Week in Review

Friday, August 5th, 2022

1. Earnings Season and Forward Guidance Surpassing Low Expectations

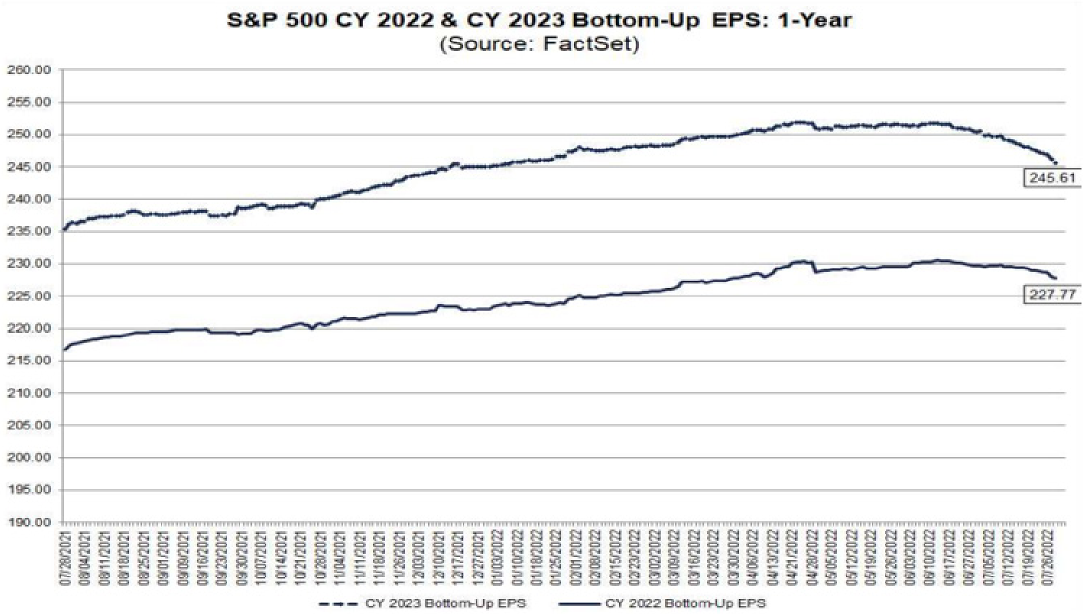
With the negative headwinds and concerns of a recession, the second quarter of 2022 earnings announcements and discussion of business conditions and financial prospects by U.S. corporations have been closely watched. As of midweek, 74% of S&P 500 companies have reported and overall, the scorecard has likely surpassed low expectations.

In terms of second quarter financial performance, 69% are beating (vs. 79% avg. last 4Qs) and 66% are beating revenue estimates (vs. 77%). Looking at the magnitude of the earnings beats, earnings have surprised to the upside by 3.3% (vs. 11.1% on avg. through the past 4Qs). While the percentage and magnitude of beats are below the averages of the past year, in aggregate the reports have resulted in positive post-announcement performance of the reporting company's stocks. The lower earnings growth rate for Q2 2022 relative to recent quarters can be attributed to both a difficult comparison to unusually high earnings growth in Q2 2021 and continuing macroeconomic headwinds.

However, there have been winners and losers with the largest sales and earnings beats coming from the energy and consumer staples and most notable drags from financials and communications. Overall, the winners have outshined the losers with net second quarter 2022 earnings for the S&P 500 having been revised up 3.8% since the beginning of earnings season.

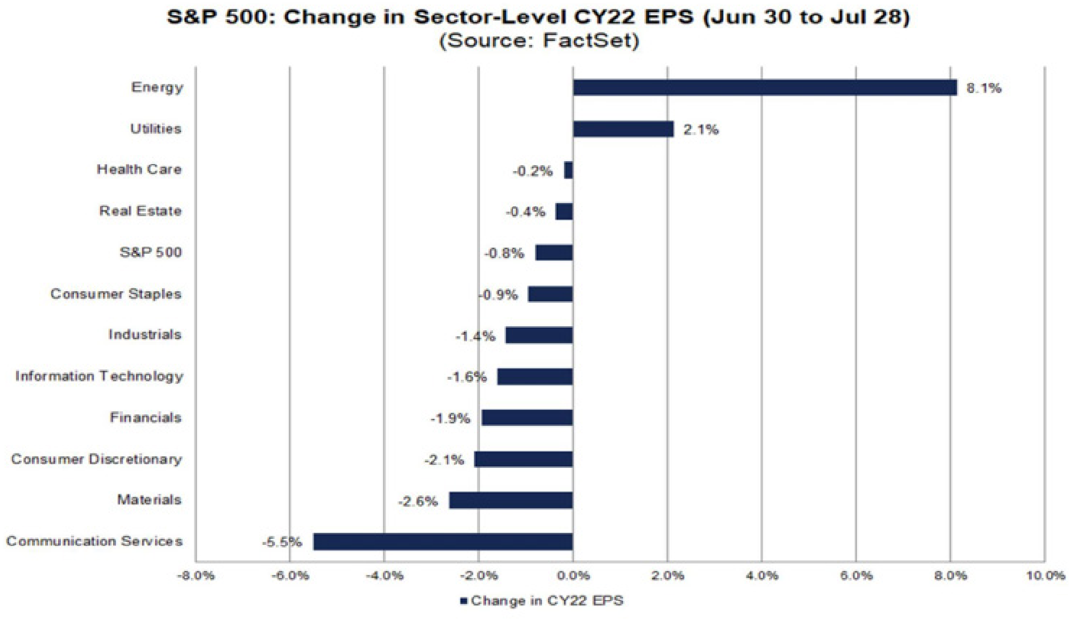
While the reports of the latest quarter's performance are important, the discussion of business conditions and guidance for prospective financial performance is likely even more closely watched. The term "guidance" is defined as a projection or estimate for EPS provided by a company in advance of the company reporting actual results. Guidance is classified as negative if the estimate (or mid-point of a range estimates) provided by a company is lower than the mean EPS estimate the day before the guidance was issued. Guidance is classified as positive if the estimate (or mid-point of a range of estimates) provided by the company is higher than the mean EPS estimate the day before the guidance was issued. As of the end of last week (July 28), 243 companies in the index have issued EPS guidance for their current fiscal year (FY 2022 or FY 2023). Of these 243 companies, 134 have issued negative EPS guidance and 109 have issued positive EPS guidance. The percentage of companies issuing negative EPS guidance for their current fiscal year is 55% (134 out of 243).

The financial community also looks at consensus estimates by the analyst community following earnings releases. On this measure, analysts decreased earnings estimates in aggregate for the third quarter (-2.5%) as well as the fourth quarter (-2.4%). Given the decreases in the bottom-up EPS estimates for the third and fourth quarter, which were partially offset by the increase in the bottom-up EPS estimate for Q2 2022, analyst estimates for all of 2022 have declined by 0.8% (to $227.77 from $229.63) from June 30 to July 28 but remain 9% above 2021. Looking further out, estimates for 2023 were also reduced but remain approximately 8% above the expectations for 2022.



Source: Factset

While the pullback in both corporate guidance and analyst estimates may be disappointing in normal times, the current level of revisions, at least at the aggregate level, is likely well above the level incorporated in recent trough levels of sentiment. However, looking below the aggregate level, there is significant variance by sector in terms of the trajectory of earnings estimates for the S&P 500. Nine sectors witnessed a decrease in their bottom-up EPS estimate for CY 2022 from June 30 to July 28, led by the Communication Services (-5.5%) and Materials (-2.6%) sectors. On the other hand, two sectors witnessed an increase in their bottom-up EPS estimate for CY 2022 during this time, led by the Energy (+8.1%) sector.

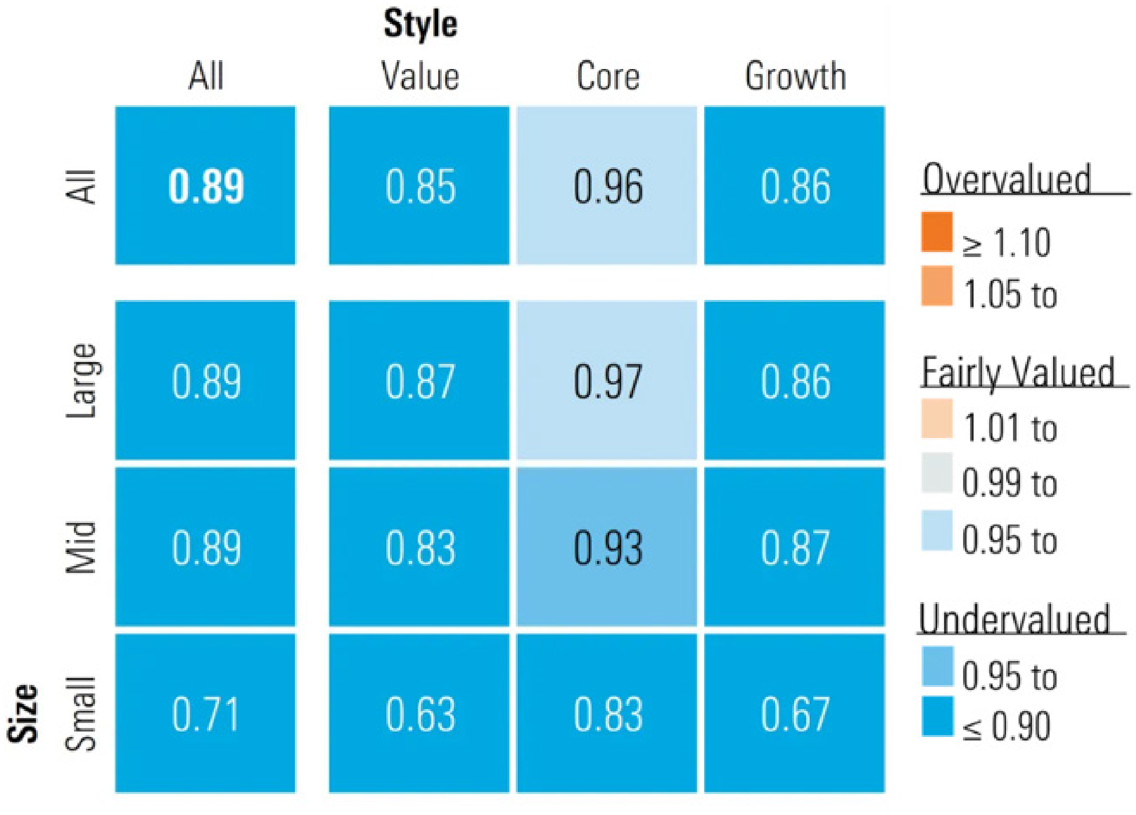


Source: Factset

The variance in forward expectations is clearly representative of concerns about slowing growth and high energy costs. The market will certainly be watching EPS estimate revisions over the next few weeks to see if growth and margin pressures continue to lower EPS estimates for CY 2022 and CY 2023.

2. Financial Markets Remain Reasonably Valued by Morningstar

The ability of earnings to hold up overall during the current earnings season coupled with a view that inflation and the Federal Reserve's rate increases may be at a peak has resulted in a strong month for the markets. Despite or perhaps in support of this positive move, Morningstar continues to view the broad U.S. equity market as materially undervalued. At the end of July, the Morningstar price to fair value for U.S. markets in aggregate was at a discount of 11%.



Source: Morningstar. Data as of July 29, 2022.

In support of their outlook and valuation, Morningstar forecasts that the headwinds of slower growth expectations and inflation could shift and turn to tailwinds. For example, Morningstar notes that even after accounting for the negative gross domestic product reports in the first and second quarter, the U.S. is still projecting real GDP growth of 2% this year. They also think inflation has peaked and should begin to moderate from here on out. However, Morningstar's forecast is not without caveats as they note any metrics that indicate the economy is continuing to weaken or that inflation will remain hotter for longer would most likely put renewed downward pressure on stocks and acknowledge that long-term investors should brace themselves and expect volatility to continue over the next several months.

Thinking Ahead

Expectations coming into this season's earning season (second quarter reports) were undoubtedly low. With the bulk of reports now in, this season has likely surpassed expectations and concerns about a prospective earnings cliff have been largely overcome for the time being. The financial markets have responded positively in the past month and confidence has risen that current valuations are reasonable, and potentially at a discount for long-term investors. Upcoming data on inflation and geopolitical events will be particularly important guideposts in the coming months.

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