Weekly Market Commentary

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Corporate Calm

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Highlights

We remain confident in corporate America's ability to generate solid earnings growth in the current global economic environment despite the slowdown in Europe (and to a lesser extent, China).

A number of U.S. companies have performed relatively well in Europe, with some not yet seeing signs of a slowdown in their business.

The business environment overseas appears to be good enough for companies to largely maintain their outlooks for the rest of the year and into 2015.

The stock market's recent gains have gone a long way toward restoring calm in the marketplace. The rebound — 5% off the S&P 500 low on October 15, 2014 — has been driven by a combination of factors, including some better economic data, prospects for more support from central banks, old fashioned bargain hunting, and perhaps most importantly, generally solid earnings results. The market's concerns have not fully been alleviated, but progress has been made.

We would argue that the market's biggest concern right now is slower global growth, particularly in Europe where the Eurozone is potentially on the verge of another recession. Slowing growth in China also remains a concern, though less so. To help assess these growth concerns, we turn to corporate America to try to gauge the potential impact these slowing economies might have on corporate revenues and profits. This week, we look at what some of the most global U.S. corporations have told us about the global economic environment thus far during earnings season.

Putting Europe and China into Context

First, let's put Europe's influence into context. S&P 500 companies generate only about 15% of their revenue from Europe (excluding the United Kingdom). Therefore, a drop in demand in Europe must be seven times as large as one in the United States to have equal impact. From an economic perspective, Europe is an even smaller piece. The Eurozone is the destination for about that same percentage (15%) of our exports. That does not mean the region isn't important, but this perspective is helpful. China is an even smaller revenue driver, as we estimate less than 5% of S&P 500 revenue comes from that country.

What Corporate America Is Telling Us

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Four times a year, management teams from the largest U.S. public companies provide insight into the markets they serve around the world. It's a great time to hear from companies with their feet on the ground overseas and find out what they are seeing. Right now Europe is the primary concern, so that is where we focus our attention. But many CEOs have commented on the economic environment in other slowing economies, such as China and Russia, in their quarterly earnings press releases and conference calls during the past several weeks. A number of U.S. companies with global reach have

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performed relatively well in Europe, with some not yet seeing signs of a slowdown in their business.

For example, companies citing strong growth in Europe included tech giants Apple and Microsoft, and energy services provider Schlumberger. Caterpillar (industrials) noted its business was flat or up higher in Europe, while Procter & Gamble was up a little bit in Europe. Companies such as Illinois Tool Works (industrials) noted they had not seen signs of a slowdown in Europe. At the same time, other companies acknowledged a Europe slowdown, though not a particularly dramatic one, including General Electric and 3M.

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Turning to China, another key overseas market, we heard generally positive comments from companies with large operations there. For example, Honeywell (industrials) and Alcoa (materials) noted that China was a strong market for them. We did find companies more cautious on China, including Caterpillar and Microsoft, but they were few and far between. (Here, we exclude companies lowering their outlooks due to food safety issues, such as Yum! Brands, McDonald's, and ConAgra.)

Pulling It All Together

So what does all this mean? Besides providing more evidence that while Europe is a concern for investors, these comments, which help provide context and a qualitative view of the business landscape, suggest revenue performance in Europe is relatively stable, not falling off a cliff, and that expectations there are low. We also have some evidence that China may continue to grow in-line with expectations. Though our sample size there is relatively small, we would argue that hearing few mentions of China is a positive.

We do not expect the United States to completely decouple from Europe, but companies are managing the slowdown there quite well currently, with help from strength in the United States.

While we were looking for CEO commentary on the global economy, we found many companies cited strength in the United States (and North America). Overall, the business environment overseas appears to be good enough for companies to largely maintain their outlooks for the rest of the year and into 2015, which should keep us on the high-single-digit earnings growth pace produced thus far in 2014. We do not expect the United States to completely decouple from Europe, but companies are managing the slowdown there quite well currently, with help from strength in the United States.

Another frequent topic of discussion on earnings conference calls—though not as much as Europe—has been the impact of the strong U.S. dollar. After modestly trimming third quarter earnings results, currency will be a bigger drag during the fourth quarter. This potential impact is already being factored into many analysts' estimates, and we would not expect a strong dollar to derail the positive earnings trajectory. Consensus estimates for S&P 500 earnings growth are tracking to about 9% year over year for the fourth quarter, down from 11% as of October 1, 2014, according to Thomson Reuters.

The earnings impact during the third quarter has been minimal, and, currency aside, we would expect a similar impact during the fourth quarter.

Corporate Calming Effect

During earnings season, corporate CEOs give us good insights into the health of the global economy. We remain confident in corporate America's ability to generate solid earnings growth in the current global economic environment despite the slowdown in Europe (and to a lesser extent, China). The earnings impact during the third quarter has been minimal, and, currency aside, we would expect a similar impact during the fourth quarter. Look for an earnings season wrap-up after more results are reported, in which we will discuss other corporate trends. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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