MARKET SIGHT LINES



Where Are Earnings Headed? By Michael O'Keeffe, *Chief Investment Officer*



Equity earnings influence equity valuation. Investors are forward looking, and so stock market performance can be driven by not just current earnings but the changing views on future earnings. In this week's Sight|Lines, as we approach the end of summer, we provide a brief update on the results of the second quarter earnings season and share some insights on where we believe earnings are headed as we make our way through this robust recovery.

Positive Surprises

When reviewing S&P 500 earnings, positive surprises have been common. In the last five years, an average of 75% of S&P 500 companies' earnings have beaten expectations, with the positive surprise averaging about 7.8%. The second quarter 2021 earnings results have exceeded that trend.

So far, 472 of the companies in the S&P 500 have reported second quarter earnings. Of these, 88% have beaten expectations, exceeding consensus estimate by about 18.1%, in aggregate. We see the historic monetary and fiscal policy support positively affecting these results and the robust recovery more generally.

Company earnings also provide a wealth of information about the business environment, including pressures that are building.

Company Messaging: Risks Are Building

As inflation has heated up, companies are talking about price pressures and increasing costs. Higher costs mean lower margins, which erode earnings, or higher prices passed on to consumers, which mean higher inflation. Some quotes:

- "We've seen commodity inflation continue to rise. And while it's come down off the peaks, we expect second half commodity expense to be \$1.5 billion to \$2 billion higher than the first half of the year." (*General Motors*)
- "Maybe on the freight side, we've seen some level of cost pressure that is a bit out of the norm at this point in the cycle." (*Apple*)

Supply chains are being disrupted, even as demand for goods and services has increased, depleting inventories. Some companies have lowered their sales forecasts as a result. Some quotes:

- "In Seating alone, production downtime in the second quarter related to semiconductor shortages reduced our sales by approximately \$660 million, or 15%." (*Lear*)
- "Since the start of the third quarter, we are seeing dislocation across the board including in fiber supply...as a result of those dislocations, we have previously provided guidance of 3 million homes passed this year. We're probably going to come in a little bit light of that, probably around 2.5 million." (AT&T)



Many companies are experiencing a labor shortage. Employees have been hesitant to come back to work, are demanding higher wages, and are asking for more flexibility. Companies are having to adjust. Some quotes:

- "Labor availability continues to be an issue across many industries in the U.S., and our businesses are impacted as well." (*Emerson Electric*)
- "Labor shortage is a real issue, probably the single biggest issue that we're dealing with." (*Hilton*)

Finally, there's lots of discussion about the delta coronavirus variant, but uncertainty is high, so companies are not able to factor delta into their forecasts. Some quotes:

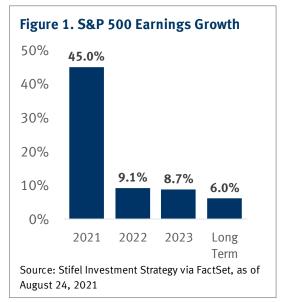
- "No one can forecast the unknown. The delta variant is out there, and our updated guidance does not bake in a shutdown case." (*Sysco*)
- "The most talked-about issue among airline investors recently, the delta variant. As you'll hear from our bullishness today, we haven't seen any impact at all on bookings, which continue to just get stronger and stronger every week, but of course, that is backwards-looking data." (*United Airlines*)

These building risks are influencing earnings forecasts from here.

Earnings Growth Declining

Figure 1 presents forecasted earnings and earnings growth for the S&P 500 for the balance of this year as well as next year and beyond. For the last two quarters of the year, analysts are projecting EPS growth rates above 20%, bringing the full-year 2021 EPS growth rate to 45%. For the subsequent two years, the pace of earnings growth is expected to moderate but still remain above the historic average.

Stock market returns have been positive this year, with the S&P 500 up about 20.6% year to date. Clients often ask: Given the slowdown in earnings growth, where do stocks go from here? As mentioned, equity investors are forward looking, meaning they've likely taken into account this slowdown in earnings growth. Historically, market returns, while still positive, have typically moderated following the initial rebound from a bear market and recession. So, what matters from here? The next stage of the market cycle is usually driven by the quality and growth of company earnings rather than multiple expansion. So, we are focusing further on "quality" in our portfolios while still favoring cyclical assets and those more closely correlated to economic growth.



Conclusion

Stock market results are driven by current earnings and the changing views on future earnings. The second quarter earnings season has been positive, but business risks are building, and a slowdown in earnings growth is expected looking forward. We expect that through the balance of the year and into 2022, many of these pressures companies are facing will subside, but the big question is: Will results be better or worse than expected?

Michael P. O'Keeffe, CFA

Chief Investment Officer michael.okeeffe@stifel.com



The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0821.3734259.1

