MV CAPITAL MANAGEMENT

Weekly Market Flash

Killer Earnings, Fading Exuberance

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The second quarter earnings season is about to end, and it's been a barnstormer. With about 90 percent of all S&P 500 companies having reported, the blended growth rate – comprising the actual reported numbers along with analysts' estimates for the remaining 10 percent – is a stonking 91 percent. Yes, a big part of that dazzling figure comes from the basis of comparison being the lockdown period of Q2 2020. But even so, the results far outperformed expectations. At the beginning of the second quarter the consensus forecast for earnings growth was 52 percent, so when all is said and done the growth rate will wind up being nearly double that earlier prediction.

Earnings Fatigue

And yet for all those stellar earnings beats (that's finance-speak for companies that deliver better results than analysts expected) the response from the market has been little more than a yawn. Companies that reported higher than expected earnings saw on average a gain of around half a percent in their share price immediately following the announcement. Those that missed the consensus estimate experienced on average a drop of about two percent.

Why the asymmetry? It seems that the Q2 earnings season got dragged into the emerging "peak growth" narrative that has settled into mainstream thinking. Nobody expects these companies to be plowing ahead with consistently high-double digit earnings growth once the immediate post-lockdown distortions have settled down, so the inclination is simply to treat the current round of numbers as so much noise. Better to focus on what could go wrong than on what has gone right – hence the more punishing reaction to companies missing their target numbers.

All About the Margins

For many analysts and investors the focus going forward is less on earnings growth itself than it is on profitability margins. We've all seen the inflation numbers shoot up in the past several months, both at the wholesale level (which companies experience when they purchase raw materials and intermediate goods) and the consumer level. Both wholesale and consumer price indexes are currently at decades-long highs, but there are differences of opinion as to whether this is merely a temporary phenomenon (which is what the Fed, among others, have long been saying) or something more structural.

To the extent that higher prices are here to stay, companies will face decisions about how much of the higher costs they assume at the wholesale level can be passed on down the value chain to consumers. Eating the costs themselves to keep prices low may help maintain selling volumes, but they will be earning fewer cents on each dollar of goods sold. Raising prices, on the other hand, may result in lower demand and loss of market share.

There's not much in the current quarter's numbers to give analysts a definitive read on margin prospects. But earnings calls have been dominated by questions about how management teams are experiencing inflation and how they see this playing out in the quarters ahead. We expect that when the third quarter earnings season starts in October, margin performance will be front and center. And with valuations still at historically elevated levels – despite the respite provided by the blowout earnings growth of the second

quarter – we also expect that the performance bar will be set high. The earnings fatigue we have seen in the most recent quarter is not likely to dissipate any time soon.

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