CORPORATE EARNINGS: SURPRISE TO THE UPSIDE

by **Robert F. DeLucia, CFA**
Consulting Economist

One of the central themes of the 2020 economy is the surprisingly strong performance of corporate profits, as reflected in third quarter company financial reports. The favorable outlook for corporate earnings bodes well for the equity market. A strong recovery in earnings, cash flow, and dividends in 2021 and 2022 should boost stock prices over the medium term. However, although stocks should perform well over the next 12 to 18 months, it is unlikely that equity prices will be able to keep pace with the rapid upward path of earnings, implying some gradual deterioration in valuation measures.

Summary and Major Conclusions:

- One of the central themes of the 2020 economy is the surprisingly strong performance of corporate earnings in virtually all sectors, as reflected in third quarter company financial reports.
- Corporate earnings have proven to be surprisingly resilient in the aftermath of the pandemic, considering the extremely hostile economic environment faced by the business sector. Companies in the S&P 500 have reported earnings during the past two quarters that have exceeded Wall Street estimates by a wide margin.
- Third quarter company revenues and earnings also exceeded Wall Street estimates by a record amount. More than 90% of companies have announced Q3 results, with 86% of S&P 500 companies reporting a positive surprise. On average, earnings per share (EPS) for Q3 exceeded expectations by nearly 20%, an all-time record.
- It now appears that EPS for the full year will experience a much lesser decline than previously assumed, estimated at 15%, falling to $140 versus their all-time peak of $163. This compares favorably with the decline in EPS during the Great Recession, when earnings plunged by 45% in 2008.
- The surprising strength of corporate profitability this year can be attributed to superb management of costs by business executives, who have aggressively restructured their operations while adopting revolutionary new digital and cloud technologies to increase productivity.
- Profit margins have also benefited from a weak labor market and very slow growth in wages. Revenue growth of the largest companies in the S&P 500 has also been supported by rapid development of new products and services along with market share gains, as industry leaders capitalize on widespread business failures and consolidation in many industries.
- The outlook for corporate earnings in 2021 and 2022 is encouraging. My positive forecast assumes a peaking of the pandemic in mid-January; a rollout of vaccines for the general population in the spring; and congressional passage of additional fiscal stimulus in January or February of next year.
- Business conditions should be supportive of earnings growth in both 2021 and 2022. My economic assumptions include the following: Real GDP growth of 3.5% in 2021 and 5% in 2022; consumer inflation of 2% in 2021 and 2.5% in 2022; wage growth of 3% in both years; and solid productivity increases of 2% in 2021 and 3% in 2022.

- On the basis of this combination of economic trends, I expect EPS for the companies in the S&P 500 to increase by greater than 20% in both 2021 and 2022. Revenues are expected to increase by 7% in 2021 and 9% in 2022. If so, this would be the strongest two-year growth in EPS since the 1990s.

- In principle, the primary determinant of the long-term direction of stock prices is the path of company EPS. The favorable outlook for corporate earnings bodes well for the equity market over the medium term.

- Although stocks should perform well over the next 12 to 18 months, it is unlikely that equity prices will be able to keep pace with the rapid upward path of earnings. A combination of a rising trend in bond yields and increasing inflationary expectations should exert downward pressure on equity market valuations as 2021 unfolds.

- However, caution is advised in the very short term, primarily because of the rapid deterioration in public health conditions. New infections, hospitalizations, and deaths are on a steep incline and are unlikely to reverse course until January or February of next year.

- While another nationwide lockdown appears unlikely, stricter guidelines for nonessential businesses are likely to be imposed in heavily diseased states and regions. The result could be a disruption in business and commerce, manifested in weakness in aggregate spending and output, along with a rising trend in unemployment.

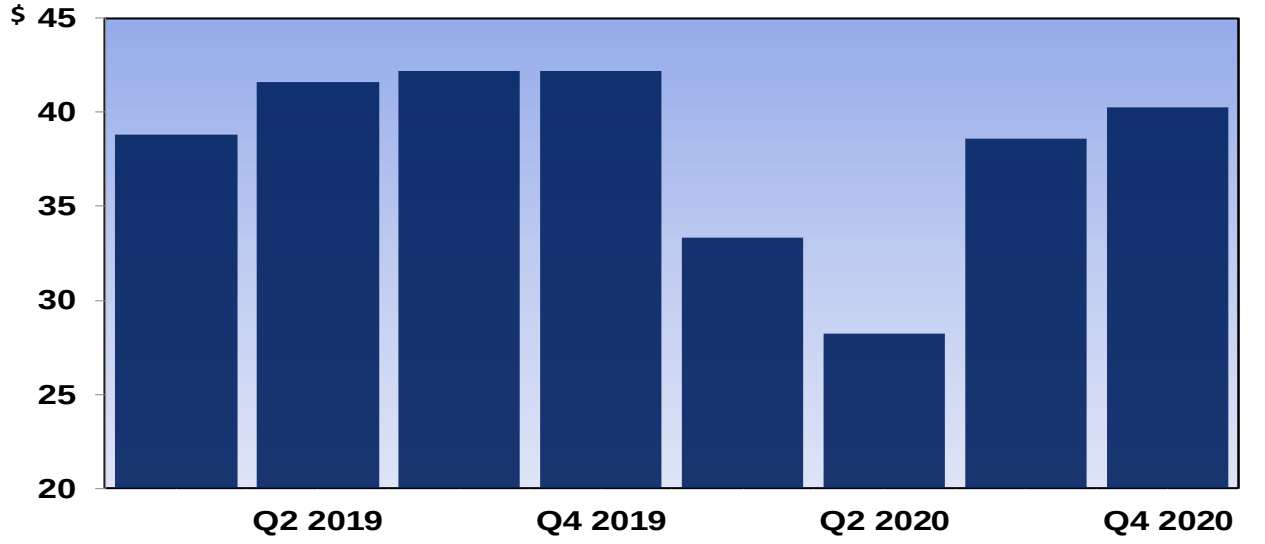
- Finally, political uncertainty is likely to remain elevated over the next several months. There is also profound uncertainty regarding the future path of fiscal policy. The bottom line is that while medium-term prospects for common stocks remain favorable, there are lingering political, economic, and health care risks that could undermine investor confidence in the short term.

Equity markets are notorious for volatility in the short term. Day-to-day and week-to-week fluctuations in stock prices are typically caused by transitory psychological and emotional factors, often associated with news headlines. *However, over the long term, the primary driver of stock prices is the trend in corporate earnings*. *An analysis of stock market history reveals a very strong statistical correlation between stock prices and company earnings*.

Net Present Value: As is true for all long-term financial assets, the present value of common stocks is defined by the expected future stream of cash flows, discounted back to the present by an appropriate capitalization rate. Stated differently, the level of stock prices at any point in time is equivalent to the product of two key variables: (1) The level of corporate earnings per share (EPS); and (2) A discount rate largely determined by the term structure of interest rates.

- **Market Value**: As an example, the current value of the S&P 500 Index of 3600 is comprised of two multiplicative factors: Estimated 12-month forward EPS of $168 and a price-to-earnings (P/E) multiple of 22x. A P/E ratio of 22x is the equivalent of an equity market discount rate of 4.5%.

Chart 1: Sharp Reversal In Quarterly Earnings
Earnings Per Share, S&P 500 Companies
Source: FactSet



- **Dow Jones Industrials**: For the Dow Jones Industrial Average (DJIA), the comparable numbers are estimated EPS of $1200 and a P/E ratio of 25x, which equate to the current market value of the DJIA of 29,735.

My equity market forecast for 2021 assumes a sharp rise in EPS, partially offset by a shrinkage in the P/E ratio that is likely to result from a rising trend in bond market yields.

CURRENT EARNINGS

One of the central themes defining the 2020 economy is the surprisingly strong performance of corporate earnings during the third quarter. Corporate earnings have proven to be unusually resilient in the aftermath of the pandemic, especially considering the extremely hostile economic environment. *Companies in the S&P 500 have reported earnings during the past quarter that exceeded Wall Street estimates by a wide margin*, which has favorable ramifications for the equity market in 2021.

Third Quarter: With official reports from more than 90% of the companies in the S&P 500, Q3 revenue and earnings performance has exceeded Wall Street estimates by a historical margin. Compared with a projected decline of more than 20% on September 30, actual earnings are on track to decline by only 7% (see chart 1).

- **Unprecedented Beats**: A record 86% of companies announced EPS that were higher than Wall Street estimates, which compares with a historical average of 73%. European companies also beat analyst expectations, declining by 22%, a big improvement from the 62% decline in the second quarter.

Chart 2: Strong Earnings Recovery Expected in 2021 and 2022
Earnings Per Share, S&P 500 Companies
Source: FactSet

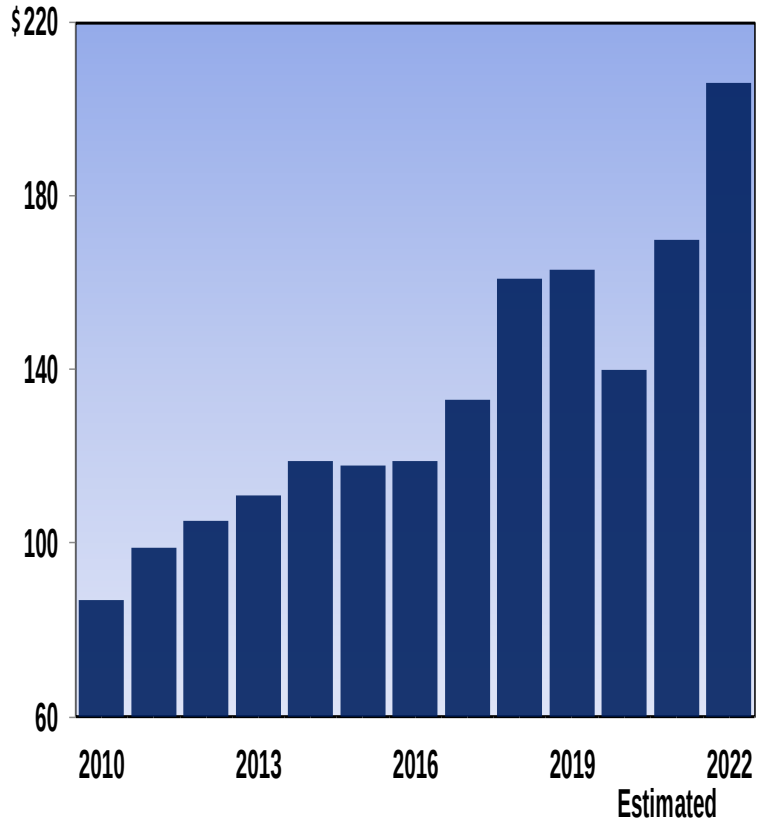
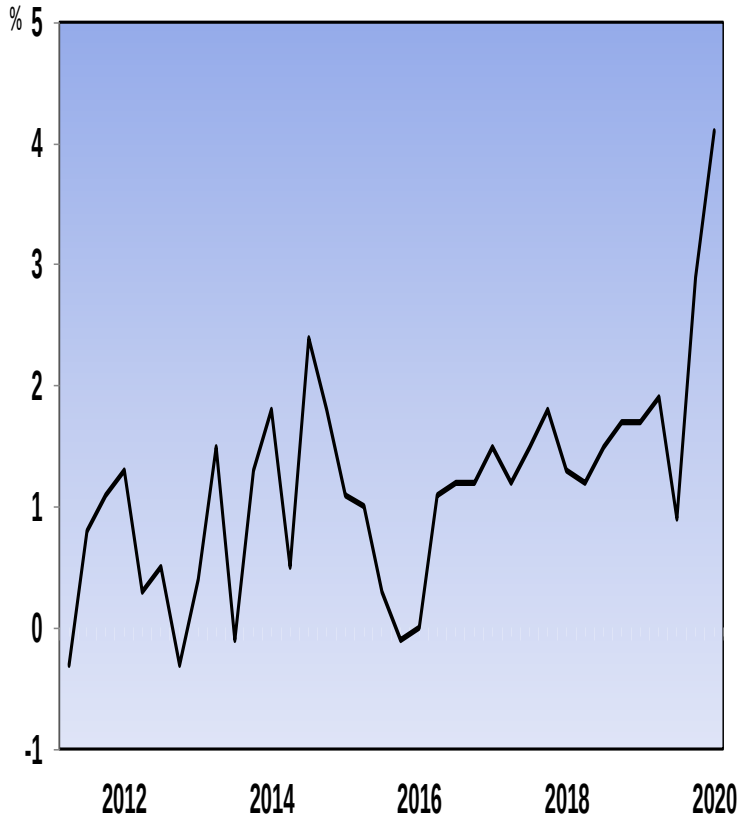


Chart 3: Accelerating Growth in Labor Productivity
Output Per Hour, Nonfarm Business Sector
Annual Percentage Growth Rate
Source: Bureau of Labor Statistics



Full-Year 2020: It now appears that the full-year decline in EPS will be far less than previously assumed. Compared with their all-time peak of $163 in 2019, EPS for the companies in the S&P 500 are expected to be $140 in 2020, a decline of only 15%. This compares quite favorably with the decline in EPS during the Great Recession, when EPS for the companies in the S&P 500 plunged by 45% in 2008 (see chart 2).

Earnings Resilience: What explains the much better performance of corporate earnings? There are numerous factors at work but most revolve around the ability of the business sector to manage costs and to quickly introduce efficiencies into their operations.

- Company executives have restructured their businesses and adopted new business models to keep operating costs under excellent control, thereby allowing profit margins to expand.

- Companies have utilized digital and cloud technologies to achieve internal efficiencies and to boost productivity, which has risen to the highest level in decades (see chart 3).

- Industry leaders have been creative in responding to the crisis by introducing new products and services for customers to help them navigate the pandemic.

- Profound weakness in the labor market has resulted in a sharp slowdown in wage and salary increases. Companies have eliminated jobs and instituted wage and salary cuts.

- Profit margins have also benefitted from cutbacks in other areas, including capital spending, sales and advertising, and business travel.

- Widespread failures of small and mid-sized companies have allowed the leading firms in their industries to gain market share. The S&P 500 is comprised of the largest and most dominant companies in the world, many of which have taken advantage of the profound weakness within the small business sector to win new customers.

EARNINGS OUTLOOK

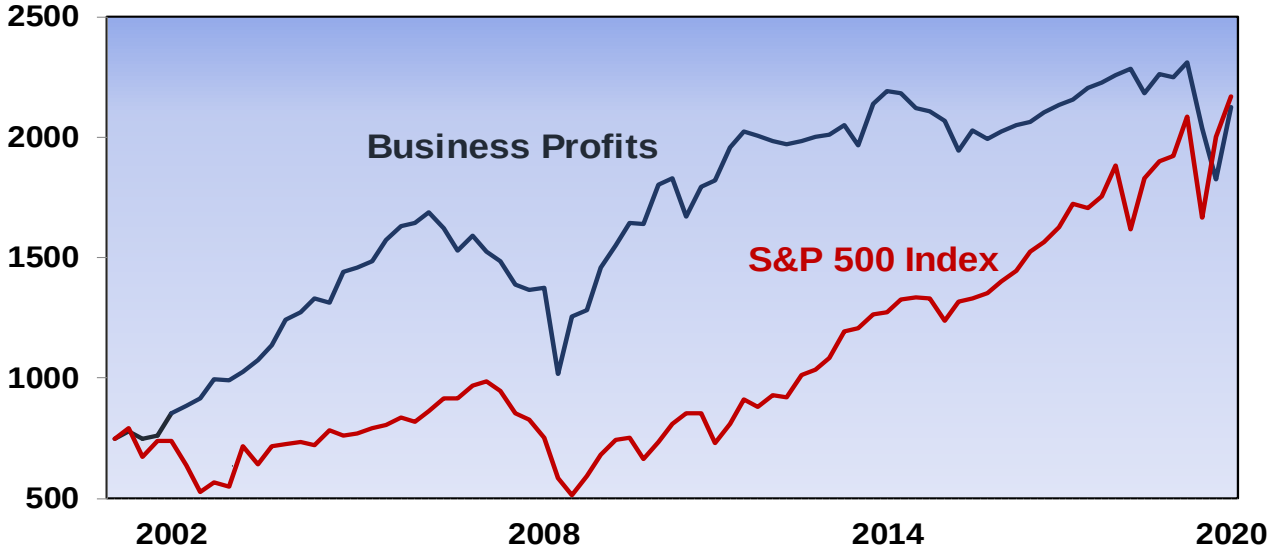
The outlook for corporate earnings in 2021 and 2022 is encouraging. My positive outlook is predicated upon three assumptions: (1) The current worldwide pandemic reaches a peak in mid-January, following implementation of stricter public health guidelines; and (2) The FDA approves one or more vaccines — along with monoclonal antibody treatments — that are available in sufficient quantities during the first half of next year; and (3) The current business expansion cycle is sustained, with accelerating economic growth as 2021 unfolds, followed by healthy growth in 2022 (Bar Chart).

Economic Conditions: My favorable assumptions for corporate profitability during the next two years include the following:

- Real GDP growth of 3.5% in 2021 and 5% in 2022
- Consumer inflation of 2% in 2021 and 2.5% in 2022
- Wage growth of 3% in both years
- Solid productivity increases of 2% in 2021 and 3% in 2022
- Unit labor cost increases of only 1% or less in both years
- A steadily weakening trend in the US dollar over the next two years

Based upon this combination of trends, I expect EPS for the companies in the S&P 500 to increase by 20% to 25% in both 2021 and 2022. Revenues are expected to increase by 7% in 2021 and nearly 9% in 2022. If so, this would be the strongest growth in company sales and EPS since the 1990s.

Chart 4: Strong Correlation Between Stock Prices and Corporate Earnings
S&P 500 Index
Business Profits
Operating Earnings: Billions of Dollars
Source: Bloomberg



INVESTMENT PERSPECTIVE

The favorable outlook for corporate earnings bodes well for the equity market. A strong recovery in earnings, cash flow, and dividends in 2021 and 2022 should boost stock prices over the medium term. Historically low bond yields and highly accommodative monetary conditions also add to the appeal of common stocks. Major breakthroughs in vaccine and therapeutics technologies will provide an additional support to the equity market.

Although stocks should perform well over the next 12 to 18 months, it is unlikely that equity prices will be able to keep pace with the rapid upward path of earnings. A combination of a rising trend in bond yields and increasing inflationary expectations should exert downward pressure on equity market valuations. Nonetheless, I expect common stocks to be the best-performing asset class through 2022 (see chart 4).

However, caution is advised in the very short term, primarily because of the rapid deterioration in public health conditions. New infections and hospitalizations have surged to record levels and are unlikely to reverse course until January or February of next year. And while another nationwide lockdown appears unlikely, states and regions are likely to impose restrictions on nonessential activity.

At the same time, consumers, workers, and businesses are likely to adopt voluntary restrictions on their activities for safety reasons. The result could be a progressive weakness in aggregate spending and output into the new year along with a rising trend in unemployment. Recent news on the medical front has been extremely promising, but several critical questions remain unanswered with respect to timing of the nationwide rollout of vaccines and the durability of immunity over time.

Finally, political uncertainty is likely to remain elevated over the next several months. While the election results appear to be secure, the ultimate outcome of the presidency and Senate will not be official for a number of weeks. There is also profound uncertainty regarding the future path of fiscal policy. Finally, there is uncertainty regarding a highly unpredictable President Trump and the potential for surprises in the form of executive orders in the lame duck session. The bottom line is that medium-term prospects for common stocks remain quite favorable but there are lingering risks in the short term.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

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Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

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