Investment Perspectives

Q3 Earnings Strong Enough to Sustain Rally

November 2019

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Key Takeaways

- Earnings results beat very low expectations and were good enough to stabilize investor sentiment
- The market rewarded earnings beats more than usual, while also punishing those that missed less than usual
- Earnings growth expectations remain low for Q4, but turn meaningfully more optimistic in 1H 2020
- With P/E multiples just above 5-yr averages and bond yields near historically low levels, domestic equities remain attractive

Third quarter U.S. corporate earnings were better than feared and enough to keep investors constructive through year end. Despite ongoing pressures from U.S.-China trade relations, concerning manufacturing data, and global geopolitical uncertainty, the S&P 500 continues to reach new all-time highs. Investors have been rotating out of equities throughout the year and positioning now appears light. With near-term headwinds dissipating, equities have room to move higher.

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With 92% of S&P 500 companies having reported results, earnings are broadly characterized as better than feared: For the quarter, the blended earnings growth rate[1] is -2.3% year-over-year. While that measure may not seem inspiring, on September 30th the consensus estimate for earnings growth was -4.1%. The uptick in actual results was good enough to stabilize investor sentiment and the S&P 500 continues to reach new all-time highs. Even with significant uncertainty related to ongoing trade issues, concerning manufacturing data, and global geopolitical tension, it appears that risk in equity markets has been pushed to 2020.

The market rewarded companies that beat expectations more than usual, while also punishing those that missed estimates less than usual: Companies that reported positive earnings surprises have seen average price appreciation of +2.3% measured two days prior to earnings through two days after vs. +1.0% on average during the same period over the last five years. Companies that missed saw shares decline -1.5% during the same period vs. -2.6% on average over the last five years. This disparity is indicative of how bearish sentiment had grown entering earnings season. With such a low bar for management to clear, three quarters of companies reporting beat estimates, providing a lift to the market. Expectations remain low for Q4, with analysts projecting -1.4% earnings growth year-over-year. Looking ahead, estimates become meaningfully more optimistic, with consensus earnings growth of 5.1% expected in Q1 '20 and 6.4% expected in Q2 '20.

U.S.-China trade relations remain in the forefront, but headlines indicate an interim deal may be near: The number of companies citing "tariffs" on earnings calls decreased from Q2, but 25% still reference the headwinds from trade. Though the current trade war is unprecedented when measured by both size and impact to global growth, history indicates that trade negotiations could be long-lasting. Headlines have been encouraging that an interim deal is near, but the reality is that hurdles for a larger agreement remain, including the scale of tariff relief, level of commitments for agricultural purchases, intellectual property protection, and enforcement mechanisms. It's estimated that S&P 500 revenues are split 60/40, U.S./International – given the importance of international revenues to the S&P 500, it is surprising that daily volatility has been subdued.

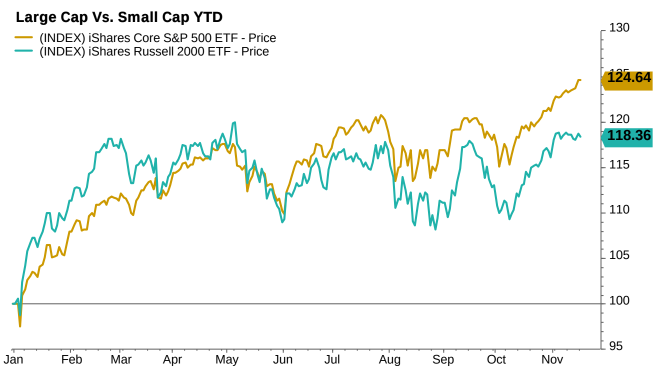
Despite a bull run that has lasted more than a decade, U.S. equity valuations do not look stretched: The forward 12-month P/E ratio for the S&P 500 is 17.6, slightly above the 5-year average of 16.6, but not materially so. Typically, a correction to equity markets is not caused by valuation without a significant premium to historical P/E averages. With bond yields near historically low levels both domestically and abroad, investors may be forced to turn to equities in search of returns. The set-up is not perfect for a continued move higher, but should corporate earnings growth match expectations in 1H 2020, investors will be content with accompanying returns, particularly when compared to fixed income markets.

S&P 500 Price and P/E Forward 12 Months

Source: FactSet Research Systems

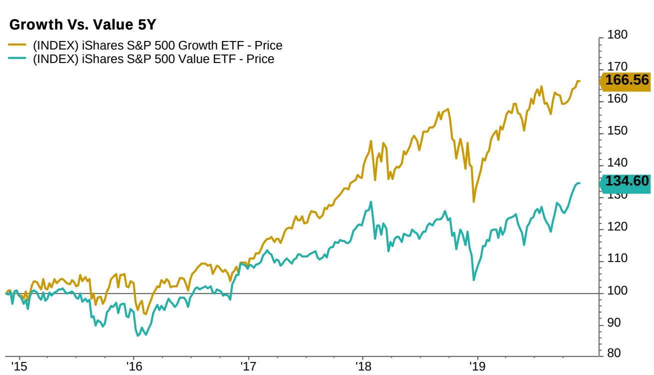
[1] Actual results for those reported, averaged with estimated results for those that have not

Large cap has outperformed small cap YTD: The S&P 500 Index has led the Russell 2000 Index by 6.25% so far this year. The outperformance by large caps is surprising given that one would expect large, multi-nationals to face greater headwinds from issues pertaining to global trade and a consistently strong U.S. Dollar. Slowing global growth abroad and a comparatively hawkish tone from the Fed has pushed the U.S. Dollar to multi-year highs when compared to a basket of foreign currencies - problematic for those collecting unhedged revenues in foreign currencies. Large cap outperformance YTD is meaningful, and the disparity of returns favors a tilt towards small cap in the near term. We expect reversion to the mean in the coming months and for relative outperformance from the Russell 2000 given continued domestic economic strength.



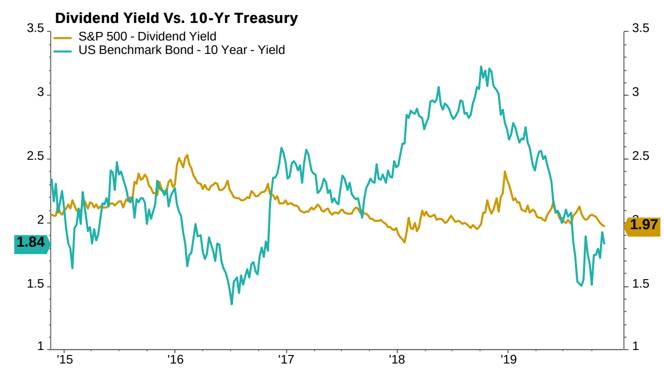
Source: FactSet Research Systems

Value stocks have lagged growth since the Financial Crisis, but there has been a rotation to value recently: There has been ongoing conversation about growth vs. value as investors seek long-term opportunities in a challenging environment for stock pickers. Over the last two months, the performance gap between the two narrowed slightly, as a rotation in favor of value occurred. Despite the rotation, value



Source: FactSet Research Systems

still trails growth by a wide margin after years of compounding outperformance from technology stocks and other momentum-driven names. One area of value that could see meaningful outperformance in the near-term are stocks with high dividend yields. The S&P 500 dividend yield offers 10bp more income to investors than the 10-Year U.S. Treasury. It would not be surprising to see fixed income investors who are desperate for yield to cross over and seek income from high paying dividend stocks.



Source: FactSet Research Systems

Overall, we believe the current environment is favorable for equity investments. Investors who have rotated out of equities in favor of cash or bonds face the decision to establish positions at current levels or risk missing out on any further appreciation. With valuations at reasonable levels in a historical context and near-term risks abating, it appears that the path of least resistance for equity markets is higher.