[Earnings Season Road Trip]

Bottom Line:

Markets were mostly directionless in a short, light trading week before 2nd quarter corporate earnings season begins. Analysts have been steadily raising earnings expectations, which we hope materializes over the next few weeks. The coronavirus pandemic recovery has been marked by resilient performance and stronger than expected earnings growth. This earnings growth should help relieve elevated valuations while still supporting stock market gains.

The Full Story:

This past week was a bit of a financial markets lull. Call it a summer vacation in the family truckster. The trading week was shortened by a day with Independence Day closing stock and bond markets on Monday. Stock indexes' performance was a mixed bag, but mostly flat on the week after Friday's gains recouped Thursday's losses.

On the economic calendar, the only reports of note were the ISM Manufacturing report on Tuesday (solid growth but down slightly from May), Job Openings and Labor Turnover Survey on Wednesday (record high job openings and record low layoffs), and Initial & Continuing Unemployment Claims on Thursday (initial claims slightly rose unexpectedly but continuing claims were down). The last two report releases show some imbalance and tightness in the current labor market. Employers are struggling to fill open positions and offering higher pay and bonuses to incentivize workers, while expanded unemployment benefits are still available but will start to expire in several states in the upcoming weeks.

This is the quiet period for corporate earnings releases as the second quarter earnings season doesn't kick off in earnest until next Tuesday with the big banks. Of the 23 S&P 500 companies scheduled to report earnings next week, 16 (70%) are in the financial sector with only seven other companies in the consumer staples (2), health care (1), and industrials sectors (4).

Overall, stock analysts are positive on the companies that they cover. For the broader S&P 1500, nearly a quarter of companies (23.5%) have seen earnings estimates increased over the last month. This is not necessarily the norm. Typically, analysts will have downward earnings revisions heading into reporting, giving companies the opportunity to beat lowered estimates and get a stock performance bump. This relationship has broken down during the COVID pandemic recovery where initial analysts' earnings expectations have consistently underestimated reality. Last quarter, the analyst earnings revisions spread was +15.9% heading into earnings season, and the S&P still rose 0.88%. That was the fourth straight quarter where the revisions spread was positive heading into earnings season, and the market rallied. That has not happened since 2008.

S&P 500 Performance During Earnings Reporting Period

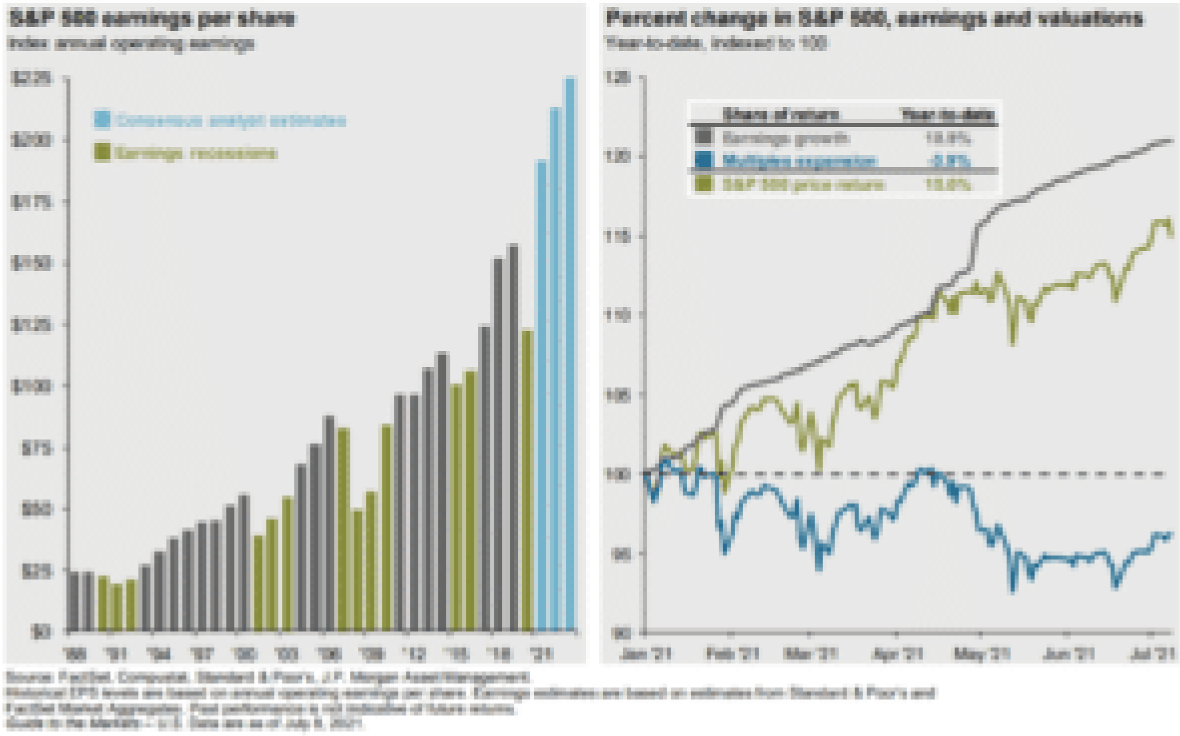
Reporting Period	Earnings Revisions Spread Start of Earnings Season (%)	S&P 500 Performance Next Six Weeks (%)
Q1 18	-1.3	4.17
Q2 18	-1.7	3.27
Q3 18	-8.1	-5.17
Q4 18	-28.3	7.57
Q1 19	-17.9	-1.15
Q2 19	-22.2	-3.40
Q3 19	-21.5	5.71
Q4 19	-4.1	2.22
Q1 20	-76.5	5.94
Q2 20	10.7	6.66
Q3 20	21.5	2.31
Q4 20	19.2	2.14
Q1 21	15.9	0.88
Q2 21	23.5	

Source: BespokePremium.com

Valuations

The undeniable strength in the economy should be the primary factor driving asset allocation. Policy decisions, whether it is Federal Reserve quantitative easing and rate decisions or federal fiscal policy (e.g., infrastructure or tax reform), should be secondary factors, and not the other way around.

A strong revenue, earnings, and mergers and acquisitions environment should benefit equities. While the bond market is bound by low interest rates and tight credit spreads, equities are unbounded by potential earnings growth. Earnings estimates are moving higher, set to more than double since just 2015 (see below).



The increased corporate earnings level alleviates some pressure on stock market valuations. Over the last 12 months, forward price-to-earnings multiples have stopped rising and started to gently trend lower as estimated forward earnings have soared. Year-to-date, earnings growth (18.9%) has outpaced the S&P’s price return (15%), resulting in a lower P/E multiple. On a forward basis and in context, the S&P 500 is trading at 21.6x, which is still notably higher than the 25-year average of 16.7x.

I should note that disparities in valuations are much higher than average. While we discuss an index to address the overall market, there are styles, sectors, industries, market capitalizations, and regions that offer more compelling valuations. U.S. large cap value trades at 16.9x vs. U.S. large growth at 31.1x. Both are above their 25-year averages, but even with value outperforming year-to-date, their relative valuation gap is still near an all-time high.

On an asset category relative basis, the S&P 500 earnings yield is 1.4% greater than the Moody's Baa seasoned corporate bond yield, which is notably better than the 25-year average of a +0.11% spread. This relative advantage of stocks over bonds has existed for some time now. There is also cash, which is yielding almost nothing with the federal funds rate at 0 – 0.25%. Stocks are being called the TINA – There Is No Alternative – of the liquid asset classes due to historically low interest rates. Currently, the yield on the 10-Year US Treasury note is dead-even with the dividend yield of the S&P 500 at 1.35%. That is with dividend yields sitting around some of the lowest levels since the early 2000's. The TINA characterization is a little strong because we can see past Treasury and agency bonds to the broader fixed income market to find some reasonable yield alternatives.

Looking at the broad fixed income opportunity set, valuations range somewhere between fair and full, depending on the asset class. Building a diversified portfolio around the 2% to 4% yield range is feasible. Although like the equity market, there is little that would be considered "attractively valued," and there are some asset classes to avoid completely. As you may note in the chart below, structured credit, high yield, securitized, and emerging markets debt offer some fair valuations while short and intermediate term government (US and European) and even some high quality securitized fixed income are priced near perfection.

Fixed Income Valuations Range

Sources: Bloomberg and BlackRock, data as of April 29, 2021. Index returns are shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

Have a great Sunday!

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Sources: Bespoke Investment Group, BlackRock, JPMorgan