EQUITIES

Great expectations: Insights as Q2 earnings season wraps up

By: Yana S. Barton, CFA | & Lewis R. Piantedosi | August 19, 2020

Boston - Second quarter earnings season is nearing completion, with most companies besting lowered earnings and revenue expectations. Against the backdrop of continued market strength, investor focus has shifted to next year's profitability and the reliability of current guestimates.

History would suggest that earnings projections for 2021 are still too optimistic, but past analogs could prove misleading given the weighty implications of key market unknowns: progress on the COVID-19 vaccine and the outcome of the US presidential election. We believe that focusing on company-specific fundamentals remains prudent, irrespective of macro and geopolitical fortunes.

Q2 recap: Lowered expectations leading to record upside surprises

Through mid-August, over 90% of the S&P 500 Index companies have reported, with 82% reporting better-than-feared earnings and 64% besting sales. Although the index is on track for record quarterly earnings beats, expected blended quarterly earnings for the S&P 500 is still negative — a year-over-year decline of 34%, to be exact.

According to Bank of America/Merrill Lynch research, management commentary regarding future prospects appears to be the most optimistic since late 2016, which tends to support the positive earnings revisions trends and recovery expectations that are anticipated in the second half of the year. While 2020's calendar earnings are projected to decline 19% year over year, the next few quarters are expected to post sequential improvement.

2021 preview: Expecting economic and corporate profit rebound

The sell side is expecting an economic and corporate profit rebound in 2021 across all sectors, particularly cyclicals. Here are the estimates from Ned Davis Research (NDR) as of mid-August:

Cyclical sectors expected to lead 2021 EPS rebound

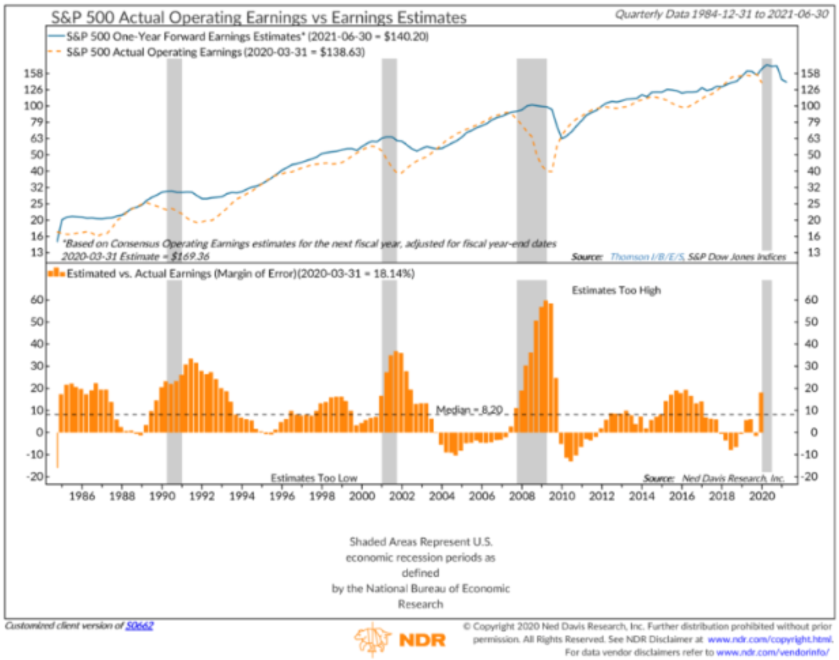
Consensus Estimates for S&P 500 Operating EPS Growth

Sector	CY20 (%)	CY21 (%)
Consumer Discretionary	-59.2	130.5
Industrials	-58.7	116.1
Financials	-61.1	86.5
S&P 500	**-30.5**	**47.8**
Materials	-17.6	39.9
Communication Services	-14.2	30.5
Health Care	13.2	23.2
Information Technology	4.2	22.7
Real Estate	-38.3	13.7
Consumer Staples	-4.5	10.1
Utilities	-3.4	9.5
Energy*	N/A	N/A

*Energy consensus EPS: -$13.33 for CY20 and $8.76 for CY21.
Source: S&P Dow Jones Indices

Ned Davis Research T_SSF20_27.1

The current estimate of $165 in earnings per share would be an all-time high for the S&P 500. As demonstrated by this recent analysis from NDR, history suggests that sell-side analysts are an optimistic group, overshooting by approximately 8% on average when comparing actual to estimated annual earnings results:



At this juncture, however, anchoring to historical trends might prove tricky, given the potential impacts to the economy, markets and investor sentiment of progress on COVID-19 vaccines and the results of the US elections.

What if?

COVID-19 has affected about 22 million people worldwide, including more than five million in the US alone. With researchers around the world racing to find a vaccine, more than 165 are in development and 30 are already in human trials. Understandably, success against the virus would yield great benefits to all, not just sentiment and earnings.

Barely three months remain until the November election — an eternity in the political and investment realms. In the US, should a Biden presidency come to fruition, federal corporate tax hikes are likely. The full impact, timing and realization of the proposed corporate tax hike is difficult to calculate with precision. Estimates from RBC, Strategas and NDR suggest that the proposed 7% tax hike could lower earnings on the S&P 500 by anywhere from 4% to 13%.

Bottom line: Equity markets' resiliency and ascent to date have been impressive. Over the long term, stock prices move in sync with earnings. Earnings are always a moving target, and much can change amid COVID-19 and election uncertainty. Volatility will undoubtedly return and so, we believe, should an investor's focus on company-specific fundamentals, rather than market prognostication.

With contributions from Carolina Concannon, CFA.

S&P 500 Index *is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.*

The value of investments may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the US and global markets. The value of equity securities is sensitive to stock market volatility.

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"Prediction is difficult, particularly when it involves the future."__ Mark Twain

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