Legacy Trust

Investment Perspectives

Strong Start to Q3 Earnings Lifts S&P to New Highs

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Key Takeaways

- S&P 500 earnings have begun and with half of the index having reported, 82% have reported better than expected earnings per share
- Earnings have been underpinned by a strong domestic demand backdrop, despite global supply chain disruption and inflationary pressures from wage growth and commodity pricing
- U.S. equities remain attractive into 2022 due to unattractive alternatives given all-in yields in fixed income and large cash balances for both households and corporations that will lead to net buying and share repurchases

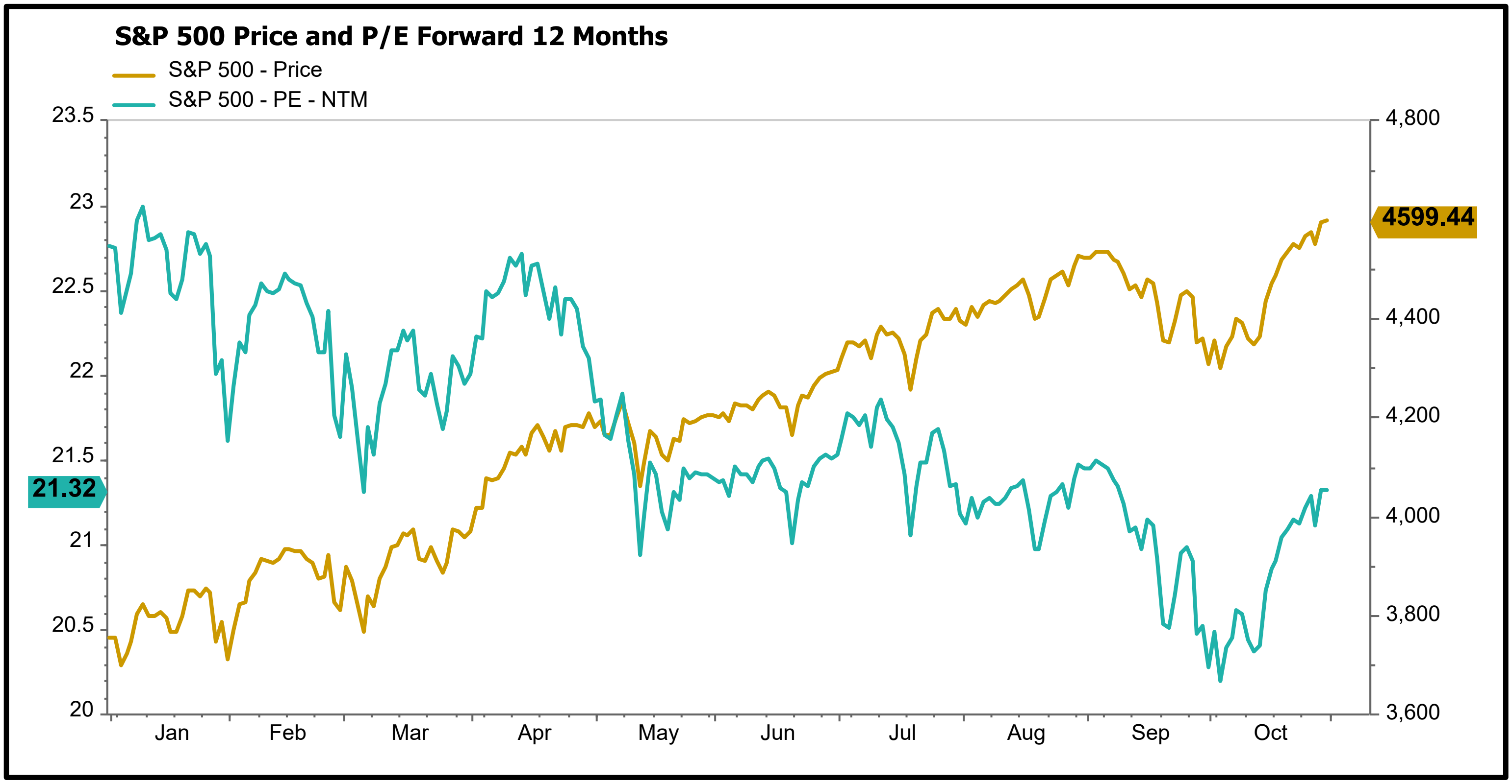
3rd Quarter U.S. Corporate Earnings are underway and with half of the S&P 500 having reported, more companies are beating estimates than average and by a wider margin. Management teams have cited a robust domestic demand backdrop, helping to more than overcome headwinds from inflationary pressures and supply chain disruption. The S&P 500 is +23.8% YTD, supported by strong year-over-year earnings growth, while forward 12-month price-to-earnings multiples have moderated.

With half of S&P 500 companies having reported earnings, early results point to strong year-over-year growth: Of the companies that have reported, 82% have reported EPS above estimates, well above the 5-year average of 76%. For the quarter, the blended earnings growth rate[1] is +36.6% year-over-year. Should that rate hold, it would match the third-highest year-over-year growth rate reported by the index since 2010, trailing only Q1 and Q2 2021. Strength has been broad based across sectors, with Financials, Energy, and Health Care reporting the best results in aggregate through October 29th. Results thus far in the quarter are due to a combination of robust earnings growth driven by a strong domestic demand backdrop, coupled with easier comparisons to year-ago results due to the negative impact of Covid-19 on multiple industries. Earnings reports continue at a blistering pace the first week of November, with another 167 S&P 500 constituents reporting.

The S&P 500 continues to mint new highs, but those who miss estimates are being punished more than average: Companies that have reported below EPS estimates (just 14% of those who have reported) have seen an average price decrease of -3.1% (2 days before announcing through 2 days after reporting) compared to 5-year average of -2.3%. The less favorable price action can largely be chalked up to missing a comparatively low bar entering earnings season given forecasters' inability to confidently project the effects of ongoing Covid considerations and supply chain constraints.

Supply chains remain disrupted globally and fears about input costs and inflation remain: Inflationary pressures have been cause for concern and a frequent topic for management teams across industries on earnings calls. Inflationary pressures have come from a wide variety of sources, but perhaps the most pressing at present are wage inflation in entry level roles and commodity prices, as crude oil has rallied above $80/barrel. At first glance, it appears that many management teams have exercised their ability to pass additional costs onto the consumer, helping to preserve margins. Earnings of McDonald's and Coca-Cola, who operate in low margin businesses, posted impressive earnings beats this week after the companies reported rising demand even in the face of price hikes. While it remains to be seen what components of inflation will prove transitory and which will not, we likely will not continue to see upward pressure of the same magnitude going forward in either wage or commodity pricing.

Supply chains, too, have remained an issue across industries as the lingering effects of Covid continue to hinder consistent production of everything from vehicles to holiday toys. The complexity of a global supply chain means that even as one geographic region normalizes, corporations can still face significant challenges as other regions lag in their ability to return to normal. Few have been spared from the far-reaching effects – Apple missed revenue expectations and CEO Tim Cook cited supply constraints as the culprit given continued constraints caused by industry wide chip shortages and Covid-related manufacturing disruptions in



Source: FactSet Research Systems

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

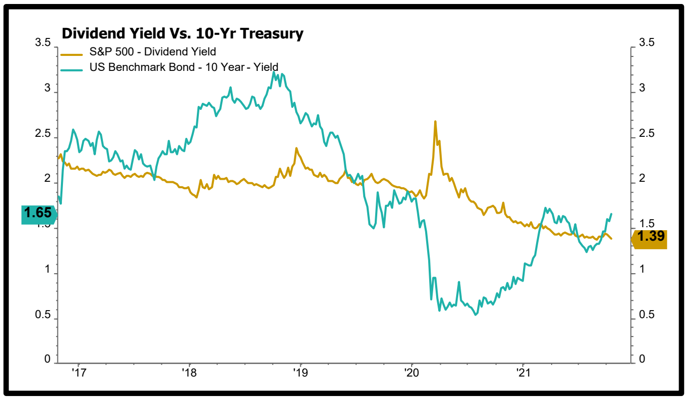
Southeast Asia. In total, the estimated effect on revenue was $6B (miss vs. expectations $1.7B) and the detriments are expected to linger on in coming quarters.

Repair of global supply chains is not immediate, and management teams are prepared to face continuing challenges until at least 2H 2022, but over time improvement is inevitable. In the meantime, expect more of the same, with holiday spending, consumption, and travel only amplifying an already complex situation.

U.S. equities remain attractive given valuations and unattractive alternatives: While the S&P 500 has had an impressive run (+31.4% in 2019, +18.3% in 2020, +23.2% YTD), the path of least resistance remains higher. Markets are very forward looking – at present, market participants are looking forward 6-12 months and have priced a scenario where supply chain issues have moderated and much of the inflationary pressures have proven transitory, while domestic demand and the U.S. consumer remain healthy. Should inflation prove more of an issue in the medium and long-run (unlikely, as technology is the great equalizer to inflationary pressures), equities serve as one of the best hedges to inflation.

Forward 12-month P/E multiples at 21x are elevated (5yr average 18.3x), but don't appear stretched given accommodative Fiscal and Monetary policy paired with strong earnings growth. In fact, valuations on a Forward 12-Month P/E basis have moderated since the beginning of the year, meaning that the entirety of this year's gains and more have come from year-over-year corporate earnings growth rather than multiple expansion. Typically, a correction to equity markets is not caused by valuation without a significant premium to historical P/E averages.

With "lower for longer" interest rates holding true both domestically and abroad, investors with cash are faced with few options given the possible prospect of negative real returns in fixed income markets coupled with cash yields near zero.



Source: FactSet Research Systems