MV Capital Management Weekly Market Flash

Next Up: 3Q Earnings

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The depressing Washington sideshow is certainly not over. It appears that we have at least another six weeks of empty rhetoric and vainglorious posturing to endure while policymakers search for a clue about how to run the government and pay for things. But investors, weary of this unbecoming spectacle, are turning attention back to corporate earnings. We had our brief volatility flare-up this week, followed by an equally brief relief rally, and now it's back to business. The 3Q earnings season is underway, and it will be an important gauge of where we are in the economic recovery.

The "Consensus Oracles"

To make sense of earnings season requires one to study that curious species of human known as the "consensus group". These are professional analysts and economists who supply estimates about company revenues and earnings to media groups and market researchers. The watchword is "surprise". If a company beats expectations, then it is a positive surprise. The company's stock may then rally (but not necessarily, as we discuss below). Failing to exceed the estimates bar, conversely, can be a bad thing.

The Waltz of the Estimates

Looking at some data around recent quarters we are struck by how often a certain pattern repeats itself – a three-step estimates waltz, if you will:

Step 1: Early in the calendar year, the consensus group makes predictions about performance in each of the coming four quarters. The predictions are almost always rosier than the actual results turn out to be.

Step 2: As the reporting season approaches, the consensus estimate is revised downwards, often sharply.

Step 3: A majority of companies then wind up outperforming the downwardly revised estimates. "Positive surprises" abound, and everyone goes home happy…unless there are hints by company executives about some approaching bumps in the road. That's known as "guidance" in earnings season parlance.

Reading the 3Q Tea Leaves

So earnings season is actually less a straightforward reporting of company performance and more a psychological puzzle about how the market will respond to this combination of evolving estimates, surprises and guidance. Take, for example, some of the current data as the 3Q season gets underway. The latest revision to consensus group EPS expectations for the quarter comes in at 3.4% below the estimate on July 1, according to FactSet. Bad, right? Maybe not. That 3.4% downward revision is actually less of a downward revision than the average going back to 4Q 2009. In other words, the consensus is less negative, in relation to its view three months ago, than it usually tends to be. Or something.

Earnings estimates are important, because they are the denominator of one of the most closely-watched valuation metrics – the forward P/E ratio. If forward estimates are too rosy then an attractive-looking P/E, i.e. where prices do not seem overvalued relative to earnings, can start to look less promising. We will be keeping a close eye on the tea leaves as they emerge from this earnings season.

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