Everything's Different Now

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When we previewed fourth quarter earnings season in January, very few people were focused on a new virus emerging in China. Now, many states in the U.S. and over 100 countries have closed nonessential businesses and restricted their citizens' ability to travel. Market sentiment revolves around coronavirus news and its' impact on the economy. Predicting the effect on earnings against this backdrop is a significant challenge. Highly levered companies have scrambled to shore up their balance sheets, increase cash positions and, in some cases, reduce dividends. Even some financially strong firms have issued debt or drawn down their credit lines. Earnings season will be in full swing by mid April, and we will be looking for insights from company management on plans to navigate the remainder of 2020.

Consensus earnings estimates for the year have started to decline, but it is not a stretch to imagine that more reductions are coming as Wall Street analyst changes tend to lag economic developments. Indeed, an informal poll of institutional investors revealed expectations for another 7% downside to S&P 500 earnings, to $140 in 2020, which would be a 14% decline year over year. A handful of investors expect a decline to perhaps $100, or a 38% drop from 2019. Earnings growth is expected to bottom in second quarter (-19.4%) when the largest number of businesses will be shut down *(Exhibit 1)*. To show how quickly expectations are changing, the expected second quarter decline on April 3 was -14.7%. The current expectation is that the U.S. will begin a recovery in late May or early June, including many people going back to work.

Looking at individual sector estimates, first quarter earnings growth rates appear to be directionally correct. Defensive Consumer Staples companies are expected to report an increase of 0.9% year over year in the aggregate; as they have seen an elevated sales benefit from "stock up" trips to the store which, will be somewhat offset by increased costs. Of some concern for that sector, demand has already started to trail off and there will eventually be an air pocket when consumers decide it is OK to stockpile less toilet paper. Energy, on the other hand, has the lowest expectations (-49% year over year earnings this quarter and -117% next) due to the dramatic oil price decline fueled by a collapse in demand and ongoing price war between large producers. Consumer Discretionary also makes the list for ugly expectations, with predictions for a 28.7% decrease this quarter. The sector is called discretionary for a reason and consumers that are staying home or worried about their jobs aren't buying things they don't need. Industrials are among the most cyclical group of companies, so a 29.6% earnings decline makes sense here too.

Exhibit 1: More Cyclical Sectors Expected to Have the Largest YOY Earnings Declines

Sector	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1
Consumer Discretionary	8.1%	2.7%	1.8%	2.5%	-28.7%	-44.1%	-12.0%	-0.5%	44.3%
Consumer Staples	1.0%	1.7%	3.7%	2.6%	0.9%	-1.4%	2.1%	4.4%	6.7%
Energy	-26.1%	-8.8%	-37.8%	-41.2%	-49.0%	-117.4%	-94.0%	-73.0%	-31.6%
Financials	8.0%	10.0%	2.6%	10.2%	-13.7%	-20.9%	-14.6%	-11.4%	4.0%
Health Care	10.3%	10.3%	8.8%	10.1%	1.6%	-3.2%	5.8%	10.2%	13.9%
Industrials	6.9%	-9.5%	3.4%	-9.3%	-29.6%	-49.6%	-30.0%	-2.9%	27.4%
Materials	-13.4%	-12.7%	-10.9%	-12.4%	-13.5%	-16.5%	-7.5%	1.9%	23.3%
Real Estate	6.2%	3.1%	5.9%	7.0%	1.0%	-2.7%	-2.8%	0.0%	4.5%
Technology	-1.1%	-2.2%	-1.7%	9.2%	2.6%	0.1%	3.8%	6.0%	18.0%
Communication Services	-9.9%	17.6%	-1.4%	8.2%	7.8%	-9.2%	-0.1%	-5.0%	12.0%
Utilities	-0.5%	1.1%	6.7%	17.8%	2.3%	3.4%	2.2%	7.4%	4.4%
S&P 500	**1.6%**	**3.2%**	**-0.3%**	**3.1%**	**-8.1%**	**-19.4%**	**-8.6%**	**-1.9%**	**13.7%**
S&P 500 Ex-Energy	3.0%	3.9%	2.2%	6.1%	-6.6%	-14.7%	-5.1%	0.7%	14.6%

Source: I/B/E/S data from Refinitiv (as of 4/9/20)
Note: Numbers for 2020Q1 and beyond are estimates. Source: I/B/E/S data from Refinitiv (as of 4/9/20)

Learning from the Past

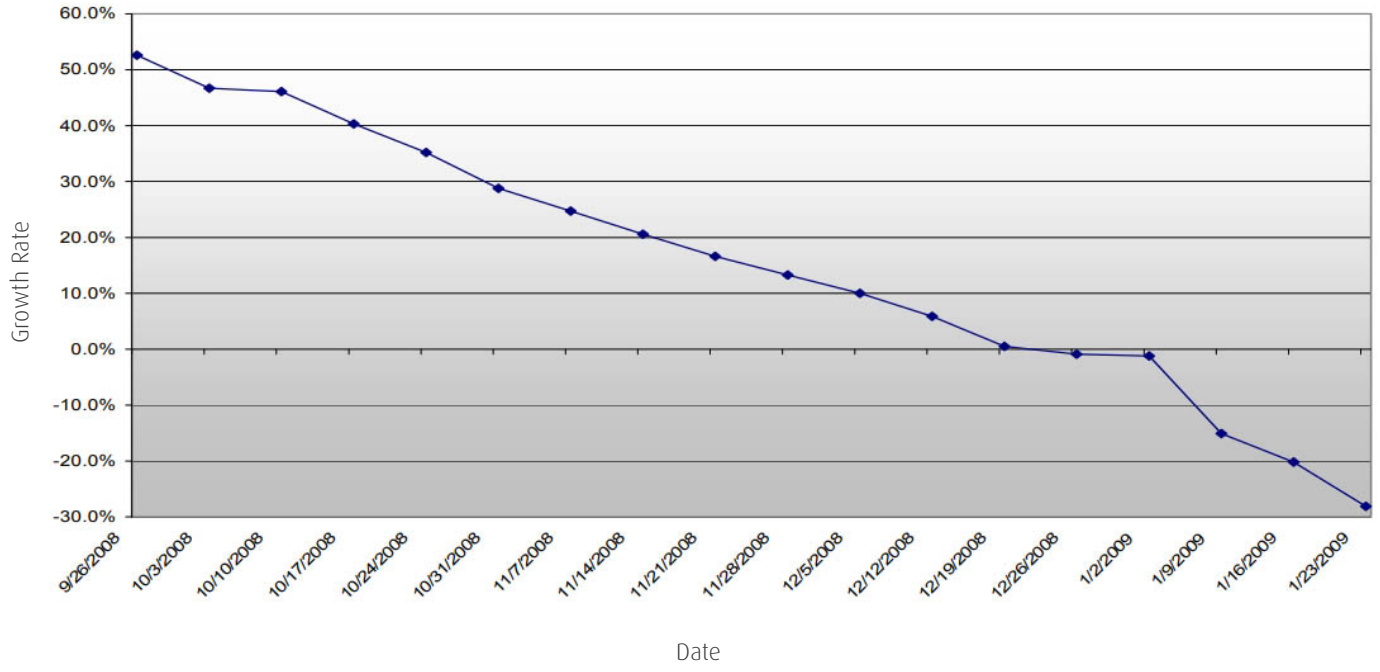
The global financial crisis in 2008 and 2009 was a very different situation, with excesses in the sub-prime mortgage lending market tipping us into recession. However, the economic impact was severe and that experience can give us a glimpse into how much earnings can drop. The lowest earnings for that period occurred in fourth quarter of 2008. Though in September of that year, investors were hoping for a more than 50% rebound from 2007, but by January had concluded that an almost 30% decline was more realistic *(Exhibit 2)*. Once the final tally was in, reported earnings declined 65% for the quarter and 23% for 2008. Financials was the most negatively impacted sector, being the most overexposed to the housing and mortgage markets. Other sectors that contributed to declining estimates included Consumer Discretionary, Materials and Energy. This time around the worst performing sectors are slightly different, but Energy and Discretionary are again in the crosshairs.

Conclusion

The extent of the damage to the U.S. economy will become much clearer over the next few months as we learn how quickly consumers can bounce back and businesses can (hopefully) resume their normal functioning. In the meantime, earnings are likely to be disappointing as the shut down drags on. The sooner we are back to normal, the smaller the hit, and Wall Street looks to be forecasting a trough in late Q2 or early Q3. Should developments prove that timeline optimistic, then additional downward revisions will likely be forthcoming.

Exhibit 2: Estimate Revisions Can Be Significant

Q4 2008: Estimate Revisions
S&P 500: Weekly Change in Q4 2008 Earnings Growth Rate



Source: Refinitiv fka Thomson Reuters (1/23/2009)

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