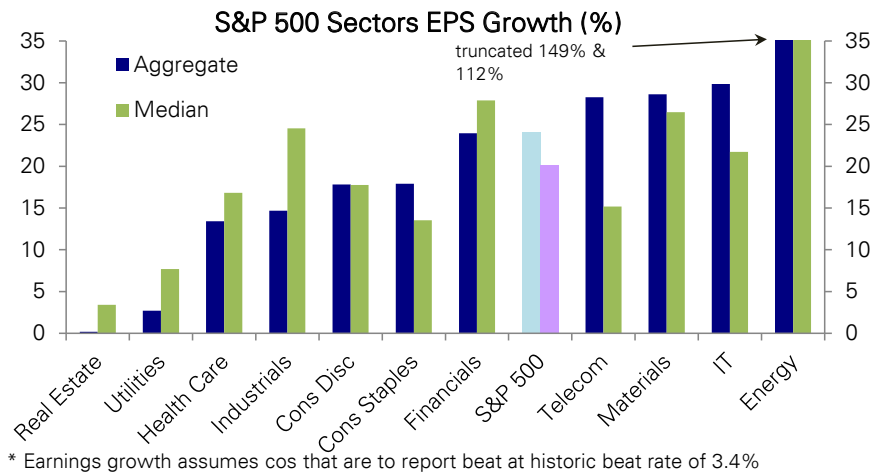


Figure 5: Assuming a typical beat, Q2 earnings growth (24%) would only be modestly lower than the extremely robust pace of Q1 (26.6%)



Source: ISM, FRB, Markit, Bloomberg Finance LP, Haver, Factset, Deutsche Bank

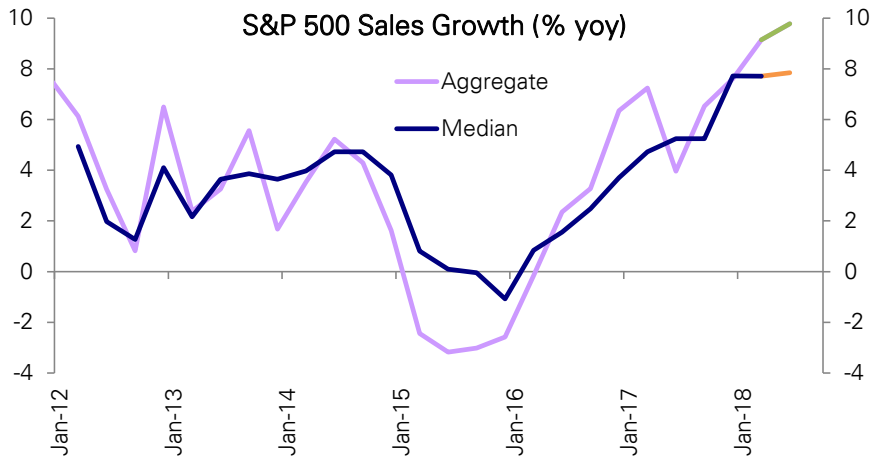
Figure 6: Across sectors, while Energy sticks out, several sectors are expected to post very strong growth



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank



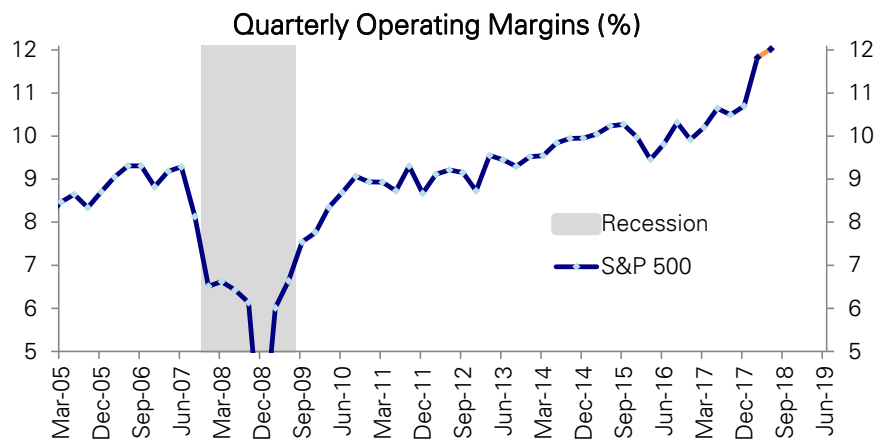
Figure 7: With a typical beat, sales growth will be at a new cyclical high...



* Q2 growth assumes cos that are to report beat sales at recent beat rate of 1%

Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

Figure 8: ...as will margins

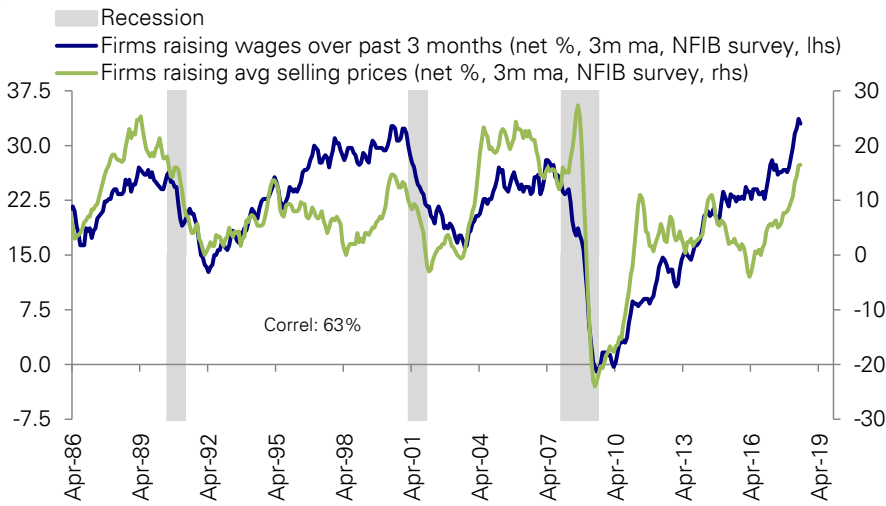


* Q2 margin assumes cos that are to report beat earnings at historic beat rate of 3.4% and sales at recent beat rate of 1%

Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

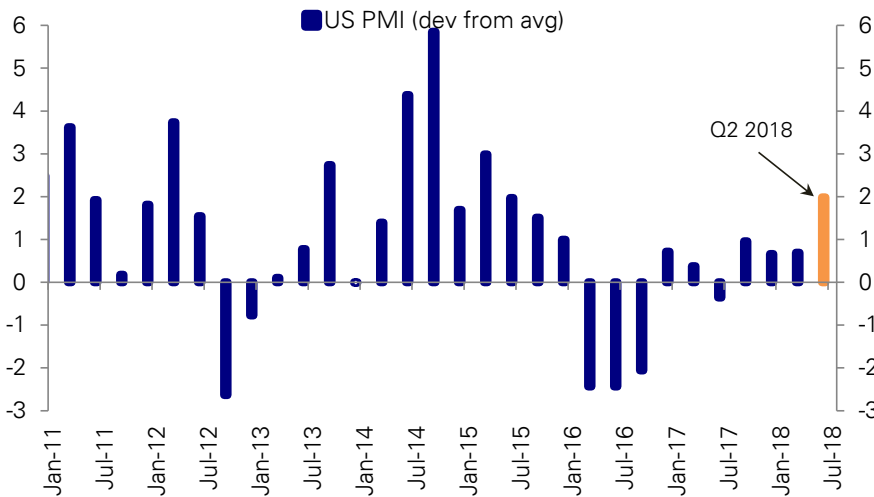


Figure 9: The share of firms raising prices is rising sharply, shrinking the gap to the share of those raising wages



Source: NFIB, Haver, Deutsche Bank

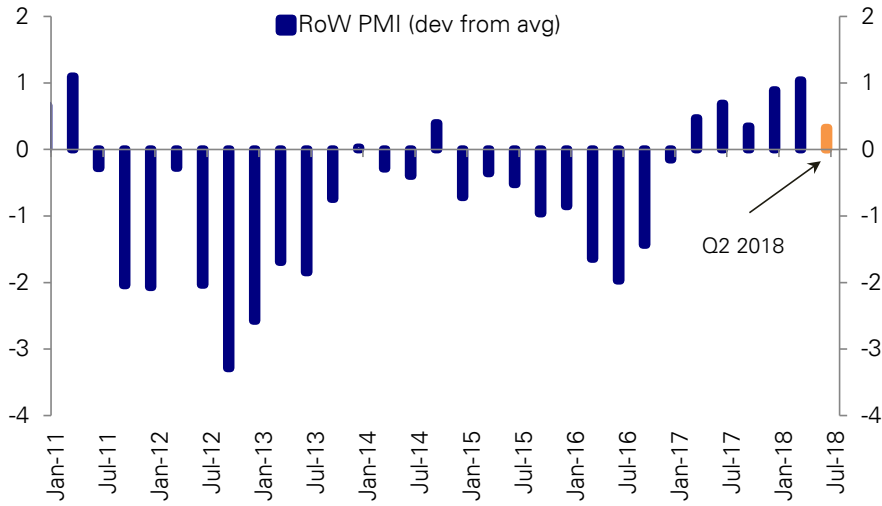
Figure 10: Amongst the top-down drivers, US growth accelerated in Q2 ...



Source: Markit, ISM, Haver, Deutsche Bank

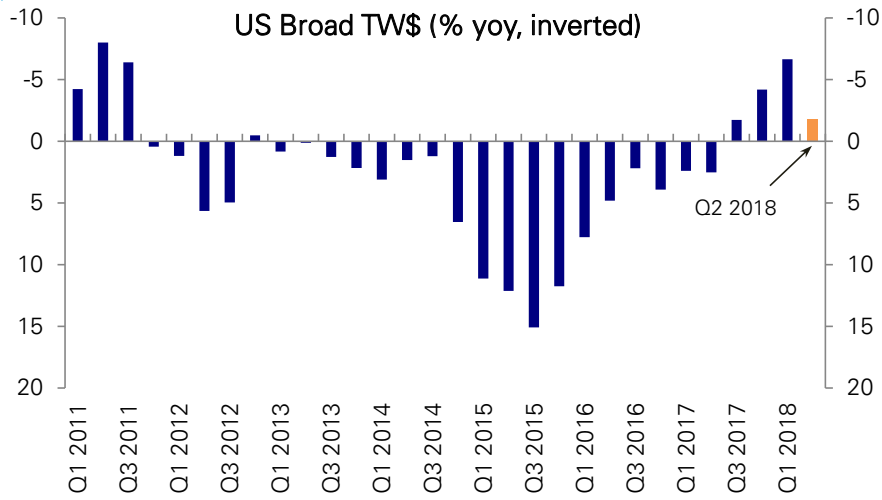


Figure 11: ... but global growth has slowed ...



Source: Markit, ISM, Haver, Deutsche Bank

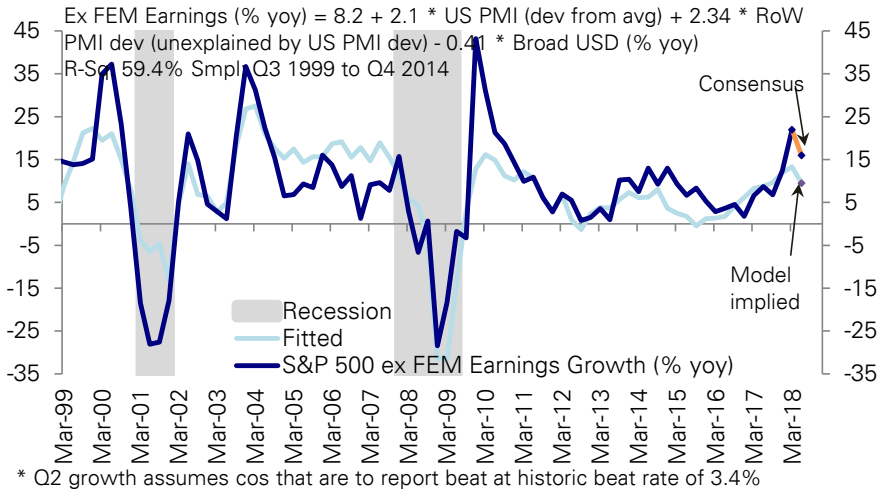
Figure 12: ... and the dollar will be less of a tailwind



Source: FRB, Haver, Deutsche Bank

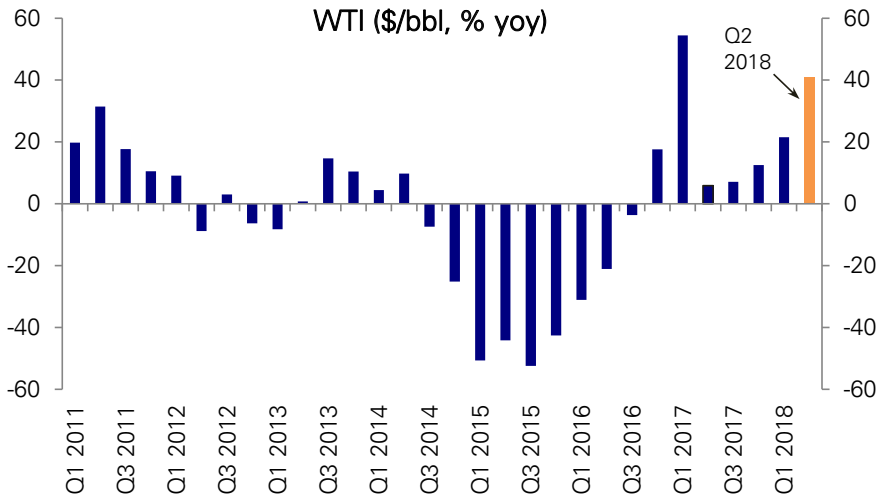


Figure 13: The top-down drivers together point to a deceleration in growth compared to Q1



Source: Markit, ISM, FRB, Bloomberg Finance LP, Haver, Factset, Deutsche Bank

Figure 14: Higher oil prices will boost Energy earnings



Source: Haver, Deutsche Bank

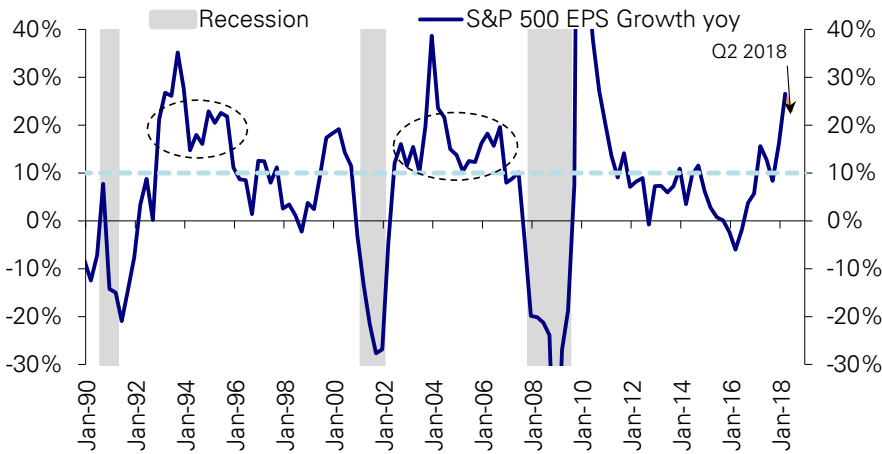


Figure 15: Our model suggests beats this earnings season but in line with the historical average



Source: Markit, ISM, FRB, Bloomberg Finance LP, Haver, Factset, Deutsche Bank

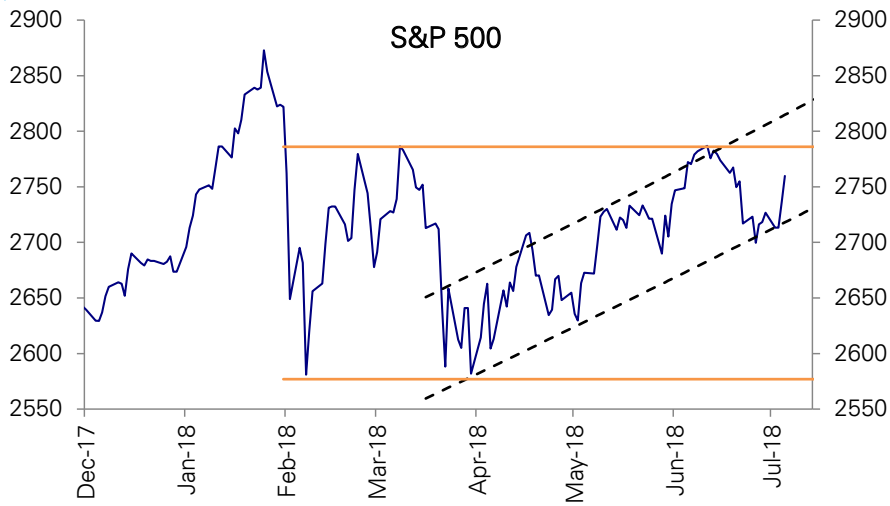
Figure 16: Double-digit earnings growth has been the norm during cyclical recoveries



Source: Bloomberg Finance LP, Haver, Deutsche Bank

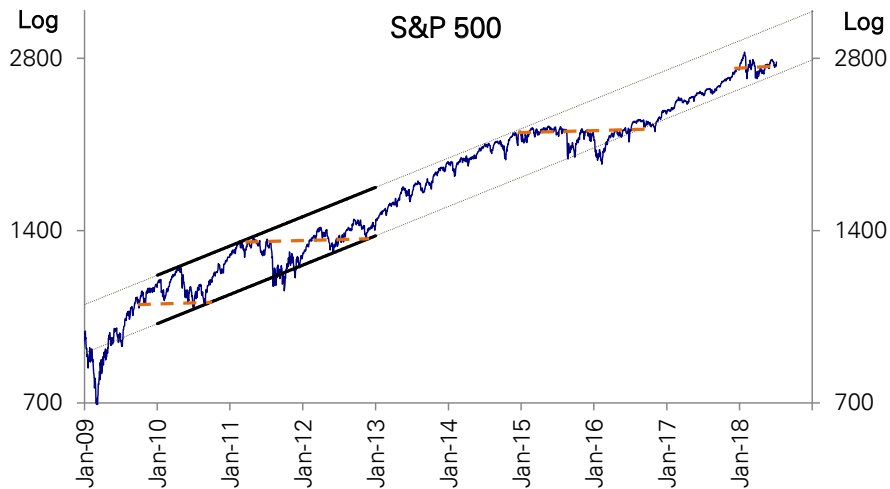


Figure 17: The S&P 500 has been in a range for the last 5 months



Source: Haver, Deutsche Bank

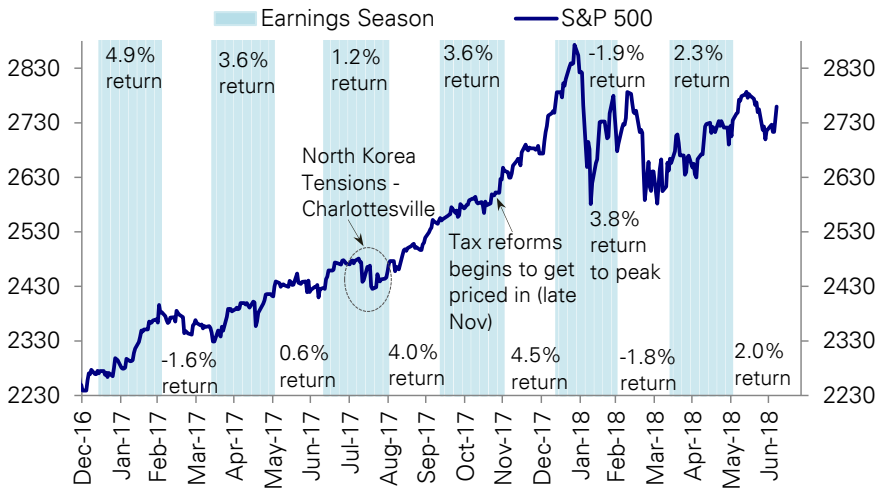
Figure 18: There have been very few episodes in the last 8 years when the market remained range bound for an extended period



Source: Haver, Deutsche Bank

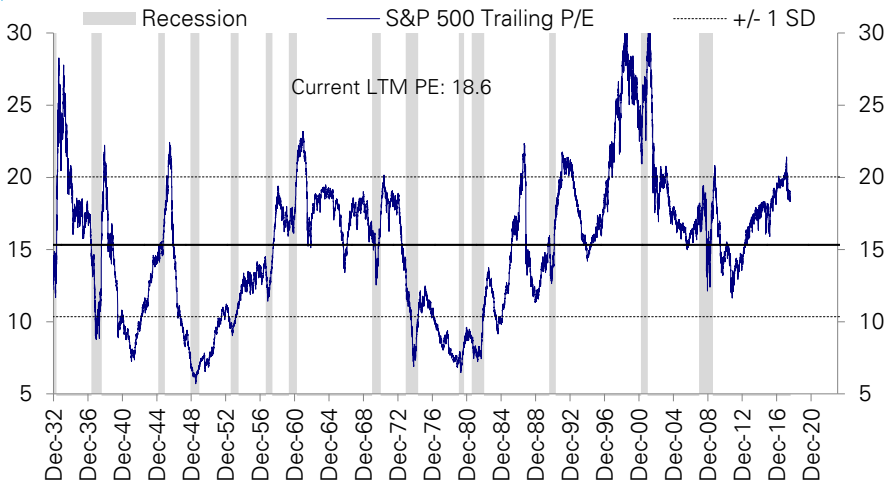


Figure 19: Markets have remained range bound this year despite very strong earnings



Source: Haver, Deutsche Bank

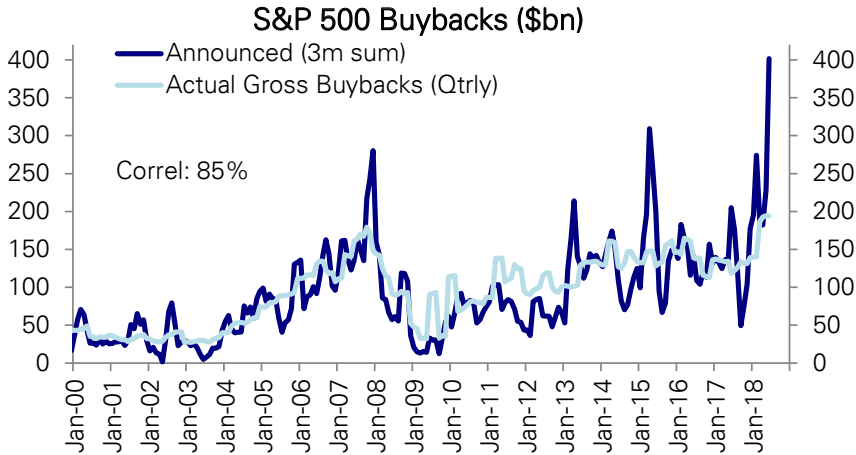
Figure 20: With strong earnings and a range-bound S&P 500, the market multiple has de-rated significantly



Source: Bloomberg Finance LP, Haver, Factset, Deutsche Bank

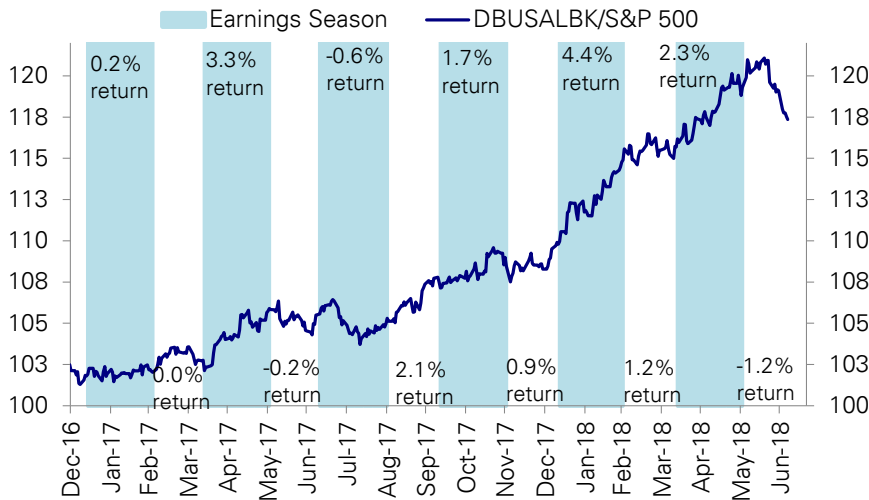


Figure 21: With strong earnings and cash flow but elevated uncertainty, we see buyback announcements continuing to ramp up



Source: Bloomberg Finance LP, Compustat, Deutsche Bank

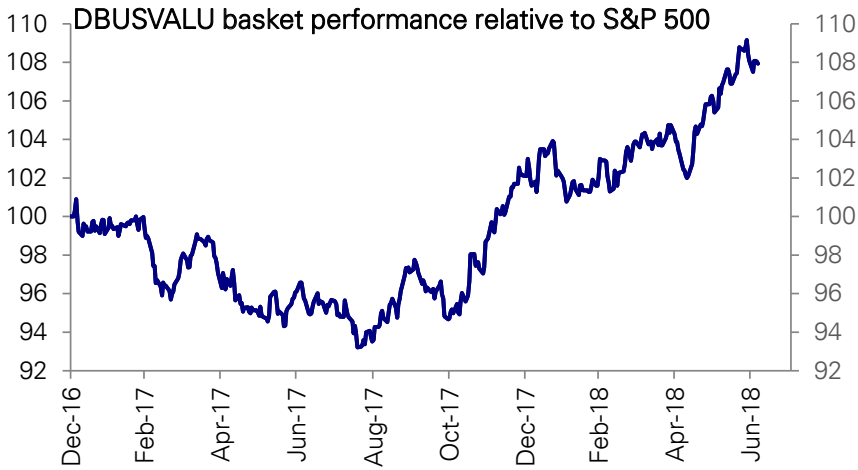
Figure 22: The DB Alpha Buybacks basket has outperformed this year, especially during earnings seasons



Source: Bloomberg Finance LP, Deutsche Bank

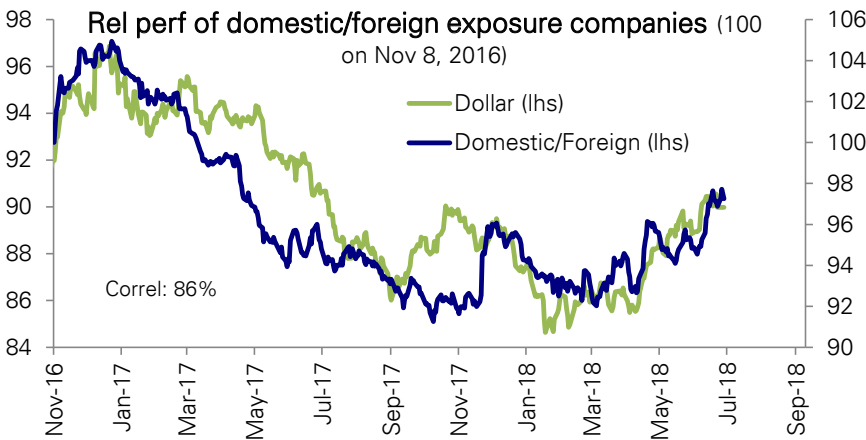


Figure 23: The DB Value basket has been outperforming since last September



Source: Bloomberg Finance LP, Deutsche Bank

Figure 24: Companies that have a high share of domestic sales have outperformed those with high foreign sales since March on a rising dollar, faster US growth and rising trade concerns

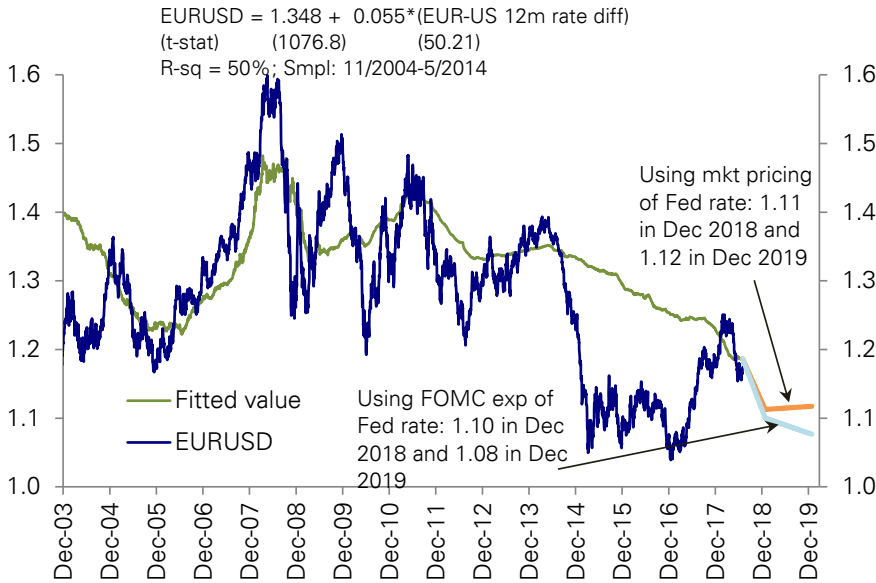


Bottom quintile / top quintile by foreign sales exposure per geographical distribution in company filings;

Source: Factset, Deutsche Bank

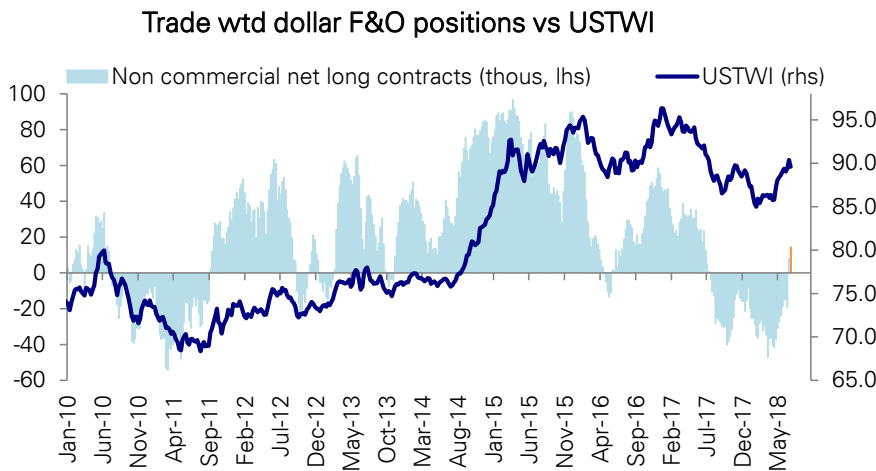


Figure 25: With the Fed continuing to hike while other central banks remain on hold, rate differentials will continue to move in favor of the dollar



Source: FRB, Bloomberg Finance LP, Haver, Deutsche Bank

Figure 26: Dollar positioning has just turned slightly long with plenty of room to move higher



Source: CFTC, FRB, Haver, Deutsche Bank



Appendix 1

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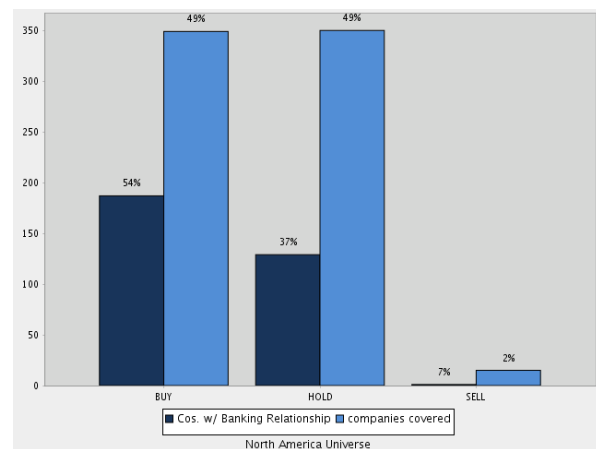
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