Legacy Trust

Investment Perspectives

Takeaways From Q2 Earnings Season

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Key Takeaways

- Q2 Earnings were weak, with a year-over-year blended decline of -33.8%
- Analysts expect a return to earnings and revenue growth in Q1 2021, before coming up against easy YoY comps for the remainder of the year
- The S&P 500 forward 12-months P/E ratio is 22.6x and is above long-term averages, but is not yet cause for concern
- Tech mega-cap names beat already elevated earnings expectations. FB, AAPL, AMZN, MSFT, and GOOGL (FAAMG) now represent 23.4% of the S&P 500's market capitalization

Analysts' estimates for S&P 500 Q2 earnings proved to be too cautious as 83% of companies reported EPS above consensus. Estimate ranges were wider than usual as analysts weighed the damages caused by Covid-19, counterbalanced by aggressive cost control measures taken to preserve liquidity. The S&P 500 continues to reach new all-time highs despite year-over-year earnings contraction, as investors look through near-term weakness and anticipate the successful deployment of a vaccine.

S&P 500 Q2 earnings were weak, but analysts expect results to improve in the quarters ahead: For the quarter, the blended earnings growth rate[1] is -33.8% year-over-year, with revenues -9.8% year-over-year. The results were unsurprising given the timing of the spread of Covid-19 and the resulting global lockdown (keep in mind S&P 500 revenues are split 60/40, U.S./International). Energy, industrials, and consumer discretionary earnings were particularly weak.

Analysts expect the worst is behind us and forecast returning to meaningful growth in Q1 2021 and beyond: Consensus estimates indicate that earnings for the remainder of 2020 are likely to be constrained, but materially better than Q2. As time goes on, corporations have become increasingly successful operating in this new environment in part because consumers and employees have adapted and implemented precautions to remain safe.

S&P 500 Consensus Expectations (YoY)	Earnings	Revenue
Q3 2020	-22.9%	-4.4%
Q4 2020	-12.8%	-1.4%
Calendar Year 2020	-19.0%	-3.2%
Q1 2021	12.9%	3.1%
Calendar Year 2021	26.5%	8.4%

After calendar year 2020 ends, U.S. corporations are going to come up against very easy year-over-year comps. Fiscal-year 2021 consensus expectations call for a whopping 26.5% YoY earnings growth rate, with revenues growing 8.4%.

Market levels reflect optimism about a potential Covid-19 vaccine as the S&P 500 continues to reach new all-time highs and is +6.5% YTD: Investors continue to look through near-term weakness as the world's brightest minds in medicine work towards approval. There are currently eight vaccines in Phase 3, large-scale efficacy tests with many more in earlier Phases and more than 100 in preclinical stages. Continued progress and a fast-tracked approval process could mean that life, and the resulting economic activity, returns to normal levels in 1H 2021. The continued evidence that markets are incredibly forward looking, in part, explains why trying to time near-term market movement generally fails investors.

Forward 12-month P/E ratios remain elevated compared to historical averages, but don't appear stretched: The forward 12-month P/E ratio for the S&P 500 is 22.6, above the 5-year average of 17.0, but not yet at a level to raise concern. Typically, a correction to equity markets is not caused by valuation without a significant premium to historical P/E averages. The index remains buoyed by a lower-for-longer rate environment, as investors must look outside of fixed income in search of returns. We expected U.S. equity markets to continue to rally in 2020 – the path was atypical and far from what we expected, but the result the same. Now, despite an unsolved global pandemic and a looming presidential election, the path of least resistance continues to appear to be higher.

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

Source: FactSet Research Systems

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

Technology continues outperformance, led by mega-cap FAAMG names: While the broader sector's Q2 earnings held steady YoY, revenues grew 3.9% compared to Q2 '19. Part of being comparatively immune to the effects of Covid-19 and shelter in place comes from entering the quarter in a position of strength: strong balance sheets, continuous growth of revenue and earnings, and ability to innovate. Facebook, Apple, Amazon, Microsoft, and Google (Alphabet) continue to move higher off impressive Q2 earnings which beat already elevated expectations. Apple's total return tallies +71.4% YTD resulting in a $2T+ market cap ahead of a 4-for-1 stock split scheduled for the end of August. FAAMG now represents 23.4% of the S&P 500's capitalization (FB 2.3%, AAPL 7.2%, AMZN 4.9%, MSFT 5.7%, GOOG/GOOGL 3.3%).

Overall, we continue to remain cautiously optimistic about domestic equity market returns in the next 12 - 18 months. Given the rate environment and a lower-for-longer policy stance, we favor U.S. equity to fixed income investments. Valuations remain reasonable in a historical context, particularly as revenue and earnings growth is forecasted to return in FY 2021.