J.P. Morgan Asset Management

When will earnings estimates begin to decline?

10/21/2022

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Investors can decompose equity markets returns into three variables – changes in earnings expectations, changes in valuations (forward P/E ratio), and dividends. 2022 has been a volatile year, and this volatility has been almost entirely driven by fluctuations in valuations; until recently, earnings estimates had been climbing or stable. However, with the end of the year in sight, many investors have begun to focus on the fact that earnings estimates are too high; frankly, we would agree. So when will earnings estimates begin to decline and how far could they possibly fall?

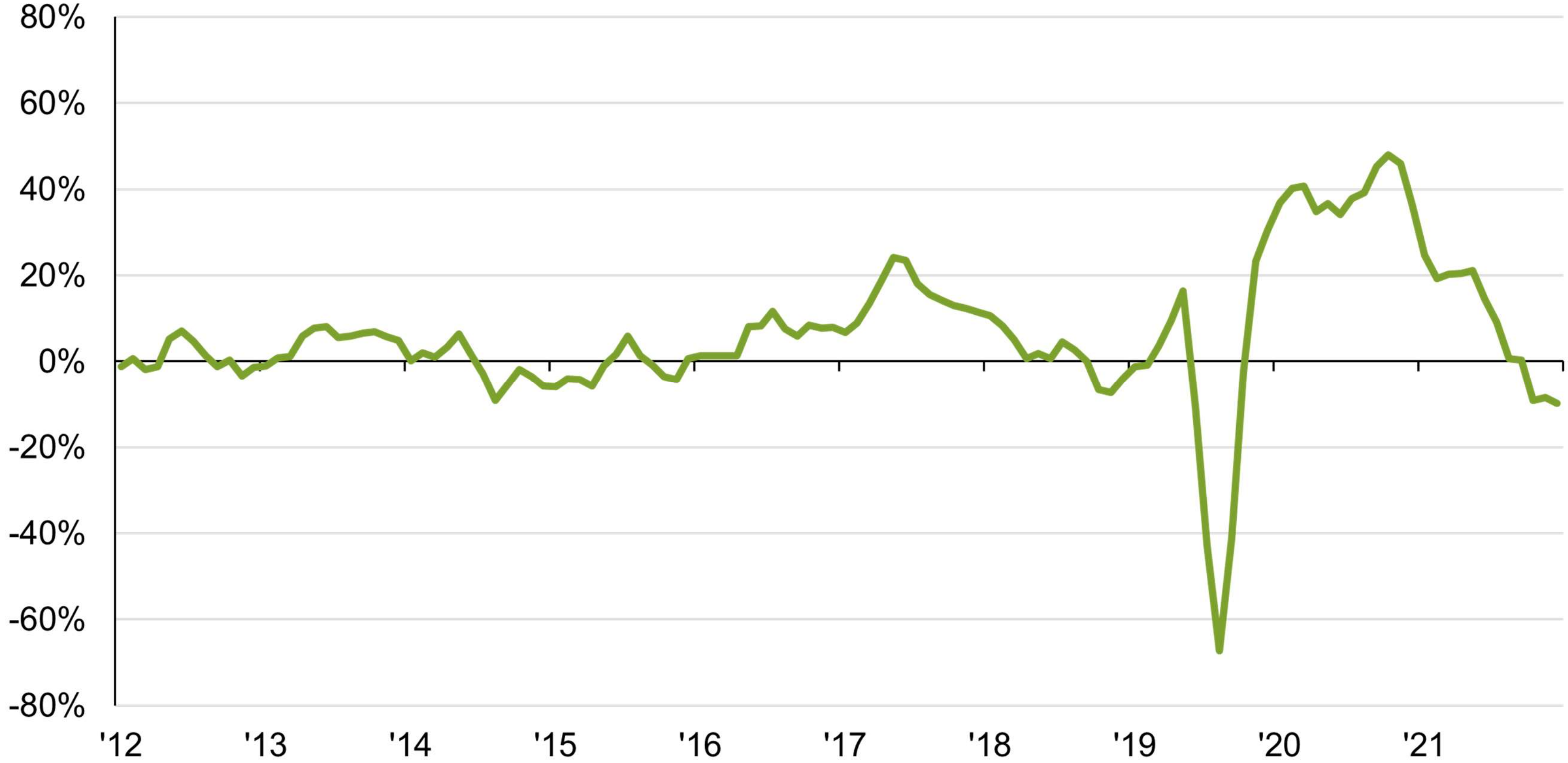
By our lights, earnings reports over the coming weeks will also provide some insights as to what companies expect in 2023. Consensus estimates for 2023 currently stand at $239 per share, down a mere 2.4% from the $245 per share predicted at the start of the year, and implying earnings growth of 7.4%. With issues like a stronger U.S. dollar and rising input costs already weighing on profits, it seems reasonable to expect that 2023 earnings figures will be downgraded in a significant way. As shown in the chart below, the trend in net earnings revisions – calculated as the difference between the number of upgrades and downgrades as a percentage of the total – has begun to move lower in recent months.

We recognize the potential for earnings to decline next year if a recession takes hold, but there are nuances to this view. To start, inflation which fails to subside quickly could support revenue growth in a way that has not typically been the case when economic activity has slowed in recent years. Additionally, it is important to acknowledge that share repurchases have begun to contribute to earnings growth, and their impact could increase if equity valuations remain subdued in 2023. That said, higher input costs and wages will remain a headwind to profits, leaving margins as the key determinant of earnings growth in 2023. We are currently tracking 3Q22 S&P 500 operating margins of 12.4% with about 20% of companies reporting, well above what our model is forecasting for next year.

Earnings estimates remain too high, and will decline – as they should – as we work our way through the current earnings season. However, given the unique nature of this cycle, it may be inappropriate to simply assume any decline will align with what has been seen on average during recessions over the past seventy years.

Earnings downgrades are beginning to outpace upgrades

S&P 500 net earnings revisions, %, 3-month moving average



Source: FactSet, J.P. Morgan Asset Management. *Net revisions are a 3-month moving average and calculated as: (upgrades - downgrades)/(upgrades + downgrades + unchanged). Data are as of October 19, 2022.

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