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MARKET SIGHT LINES

Where Are Earnings Headed?

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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*)

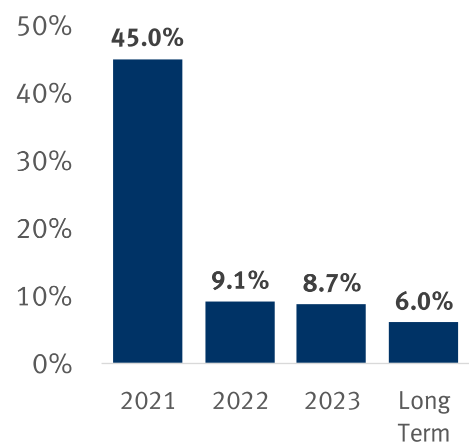
These building risks are influencing earnings forecasts from here.

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.

Figure 1. S&P 500 Earnings Growth



Source: Stifel Investment Strategy via FactSet, as of August 24, 2021

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?

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