Northern Trust | Jim McDonald: How Big a Problem Are Falling Earnings?

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How big of a problem are falling earnings? Earnings estimates worldwide are falling due to the plunge in oil prices. In the US, the strength of the dollar is also a problem. This is leading to an earnings recession that will extend through the second quarter of this year. So how big of a problem for the stock market are falling earnings and what does this mean for investors?

Earnings do matter in the long term. Last week, we conducted a study to determine the impact of earnings on stock prices and we focused our research on US data, where we have the longest data set. And it's our experience that investor behavior is similar across most major markets.

The study confirmed our view that over the short term, earnings matter little, but over the long term, they matter a lot. The data shows that the correlation of earnings to stock market prices on a one-year basis is virtually zero and only improves modestly when you extend your period to five years. But long term, earnings are the biggest driver of stock prices, followed by dividends.

Falling earnings happen in both expansions and recessions. I recently read a report which showed some worrisome data about stock performance during earnings recessions. Our study showed that there were 21 earnings recessions in the United States since 1936 and in 13 of those, we also had an economic recession. Stocks fell 13% ahead of these double recessions while they actually rose 18% when we avoided an economic recession. It's our belief that we will avoid an economic recession this cycle and the positive performance of stock so far lends support to this view.

Earnings growth should improve by late 2015. Earnings have been punished by falling commodity prices. For example, energy earnings this year are expected to be down over 50% in the developed markets. This led to the start of the earnings recession in the United States in the fourth quarter, which will extend through the second quarter of this year.

Earnings growth should resume in the third quarter, but may only reach 2% to 4% globally this year. And while the energy earnings are down, we are seeing stronger growth in sectors such as consumer discretionary, financials, industrials, and technology. So with the continued economic expansion, we do expect worldwide earnings growth to accelerate to 5% to 6% in 2016.

What does all this mean for investors? Short-term earnings reports matter mostly at the individual stock level, not at the market level. The earnings recession underway should not be a major problem if the economic expansion continues. And a continued moderate economic expansion does remain our base case. The earnings slowdown and weak labor reports like last Friday's US payroll report only serves to extend the period of easy monetary policy, but we do expect heightened volatility to remain the norm this year.

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