MARKET
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Good News Amongst the Bad: Earnings Recovery

The coronavirus pandemic of 2020 has been a decidedly unexpected shock to the system. Though unexpected, the shock triggered a severe recession and decline in company earnings. As I reflect on recovery, the idea of an external shock got me thinking about how economists frame this, and I was reminded that a business cycle contraction may be triggered by internal (endogenous) forces or external (exogenous) causes. No one would argue, I think, that this recession was triggered by an external shock, a pandemic that caused the economy to shut down.

Second Quarter Earnings Season

As is our practice, we're digging into second quarter earnings results in this latest "earnings season." From the timing of the shutdown and the reopening, we know that this will be the quarter most negatively impacted by the pandemic shutdown. So, let's consider the results. With almost all the companies in the S&P 500 reporting, we've learned that second quarter earnings fell -31.7%, as compared to the second quarter in 2019. Believe it or not, there is some good news embedded in these results.

If we go back as recently as June 30, analysts were forecasting a more negative result. The consensus estimate was for a -44.1% decline in second quarter earnings, compared to a year ago. At the time, analysts expected all 11 sectors to post earnings declines. But as earnings season unfolded, 84% of S&P 500 companies reported better-than-expected earnings, meaning a positive earnings surprise. And while eight sectors still posted declines, three posted earnings growth, led by utilities at +9.2%, healthcare at +8.3%, and technology at +3.4%. This 84% with positive earnings surprise is the highest such percentage since FactSet began tracking this metric in 2008.

Earnings Per Share (EPS) Guidance

Over the last five years, each quarter, an average of 106 companies chose to offer forward guidance on their future earnings per share (EPS). Such guidance has leaned negative, with 31% of these companies offering positive guidance, and the rest neutral to negative. Unsurprisingly, given the uncertainty and the unknowns of the coronavirus pandemic, only 65 companies chose to offer EPS guidance in this earnings season. But a little more good news in these results: 68% of this guidance is positive, well above the 31% average over the last five years.

Path to Recovery

Consensus forecasts offer a view of one path to earnings recovery for the S&P 500. Third quarter 2020 earnings are forecasted to be -22.4% below third quarter 2019. Fourth quarter 2020 earnings are forecasted to be -13% below fourth quarter 2019. But then first quarter 2021 earnings are forecasted to be +13.2% above first quarter 2020. So earnings growth is expected to return in 2021.

Another Lens: Annual Earnings

While a look at the year-over-year changes to quarterly earnings helps us understand earnings declines and earnings growth, another metric commonly used to assess earnings and their effect on stock market levels are annual earnings. So, for example, it is common to watch how the market's past year of earnings is changing over time. Given the speed with which earnings have declined and started to recover in this environment, the annual results are a little less dramatic.

Consider Table 1. As we track the annual earnings of the S&P 500 through time, we see the peak-to-trough decline in 2020 is -16%. From the trough, which occurred in June, the consensus forecast is for annual earnings to recover in five quarters (15 months), or by September 30, 2021.

Table 1.

Peak-to-trough Decline

		S&P 500		Months to Recovery	
	U.S. Real GDP	Trailing 12 Month Earnings	Return	S&P 500	Earnings
2020	-10.2%	-16.0%	-33.9%	5	15*
2008-2009	-4.0%	-49.2%	-56.8%	48	54
2001	-0.6%	-25.9%	-49.1%	55	42
1990-1991	-1.6%	-38.8%	-19.9%	4	60
1981-1982	-2.6%	-18.2%	-27.1%	3	30
1980	-2.2%	-5.9%	-17.1%	3	18
1973-1975	-3.7%	-31.9%	-48.2%	81	24
1969-1970	-1.4%	-15.9%	-36.1%	22	36
1960-1961	-1.3%	-14.6%	-28.0%	15	24
1957-1958	-3.6%	-18.0%	-21.6%	11	9

**Based on estimates*

Historical Analysis

Table 1 also provides some context for the 2020 earnings experience, as compared to history. The -16% is a "middle of the road" result. Of the 10 recessions listed since 1957-1958, the average annual earnings decline was -23.4%. So, in fact, 2020 has been better than average in terms of the magnitude of decline. And then consider the estimated time to full recovery of 15 months. This is much better than the average recovery period of 31 months.

Market Implications

Finally, Table 1 provides a look at the peak-to-trough market returns in each of these periods. The 2020 experience of -33.9% is in line with the average decline of -33.8%, but the speed of the market recovery has been faster than most. Given the speed with which earnings appear to be recovering as the economy reopens, the market seems to be pricing more to future, recovered earnings.

Of course, there are currently a number of factors influencing the markets, each of which may impact earnings and corporate performance. The 2020 elections are less than two months away, and a Democratic sweep would likely result in higher taxes and increased regulation. A focus by the Trump administration to lessen our dependence on trade with China will disrupt supply chains and may increase expenses. And, of course, the path of the virus, and the related reopening, will influence earnings and the markets. We await news on an approved vaccine and the feasibility of getting enough of the population inoculated to stamp out the virus. This timing will impact company performance and earnings.

Conclusion

The 2020 pandemic has been all about speed: the speed of the spread, the rapid shutdown, and the measured, but fast-paced reopening. This has led to a quick fall in stock market earnings, but then a rapid recovery, by historical standards. The stock market decline and recovery have been even faster. The path of earnings recovery, and other drivers of market volatility, will remain in keen focus.

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