

BUSINESS & FINANCIAL OVERVIEW

Stock market may be in for a rude awakening as earnings growth hits a wall, warns strategist

Blockbuster earnings, which until now have played a pivotal role in fueling the stock market's multiyear over the past few years, could be a distant memory as corporate profits hit a wall. Mike Wilson, chief equity strategist at Morgan Stanley, on Monday downgraded S&P 500's earnings-per-share growth target for the year to 1% from 4.3% and warned of a looming earnings recession.

"Our earnings recession call is playing out even faster than we expected," said Wilson in a report. "When we made our call for a greater than 50% chance of an earnings recession this year, we thought it might take a bit longer for the evidence to build." The strategist, whose views on the stock market are among the more subdued in the industry, believes the odds of a contraction in corporation's bottom line are rising with the possibility of flat earnings in the first half and a "hockey stick" for the second half.

One doesn't have to look far for clues on where the corporate sector's performance is headed. Fourth-quarter earnings season, which is in the process of winding down, alone attests to the strategist's lukewarm outlook. As of Feb. 8, with 66% of S&P 500 SPX, +1.29% components having announced results, fourth-quarter earnings rose 13.3%. If this holds, it will be the first quarter that the index has not posted an increase of 20%, according to John Butters, senior earnings analyst at FactSet Research.

For the current quarter, U.S. companies are projected to report an earnings contraction of 4.1%, based on analysts' median estimates in January. That is significantly deeper than the average 1.7% decline over the past 15 years, Butters said. Things could improve toward the latter part of 2019 with analysts predicting earnings growth to accelerate to about 9.5% in the fourth quarter versus roughly 1% over most of the year. But Wilson is urging investors not to buy too much into the "inflection" given that the recovery is not a sure bet.

"We have seen this kind of inflection happen a few times, but these inflections were all related to 1) comping against negative or slower EPS growth or 2) tax cuts mechanically lifting the growth rate. Neither of those force are at play this year. In fact, it's the opposite making the achievability of these estimates even more unlikely," he said. The strategist actually took it further and suggested that investors should brace for more downward revisions, higher volatility and increased pressure on returns.

"If current estimates move in line with history, we could see a full year decline of about 3.5% in S&P earnings," said Wilson. Still, the strategist kept his S&P 500 price target at 2,750 for the moment, stressing that the market's returns can still be positive on the back of the Federal Reserve's dovish bias.

The Federal Open Market Committee unanimously kept key interest rates unchanged at a range of 2.25% to 2.50% at its January meeting, as widely expected. It also stressed that it will be "patient" and went as far as to suggest that it may curtail trimming its balance sheet if needed.

The central bank's retreat from its earlier hawkish stance has helped to shield stocks from the worst of the U.S. and China's trade spat and the political gridlock over the spending bill which could lead to another government shutdown next week. The S&P 500 is up 8.1%, while the Dow Jones Industrial Average DJIA, +1.49% gained 7.4% and the Nasdaq COMP, +1.46% rallied 10.1% so far this year.

