AN UNUSUAL DISCONNECT

Carmignac's Note

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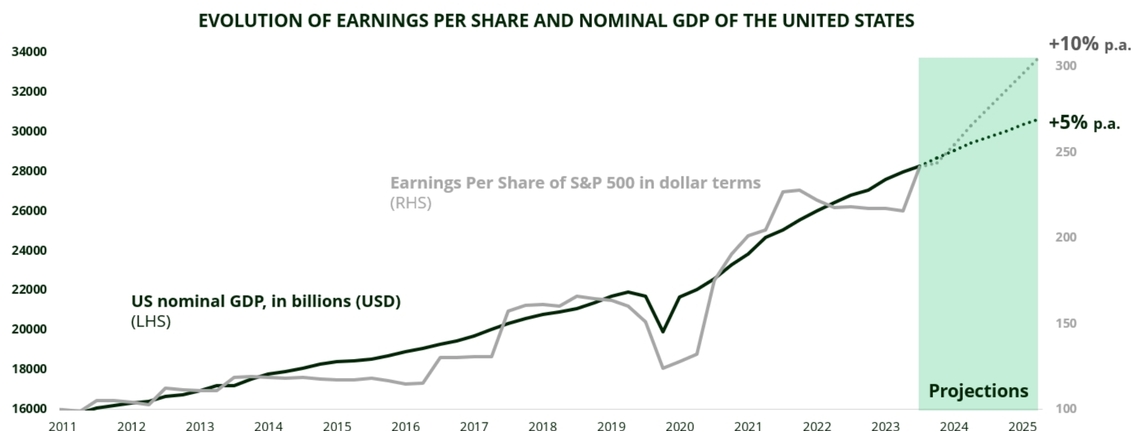
How can one reconcile expectations of a sharp rise in corporate profits with sluggish economic growth and a disinflationary environment?



Source: Carmignac, Bloomberg, July 2024.

The chart above illustrates the unusual disconnect between the consensus expectations for the earnings growth of US large capitalisation companies and the country's expected economic growth. Earnings Per Share (EPS) are predicted to expand by +10% this year and the next, while nominal GDP growth (including inflation) is expected to be between +4% and +5%[1].

Over the medium term, growth in corporate earnings tends to converge with nominal economic growth for a number of reasons. Firstly, companies are an integral part of the economy and their performance is therefore closely linked to economic activity[2]. Second, productivity growth contributes both to overall economic growth and to the improvement in companies' earnings. And finally, nominal company earnings also include the effect of inflation on the price of goods and services. A difference of 5 to 10 percentage points between the two over one or two years is, therefore, an anomaly.

So, how can one reconcile expectations of a sharp rise in corporate profits with sluggish economic growth[3] and a disinflationary environment that is contributing to weak nominal growth?

The strong growth in expected corporate earnings is largely - but not solely - due to favoured technology sectors, notably artificial intelligence. Arguably, at some point, the exponential profits growth of key players will run out of steam (the broader sector accounts for half of the expected rise in profits of the entire S&P 500 index). At that point, the overall earnings outlook, which would then be underpinned by sectors that are more dependent on the economic cycle, could disappoint and contribute to the downward convergence of earnings and economic growth.

Such an environment favours stocks that offer a high degree of visibility on future earnings trajectory and lowering allocation to the most popular stocks, which are more prone to disappointment. This repositioning should benefit defensive stocks. In any case, the recent market rise has been highly concentrated in too few stocks. This alone should lead investors to diversify their investments in favour of stocks and sectors which have been shunned.

The reconvergence of profits and the economy can also be achieved by economic growth catching up. After all, the US economy has proven surprisingly resilient and has managed to twist a widely expected recession into a soft landing. Could it continue to surprise by its future strength? The increasingly likely election of Donald Trump as President of the United States should give rise to supply-side economic policies like those implemented by Reagan in the early 1980s. Such policies would take the form of tax cuts for corporates, deregulation and industrial investments. They would also be accompanied by higher inflation, which would contribute to an increase in nominal growth.

Such a hypothesis has its merits. Its validation would imply an extension of the economic cycle, most favourable to those companies and sectors able to better cope with higher interest rates.

As with the first scenario (that future earnings growth will be disappointing), one needs to be particularly vigilant regarding valuation levels in order to build a portfolio suited to the emerging environment and the risks it brings in its wake.

[1]This year US real GDP is expected to rise by 2% and inflation by 2.5%, hence nominal growth to be of 5%; and for 2025, real growth is expected to grow by 1.8% and inflation by 2.1%, corresponding to a nominal growth of 3.9%. The S&P 500 EPS are expected to rise by more than 10% this year and by almost 15% in 2025.

[2]In the United States, more than 70% of the economy is linked to domestic factors.

[3]Household consumption stood at +1.7% in the first half, compared with +2.4% in the pre-Covid era, coincident indicators point at US GDP growth at 1.5% for the second quarter, and fewer jobs are being created.

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