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Q3 Earnings Roundup & Sector Views

With 26% of the S&P 500 earnings reported, third-quarter results have been mixed, although they generally have come in better than expected, risks remain. Thus far, 70% of companies beat on top line while 59% beat earnings expectations.[1] The improvement is due in part to downward adjustment in expectations, which reflects slowing economic growth. At the start of Q3, analysts expected earnings growth of 2.4%, which would be the lowest figure reported by the S&P 500 index since Q3 2020, according to FactSet.

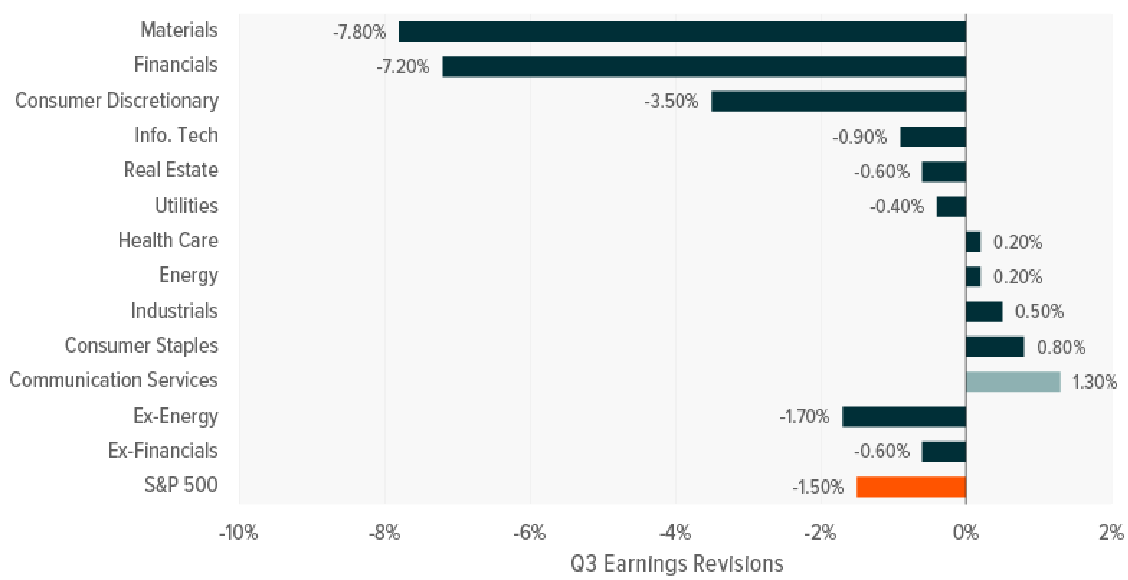
Key Takeaways

- 59% of S&P 500 companies have beaten earnings estimates, and 70% topped revenue expectations.
- Communication Services and Health Care contributed the most to overall earnings growth for the S&P 500 index.
- Downward revisions to estimated earnings and negative earnings surprises have been led by the Materials, Financials, and Consumer Discretionary sectors.
- Blended profit margins for the S&P 500 in Q3 is on track to mark the fifth straight quarter of declines, driven by high producer prices.

The combination of rising interest rates, strong US dollar, and high inflation have weighed on analyst sentiment going into Q3. Six out of nine sectors are forecasted to see earnings decline in Q3, led by Materials, Financials, and Consumer Discretionary, according to FactSet. The Communication Services sector had the largest increase in earnings expectations, which contributed to recent disappointments. And excluding Energy, downward revisions to Q3 earnings have been greater than the index.

REVISIONS TO CONSENSUS 3Q22 EARNINGS SINCE START OF OCTOBER

Sources: FactSet, BofA US Equity & Quant Strategy data as of October 24, 2022



Year-over-year earnings growth has been led by the Energy sector, driven by high oil prices. However, downward revisions to revenue estimates for Energy companies have contributed to the decline in overall revenue growth rate for the S&P 500 index since September 30.[2]

Top Line Improvement

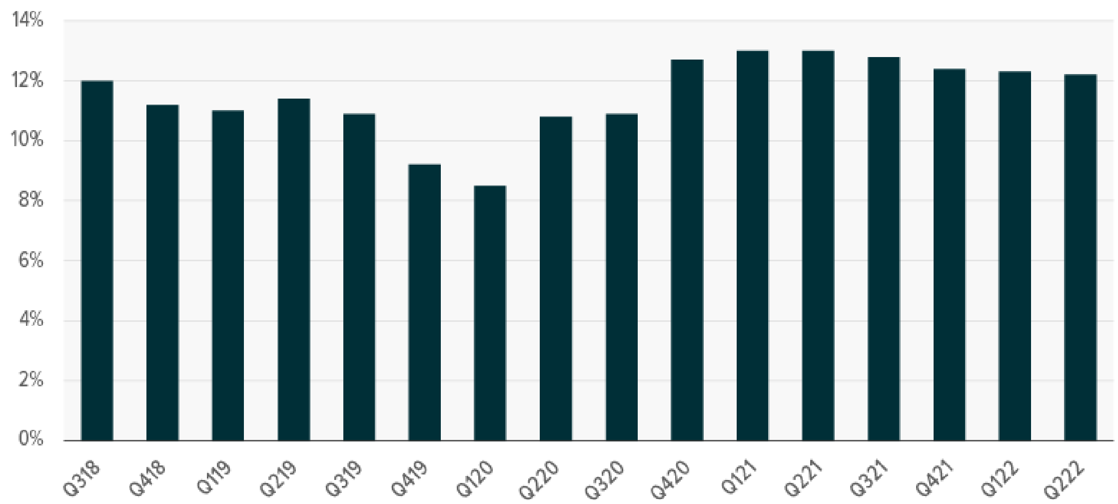
Blended top-line growth of 9% is on track to beat forecasts of 8.7% year-over-year. 70% of S&P 500 companies have beaten revenue expectations in Q3. On the sector level, 90% of Health Care companies reported revenue above expectations, compared with 83% of Materials companies, and 80% of Energy companies over the same period.

Despite recent improvement, both the number and magnitude of positive earnings surprises are below their 5-year and 10-year averages. However, those averages are skewed higher recently because of strong earnings growth coming out of COVID-19 lockdowns over the past year, according to FactSet.

Margins Under Pressure

US producer prices rose by 8.5% year-over-year in September, which negatively impacts corporate profits. So far, blended profit margins for the S&P 500 in Q3 is 12%, on track to mark the fifth straight quarter of declining profit margins for the index.[3] And over the past three months, 412 companies have cited “inflation” on earnings calls, which is the second highest count in more than 10 years.

S&P 500 NET PROFIT MARGIN
Source: Factset data as of October 24, 2022



Still, Energy was one the seven sectors that reported net profit margins above their five-year average, increasing to 14.6% versus 8.9% in Q3 2021. On the other hand, Financials have led the decline in overall profit margins (down to 14.9% in Q3 versus 16.5% in Q3 2021), followed by Materials (down to 11.4% versus 14.2% in Q3 2021).

Rising labor costs have also been a headwind for corporate profit margins. US wage growth has accelerated across all industries this year, most notably in Transport and Leisure.[4] Other cyclical industries such as Manufacturing and Construction have seen high wage growth, which reflects tight labor conditions.

Corporate margin expectations are still relatively high and will likely decline as earnings reflect rising labor costs. As such, a tilt toward defensive and quality sectors such as Health Care and Consumer Staples and lower exposure to cyclical sectors such as Industrials/Transports can mitigate downside risks in a portfolio. In previous cycles, a trough in S&P 500 margin estimates has occurred around market lows.

Our sector views table below 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	Beneficiary of reasonably positive trends in subscription services including streaming. Potential future benefactor from development of augmented reality and metaverse.	Privacy overhang from major hardware providers could impact revenues for interactive media companies moving forward. Higher interest rates may adversely impact the discount rate applied to future earnings and cash flows. This has encouraged a rotation from growth to value this year.	**Underweight**
Consumer Discretionary	Consumers have increased their use of online ordering and deliveries over the past two years, while greater savings and a tight job market could encourage spending.	Wage pressure combined with higher input costs in materials are a risk to margins, especially if companies are unable to raise sales prices. And a deeper economic contraction could weigh on consumer spending. Adversely impacted by rising inventories. Some companies have indicated plans to cut sales prices to get rid of excess inventories.	**Underweight**
Consumer Staples	Demand for consumer staples could remain steady for the remainder of	Inflation is likely to negatively impact margins for companies that cannot	**Overweight**

	the year, especially in the event of a deeper economic contraction.	pass through rising materials costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly.	
Energy	Escalated tensions with Russia and greater natural gas demand from Europe could keep energy prices elevated globally, positively impacting the sector. OPEC+ production cuts, and delayed supply response in terms of drilling could keep energy markets tight and prices high. Large, diversified oil and gas companies have ramped up buybacks along with record profits and healthy balance sheets.	A global economic contraction could weigh on demand.	**Market Weight**
Financials	The financial sector benefits from strong household and corporate balance sheets. Consumer spending remains robust, and, to a certain extent, rising rates are starting to benefit net interest margins.	A deeper economic contraction could offset the favorable rise in interest rates. A flattening or inversion of the yield curve will likely hurt margins.	**Market Weight**
Health Care	Aging demographics around the world combined with the growing middle class in emerging markets benefit health care demand. Health Care is a defensive sector that typically outperforms during severe economic downturns. Sector has strong fundamentals relative to the S&P 500 on a Forward P/E basis.[5]	Drug pricing pressure remains a risk factor. Senate proposals to grant Medicare powers to negotiate prices on some drugs could limit price increases on medicines.[6]	**Overweight**

Industrials	Beneficiary of rising interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift toward 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 this sector's performance. Rising labor costs could pressure margins, particularly within the transport industry. Companies are issuing more negative than positive earnings guidance.	**Market Weight**
Information Technology	Sector displays quality factors and positive FCF growth. The increased adoption of certain key disruptive technologies such as cloud computing, cybersecurity, and CleanTech are likely to remain in a post-COVID-19 world as societies adapt to these new technologies.	Increased regulatory scrutiny is a risk for this sector. There is a bipartisan support for increased regulation in this space. Rising interest rates and slowing economic growth would negatively impact long duration growth sectors such as Information Technology.	**Market Weight**
Materials	Increased focus on Electric Vehicle adoption, alternative energy sources and energy storage should be beneficial to Lithium miners and Battery producers. Beneficiary of rising inflation, leading to higher prices for raw materials.	A deeper economic contraction would be a big headwind for Materials. Increased regulations, especially those focused on preventing climate change, is a potential negative.	**Underweight**
Real Estate	Inflation protected yield.	A fast rise in interest rates could increase the cost of financing, and a deeper economic contraction could raise the risk of costs not being passed along to tenants.	**Market Weight**
Utilities	Preferred defensive sector in recessionary environment due to the	The potential for increased climate-related regulations	**Overweight**

	inelasticity of goods and services. Adoption of renewables could help transform sector in the long run.	over time may detract from the appeal of this sector. Companies may not be able to pass through higher inflation related costs due to government regulations.	

Footnotes

All data sourced from FactSet unless otherwise noted.
1. Bloomberg, Q3 2022 Earnings Tracker: Margins Under Fire, October 24, 2022
2. FactSet, S&P 500 Earnings Season Update, October 21, 2022
3. FactSet, S&P 500 Reporting a Lower Net Profit Margin for 5th Straight Quarter, October 24, 2022
4. US Bureau of Labor Statistics, Job Openings and Labor Turnover Summary, October 4, 2022
5. BofA, When Alternatives Go Mainstream RIC Report, August 9, 2022
6. CNBC, 'Once-in-a-generation' Prescription Drug Pricing Reform Could be Coming, July 29, 2022

Definitions

Free Cash Flow (FCF): A company's cash balance after operating and capital expenditures are paid.

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