FEBRUARY 18, 2020

Fear vs Fundamentals: Redux

Recapping the market's reaction to fourth quarter earnings season and the Coronavirus outbreak

We are well into earnings season for the final quarter of 2019, but one could be forgiven for not noticing. After all, Coronavirus fears and the accompanying environment of heightened uncertainty have stolen the headlines. At the same time, they have poured cold water on what's been a solid reporting season thus far, and we believe market movements have been driven more by fears of a global pandemic rather than reaction to economic fundamentals.

An early take on earnings

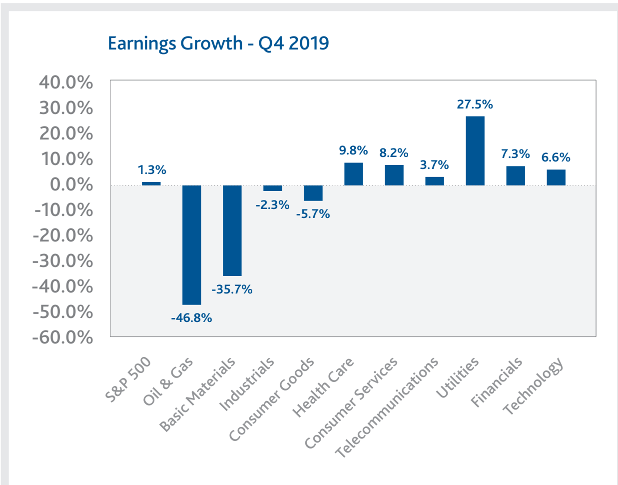
As of February 14th, 289 of the 389 companies in the S&P 500 that have reported earnings have beaten the Street's estimates, with the average report being 5.4% better than predicted by analysts. Of note, U.S. banks got the season underway with some strong results. Gains were reported across most business lines, with notable strength in the consumer divisions, reflecting ongoing domestic resilience that's been at odds with woes in the factory space.

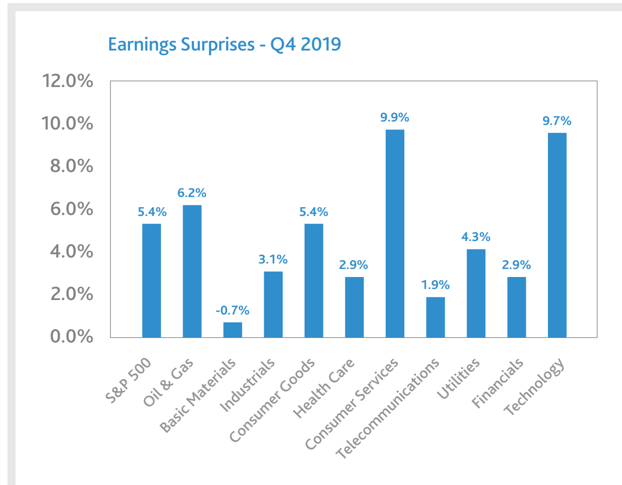
Bellwether company Caterpillar (a barometer for the health of the world economy) also reported earnings that exceeded estimates, though provided a cloudy assessment for the global backdrop in 2020. Meanwhile, other major players such as Apple, Microsoft, and Amazon – which together make up 13% of the S&P 500 – also impressed. Apple smashed expectations and reported much stronger-than-expected quarterly earnings and revenues, while reporting their highest quarterly revenue on record, again thanks to strong consumer demand that has prevailed across the globe.

Beat the street

Overall, Q4 net income rose a moderate 1.3% year-over-year so far in Q4 2019, tempered somewhat by bottom line decreases in the Oil & Gas and Basic Materials sectors; excluding those two, S&P earnings are up by 6.9%. But it wasn't just the S&P's earnings themselves that drove the surprises. Importantly, a large driver of the earnings surprises was in fact lower analyst estimates heading into the season – estimates that we believe were too gloomy given our expectation for a revitalization in global growth. While predictions were that the manufacturing slowdown would spillover into the consumer space, that didn't seem to be the case and instead, the consumer remained a pivotal source of global strength. This left many analysts surprised by corporate bottom line growth.

Given the generally positive earnings surprises, our expectation is that The Street will begin revising upwards its estimates. Moreover, we believe that going forward, earnings will play a more meaningful role in the market expansion than they did in 2019. Last year, equity gains were predominately driven by multiple expansion – the S&P 500 was up 724 points,





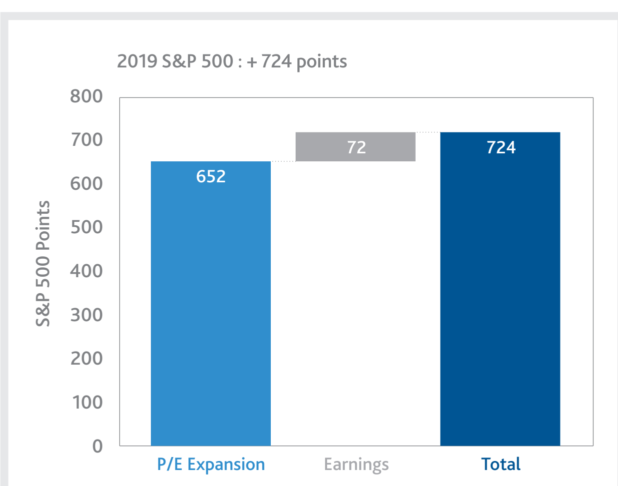
Source: Fiera Capital. S&P 500 data via Bloomberg as of 02/14/2020

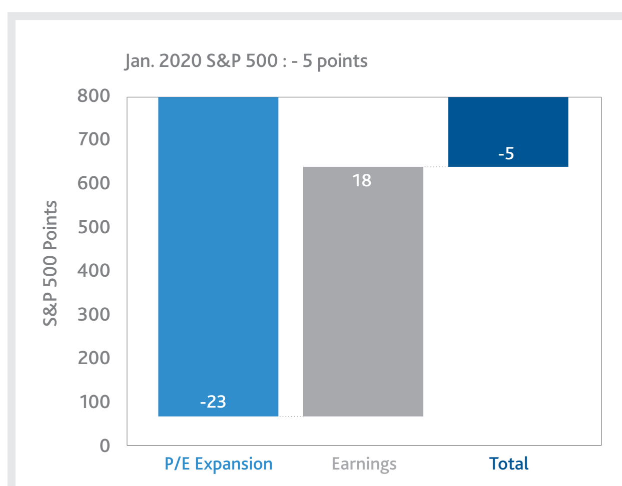
652 of which were due to P/E expansion (thank you, dovish central bankers), leaving just 72 points being driven by earnings. However, given these later stages of the cycle, we believe there's little room left for multiples to grow and expect this trend to reverse, with earnings making a greater contribution to market performance in 2020. Already in January, with the S&P down 5 points, earnings contributed +18 points to that figure, offset by -23 contribution by P/E contraction. Thus, we are already seeing the beginning of an earnings-driven market.

Focus on fundamentals

Despite the major news coming out of U.S. earnings and economic releases, it's clear to us that the Coronavirus has been the driving force in financial markets over the last few weeks. We'd thus be remiss if we didn't at least mention its impact on global markets. We caution that the spread of the Coronavirus is but a few weeks old, and no one knows for certain how it will grow and what economic consequences it will have.

Undoubtedly, there will be a negative macroeconomic impact in the near-term. The viral outbreak poses some serious downside risks to an already-fragile recovery as the slowdown in China is surely to have some spillover effects across the globe as firms brace for supply-chain disruptions and a blow to demand. However, similar to previous epidemics, weakness should prove short-lived and result in a sharp recovery later this year once the outbreak has been contained. What's more, Chinese policymakers responded swiftly and injected liquidity into an already abundant financial market system, which should help to cushion the blow from any virus-related slump.





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So how does this impact our outlook for the global economy? Rather than speculate wildly on how the virus could harm markets, we prefer to focus on fundamentals. As of now, earnings season is telling us that American corporations are on a continued growth trajectory, while globally, economic data continue to impress – the Citi Economic Surprise Index (Global) just hit its highest level since early 2018. In short, our view is that the reflationary train is delayed, but not derailed. We advise our clients to stay the course and to refrain from letting fear trump fundamentals, as we believe those that focus on the latter stand to profit from those that don't.

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Source: Fiera Capital. Citi Economic Surprise Index (Global) data via Bloomberg as of 02/14/2020

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