Market Perspectives

PRIVATE CLIENT SOLUTIONS

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Earnings Recap

US earnings season is in its final throws with ~90% of S&P 500 companies reporting Q1 results. The impact of COVID-19 towards the latter half of Q1 was enough to push earnings growth well into the red. Recall, in 2019 S&P 500 earnings growth was essential flat (grew 1.5% yoy) while the market itself managed to gain ~30%. With no earnings growth, 2019's impressive gains came from price-earnings (PE) multiple expansion, not from an improvement in earnings.

- As we entered 2020, analysts were looking for 5.3% EPS growth in Q1/20 but as is typical fashion, estimates fell as analysts sharpened their pencils ahead of the quarterly reporting season. Once reporting season began, Q1/20 EPS growth slipped to -13.9%; if -13.9% is the actual decline for the quarter, it will mark the largest yoy decline in earnings reported by the index since Q3 2009 (-15.7%).
- On March 23, the forward 12-month PE ratio was 13.1x, as the price of the index hit its lowest value since 2016 at 2,237. Since that date, the price of the S&P 500 has increased by ~30%, while the forward 12-month EPS estimate has decreased by 16.5%. Thus, the increase in the "P" and the decrease in the "E" have both been drivers of the sharp increase in the PE ratio over the past seven weeks.
- In our February *Insights & Strategies: Value is What You Get* we discussed market valuation levels, given at the time the market was also trading at a very rich multiple. In the report, we outlined the potential risk/reward profile for the market, if an investor were to place capital to work in a richly-valued market.
- From our perspective, the market is trading on the expectations of a v-shape recovery and that further stimulus measures will be implemented to support the economy. Some have argued the disconnect between earnings growth and stock prices is justified due to the trillions in central bank liquidity and fiscal stimulus; the classic "don't fight the Fed" mentality.

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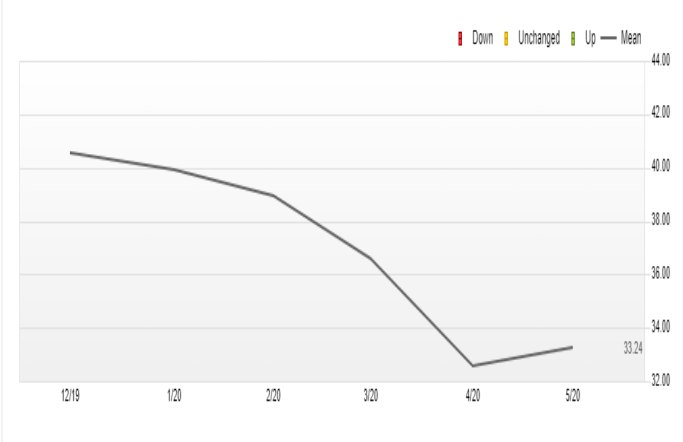
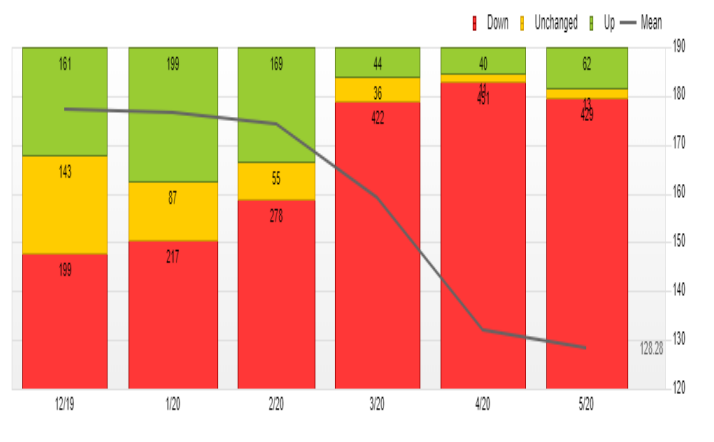
US earnings season is in its final throws with ~90% of S&P 500 companies reporting Q1 results. The impact of COVID-19 towards the latter half of Q1 was enough to push earnings growth well into the red. Recall, in 2019 S&P 500 earnings growth was essential flat (grew 1.5% yoy) while the market itself managed to gain ~30%. With no earnings growth, 2019's impressive gains came from price-earnings (PE) multiple expansion, not from an improvement in earnings. This significant expansion was driven by a notable shift in global monetary policy, an easing in US-China trade tensions and nascent signs the slowdown in the global economy had bottomed. Plus, the market was looking toward 2020, which was estimated to deliver 10% annual earnings growth. Taking into consideration the level of interest rates and subdued inflation, an argument could have been made to justify the market's advance.

As we entered 2020, analysts were looking for 5.3% EPS growth in Q1/20 but as is typical fashion, estimates fell as analysts sharpened their pencils ahead of the quarterly reporting season. Once reporting season began, Q1/20 EPS growth slipped to -13.9%; if -13.9% is the actual decline for the quarter, it will mark the largest yoy decline in earnings reported by the index since Q3 2009 (-15.7%). However, the real damage to corporate earnings will showup in Q2/20 with growth anticipated to crater a remarkable 41.7%. For the full calendar year 2020, S&P 500 EPS have been revised 28% lower, the steepest decline since the financial crisis, to US$127.70/sh implying growth of -21%. However, the market has largely written off 2020 and is focused on 2021 with analysts predicting a 30% rebound in earnings to US$163.40/sh.

S&P 500 Q1/20 EPS Trend



S&P 500 Full Year EPS Estimate



Source: FactSet

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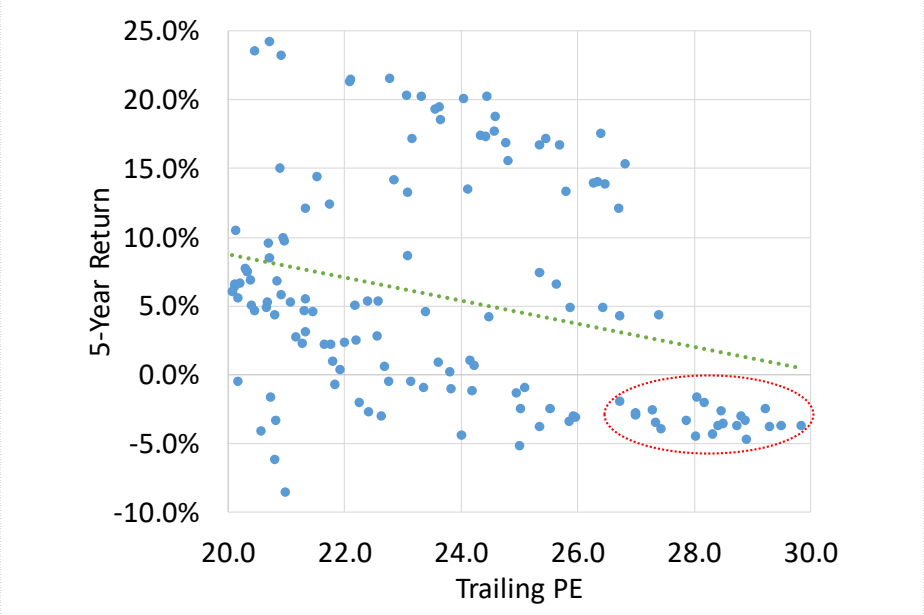
investor were to place capital to work in a richly-valued market. With the market trading at even more elevated levels it is worth repeating here:

"If buying the market at a low valuation results in a superior outcome, then surely the opposite is true for buying the market when valuations are stretched? The short answer is yes, but the numbers provide some surprises. An investor who places capital at work when the market is trading at or above 20x trailing earnings experiences an average 5-year return of 5.6%, a reasonable outcome, particularly in this environment. However, it's not all good news as the chances of a positive return outcome falls to 66% and the investor will also experience greater volatility in returns. In fact, the volatility is double what an investor would experience who buys into a discounted market. In the chart below, we can also see a clustering of data points (red circle) in the lower right quadrant highlighting the negative outcomes that can occur when one invests near peak valuation."

S&P 500 Return Profile at Premium…



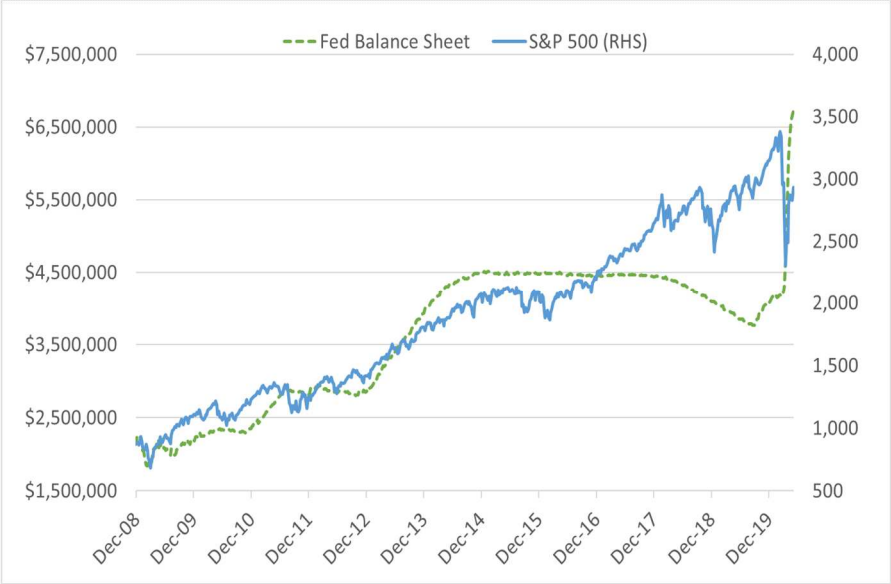
Source: FactSet, Raymond James Ltd.

From our perspective, the market is trading on the expectations of a v-shape recovery and that further stimulus measures will be implemented to support the economy. Some have argued the disconnect between earnings growth and stock prices is justified due to the trillions in central bank liquidity and fiscal stimulus; the classic "don't fight the Fed" mentality. In the chart below, there is certainly a strong correlation between the Federal Reserve's balance sheet and the S&P 500 (weekly correlation 0.82) and the central bank has committed to an opened asset purchase program, which in theory could continue to push market and valuation levels higher. However, we are of the belief that fundamentals will eventually begin to dictate asset prices.

We have been consistent in our caution view on the market for over 12 months now, advocating for investors to move up in quality in both equity and fixed income sleeves. Know the risks and be comfortable with the level you're taking, find companies that have decent earnings visibility and build positions in post-COVID winners (this will be our focus for our June Insights & Strategies), and have a little extra cash so you can be

greedy when others are fearful. You don't get many second chances in life, so take this opportunity the market has given to right size your portfolio.

Federal Reserve Balance Sheet and S&P 500



Source: FactSet, Federal Reserve

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