LPL RESEARCH WEEKLY MARKET COMMENTARY

May 26 2020

EARNINGS SEASON'S MIXED RESULTS

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First quarter earnings season offered something for everyone. On the positive side, corporate America produced solid results outside of the COVID-19 pandemic trouble spots, which included retailers, travel-related businesses, and banks. At the same time, 2020 earnings estimates have plunged, and a return to "normal" earnings could be two years or more away.

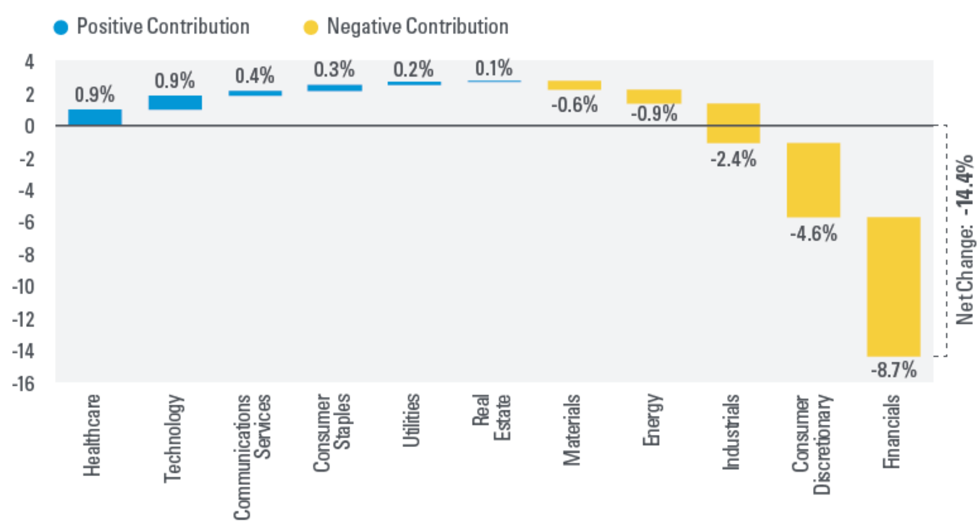
LOW BAR PROVED TOUGH TO CLEAR

At the beginning of the first quarter corporate earnings reporting season, we noted the earnings bar probably wasn't set low enough, given the abruptness of the shutdowns in March. And that proved to be true, as S&P 500 Index earnings have fallen 14% year over year, compared to March 31 expectations for a roughly 5% decline. The big difference wasn't particularly surprising after many companies withdrew their guidance following the swift and severe economic shock in mid-March. The shortfall also came despite one of the broadest rounds of estimate cuts ever witnessed, when 93% of the estimate changes in late-March through early April were cuts (source: Bespoke Investment Group).

WIDENING GAP BETWEEN WINNERS AND LOSERS

We also expected results to drive an even bigger wedge between winners and losers. We can look at the sectors that produced earnings growth in the first quarter to identify the pandemic winners that contributed the most to last quarter's overall earnings growth **[FIGURE 1]**.

1 CONTRIBUTION TO Q1 2020 S&P 500 EARNINGS BY SECTOR



Source: LPL Research, FactSet 05/21/20

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- **Healthcare** is benefiting from COVID-19 testing and treatments and is a significant beneficiary of recent fiscal stimulus—and additional fiscal stimulus may be coming in June. The sector historically has enjoyed relatively good earnings stability during challenging economic environments.
- **Technology** and **communication services** are benefiting from the work-from-home trend, whether through outfitting home offices, enabling web conferencing, or entertaining us with streaming services.
- **Consumer staples** companies helped us stock our shelves in March. Household products companies grew earnings more than 13% year over year during the quarter, while earnings for beverage companies within the index (including the adult variety) rose more than 6%.

On the flip side, virtually all of last quarter's drop in S&P 500 earnings came from two sectors: consumer discretionary and financials. Consumer discretionary includes some of the hardest hit areas of the crisis, such as apparel, restaurants, retail, and travel and entertainment, which includes cruise ships, hotels, and casinos.

Financials braced for a wave of loans going bad as banks dramatically increased loan-loss reserves, which contributed to a 60% year-over-year drop in bank earnings for the quarter. If we were to take out those two sectors, the quarter's earnings would have been flat rather than down 14%. The industrials sector, which includes the embattled airlines, was also a drag on overall earnings, but by only about half as much as consumer discretionary.

These results generally align with our tactical sector recommendations, in which we are positive on communication services, healthcare, and technology, and negative on consumer discretionary. Our consumer staples, financials, and industrials sector views are neutral.

ALL ABOUT GUIDANCE

Every quarter when we write about earnings, we say guidance is more important than the quarterly results being reported. That statement was especially true this season. Few companies issued guidance in April or May, which made sense, given the uncertainty around the re-opening process. But analysts have gathered enough information to reduce 2020 estimates by about 20% in April and May (source: FactSet). However, the biggest earnings hits most likely will come in the current (second) quarter, when consensus earnings estimates have fallen 30% during April alone.

A 20% trim to annual earnings estimates has been consistent with typical recessions historically. However, given the severity of the (unofficial) recession the US economy entered in March and the challenges for many businesses incorporating social distancing, the hit this time could be bigger. The counter-argument is that this recession already may be over, now that the United States is open for business—to varying degrees on a state-by-state basis—and a vaccine could arrive around year-end. The 2008–09 recession lasted 18 months, but this one could be over in six months.

2 **2020 MARKET FORECASTS**

	Base Case	Bear Case
10-Year Treasury Yield	1.25–1.75%	0–0.5%
S&P 500 Earnings per Share	$120–125	$110–115
S&P 500 Fair Value	3,150–3,200	2,400 or Lower

Source: LPL Research, Bloomberg 05/22/20

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Economic forecasts set forth may not develop as predicted and are subject to change.

*As noted in our Weekly Market Commentary dated 05/04/2020, our year-end fair value target for the S&P 500 of 3,150–3,200 is based on a price-to-earnings ratio (P/E) of about 19 and potential normalized S&P 500 earnings per share of $165 in 2021–2022.

2020 EARNINGS FORECAST

At this point, we think our $120 to $125 per share forecast for 2020 S&P 500 earnings is reasonable **[FIGURE 2]**. That's about 25% below 2019's level and a bit more than the average decline in previous recessions. Consensus estimates have fallen to around $128.50 per share (source: FactSet). While our headline number is slightly more pessimistic, we believe the economic recovery in the United States likely may be steady through year-end and into 2021, bolstered by significant fiscal and monetary stimulus and potential medical breakthroughs. We are envisioning a U-shaped or "swoosh" recovery rather than a V-shaped; a W-shaped recovery may be possible if a second wave of infections hits.

We have more information now than we did five weeks ago when we previewed earnings season, but the risk that our earnings forecast is overly optimistic is still high.

TOUGH MARKET TO VALUE

To value stocks on earnings, given how depressed they are, we think investors should look to 2021 and 2022 to anticipate a return to "normal." Our year-end 2020 fair-value target range for the S&P 500 remains 3,150–3,200, less than 7% from the May 22 market close at the low end of the range. To get there, we use a price-to-earnings ratio (PE) of about 19 and a normalized earnings figure of $165. An annual earnings run rate like that may not be achievable until into late 2021 or early 2022, but with interest rates so low, and a COVID-19 vaccine likely during that time frame, we are comfortable using a longer-term earnings target to value stocks right now. Aggressive monetary policy stimulus and low inflation may support a higher PE multiple, even if those earnings aren't generated until 2022 or later.

In the short-term, we still think stocks have come too far, too fast, and a 10% pullback would not surprise us. Historical patterns following prior bear market lows support this view. For long-term investors, we continue to believe stocks may be more attractive than bonds at current valuations, and we would recommend overweight allocations to stocks and a corresponding underweight to fixed income for suitable investors.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Forward Price To Earnings (Forward P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation. While the earnings used are just an estimate and are not as reliable as current earnings data, there is still benefit in estimated P/E analysis. The forecasted earnings used in the formula can either be for the next 12 months or for the next full-year fiscal period.

All index data from FactSet.

Please read the full Outlook 2020: Bringing Markets Into Focus publication for additional description and disclosure.

RES-23200-0520 | For Public Use | Tracking # 1-05014275 (Exp. 05/21)