The song remains the same: bumping up S&P 500 earnings and targets

Booming economy, surging earnings

Second quarter earnings season gets underway this week, and our Chief Investment Office for Global Wealth Management (CIO) expects another very strong set of results. On a year-over-year basis, CIO looks for S&P 500 profits to surge more than 80% on revenue growth of 15%. Obviously the very depressed level of profits in the second quarter last year—during the height of the lockdowns—is distorting year-over-year growth rates. But still, the second quarter result should be a new all-time quarterly high. At a sector level, the growth is being driven by a powerful rebound in cyclical areas such as energy, financials and industrials but even the tech sector should see profit growth of 30%. The ebbing of the pandemic and the massive government response to it are the primary drivers of the profit surge.

CIO’s estimates for the second quarter imply that S&P 500 earnings will beat consensus estimates by 15%. The bottom-up consensus suggest earnings will decline by 8% relative to the first quarter. This makes little sense to CIO. Historically, second-quarter EPS is usually 7% higher than first-quarter EPS, driven by a pickup in overall economic activity as the winter gives way to warmer weather. This year’s second quarter could get an even larger-than-normal lift versus the first quarter based on the timing of the easing of the pandemic. For example, according to Bloomberg consensus estimates, economists expect real GDP to be 9.2% (annualized) higher in the second quarter versus the first quarter—the second highest quarterly growth rate since 2000. Recent economic data supports this strength. Air travel and restaurant reservations made through OpenTable continued to improve in 2Q and are at or above pre-pandemic levels. Many consumers are itching for a sense of normalcy and household balance sheets are flush with cash suggesting spending has been—and will continue to be—solid.

What CIO is seeing so far—and what to expect

While it is still early, the 18 companies that have already reported results are off to a strong start. Ninety percent are beating earnings estimates by about 18% in aggregate. Across sectors, CIO expects the more cyclical areas to drive a large chunk of the beats which is consistent with results in recent quarters.

In the last couple of earnings seasons, large earnings beats have not always been rewarded by the market. CIO can’t rule out a similar experience this earnings season. But CIO advises investors to not lose sight of the big picture. Despite the somewhat mixed initial reaction to positive earnings news, the S&P 500 is up 17% this year. Perhaps not coincidentally, the bottom-up estimate for 2021 has risen a similar magnitude—up 15%. In terms of sector performance, energy and financials are two of the best performers. They are also producing the best earnings growth. At the other end of the spectrum, utilities and consumer staples have lagged the most and, not surprisingly, these sectors are producing the slowest earnings growth. So, earnings matter. But the initial reaction to the announcement may not paint the complete picture.

As always, management teams’ commentary about the outlook will be crucial. Investors will likely be keenly focused on any discernable impact from the recent uptick in COVID-19 cases due to the delta variant. CIO does not think activity levels have yet been affected by the higher case counts, but management teams might highlight it as a potential risk to the outlook. Wage, shipping and supply chain costs will also be top of mind. While costs are clearly rising, robust revenue growth is more than compensating and net profit margins should hit a new all-time high. Typically, margins take...
their cue from revenue growth. When revenue growth is strong, margins rise, even if costs are also rising. Finally, as economic activity continues to normalize, CIO expects more companies to ramp up their investment plans, especially considering that capital spending looks quite low relative to depreciation. Strong corporate profits mean that companies should also be able to fund dividend increases as well as larger share buyback programs.

More upside ahead
Even though the breadth of positive earnings estimates revision is at the highest rate in 35 years, CIO believes EPS estimates are still too low. The economy remains on solid footing, and although growth will slow, it will remain above-average for several quarters. Businesses are scrambling to add capacity and rebuild inventories. And consumers still have huge pools of savings to tap into to support additional economic activity. The Fed will likely begin to start tightening monetary policy, but it will happen at a snail’s pace, ensuring that businesses and consumers still have ample access to capital. As a result, business sentiment as measured by the ISM Manufacturing index should remain very healthy.

Solid business sentiment readings typically correspond to continued positive earnings revisions. While CIO maintains its above consensus 2021 EPS forecast of USD 200 (40% growth), CIO bumps up its 2022 estimate by USD 5 to USD 220 (10% growth). CIO’s 2022 estimate includes a 4-5% drag from higher corporate taxes.

With CIO’s higher earnings estimates, it lifts its S&P 500 price target for both December 2021 and June 2022 by 100 points to 4,500 and 4,650, respectively. CIO’s price targets assume a forward P/E of 20.5x—slightly below today’s 21.6x P/E. While valuations are high and remain above historical averages, they are reasonable in the context of very low interest rates. Valuations typically only contract when investors fear a pronounced growth slowdown is in the cards or central banks are making a policy error. CIO’s outlook for healthy ISM readings over the next year also suggests further upside for stocks.

Positioning—maintain a cyclical tilt
Despite recent underperformance, CIO continues to recommend a cyclical tilt in portfolios. Across sectors, CIO has a moderately preferred view on consumer discretionary, energy, financials, and industrials and a less preferred view on consumer staples and utilities. In CIO’s view, value stocks look more attractive than growth stocks.

Consumer discretionary companies should continue to benefit from the reopening, especially in retailing, restaurants, and hotels. Low mortgage rates and secular growth in e-commerce bolster the outlook. Increasing demand for oil and prudent capital discipline should keep oil prices well-supported and drive very attractive free cash flow for energy companies. Although interest rates have fallen since the hawkish Fed surprise in June, CIO expects this trend to reverse and drive financial sector outperformance. Industrials should benefit from a rebound in aerospace and a further pickup in capital spending. CIO’s cautious views on consumer staples and utilities are driven by their defensive nature. These sectors tend to lag the market when earnings revisions are positive.

Despite the surge in growth stocks that has led to roughly 10 percentage points of outperformance over the last five weeks, CIO maintains its preference for value stocks. CIO believes the recent setback in value was driven by concerns about new virus variants, the risk that the Fed may raise rates too quickly, and technical factors within the Treasury market.

As CIO has highlighted in recent blogs, the two key pillars of its recommendation are higher long-term interest rates and strong earnings growth. While the new variants are a concern, activity levels have remained healthy in highly vaccinated countries that are contending with rising cases due to the delta variant, such as the UK. The US could experience something similar.

And as CIO has explained above, the current, strong economic momentum will likely persist due to strong business and consumer fundamentals. During periods of higher-than-average GDP growth, value earnings typically grow at a faster pace than growth earnings. Furthermore, as a result of this favorable economic outlook, CIO’s fixed income team expects the 10yr Treasury yield to rise, reaching 2% by year-end. Higher rates would benefit profit growth for financials (the largest sector in the value index) and would be a headwind for growth stock valuations. Speaking of valuations for growth stocks, they look lofty. The growth index forward P/E is at its largest premium relative to value since the dotcom bubble.