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Earnings Roundup and Sector Views

This has been a tough earnings season for certain sectors of the S&P 500 Index. This earnings season provided investors insight on how impactful supply chain issues and inflation were on corporate profits. Positive earnings surprises were not rewarded to the same extent versus the recent past. In Q1 2022, companies that reported positive earnings surprises saw an average price decrease of -0.3% two days before and after their report. At the same time, negative surprises were punished with average price decreases of -5.1% two days before and after earnings release. With 488 companies, making up 97% of the S&P 500 index, having reported their Q1 2022 earnings, we can dissect what happened and how expectations provide insight into the future.

Key Takeaways

- 77% of companies have reported positive bottom line, EPS, surprises.
- 73% of companies have reported positive top line, Revenue, surprises.
- 67 companies reported negative earnings per share (EPS) guidance for Q2, while only 29 companies gave positive EPS guidance.
- The forward 12-month P/E is about 17x, below the 5-year average of 18.6x and in line with the 10-year average.

The number of companies that have cited "inflation" on their earnings calls has shot up this quarter. Over 400 companies mention that inflation had some level of impact on their performance, up from 350 in Q4 2021, and 300 in Q3 2021. At the same time, the number of companies citing "supply chain" challenges have decreased a bit. About 350 companies have spoken to some degree of how the supply chain challenges are impacting performance, down from 360 in Q4 2021, and down from 365 in Q3 2021.

Revenues

The Industrials, Consumer Staples, and Information Technology sectors had the highest percentage of companies reporting revenues above estimates. Concurrently, the Communication Services and Financials sectors have the lowest percentage of companies reporting revenues above estimates.

Currently, the blended revenue growth rate of the S&P 500 is around 13.6% and is above both the five and ten-year averages of 7.1% and 4.0%, respectively. The sectors that had the largest growth in revenue were the Energy, Materials, and Real Estate sectors. These are the same sectors that are beneficiaries of higher inflation. For the Energy sector, oil prices were the dominant factor as the average price of oil in Q1 2022 was 63% higher than in Q1 2021. The Materials sector experienced revenue strength from rising commodity prices due to dislocations in global trade owing to a fractured supply chain. The Real Estate sector experienced strength from rising rents and property values. The adverse impacts of rising yields and mortgage rates have yet to make their way into the earnings reports for this sector, we will likely see an impact in Q2.

Margins

The blended net profit margin for the S&P500 index in Q1 was around 12.3%, above the five year average, but below the ten year averages of 11.2% and 12.8%, respectively. Seven sectors have reported an increase to their profit margins in Q1 2022 compared to Q1 2021. Energy is the standout, with a 10.5% margin, compared to 4.6% last year.

Real Estate and Information Technology had the widest margins out of all sectors at 36.4% and 24.8%, respectively. Consumer Discretionary and Consumer Staples had the smallest margins at 4.7% and 6.4%, respectively. The Consumer sectors are labor heavy and are prone to wage pressure and higher input costs, which includes elevated transport costs.

Profit margins declined in four sectors: Financials (from 22.6% to 17.6%), Consumer Discretionary (from 7.6% to 4.7%), Communication Services (from 13.8% to 12.6%), and Consumer Staples (from 6.7% to 6.4%).

Earnings

The percent of companies beating estimates is about in line with the five-year average and above the ten-year average. On a sector level, Industrials, Consumer Staples, and Information Technology had the highest percent of companies reporting earnings above estimates. While the Consumer Discretionary sector has the lowest percent of companies reporting earnings above estimates.

Nine out of eleven sectors had positive earnings growth – led by Energy, Materials, and Industrials. The two sectors that are reporting negative earnings growth are Consumer Discretionary and Financials.

The earnings outlook for equities remains hazy as many uncertainties remain. Lockdowns in China will likely continue to stall the transport of goods across the Pacific Ocean. The war in Ukraine will likely cause commodity prices to remain elevated and in some cases scarce. A slowing economy will likely weigh on consumer spending and demand. Thus far for Q2 2022, 96 companies have issued EPS projections with about 70% giving negative guidance. This is above both the five and ten-year averages. Much of the negative guidance has come from the Information Technology sector, followed by Industrials, and then Consumer Discretionary.

Improving inflation data in the recent PPI and PCE reports provided markets a glimmer of hope that inflation may have peaked. Combined with more dovish statements from the Federal Reserve helped alleviate equity market selling pressure at the end of May.

Our sector views table, on the next page, provides more detail on sector positioning and the current tailwinds and headwinds for each sector.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	The sector is a potential future beneficiary of the development of augmented reality and metaverse.	Higher interest rates adversely impact the discount rate applied to future earnings and cash flows.	**Underweight**
Consumer Discretionary	Consumers adapted to the pandemic by increasing their use of online ordering and delivery and in-store pickup.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping is a risk to margins if companies are not able to pass inflation pressures to the end consumer. This sector is adversely impacted by supply chain disruptions, especially the semiconductor shortage in the automotive industry. Delays in shipping by sea and heightened costs in air freight are headwinds.	**Underweight**
Consumer Staples	High inflation and slower real economic growth may force consumers to prioritize staples over discretionary purchases.	Inflation may negatively impact margins for companies that cannot pass through rising material costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly. Higher transport costs by air and sea may negatively impact company margins.[1]	**Overweight**
Energy	Escalated tensions with Russia, a large natural gas exporter to Europe, could lead to elevated energy prices globally for an extended period.	Continued COVID-19 lockdowns in China could further reduce economic growth expectations, weighing on oil demand.	**Overweight**

	Hurricane season and concerns about low storage levels may provide near-term support for the Energy sector.	The Energy sector is sensitive to the economic cycle. Should elevated energy and food prices detract from real economic growth, reduced demand pressures may shorten the commodity cycle.	
Financials	The Financial sector could benefit from higher interest rates with the Fed starting their interest rate rising cycle.	Russia's invasion of Ukraine increased inflation expectations while reducing expectations for real economic growth. Flatter yield curve and elevated inflation weighs on sector.	**Market Weight**
Health Care	Demographics favor the Health Care sector due to the aging global population and the growing middle class in emerging markets. Sector is showing strong fundamentals, quality, and record discounts vs. the S&P 500 on a forward P/E basis.[2]	Drug pricing pressure remains a risk, though the legislative process is slow, and no meaningful legislation is currently expected to be passed.	**Overweight**
Industrials	The Industrials sector is a beneficiary of rising GDP, interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift towards automation infrastructure spending will likely be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance.[3] Supply chain issues could be a major headwind.	**Market Weight**
Information Technology	Software names should benefit from higher CapEx as firms	Increased regulatory scrutiny is a risk, and there is	

	look to boost productivity amid rising wage inflation.[4] The increased adoption of key disruptive technologies like cloud computing, cybersecurity, and cleantech are likely to continue after the pandemic.	bipartisan support for increased regulation. Rising interest rates negatively impact long-duration growth sectors like Technology.	**Market Weight**
Materials	Increased focus on electric vehicle adoption, alternative energy sources, and energy storage should be beneficial to lithium and battery technology. The Materials sector is a beneficiary of inflation, higher raw materials prices and increase CapEx and infrastructure spending.	Chinese lockdowns are likely to weigh on global demand. Earnings growth likely to be weighed down by the strong dollar.[5]	**Market Weight**
Real Estate	The Real Estate sector has the potential to be a source of inflation-protected yield. The focus on real assets and locking in mortgages before yields rise provided a short-term increase in property pricing with inflation pressures building on rents. Strong demand for residential REITs is translating into higher single family and multi-family rents.	Uncertainty about a full return to the office and flex working situations may reduce demand for office space. A fast rise in interest rates, which increases the cost of financing, is a risk if costs cannot be passed along to tenants.	**Market Weight**

Utilities	Benefits from resilient fundamentals and is a defensive hedge.[6] The preferred sector in recessionary environments due to the inelasticity of goods & services.	The potential for increased climate-related regulations over time may detract from the sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Overweight**

Footnotes

All data, otherwise noted, sourced from Factset as of May 27, 2022.

[1] FactSet, Earnings Insight, 22 October 2021
[2] BofA Securities, The RIC Report: Resources for Realists, 12 April 2022
[3] BofA Securities, The RIC Report: Resources for Realists, 12 April 2022
[4] BofA, The RIC Report: Get paid to wait, 11 January 2022
[5] BofA, The RIC Report: Peace Through Strength, 8 March 2022
[6] BofA, The RIC Report: Bullish Stock Splits, Bearish Rate Hits, 8 February 2022

Definitions

Capital Expenditures (Capex): Funds used by a company to acquire, update, and maintain physical assets such as buildings, technology, and equipment; often used to undertake new investments/projects.

Core PCE inflation: Core inflation is measured by both the CPI and the Core Personal Consumption Expenditures Index (PCE) which represents the price of goods and services purchased by consumers in the U.S.

Producer Price Index (PPI): The index measures the change in the price of goods as they leave their place of production.

S&P 500 Total Return Index: The index includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.