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5 EARNINGS SEASON TAKEAWAYS

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Corporate America delivered on expectations and then some during a second quarter earnings season that some are calling the biggest upside surprise ever. We recap the results, share five key takeaways for investors, and discuss our near-term outlook for stocks with the S&P 500 Index near record highs.

MUCH BETTER RESULTS THAN ANTICIPATED

Earnings blew away expectations that ended up being way too low. With 92% of S&P 500 Index companies having reported results, the average upside surprise has been 22%, which we believe is the highest ever recorded going back several decades. At 82%, the percentage of S&P 500 companies that beat earnings targets is the highest since FactSet began tracking that statistic in 2008. Earnings are still tracking to a significant 33% year-over-year decline, but that's certainly better than the 45% decline reflected in analysts' estimates when reporting season began (source: FactSet).

WHY WERE ESTIMATES OFF BY SO MUCH?

We think estimates were off because analysts may have been guessing in many cases because of the lack of guidance from companies' management teams. Other reasons we think played a role include:

- Analysts underestimated companies' ability to cut costs.
- Analysts were surprised by the US economy's ability to bounce back as states reopened.
- Analysts underestimated the size and impact of fiscal and monetary stimulus.
- US dollar weakness provided an unexpected tailwind for multinationals' profits
- Companies that provided guidance had every reason to be conservative, given the uncertainty.

Results were good enough relative to expectations to prompt us to raise our 2020 S&P 500 earnings per share (EPS) estimated range to \$125–\$130 from \$120–\$125, as we noted in our August [Global Portfolio Strategy](#) publication **[FIGURE 1]**. Stocks are taking cues from earnings estimates in 2021 and beyond, based on currently elevated valuations, but a potentially higher base in 2020 may improve prospects for 2021 earnings.

1 2020 MARKET FORECASTS—COVID-19 CREATES SIGNIFICANT EARNINGS AND INTEREST RATE UNCERTAINTY

	Bull Case	Base Case	Bear Case
10-Year US Treasury Yield	1.5–2%	1–1.5%	0–0.5%
S&P 500 Earnings per Share	\$130+	\$125–130	\$110–115
S&P 500 Fair Value	3,450+	3,250–3,300*	2,650

Source: LPL Research, Bloomberg 08/14/20

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

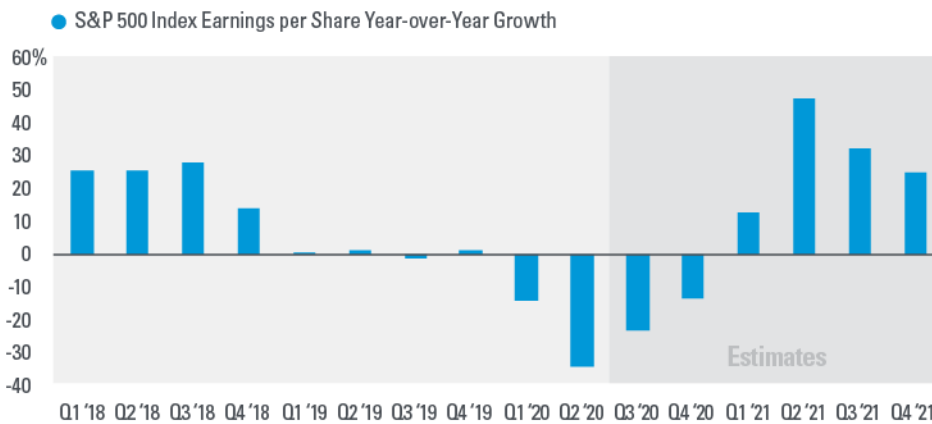
*As noted in our [Midyear Outlook 2020](#) dated 07/14/20, our year-end fair-value target range for the S&P 500 of 3,250–3,300 is based on a price-to-earnings ratio (PE) near 20 and potential normalized S&P 500 earnings per share (EPS) of \$165 in 2021–22.

FIVE TAKEAWAYS

Our top five takeaways from second quarter results are:

- 1) **All of the earnings decline came from four sectors.** The four sectors that have been among the hardest hit during the pandemic—consumer discretionary, energy, financials, and industrials—drove the entire earnings decline for the S&P 500. That means seven S&P 500 sectors were impressively around flat, collectively, in one of the worst quarters for the US economy in 100 years.
- 2) **Best pandemic performers were mostly on the growth side.** The Russell 1000 Growth Index is tracking to a 4% year-over-year *increase* in earnings for the second quarter. Meanwhile earnings for the Russell 1000 Value Index are tracking down 40% year over year. The so-called “stay-at-home” stocks, whose leadership positions have strengthened during the pandemic, are mostly found in the growth indexes—big cap technology and internet stocks in particular. We continue to believe growth-style stocks are well positioned to maintain leadership over value style in the near term, despite signs of life from value recently.
- 3) **Surprisingly upbeat guidance offered.** Estimates for future quarters have tended to fall as earnings were being reported in previous seasons. This quarter was a different story, with a 1.4% increase in the next 12 months’ S&P 500 earnings estimates since the second quarter ended, reflecting upbeat guidance from Corporate America. While that may not seem like much, and we still may not see positive earnings growth until early 2021, this encouraging development increases the chances that estimates for the third and fourth quarters may prove to be too low [\[FIGURE 2\]](#).
- 4) **Recent economic data bodes well for the outlook.** The upside surprises and increased estimates during earnings season supported our decision to increase our 2020 estimates for S&P 500 profits. But that’s not the whole story. Recent strong economic data relative to expectations may increase the probability of more upside surprises. The Citi Economic Surprise Index—a measure of the frequency with which economic data beats consensus forecasts—is near its all-time high set in July and well above pre-pandemic highs (data back to 2003). Bloomberg’s version of that index is near a 20-year high.

2 COVID-19 DELIVERED A SIGNIFICANT BLOW TO CORPORATE PROFITS



Source: LPL Research, FactSet 08/13/20

The economic forecasts may not develop as predicted.

The July employment report, the latest weekly jobless claims numbers, and the Institute for Supply Management (ISM) manufacturing and services indexes are recent examples of economic reports that came in better than expected.

- 5) **Don't forget about the dollar.** The nearly 5% drop in the US Dollar Index so far in the third quarter, which boosts internationally sourced profits for US multinationals, bodes well for the near-term earnings outlook.

GOOD PROBLEM TO HAVE

The S&P 500 has already eclipsed the high end of our 2020 year-end fair-value target of 3,300, which raises the question of whether the target should be raised. We are not inclined to make that move right now, although we know that may signal some pessimism for stocks.

While 3,300 on the S&P 500 may look pessimistic at this point for a year-end S&P 500 fair-value target, we do not want to send a signal to investors to be more aggressive with equities in portfolios at this time for several reasons: We think a pullback may be overdue. The election could drive volatility. The next leg of the economic recovery may get tougher. US-China tensions are ratcheting higher. And, stocks may be disappointed if lawmakers can't agree on another stimulus package. Also, we are valuing the stock market based on earnings 12 to 24 months out, so the strong earnings season this quarter doesn't provide much impetus for us to revalue the S&P 500 higher.

If the S&P 500 breaks through to new highs, and perhaps we get more good news on COVID-19 therapeutics or vaccines, we may reconsider, but for now, we prefer to keep our target where it is. Looking a year out, we are more optimistic about stocks, and more pessimistic about bonds, so we are keeping our tactical overweight equities recommendation. A COVID-19 vaccine may arrive within that window.

WHAT'S NEXT?

We will focus on election-related market commentary over the next two weeks, beginning August 24 with a discussion about what the markets and economy may look like in a potential Joe Biden administration. We'll follow on August 31 with a look at market and economic possibilities during a potential second term for President Donald Trump.



IMPORTANT DISCLOSURES

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

Please read the full [Midyear Outlook 2020: The Trail to Recovery](#) publication for additional description and disclosure.

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