Investment Commentary

Earnings Decline Amid Stock Market Recovery

May 20, 2020

Following the fastest bear market drawdown in U.S. history, markets gained positive momentum through mid-May. From mid-February to late March, the S&P 500 Index dropped roughly 34%. Since then, the Index has recovered with a gain of nearly 20% from the trough. In addition to the stock market recovery, the U.S. and the rest of the world began planning for a gradual reopening, as many public health experts suggest the peak of coronavirus infections has been reached.

First quarter earnings were remarkably low, as many businesses suspended operations and shelter-in-place orders were enforced globally. As of May 15, the blended earnings (combination of *actual* earnings reported and *estimated* earnings for companies that had not yet reported) decline for the S&P 500 in Q1 2020 was -13.8%. If this were to be the quarter's actual decline, it would mark the largest year-over-year decline reported since Q3 2009, when earnings dropped by -15.7%.[1] As many U.S. states begin to reopen, economic activity will pick up, and earnings are expected to increase. However, given the uncertainty that still surrounds the pandemic, businesses may not be operating at full capacity and consumers may remain cautious about increasing spending. So, the extent to which economic activity increases in the near term remains to be seen.

Earnings Recovery Journey

One commonality among all past recessions was the long journey to earnings recovery—on average, it took nearly three years of volatility before earnings reached their pre-downturn peak levels. However, the way equity markets behaved during past U.S. recessions did not consistently reflect earnings expectations. For example, in the 1990-91 recession, 12-month forward EPS hit its trough well *after* stocks had regained momentum. However, with the tech bubble recession in the early 2000s, 12-month forward EPS bottomed nearly a year *before* the market did. And lastly, the Global Financial Crisis in 2008-09 experienced earnings and equities falling at about the same pace, with the market bottoming only two months before EPS expectations hit their lowest point.

Anticipating what the road to recovery will look like for the current recession is complicated by coronavirus unknowns and the related difficulty in forecasting earnings. Of course, we don't yet know whether the market has bottomed. Typically, investors start to feel confident that the worst has passed when they can see earnings downtrends start to turn positive, but many analysts are continuing to decrease their expectations for Q2 2020 earnings. Consensus estimates speculate that second quarter earnings will be down 50-60% from Q2 2019 levels. If these estimates prove to be correct when second quarter earnings are reported (typically August), it's possible it will trigger another wave of volatility, and potentially, a new market bottom.

Our Outlook

We believe a cautious approach is warranted as many unknowns remain. In particular, we continue to focus on investments backed by high-quality companies and management, on the possibility that the economic recovery could be uneven and choppy for some time. Market volatility may remain elevated until the range of potential outcomes begins to narrow. We see the current stock market risk/reward as less compelling following the recent rally because equity valuations are not cheap at current levels. The strong rebound in stock prices despite many unknowns surrounding the pandemic indicate to us that the world may not be out of the woods.

We recognize that corrections and bear markets are a normal part of investment cycles and can create attractive buying opportunities for investors that are long-term focused and willing to take on risk while others are fearful. At the same time, with an understanding of the exceedingly challenging combination of circumstances investors are faced with, we appreciate that fear is natural. We will look for additional opportunities to selectively increase risk, if further stock market pullbacks develop. In the meantime, we will focus on dislocations in various niche markets that present attractive risk/rewards.

[1] FactSet

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