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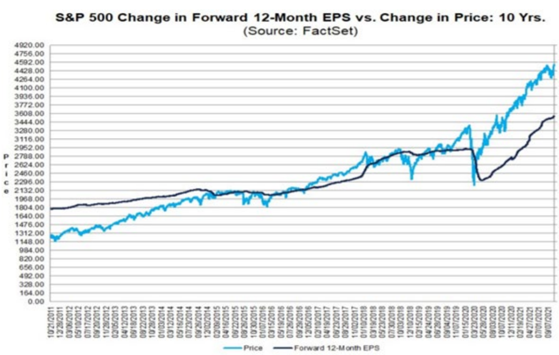
BLOG POST
Earning on Up
11/02/2021

Sentiment may dictate short-term moves in equities, but most investors will agree that a companies' earnings ultimately determine the direction of a stock. We are about halfway through Q3 earnings reports, and some interesting trends have emerged. According to FactSet data, almost 75% of companies have reported higher revenues than forecast and just above 80% of companies reported a positive earning surprise. These initial results are primarily why markets are back near all-time highs, particularly among tech stocks.

Earnings growth is poised to come in above 32% year-over-year, making it the third highest growth rate in the last 48 quarters. But before we pop the bubbly and declare the markets safe, there are other signs that may be pointing to turbulence ahead. Forward guidance has been soft, with twice as many companies guiding lower than expectations than companies guiding higher. Valuations are also beyond stretched at this point. The forward P/E ratio sits at 21, well above the 5-year average of 18 and 10-year average of 16. Those claiming the market is 30% overvalued are simply solving a math equation at this point.

Another concerning data point comes from professional portfolio managers who manage publicly traded funds. As of October 15, according to BAML, cash levels at equity mutual funds are higher than at any other time in the last 12 months. With the recent lift in stock prices, it is clearly getting more difficult to find stocks that you feel good about the valuation.

It is somewhat baffling how earnings can be so strong given the supply chain disruptions evidenced by the ships unable to port and offload containers. Sectors like Consumer Cyclicals are bearing the brunt of supply chain issues, which at this time are only impacting goods shipped to the U.S. The most surprising data involves companies who rely heavily on exporting their products and services. S&P 500 companies that generate over 50% of revenues from sales outside the U.S. are reporting 44% earnings growth, versus only 26% growth for companies with a majority of sales in the U.S. Not surprisingly, it is tech companies (Apple and Alphabet) and energy companies (Exxon and Chevron) leading the way with these four companies alone accounting for almost 30% of foreign sales, according to FactSet.



Financials have clearly been helped by the trend toward higher yields, and as a group have reported Q3 earnings more than 19% above consensus. Healthcare had the next highest positive surprise at over 12%, which could be tracked to spending on battling COVID (Abbot Labs and Quest Diagnostics). Somewhat confounding given the media attention on inflation, the Materials sector was reporting both the lowest percentage of companies beating estimates and the lowest overall upside surprise.

Before we forecast these strong earnings indefinitely into the future, there are a few factors we should consider. First, the year-over-year comparisons are against a weak backdrop as the economy was coming out of recession in 2020 following the onset of the pandemic. Many industries were still severely impacted 15 months prior as demonstrated by the Airlines contributing more toward earnings growth than any other group. Second, most industry insiders do not use the published consensus numbers, but rather the "whisper" number, when evaluating a company's performance. Companies try very hard to manage the expectation in a way that almost ensures they will beat consensus estimates. There is also a whisper estimate that is what analysts closely following the company expect the company to report. This explains why a company can beat consensus and see their stock drop if they do not exceed the whisper figure.

Of the companies reporting so far, only 37% have beat the higher whisper estimate (earningswhisper.com). This suggests that the number of companies actually producing higher earnings than experts forecast is much lower than the consensus numbers. It will be interesting to see how well companies are able to manage forward expectations given the lower guidance. As expectations rise, it clearly becomes more difficult to report positive surprises.

The biggest concern for investors should be valuations, as the chart clearly demonstrates. For the last 10 years, the correlation between EPS growth and Price growth has been remarkably strong until COVID hit. Stocks recovered from the price drop much faster than EPS recovered, and the gap between Prices and EPS is the highest it has been in decades. History is clear -- that gap will get closed either by stock prices plummeting or by EPS rising sharply. This suggests it might be a good time to consider increasing hedges in portfolios.