WILSONS

The global earnings recovery continues

Our weekly view on Asset Allocation

9 August 2021

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Global profits still beating expectations

The global earnings cycle continues to surprise with its strength. With the US second quarter reporting season now well past the halfway mark, the well-established trend of earnings upgrades has continued. Around 90% of US results are beating analyst estimates.

While there is a historical tendency for US reported earnings to "beat the street", the percentage of beats is higher than usual, and importantly forward estimates are also being raised.

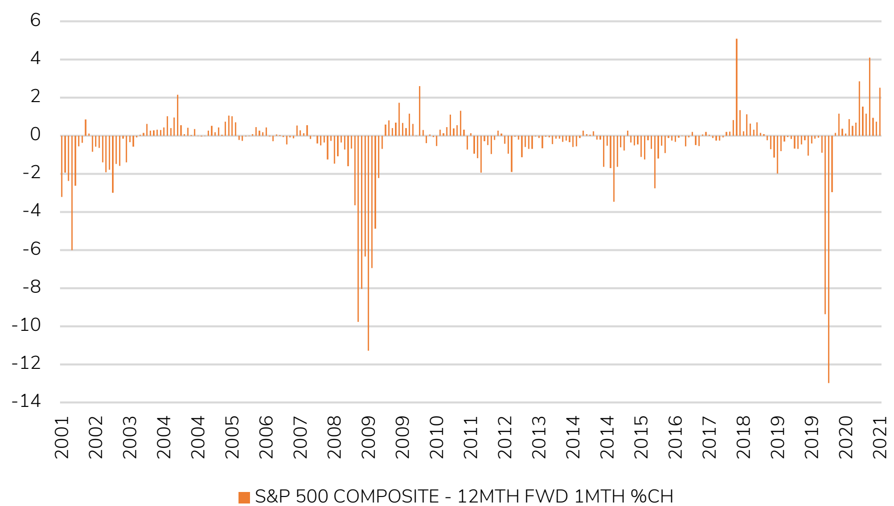
Third quarter estimates are now around 4% higher than at the start of July. July also saw a 2.5% upgrade to 1 year forward earnings estimates. This is the 14th consecutive monthly upgrade to 1 year forward estimates, which makes it the strongest run of upgrades since 2003/04.

US results are beating at both the revenue line and earnings line with beats across all 11 US sectors for earnings and 10 of 11 for revenue.

The strongest growth rates in Q2 are from the sectors most impacted by the global shutdown in Q2 last year, namely; energy, industrials, and consumer discretionary; however, growth is strong across the board. Market-wide growth estimates for Q221 are now exceeding 80% versus 63% at the start of July.

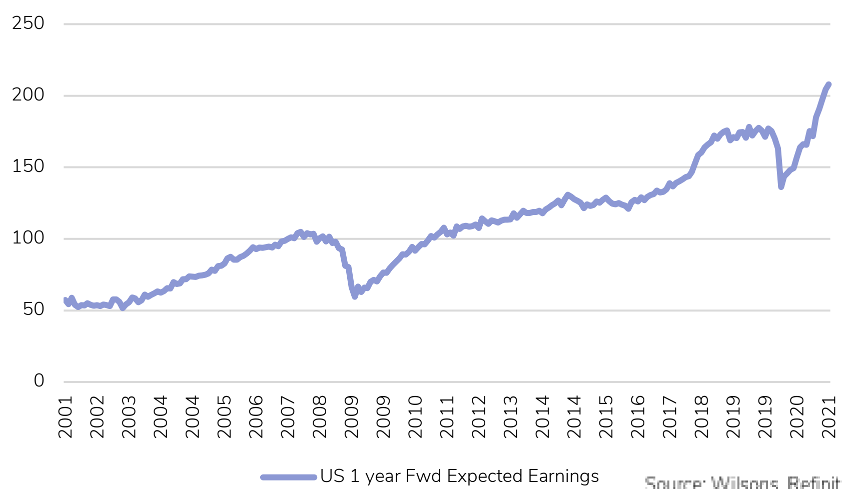
Base effects from last year's steep drop in second quarter earnings are clearly boosting second quarter earnings growth this year (when comparing to the previous corresponding period).

Exhibit 1: US earnings beating at sales and earnings lines



Source: Wilsons, Refinitiv

Exhibit 2: US earnings expectations have rebounded to well above pre-pandemic levels



However, earnings are now well above the pre-Covid level. Indeed, the current 1 year forward earnings estimate is now 19% above the forecast immediately before the onset of the pandemic.

These second quarter results (Exhibit 2) will mark the peak in earnings growth (c80%), and growth is expected to slow fairly significantly, but importantly earnings growth should remain above trend for some time.

Earnings growth is expected to slow to 28 % in Q3 and 21% in Q4, with 10% currently expected for CY22.

We still see upside risk to earnings estimates over the balance of the year against a backdrop of a strong and broadening economic recovery.

With corporate margins continuing to expand, the US markets return on equity (ROE) has surged to record highs. Interestingly there is little evidence in aggregate that input cost inflation is impacting margins beyond fairly stock-specific examples. A mixture of pricing power and operating leverage is overwhelming these impacts in aggregate terms.

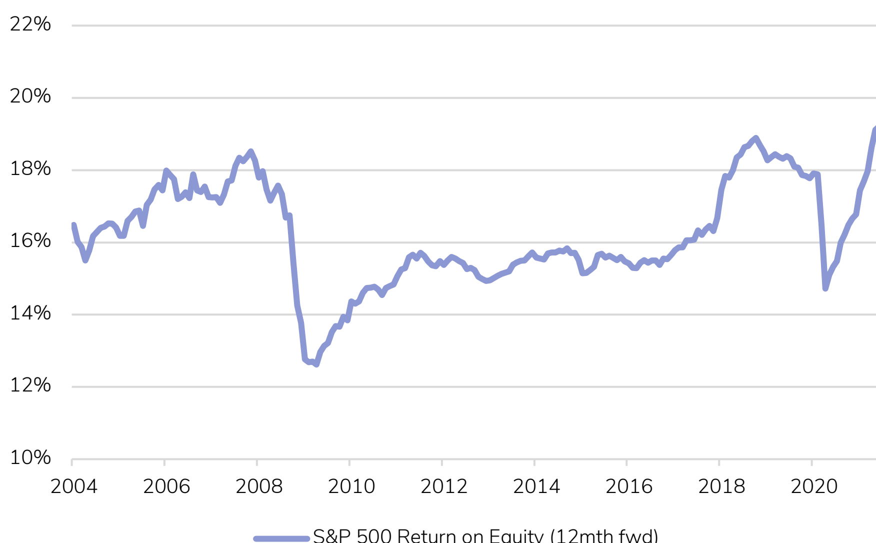
Despite continued above-average market performance, the US market multiple (21x) has eased back over the last 6 months. The edging down in the US market's PE despite strong price appreciation is due to the combination of fast earnings growth and earnings upgrades. We expect market returns to moderate going forward, but a robust profit outlook suggests the US multiple can edge lower while still allowing the market to deliver reasonable returns over the coming year.

US Multiples are still well above the 5, 10 and 20-year averages but interest rates are way below these same averages. Even though we expect interest rates to pick up, it is likely to be a gradual and stop-start process. At the same time, earnings estimates look set to continue to prove too conservative.

Powerhouse earnings and a 1.2% US 10-year bond yield?

The super-strong earnings cycle seems at odds with the message from the bond market, which has dropped back to barely above 1%. To a certain extent, the economy and the stock market are different propositions (40% of US revenues comes from outside the US). However, we still think the earnings cycle suggests the economy is in better shape than the bond market is pricing **(See: Are falling bond yields giving equities a growth warning? – 2 August 2021)**

Exhibit 3: US ROE surges to all-time highs – tax time?



Source: Wilsons, Refinitiv

Exhibit 4: The US Multiple is still high but edging down as earnings beat expectations

Source: Wilsons, Refinitiv

Continued tailwind expected despite stellar run so far

With an expected continuation of the backdrop of strong earnings growth and low interest rates, we remain reasonably constructive on the 12-month outlook for the US share-market, notwithstanding that we seem overdue for at least a modest pullback.

European Earnings also in Strong Recovery Mode

From this perspective, we are also more than two thirds through the second quarter reporting season in UK/Europe. To date, results have also been very strong. Net earnings beats are running at 33% - just down from the record 38% in Q1 and the 4th highest quarter in the last 15 years. The past month has delivered a 2.5% upgrade to 1 year forward earnings estimates for our UK/Europe composite earnings series. This is the 11th consecutive monthly upgrade which makes it the strongest run of upgrades since 2005/06.

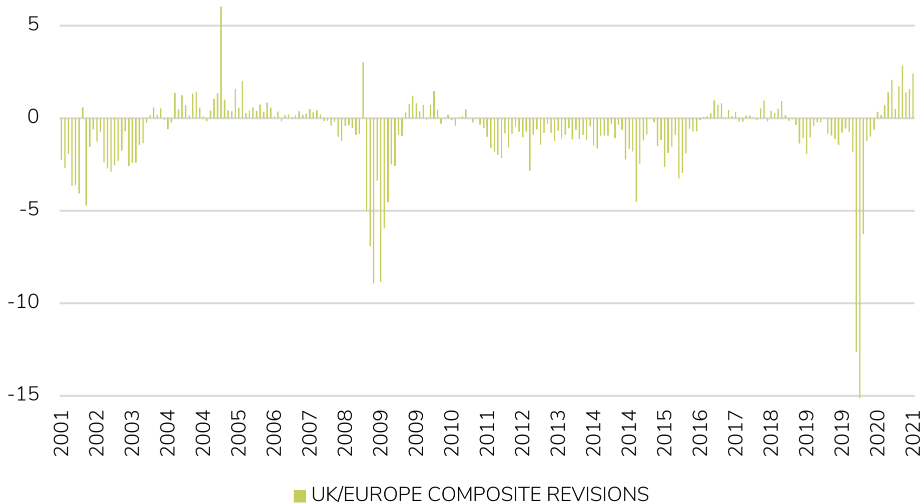
At the top-line, the most beats have come from Luxury Goods, Banks, Materials and Transport. Food Retail, Transport, Leisure, Luxury Goods and IT Hardware have produced the most net earnings beats. Of the major countries, France (Luxury Goods), Germany and the UK have had the most earnings beats with Spain and Italy weaker.

Once again, a concern for investors going into the European results was how would companies deal with sharply higher input costs. In aggregate, margins have beaten, with UBS analysis showing that 16 out of the 24 European sectors have clearly beat on margins and just 4 missing. Much like the US, a combination of pricing power and operating leverage is driving margin expansion.

This reporting season will most likely be the peak in year on year on growth rates given the base effects coming from 2020 with over 100% year on year growth in Europe. Growth is expected to slow to around 10 % in CY22, which looks too conservative in our view.

The European multiple at 16x (13x for the UK) is much lower than the US, but as we have argued previously, equity market returns from here will be driven by earnings, not multiples.

Exhibit 5: US UK/European Earnings are also in a strong upgrade cycle



Source: Wilsons, Refinitiv

European earnings growth and revisions should likely be stronger than in the US hence our preference for the value cyclical exposures of UK/Europe over the US for the next Q2 months at least.

While we think the powerhouse profit dynamics behind the US corporate sector remain underappreciated, the potential for at least a moderate increase in the corporate tax rate over the next year or two also suggests a preference for cheaper more cyclical rest of world equities, at this point in the cycle.

Corporate Profit Cycle Remains a Tailwind for Global Equities

In summary, both US earnings and European earnings are significantly exceeding analyst expectations. More importantly, we view current expectations for the coming quarters as too low. This suggests that the earnings cycle will be a tailwind, rather than a headwind, for global equities for a while yet.

While US earnings continue their impressive march forward, the UK/Europe are posting even stronger year on year earnings growth and is looking at a stronger growth rate over the coming year as economies re-open, in our view. At the margin, our cyclical (12 month) preference is for UK/Europe over the US, but we remain reasonably constructive on the US market.

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Recommendation structure and other definitions

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Wilsons contact

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au