

# Global Equity Strategy

October 8, 2020



## Earnings Matter, But This Earnings Season May Be Outshined

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### Summary

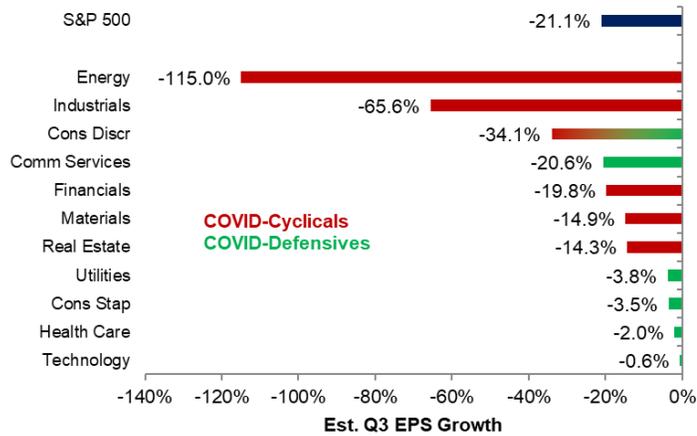
- **Q3 earnings season unofficially begins on October 13 with a few of the big US banks, while the bulk of reporting is due over the course of the next 4 weeks.**
- **While we expect year-over-year profits growth will be deeply negative, especially for more COVID-impacted sectors, we believe Q3 marked the beginning of a profits recovery as economies emerged from lockdowns and learned to live with the realities of pandemic restrictions. We expect US profits to recover further into next year, ultimately returning to pre-COVID levels in the first half of 2022.**
- **We continue to recommend a tactical rotation into more economically-sensitive sectors and regions as we look towards 2021. With that said, we expect that catalysts for any medium-term rotation will coincide with key events like the announcement of an effective vaccine or the reduction of political risks, not necessarily from any surprises emerging from this earnings season.**
- **Core portfolios should remain diversified, retaining exposure to firms with solid earnings fundamentals. We continue to expect long-run outperformance in areas like digitization, health care innovation, and clean energy, while allocations to dividend growers can provide exposure to high-quality income generating equities.**

### Q3 Earnings Preview

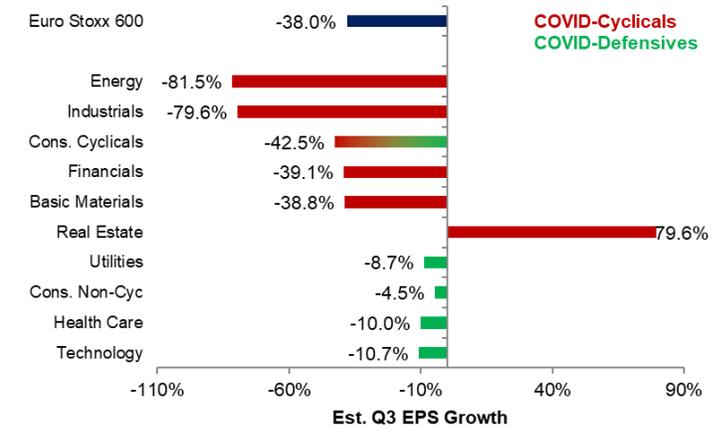
*US elections. COVID cases rising in Europe and parts of the US. On-and-off again fiscal stimulus talks.* Given the number of consequential macro events driving markets of late, you would be forgiven if Q3 earnings season – which begins with the big banks next week – was not on your radar. The bulk of US and European earnings are due in the next 4 weeks, coinciding with the height of US election season. We expect the dynamics in Q3 to have been similar to Q2, as lingering lockdown effects and record levels of unemployment continued to batter cyclical shares (Figures 1-2). But given the amount of uncertainty ahead on several fronts – from vaccine prospects to future US economic policy – we expect most diversified investors to take individual Q3 reports with a grain of salt.

With that said, there is potential for cyclical shares to beat fairly low expectations, much like they did in Q2. Looking towards next year we expect a nearly 20% rebound in profits. Given the near-term uncertainty, however, we expect only the most optimistic firms to reinstate guidance and dividends during this earnings season. *In the remainder of this piece, we highlight some areas to focus on.*

**Figure 1: S&P 500 Consensus Q3 EPS Growth**



**Figure 2: Euro Stoxx 600 Consensus Q3 EPS Growth**



Source: Refinitiv as of October 7, 2020

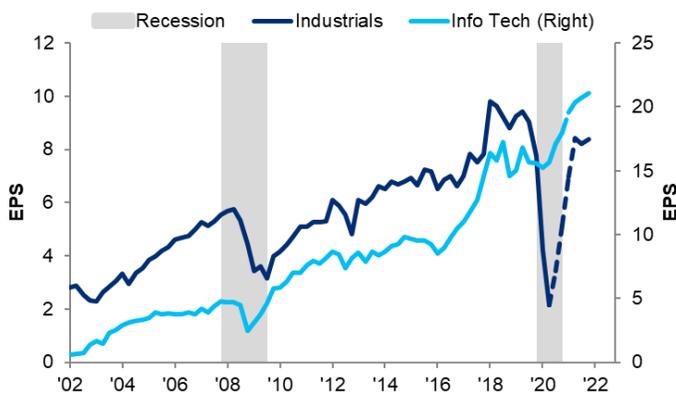
Note: COVID-defensives include information technology, health care, communications services, consumer staples, utilities and e-commerce sectors. COVID-cyclicals include industrials, financials, consumer discretionary excluding e-commerce, real estate, energy, and materials sectors  
Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. For illustrative purposes only. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

## Key Earnings Themes to Watch Instead of CNN

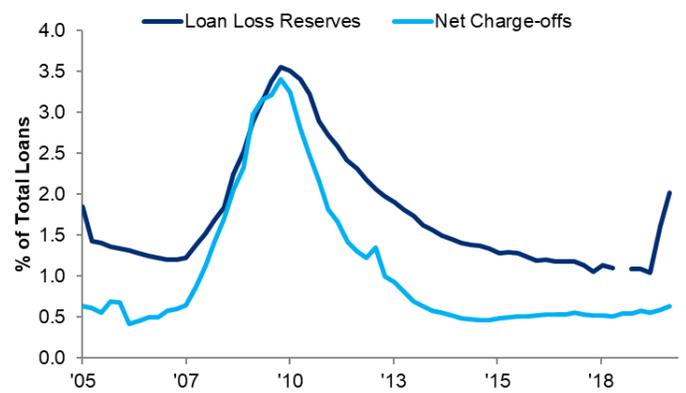
**A tale of two economies:** Given the vastly divergent prospects for firms operating in the digital world versus the physical one, analysts are likely to focus on the sustainability of growth for the former and the recovery prospects for the latter (Figure 3). Are the eye-popping numbers reported by video conferencing providers or gaming companies likely to continue in a post-COVID world? Meanwhile, investors in the most COVID-impacted shares will likely focus on more immediate concerns like cash adequacy in sectors like airlines and energy, signs of a peak in bank loan loss provisions, and occupancy rates for residential and office REITs.

Digging into US banks specifically, provisions for loan losses indeed may have peaked in Q2, which if confirmed will be an important data point for regulators who ultimately hold the cards on banks' ability to resume payouts to shareholders. Given regulatory scrutiny on banks is likely to remain intense until economies meaningfully improve, we see higher nominal rates as a necessary catalyst for a rebound in more net interest margin oriented banks.

**Figure 3: S&P 500 IT vs Industrials EPS (with consensus estimates)**



**Figure 4: S&P 500 Bank Loan Loss Reserves**

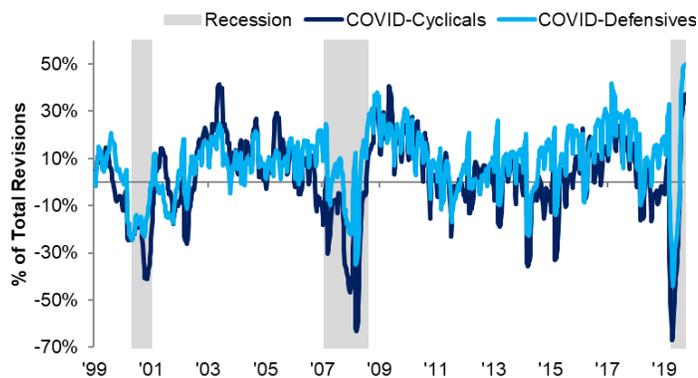


Source: Factset as of October 7, 2020

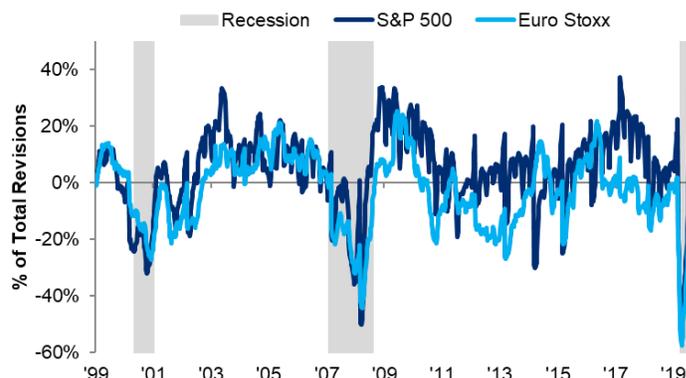
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**Revisions rollercoaster:** As markets have recovered over the last 6 months, single-stock analysts have concurrently revised up their bearish estimates from the spring, leading to a fairly lopsided ratio of upgrades to downgrades (Figure 5). We see less of a universal upgrading trend in Europe, where investors and analysts remain more skeptical of the recovery story in what is a generally more economically sensitive equity market (Figure 6). Given the dynamics of this sharp but ultimately short negative shock to earnings this year, we find the revisions volatility as largely reflecting the whiplash experienced by many investors who have tried to time the US equity market since February. With that said, earnings revisions tend to spike early in bull markets, and we do not necessarily view elevated readings as a bearish signal.

**Figure 5: S&P 500 Covid-Cyclicals and COVID-Defensives EPS Revisions**



**Figure 6: S&P 500 and Euro Stoxx EPS Revisions**

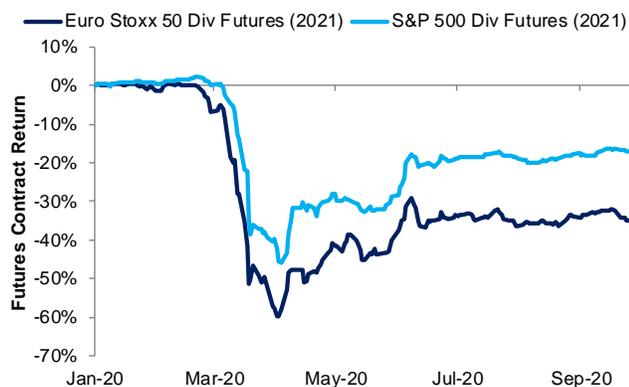


Source: Factset as of October 7, 2020

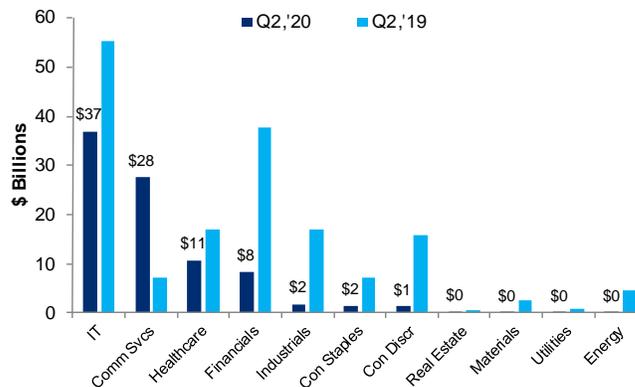
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**“Show me the money”:** Another key area of focus for Q3 earnings season will be the prospects for continued recovery in payouts to shareholders, whether they be in the form of buybacks or dividends. A number of firms who were forced to forego dividend payments amid the height of COVID uncertainty in Q2 may choose to reinstate payouts as the outlook has cleared somewhat. Dividend futures contracts have largely stabilized since June, though payout forecasts remain subdued relative to pre-COVID expectations (Figure 7). Dividend reinstatements may be particularly important for some higher-quality REITs and other perennial dividend payers whose investor bases tend to seek out steady income. Other areas like the banking sector are likely to remain constrained by regulators this year regarding how much capital they can ultimately return to shareholders (Figure 8).

**Figure 7: US and Europe Dividend Futures**



**Figure 8: S&P 500 Buybacks by Sector**

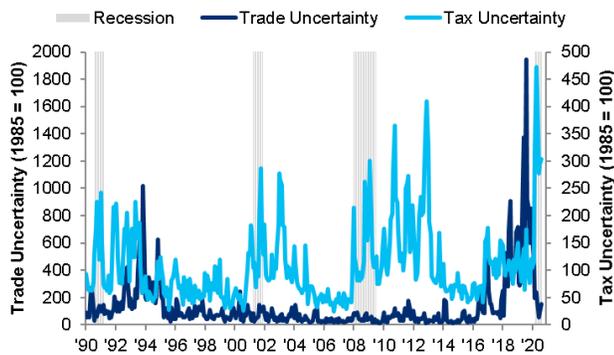


Source: Bloomberg and Haver as of October 7, 2020

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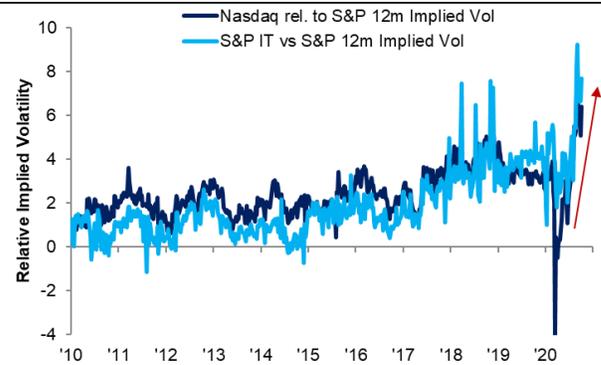
**It's rude to talk politics at the table:** With election season in full swing, executives are likely to face questions around profit sustainability across a number of political scenarios, from higher corporate taxes to carbon regulation (Figure 9). We are increasingly focused on regulatory scrutiny of mega-cap technology names, as they currently face potential headwinds across all three branches of the US federal government: separate anti-trust probes from the Department of Justice and House Democrats as well as pending lawsuits involving Apple and Alphabet making their way through the judicial system. Markets may have begun to price in some of this uncertainty, with implied volatility on technology names rising to multi-year highs relative to S&P vol in recent weeks (Figure 10). To be clear, we continue to see fundamental value in the business models of the most innovative and fastest-growing US tech firms. With that said, in the event that calls for “breaking up big tech” grow louder, we see better opportunities for outperformance among more under-the-radar small cap technology companies (Figure 11).

**Figure 9: Tax and Trade Policy Uncertainty**

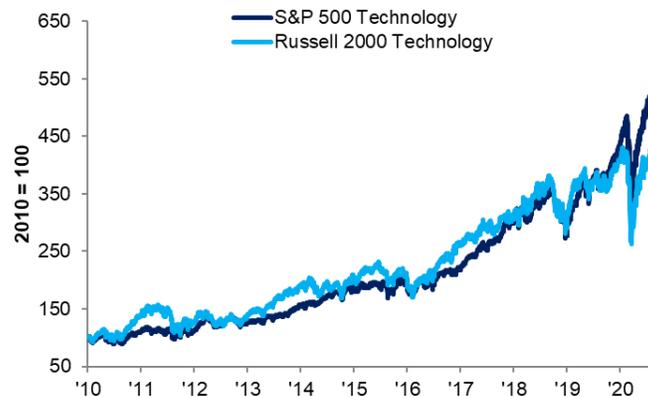


Source: Factset as of October 7, 2020

**Figure 10: Tech stock implied volatility elevated relative to the broader market**



**Figure 11: S&P 500 Tech vs Russell 2000 Tech**



Source: Bloomberg as of October 8, 2020

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