

Making Sense

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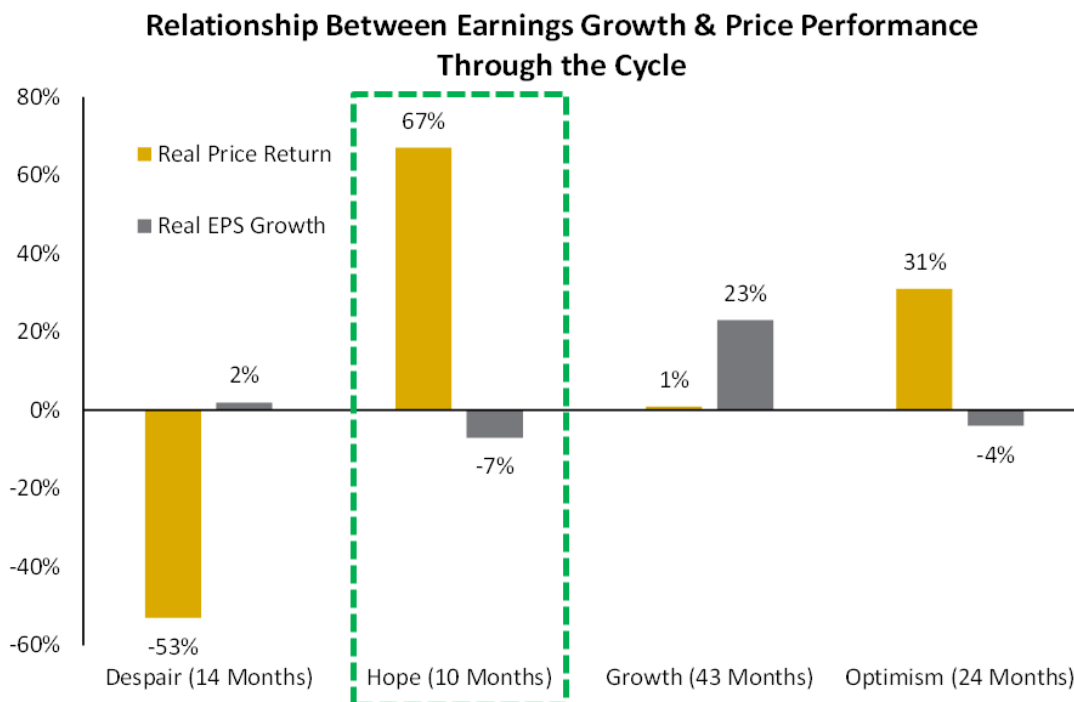
Is a Potential Earnings Recession Bad for Stock Returns?

As we've said, the potential for a material recession occurring in the next 12-months has increased to a 60% probability, and the potential for an earnings recession has also increased. **But is an earnings recession necessarily a bad thing for stocks?** Consensus expects the S&P 500's full year 2022 earnings to grow 6.7% (\$223/share). The estimated growth in earnings for 2023 is currently at 7.3%, but we anticipate that number will fall in coming months. For perspective, average earnings growth since 1950 is 7.6%.ⁱ

Let's say we do slip into an earnings recession. What could that mean for investors? Just because earnings fall, does that mean stocks may also fall? Historically, S&P 500 earnings and returns have not moved in lockstep. Also historically, there have been four phases to the earnings growth cycle: Despair, Hope, Growth, and Optimism. Let's first consider the Despair phase, as that's where we believe we are today. **During the Despair phase**, investors see a severe drawdown in price returns (often into bear market territory), but earnings per share remain positive. Consider this year: stocks have fallen, but earnings have continued to grow. Historically, following Despair is **the Hope phase**, where real price returns rebound dramatically, even as earnings per share start to turn slightly negative. The market is a forward pricing mechanism and quite often begins to look beyond an earnings contraction to better times ahead.

We believe the earnings growth cycle will likely enter the Hope phase during 2023—seeing an increase in returns, but potentially experiencing negative earnings growth. Additionally, Wall Street analysts' bottom-up consensus expectation for S&P 500 12-months forward is **4,604 or ~23% return from close on October 21st's close of 3,752**.ⁱⁱ

Figure 1ⁱⁱⁱ:



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ⁱ FactSet, 10/21/22

ⁱⁱ FactSet 10/21/22

ⁱⁱⁱ Goldman Sachs Research