Keep On the Sunny Side – The Carter Family, 1928

EARNINGS ARE POISED TO SURPRISE TO THE UPSIDE

Earnings season for Q2 2020 kicked off last week and will accelerate over the rest of the month, providing an important micro-level perspective on how the economy is fairing. Unlike last quarter, when firms had to contend with one month of lockdowns, this quarter's results will include the full impact of the lockdowns experienced by economies across the world. Given the high degree of uncertainty, low expectations, and improving macroeconomic data, we believe the results will surprise to the upside. Such positive results could drive equity markets higher, especially if they are paired with a more upbeat tone on the future. Thus, "tho' the storm in its fury break today, crushing hopes that we cherished so dear, clouds and storm will in time pass away, the sun again will shine bright and clear."

WHAT'S NEXT?

Highs (uncertainty) and lows (expectations)

Corporate quarterly earnings reports provide a useful perspective on spending, profitability, and capital flows on both a backward-looking and forward-looking basis. This perspective is especially helpful in today's context where the coronavirus pandemic has led to a global recession, over half a million deaths worldwide, and a high degree of uncertainty for households, businesses, and investors. In a couple of weeks' time, nearly 80% of firms in the S&P 500 index and 70% of those in the Stoxx Europe 600 will have shared their results, making the earnings season an important market driver over the short term.

Going into earnings season, two things seem clear: uncertainty is high and expectations are low. Many firms pulled their guidance earlier this year, and currently just 11% of firms in the S&P 500 and 4% of firms in the Stoxx 600 have provided an estimate for 2020 earnings per share (EPS). It is not just firms that are uncertain: the financial analysts who cover these firms are also unsure how earnings will evolve this year. As we mentioned last week, dispersion across estimates for 2020 EPS is very wide at USD 25 (measured via standard deviation) currently versus just USD 5 in 2019 and 2018, and USD 9 in 2009 for the S&P 500. Moreover, while the median estimate for 2020 EPS for the S&P 500 is USD 125, the low is USD 50 and the high is USD 175. At the same time, expectations for earnings this past quarter are quite pessimistic: US firms are expected to see EPS contract by 45% compared to one year ago, while European firms are expected to see a contraction of nearly 60% in aggregate. It should not be surprising that the last time earnings contracted by so much was during the Great Financial Crisis (GFC).

Importantly, the aggregate picture does not belie a more granular analysis at the sector level. While the collapse in energy prices will be a significant drag to the energy sector (EPS is expected to contract by 150% in the US and 130% in Europe), the earnings contraction is broad: excluding the Energy sector, EPS is still expected to contract by 40% in the US and 50% in Europe. Even for the US Tech sector, EPS is expected to contract by 10% and revenue by 1%, countering some investors' intuition that expectations for these firms are too optimistic. Only Utilities are expected to see largely flat EPS, and even US Healthcare firms are estimated to see EPS contract by 14% (estimates for European Healthcare firms' EPS growth are a bit better at -3%).

Improving conditions suggest firms will beat expectations

The dynamics of the macroeconomy and financial markets around turning points is critical: as we have mentioned before, the second derivative – the change of the change – is very important today. On this point, we see an encouraging picture:

- We have already mentioned the improvement in the macro data, as captured by our Growth Nowcaster, which now indicates that the global economy is recovering strongly;
- The June US retail sales number indicates that purchases are essentially back to their pre-crisis levels after five months, much shorter than the 33 months it took for them to recover after the GFC;
- Starting in May, our Growth Newscaster began retracing its collapse and recently returned to its level from early February, thus, despite the continuing spread of the virus, economic news is on a much stronger footing;
- Cyclical commodities, such as oil and copper, have also recovered strongly, driven in part by tighter supply but also by an increase in demand;
- The downward revision of EPS for the past quarter and for this year stopped in late May, indicating that analysts have adjusted their expectations to these low levels.

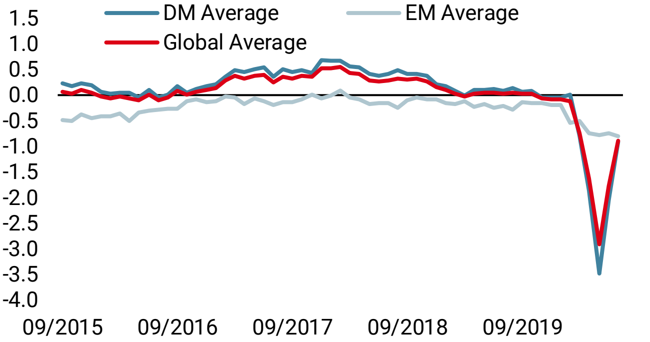
This present context of high uncertainty, low expectations, and a recent recovery in economic data suggests strong potential for firms to beat expectations. Ahead of the Q1 2020 earnings season in the US, analysts underestimated the impact of the lockdowns and only about 65% of firms in the S&P 500 beat their estimates, much below the typical 75% and lower than any quarter going back to 2009. These underwhelming results led investors to punish misses much more than they rewarded beats

(-2.5% vs +0.8%, relative to market return). If this quarter's results turn out to be a reversal from last quarter, where analysts overestimate the impact of lockdowns and many firms beat expectations, we could see a reversal of the market reaction as well, with beats rewarded more strongly than misses are punished. Indeed, Q1 2020 results for European firms elicited a similar market reaction: analysts expected a significant contraction in EPS for the Stoxx 600 (-22%, nearly double the expectation for the S&P 500), and 55% of firms beat these low expectations, which is in line with the typical beat rate for the Stoxx 600 index. The market reaction was much more favourable: firms beating their estimates saw a median return of nearly 2% relative to the market, while firms who missed saw a median return of just -0.5% relative to the market.

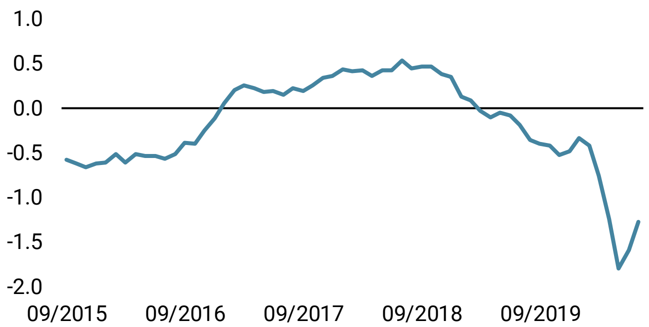
Thus, in our view, the short-term risk from this earnings season is tilted towards the upside. A confirmation in micro data of the recovery on display in the macro data could lead to a positive shift in investor sentiment. With investor exposure to equities still low and massive money market reserves, such a shift would provide a significant boost to equity prices (and risky assets more broadly) and suggest that investors may finally be buying the economic recovery.

UNIGESTION NOWCASTING

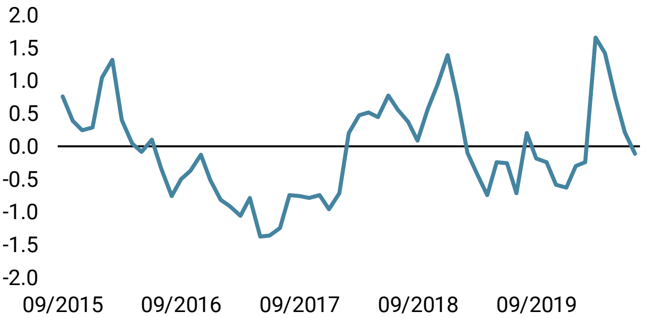
World Growth Nowcaster



World Inflation Nowcaster



Market Stress Nowcaster



Weekly Change

- Our world Growth Nowcaster increased again last week on further improvement in growth-related data, especially in the US and Canada.
- Our world Inflation Nowcaster also increased across a broad base although Europe continues to lag.
- Our Market Stress Nowcaster was down slightly over the week, with little change in either liquidity, volatility, or spreads.

Sources: Unigestion. Bloomberg, as of 17 July 2020.

IMPORTANT INFORMATION