CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

July 2021

Earnings to the Rescue

The summer months can often see a softer patch for equity markets. Over the very long-term, investors have witnessed a peculiar phenomenon – where equity returns have, on average, fared poorer between May and September than they have for the rest of the year for no apparent reason. In June this year, it looked as if 2021 may be following a similar path as stocks, particularly those most sensitive to economic growth, began rolling over. However, the second quarter earnings season in the US (reaching its halfway point at the end of July) has been exceptionally strong, with company profits beating analysts' estimates by one of the highest margins on record. This, in turn, has led to global equity markets touching new highs, once again rescuing investors from the summer doldrums.

Each quarter, numerous analysts provide their expectations for upcoming company results, which act as a baseline for the market to assess whether these results are good, bad or as expected – and share prices tend to react accordingly. Analysts are notoriously cautious on expectations, for various reasons, but in recent quarters their projections for company earnings and revenue have fallen well short of reality. Two factors are at play here: firstly, analysts are significantly underestimating the strength of the economic recovery; and secondly, companies are issuing guidance that is too cautious for what ends up being the reality. The severe impact of the COVID crisis has scarred both company management and analyst confidence, leading to recent quarterly earnings seasons giving renewed vigour to equity investors post results. Again this quarter, we are seeing companies report exceptional figures, but then offer a cautious outlook. For example, Apple posted a record quarter across most business lines, but issued caution on supply constraints for the remainder of the year. Similarly, Starbucks posted results that topped analysts' estimates but warned of slowing growth in China.

We wrote at the beginning of this year that 2021 was going to be a year of recovery, but the velocity and magnitude of that recovery around the world was very hard to predict. Whilst the first half has set a tough precedent for the rest of the year, we believe that as long as companies can keep delivering on earnings, equity markets can continue to rise. What is pleasing now, from an informed investor's perspective, is that share price increases are coming through from earnings growth rather than multiple expansion (the valuation put on a company) - the latter being undeniably stretched. Finally, the evolving inflation regime will also have an impact on future company profits in the coming quarters. So far this earnings season, it appears that the majority of companies are successfully passing costs on to customers.

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