CURRENT MARKET NEWS

The rocky road to recovery: Second quarter earnings preview

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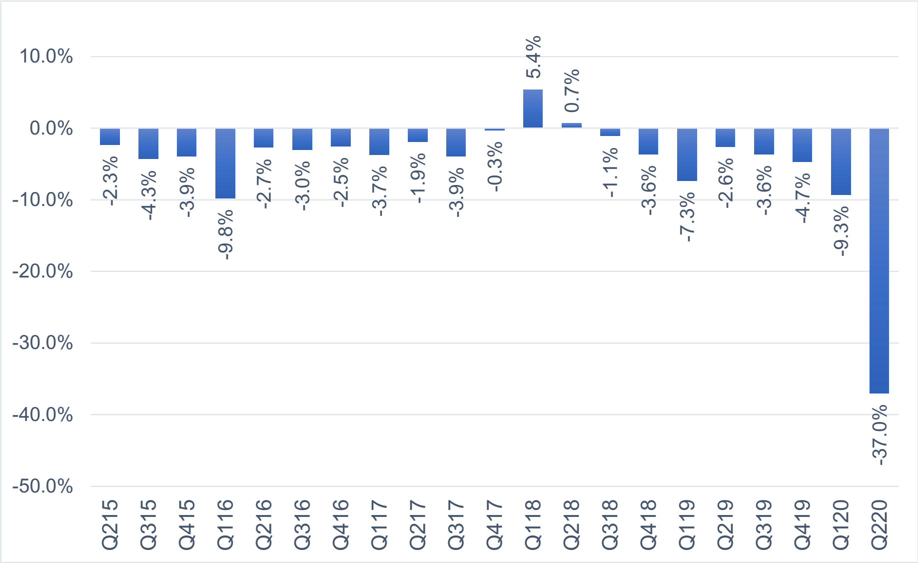
The second quarter began with the closing of many offices, stores and production facilities in response to the Covid-19 spread and government mandated lockdowns. While everyone hoped for a quick return to normal, as the quarter progressed it became clear that was not to be. However, once reopening did begin, consumers responded quickly and sales improved more than many anticipated. But Covid cases then started rising again in several states causing renewed cautiousness. As a result, the quarter ended with high frequency economic indicators from the likes of restaurants, retailers and the travel industry beginning to backslide.

As the shutdown progressed, Wall Street analysts aggressively reduced their estimates for Q2 earnings, and expectations dropped a substantial 37% during the quarter ***(Exhibit 1)***. That breaks the prior record fall (since 2002) of -34.3% seen during the height of the financial crisis. It should be noted that estimates are typically revised lower during the reporting quarter; and have in fact only seen two periods with increases since mid-2015! On average over the past 15 years, estimates have fallen 4.6% during the reporting period. Of course the stock market is forward looking, helping explain how it has managed to rise 15 of the last 20 times that estimates were being cut. (Source: FactSet)

Looking at expectations for the full 2020 calendar year, earnings are now predicted to fall 23.4% from 2019 levels. This equates to a -28.6% decline in estimates since the beginning of the year, which is also a record (since 1996). The closest comparable was 2009, when the annual estimate decreased 24.4% from January - June. One recent positive, however, is that negative estimate revisions have slowed as the Covid impact has become more understood.

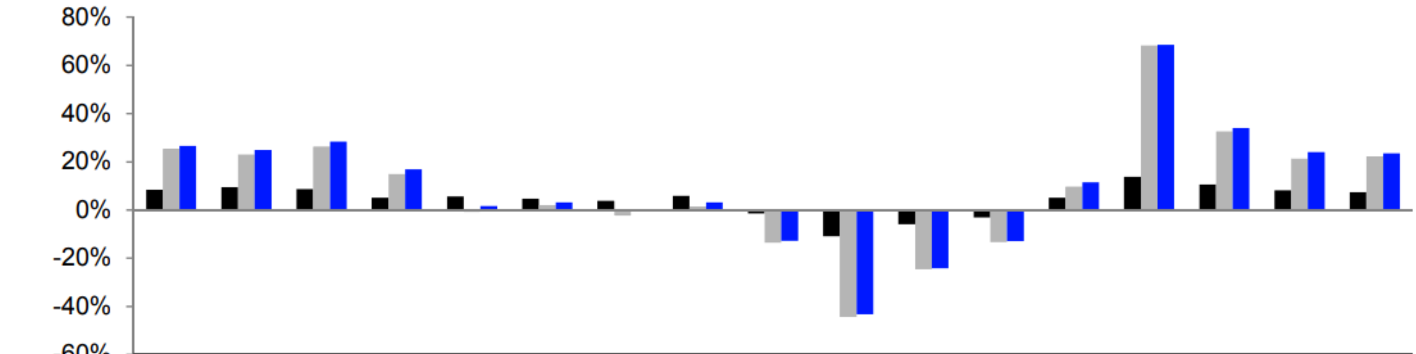
Exhbit 1: % Change in quarterly S&P 500 EPS (start of quarter to end of quarter)



Source: FactSet

The initial bounce in economic activity post reopening, coupled with record earnings estimate reductions, makes us optimistic that second quarter S&P 500 earnings will generally exceed expectations. Analysts currently forecast a 44.2% earnings decline for the quarter ***(Exhibit 2)***, which is also predicted to be the low point for growth. Third quarter results are expected to decline as well, but by a relatively smaller 24.4%. Of course under normal circumstances this would be an awful result, but is actually much improved when compared to the dire second quarter figure. Farther out, 2021 consensus estimates call for a 30.8%

Exhibit 2: S&P 500 YoY Growth Rates



	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2E	20Q3E	20Q4E	21Q1E	21Q2E	21Q3E	21Q4E	22Q1E
Revenue	8.4%	9.5%	8.6%	5.1%	5.7%	4.7%	3.9%	5.8%	-1.4%	-10.9%	-5.9%	-3.0%	5.1%	13.8%	10.6%	8.2%	7.4%
Net Income	25.4%	23.0%	26.3%	15.0%	-0.8%	2.0%	-2.3%	1.6%	-13.6%	-44.3%	-24.5%	-13.3%	9.7%	68.3%	32.6%	21.3%	22.2%
Earnings	26.6%	24.9%	28.4%	16.9%	1.6%	3.2%	-0.3%	3.1%	-12.8%	-43.2%	-24.1%	-12.9%	11.6%	68.6%	34.1%	24.1%	23.5%

Note: Numbers for 2020Q2 and beyond are estimates.

Source: I/B/E/S data from Refinitiv

earnings recovery, which would require corporate America's earnings power to return to 2019 levels. In our view this assumption seems more like wishful thinking than reality. With Covid cases in the U.S. rising but fatalities thus far remaining well below the previous peak, it's too soon to say whether the recent dip in consumer spending is cause for renewed concern. Near-term progress on a vaccine or therapy could raise consumer confidence, but absent that the economy will be dependent on additional government stimulus.

Conclusion

We see potential earnings upside for second quarter 2020, and a few companies like Pepsi (PEP) and JP Morgan (JPM) have already reported stronger than expected results. With states imposing restrictions again as cases increase, third quarter numbers could next be at risk. And due to the heightened uncertainty many companies are not providing guidance, but to the extent that they do offer insights pointing to future improvements, most stocks should react well.

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