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WEEKLY DIGEST

THE NUMBERS GAME
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Earnings ultimately drive stock returns, not geopolitics – and the quarterly earnings season has arrived.

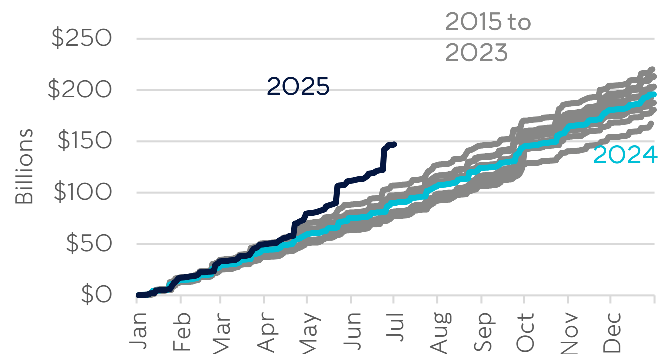
Granted, tariffs and geopolitics generate many a headline, spawned by players on the political stage who are powerful now but may not survive the next electoral cycle. But it's worth bearing in mind that the ultimate driver of the fortunes of equity investors, both metaphorically and literally, is the level of earnings generated by companies.

With this in mind, four times every year, analysts and fund managers brace themselves for a torrent of information from companies' quarterly earnings results. The weeks before this see an elaborate ritual of expectation-setting. It's taken almost as an article of faith that companies will try to massage quarterly growth expectations lower in the run-up to earnings season, only to be congratulated on beating them. Nobody really falls for this anymore, as can be judged from share price reactions, but it's vaguely comforting, nevertheless. Obviously, there are times of genuine surprise, which usually coincide with turning points in the global economic cycle. But we don't think we're at one of those today.

Tariff uncertainty prevails

Unsurprisingly, the greatest source of uncertainty as we head into this reporting period is the effect that actual and potential tariffs might have on corporate costs. This could affect US companies that import goods, as well as non-US companies that export to the US. Although we're still waiting to see exactly where tariff rates will end up, it's worth remembering that during the first quarter the prevailing average effective tariff rate was below 3% and in the second quarter it was around 13%. It's still not clear where in the supply chain the tariff hit will be taken – exporters, importers or consumers. It's not clear, either, what cost savings companies might have been able to make elsewhere to compensate for the higher tariff costs.

Starting in the US, analysts' consensus forecast for year-on-year (y/y) growth in earnings in the second quarter of 2025 is a lowly 4%, down from 12% in Q1. That's according to FactSet, although Bloomberg suggests growth of only 2.8%. Both estimates set quite a low bar.



Source: Penn Wharton Budget Model based on US Treasury data; cumulative customs and excise tax receipts for years 2015 to 2025, adjusted for inflation

This might seem at odds with the fact that US equity markets are regularly hitting new all-time highs again, but that reflects the forward-looking nature of financial markets. They're looking beyond past earnings to future earnings – and twelve-month forward earnings expectations are also hitting new highs. Indeed, although earnings growth for the S&P 500 index is pitched at just 7% for this year as a whole, the 2026 number is currently around 13%.

AI still the driving force

Aggregate numbers rarely tell the whole story. When we dig deeper, the lead in 2025 earnings growth is still coming from the technology-related sectors, with all things related to AI doing most of the heavy lifting. Communications services (+28%) and IT (+18%) display the highest growth, with energy (-28%) dragging the average down.

Another notable feature of the IT story is the 53 basis point (hundredths of a percentage point) reduction in IT companies' operating margins (profits before interest costs and taxes). This is testament to the huge boom in capital spending (capex) on AI. Even so, their average margin of 25% is still nothing to be sniffed at – these are fearsomely profitable companies, which generate enormous amounts of cash. Consumer discretionary – things we

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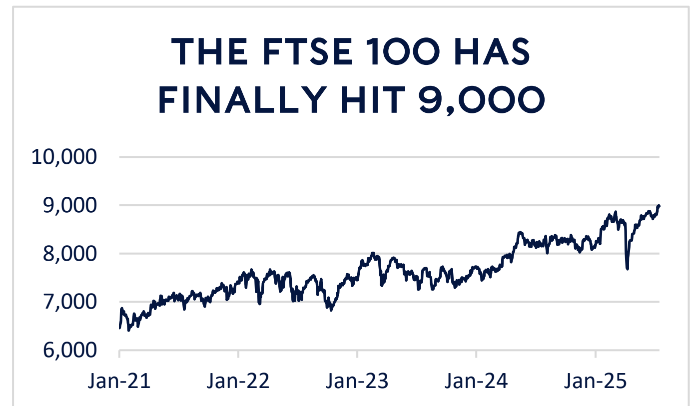
don't need to buy but choose to buy – actually looks the sector most at risk of tariff-related margin compression.

Investors have in fact responded positively to high AI capex, with AI remaining the key driver of US equity returns.
Even with all the pressure of AI and tariffs, the operating margins of S&P 500 companies remain close to all-time highs. This margin performance has largely driven the narrative of 'US exceptionalism' – the idea that the US stock market deserves its high value because its companies are more dynamic. I remain disinclined to bet aggressively against this continuing.



Source: FactSet

The bar is set low in the UK and Europe too

Despite the more ebullient tone of European equity indices this year, expectations for this earnings season are lacklustre. Indeed, combined earnings are forecast to be merely exactly where they were a year ago – and 4% lower if the strong financial sector is stripped out. One headwind is the weak energy sector. Another is the weaker dollar, which reduces income from sales in the US when it's converted back into companies' home currencies – around 26% of sales are in North America (mainly the US). Tariffs are also expected to weigh on earnings, by making margins lower than they would be otherwise. Even so, investors will be tuning in more for clues about the incipient recovery in Europe, looking especially for beneficiaries of Germany's rediscovered appetite for fiscal stimulus.

In the UK, earnings estimates have been scaled back over the last few months. Earnings per share for the first half of this year are forecast to fall 6% (y/y), or to be flat if energy companies are stripped out. But this hasn't prevented the FTSE 100 index from making a few new all-time highs, including breaching the 9,000 level for the first time ever. Currency movements and the weak oil price are the main drag factors, with a rising pound always a headwind for UK multinationals. Financials remains the strongest sector in terms of earnings growth. As we often point out, it's hard to be too negative about markets as a whole when financials are prospering.

For this week's economic highlights, see below on page 3.

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ECONOMIC HIGHLIGHTS

UK – May's GDP data provided yet another disappointing snapshot of UK economic activity: output was down 0.1% from April, against an expected increase of 0.1%. That came on top of a 0.3% fall in April. The strong first-quarter growth of 0.7% now looks very historic. The economy is probably feeling the negative impact of higher levels of employer National Insurance contributions. At least the latest retail sales report from the British Retail Consortium made for brighter reading, with like-for-like sales improving by 2.7% vs a forecast of 1%, although this might be down to the warm weather rather than something more lasting. The Office for Budget Responsibility warned that its long-term growth forecasts could be too high. This darkened sentiment on the government's fiscal outlook, sending long bond yields higher. The silver lining is that financial markets are now pricing in a 94% probability of a quarter-point cut in the Bank of England's base rate in August.

US – The latest inflation data came in pretty much as expected. The headline rate rose in June from 2.4% to 2.7%, with the core rate (excluding more volatile food and energy) up from 2.8% to 2.9%. There was some evidence of higher tariff rates being passed through to items such as toys, furniture, clothing and appliances, but nothing too concerning. The inflation data is a barrier to the Federal Reserve cutting interest rates, as long as both measures remain well above the 2% target at a time when data on economic activity is resilient. Financial markets aren't fully pricing in the next rate cut until October.

Europe – It's still a little early to expect the prospects for increased fiscal stimulus to show up in the hard numbers of actual economic activity. But there are signs of an improvement in surveys of economic sentiment. Indeed, the Eurozone's Sentix survey is now at its highest level since Russia's full-scale invasion of Ukraine. It's a similar story for the German ZEW sentiment survey, which has also rebounded nicely in response to the federal government's decision to increase spending.

China – GDP increased by 5.2% in the second quarter, ahead of the 5.1% consensus forecast, but lower than Q1's 5.4%. External demand was the key to the positive surprise, with domestic retail sales growth decelerating to 4.8% (y/y) in June (vs 5.3% expected), down from a 6.4% y/y increase in May. The decline in real estate investment intensified, with a 11.2% decline in the first half of the year. Investments in infrastructure and manufacturing also showed signs of slowing. Various leaks from the latest meeting of the politburo, the ruling party's senior leadership body, have suggested an appetite for more stimulus. But we don't think this will actually happen until the government has more certainty about its trade relationship with the US. Rumours also abound that President Xi is losing his grip on the Communist Party. We don't see compelling evidence of this yet, but will keep our ears to the ground, as any change in leadership could be game-changing.

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