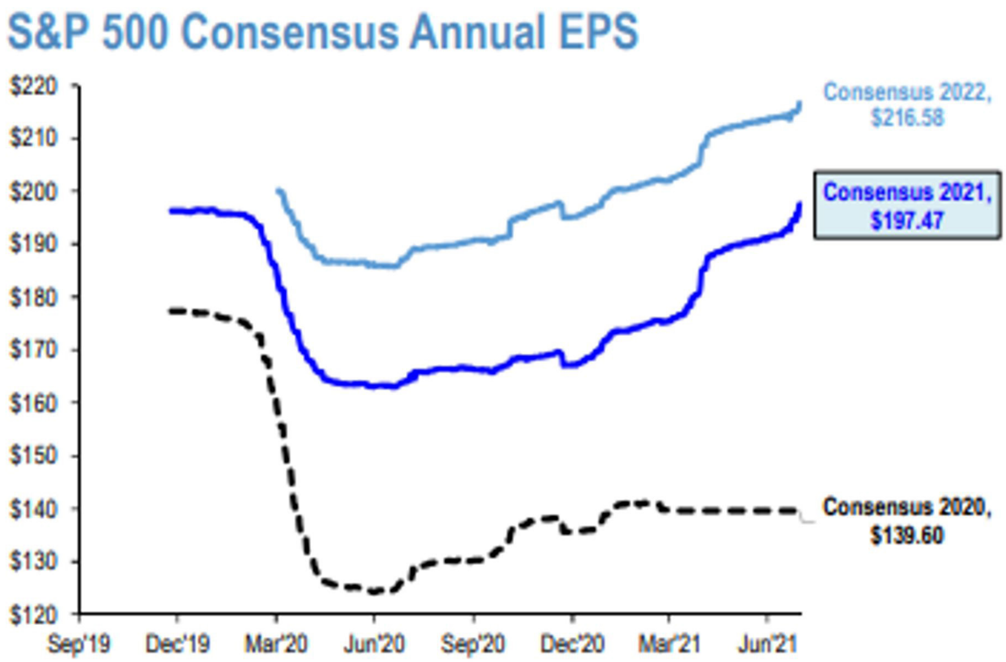
# Week in Review

Friday, July 30th, 2021

## 1. Strong Earnings Season Sees Upward Bias in Annual EPS Estimates

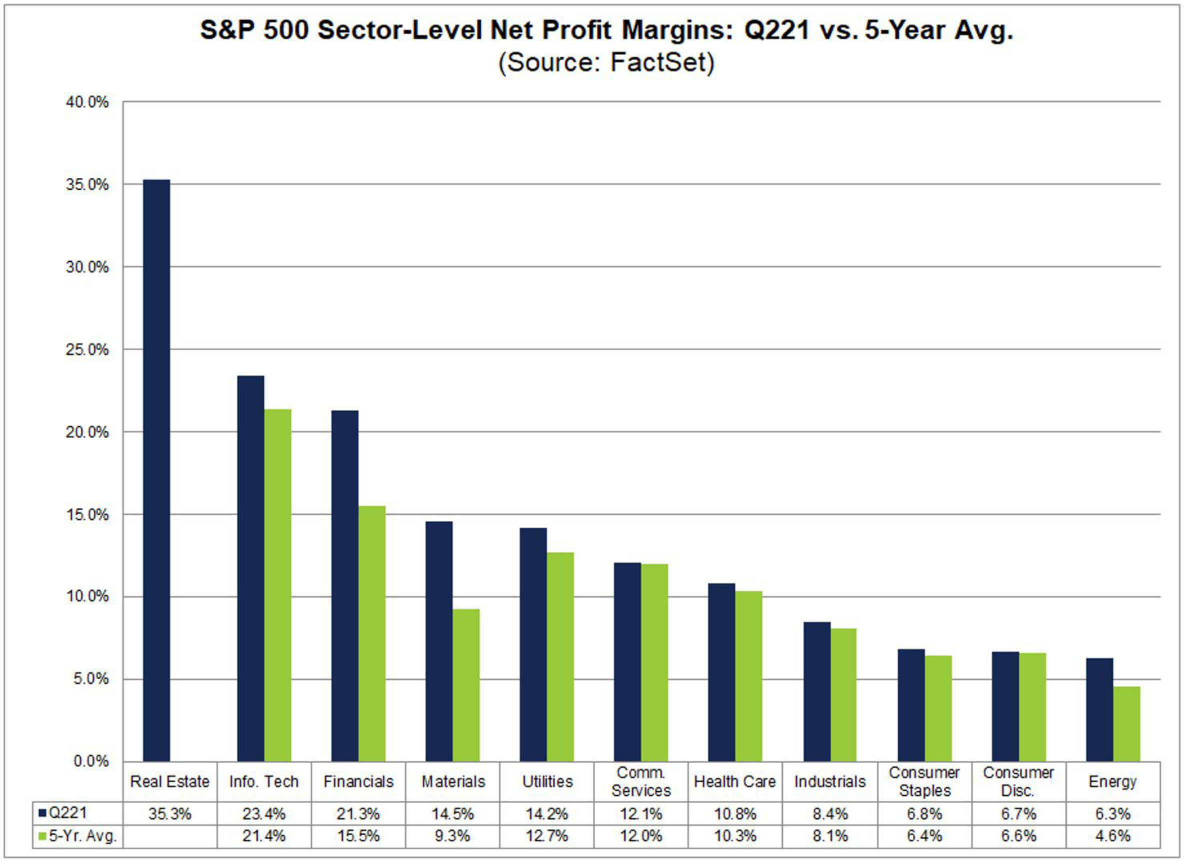



Source: JP Morgan

More S&P 500 companies are beating EPS estimates for the second quarter than average, and beating EPS estimates by a wider margin than average. The index is currently reporting the highest year-over-year growth in earnings since Q4 2009. Analysts also expect double-digit earnings growth for the second half of 2021. As a result, the aggregate index is seeing upward revisions to earnings for the second quarter, as well as for the rest of 2021 and 2022. Since the beginning of the earnings season, 2Q21 EPS has been revised up 9.5% to $49.86 (+ 78% y/y) and 2021 EPS has been revised up 2.9% to $197.47 (+ 41% y/y). Looking to the following year, 2022 EPS has been revised up 2.9% to $197.47 (+ 41% y/y). EPS for 2022 has been revised up 1.2% since the beginning of the season to $216.58 (+ 10%). Upward earnings revisions are generally positive for the market, but individual stocks and market indices have not moved up at the same pace as the positive revisions. This suggests that expectations were already high coming into this earnings season. As a result, market valuation multiples are trending lower as companies deliver strong earnings, and a lower premium is being paid for future growth expectations

## 2. Strong Profit Margins Helping to Drive Company Results

For companies that have reported so far, 2Q revenue is up around 23.3% y/y, and net income growth is substantially higher at 101.2%. The faster growth in net income relative to revenue has been driven by better profit margins. Ten sectors are reporting net profit margins in Q2 2021 that are above their five-year averages, led by the Financials sector (21.3% vs. 15.5%) and Materials (14.5% vs. 9.3%) sectors.



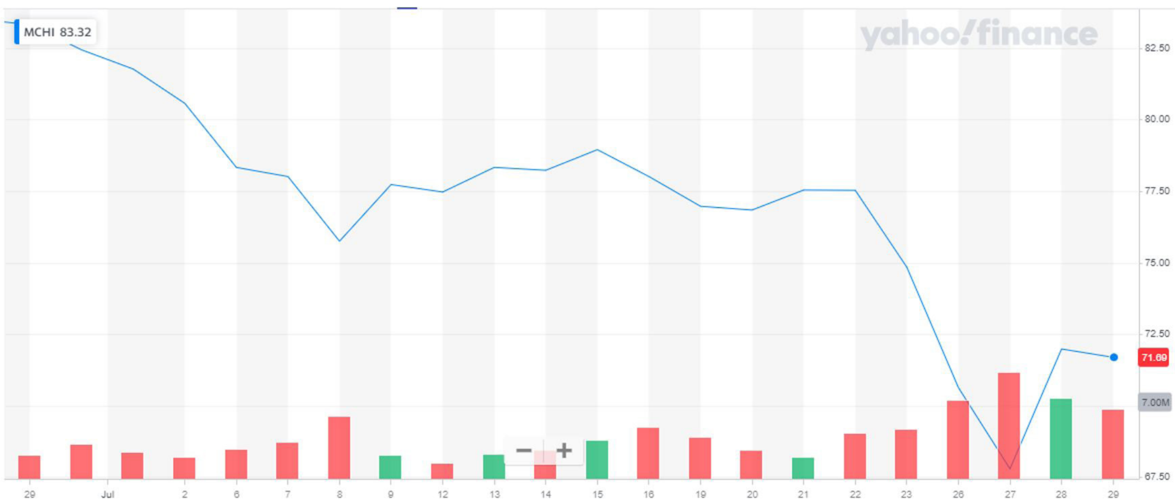

Source: Factset

However, only five sectors are reporting a quarter-over-quarter increase in their net profit margins for Q2 2021 compared to Q1 2021, led by the materials (14.5% vs. 11.7%) sector. A 14.5% realized net profit margin reported by the materials sector for Q2 would mark the highest reported net profit margin since FactSet began tracking this metric in 2008. The current record for this sector is 11.7%, which occurred in the previous quarter. The financials sector is also exhibiting strong profit margins of 21.3%, which is the second highest since 2008.

The decline in relative margins from the first quarter and several industries operating at or near peak historical margins may suggest that margins are peaking. This would suggest that the level of earnings growth realized recently may become more difficult to sustain prospectively, particularly for sectors with outsized margins such as materials and financials.

## 3. China Shares Decline and Rebound on Regulatory Concerns

China shares have had a volatile week following Beijing's issuance and then walking back regulatory edicts. China's market has been under regular pressure over the past month, but the selloff accelerated following the announcement that China would place greater scrutiny on sectors including technology, finance, and private education. This culminated in the largest one-day selloff in Chinese stock since the beginning of the COVID-19 crisis.




Source: Yahoo Finance

Following the selloff, it was reported that the vice-chair of China's securities regulator met with representatives from investment banking giants Goldman Sachs, UBS, and others. The message was that recent scrutiny was focused on specific problems in select sectors and that Beijing will consider market impacts before introducing future policies. This resulted in a relief rally but long-term investor concerns remain.

## 4. The Federal Reserve (Fed) Communicates No Change in Policy

As expected, The Fed did not change short-term interest rates or announce it was cutting back on bond-buying, but it did say the U.S. economy continued to strengthen and was making progress towards its goals. In particular, Fed Chairman Jerome Powell acknowledged that the U.S. was on a clear path to a very strong labor market – one of the Fed's stated key metrics for determining future changes in monetary policy. In other comments, the Fed Chairman stood by the stance that the U.S. will not have an extended period of high inflation and that recent evidence of rising prices will prove transitory. He also downplayed concerns about any economic fallout from the rise in the Delta variant of COVID-19.

## 5. Senate Advances Bipartisan Infrastructure Bill

A vote in the Senate this week advanced the roughly $1 billion bipartisan infrastructure bill. The vote came after Democrats and Republicans resolved their biggest sticking points to end in a final agreement. Hurdles remain to the final passage of the bill with Senate Republicans wanting to see more details first and concerns around rising deficits, while Democrats want to add more spending to the package.

## 6. Headline Q2 GDP Comes in Below Consensus

Q2 GDP came in at a 6.5% annual rate, below consensus for 8.5% but a bit better than Q1's 6.3% pace. The rise was driven by an 11.8% increase in personal consumption expenditures, with a notable contribution from food services and accommodations. While below consensus, the figures are quite strong and support the reopening that has occurred in broader areas of the economy during the second quarter.

## 7. Action Being Taken to Address Delta Variant

Led by companies and the government, precautions are being reintroduced in response to growing data on the contagiousness of the Delta COVID-19 variant. Apple will require both vaccinated and unvaccinated customers and staff to wear masks at many of its U.S. retail stores. Disney will require masks to be worn indoors again at its Florida and California theme parks. And Bloomberg reports that more companies, including Google and Lyft, are pushing back their scheduled office returns. Other companies such as Facebook have said that they will only allow fully vaccinated employees to return to their offices. The Biden administration has announced expectations that all civilian workers will need to get vaccinated or face regular testing, social distancing, mask requirements, and travel limits. Despite these changes, it is not expected that the Delta variant will have a material impact on the ongoing economic recovery.

# Thinking Ahead

Positive earnings surprises remain at or near record levels, as companies continue to see a favorable demand backdrop. However, not all the earnings news is positive as companies noted expectations for rising input prices pressuring margins. Chinese regulatory oversight of their public companies has escalated volatility in their markets. The Fed is still not expected to begin to end policy accommodation until early next year. Further government stimulus such as the infrastructure bill has progressed but remains complicated as passage gets linked to conflicting objectives. Finally, the Delta COVID-19 variant continues to raise concern that the pandemic is not fully behind us.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.