QUINTET PRIVATE BANK

COUNTERPOINT WEEKLY

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SECOND QUARTER EARNINGS

WHAT YOU NEED TO KNOW

- With 89% of companies having so far reported quarterly earnings in the US and 77% in Europe, second quarter earnings are down around 9% year-on-year (yoy) in the US, but have come in a lot better than expected – a sign that consensus expectations were very conservative.
- The second quarter reporting season is once again showing marked differences between a much stronger-than-expected US earnings season and that of European companies. As mentioned previously, this is a good reminder that sector composition matters when assessing the prospects for regional equity markets.
- This earnings season is showing that markets are far from efficient in forecasting growth prospects. Amid our more constructive macro view, we maintain our overweight equities and our regional and sector views are unchanged, with a clear preference for information technology and healthcare, and, regionally, a preference for US equities and emerging market equities over their European and Japanese counterparts.

EARNINGS DOWN LESS THAN EXPECTED

With the number of companies that have reported so far, earnings in the second quarter are down by approximately 9% yoy in the US and by 19% yoy in Europe. In both regions, the biggest detractors in absolute terms have been similar, with the more cyclical sectors lagging, such as energy, industrials, autos and materials. Conversely, more defensive sectors have fared better, including utilities, healthcare and telecoms, but also technology and internet-related consumer services.

The divergent performance between regions is simply down to the different sector composition of the regional indices as mentioned last quarter.

Q2 EPS SUMMARY

Data to 10/8/20	US - S&P 500	Europe - Stoxx600
% Companies reported	89%	77%
% Companies beating EPS estimates	84%	63%
EPS Growth yoy	-9%	-19%
EPS growth surprise vs expectation	21.91%	32.48%
Top 3 sectors EPS growth	1. Utilities	1. Consumer Services
	2. Health Care	2. Technology
	3. Consumer Goods	3. Telecommunications
Bottom 3 sectors EPS growth	1. Oil & Gas	1. Oil & Gas
	2. Basic Materials	2. Consumer Goods
	3. Financials	3. Basic Materials

Source: Bloomberg

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POSITIVE SURPRISES ARE BACK

For markets, the rate of change versus expectations matters. In the US, around 84% of companies have beaten EPS expectations, versus only 63% in Europe. If this figure holds in the US, it will be the highest surprise ratio since data records began in 2008. In the US, companies are on average reporting earnings per share that are around 20% higher than estimates – a record.

At a sector level, we saw positive surprises from the consumer goods sector, which beat analysts' expectations both in the US and in Europe. In the US, consumer products companies such as Procter & Gamble exceeded expectations, as did housebuilders – not so much of a surprise given the dynamics of the US housing market we have discussed in previous Counterpoint dailies. In addition, car manufacturers like Ford and Volkswagen reported much lower losses than expected. In the US, the consumer services sector was boosted by the strong profits recorded by Amazon.

Market performance had recently picked up for cyclical sectors such as industrial and materials. As it happens, the companies' operational performance in these segments generally came in higher than the market expected. The industrials sector has also seen handsome beats, including transport companies UPS, FedEx and DSV Panalpina. Aerospace and defence companies Raytheon and Lockheed Martin also fared well. The materials sector (including Dow and Linde) also posted solid beats, with chemical companies performing better than analyst expectations.

Q2 SECTOR POSITIVE AND NEGATIVE SURPRISES

Earnings Surprises	US - S&P 500	Europe - Stoxx600
Top 3 surprises (by # of companies)	1. Technology 2. Consumer Goods 3. Industrials	1. Consumer services 2. Healthcare 3. Materials
Bottom 3 surprises (by # of companies)	1. Consumer services 2. Financials 3. Oil & Gas	1. Utilities 2. Financials 3. Oil & Gas

Source: Bloomberg

Earnings Surprises	US - S&P 500	Europe - Stoxx600
Top 3 surprises (by growth rate)	1. Consumer goods 2. Telecommunications 3. Health Care	1. Basic Materials 2. Financials 3. Consumer services
Worst 3 surprises (by growth rate)	1. Utilities 2. Financials 3. Technology	1. Consumer Goods 2. Financials 3. Telecommunications

Source: Bloomberg

SALES

Given that most of the second quarter was spent in lockdown, the bulk of the drop in sales for businesses is being reflected in the current reporting season.

Similar to last quarter, sales are down a lot more yoy in Europe (-25%) than in the US (-11%), which, as previously discussed, is mainly down to different stock and sector composition. There is a notable difference as well in that sales for the US are coming in well ahead of expectations (an all-time high beat ratio) while in Europe sales growth is coming in notably lower than expected.

The US has been helped primarily by its higher exposure to the tech, internet and healthcare sectors. Part of our rationale for favouring the healthcare and tech sectors in our asset allocation is the more sustainable growth profiles of the sectors in aggregate – we acknowledge that these sectors are by no means homogeneous and that sub-sector dynamics are at play.

Europe in contrast boasts larger exposure to "old economy" sectors that have been hit hard in the recent recession, such as the automotive subsector within consumer goods, and the 'physical' consumer services stocks like Sodexo and Kering.

Versus expectations, Europe has also seen headwinds from specific companies within sectors such as energy (Royal Dutch Shell) and utilities (Enel, the largest stock in the Italian market), where results have come in well below expectations.

Elsewhere, it's been an interesting quarter for the banks, where numbers have generally come in ahead of expectations. Looking into the details, trading revenue was strong and generally offset the increase in loan-loss provisions for several major players. With high uncertainty surrounding the sector's future credit losses related to the Covid-19 recession, we continue to shy away from the sector.

Q2 SALES SUMMARY

Data to 10/8/20	US - S&P 500	Europe - Stoxx600
% Companies reported	89%	77%
% Companies beating Sales estimates	63%	62%
Sales Growth yoy	-11.15%	-25.05%
Sales Growth surprise vs expectation	1.34%	-3.57%
Top 3 Sectors by Sales Growth	1.Technology 2. Health Care 3. Telecommunications	1.Financials 2. Technology 3. Telecommunications
Bottom 3 Sectors by Sales Growth	1. Oil & Gas 2. Basic Materials 3. Consumer Goods	1. Oil & Gas 2. Consumer Goods 3. Consumer Services

Source: Bloomberg

LOOKING AHEAD

The unprecedented nature of the Covid-19 recession, which has brought sales down between 30% and 50% for a lot of industries, is leading to large divergences in operational performance between companies. The trends are therefore far from homogenous within sectors and bottom-up stock selection remains key going forward.

Equities are a long-duration asset, with earnings projected into perpetuity. Rather than the next quarter or the next year, we prefer to keep an eye on medium- to longer-term earnings and sales growth expectations. In this regard, when looking at the next three years of expected earnings, expectations continue to be revised down for the UK, Europe and Japan, while they are being revised higher in the US and emerging markets.

ASSET ALLOCATION IMPLICATIONS

We remain overweight to equities and riskier bonds within fixed income, given our view that the world will continue to “repair” in the coming months and quarters, supported by substantial fiscal and monetary policy.

We believe the most important near-term drivers of equity markets will be:

1. Vaccine news flow
2. Further fiscal stimulus
3. Investor risk appetite

Within equities, our positioning continues to favour the sectors we believe to be attractive in the long term, such as healthcare and information technology. This leads us to remain overweight US and emerging market equities.

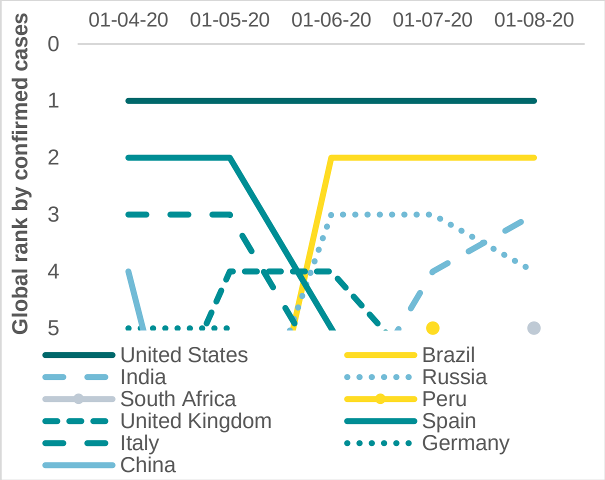
COVID-19 WATCH

Globally confirmed cases of Covid-19 have now exceeded 20 million, up from approximately 18 million seven days previously. The US, unenviably, recorded its five millionth case, while Brazil surpassed 100,00 confirmed deaths – a figure only matched in official records by the US.

There was better news in Western Europe. For the first time since the earliest stages of the pandemic no European country featured in the top 10 countries by number of confirmed cases, with Spain and the UK now lagging Colombia, Chile and Iran.

While confirmed cases data is subject to the limitations and rigor of testing it is noteworthy to consider how global rankings have changed over time. As the chart shows, the US has had the highest number of total confirmed cases throughout the second and third quarters. In contrast, Western European countries such as Spain, the UK, Italy, and Germany, while badly hit in April and May, were able to manage their outbreaks and started to descend the rankings. In their place came populous emerging market countries such as Brazil, India and Russia.

COVID RANKINGS OVER TIME



Sources: Ourworldindata.org, CDC

As the centre of the pandemic has shifted from Asia to Europe to the Americas we, as investors, watch closely as new Covid-19 hotspots emerge in the Indian sub-continent and in South Africa.