EARNINGS SEASON ANALYSIS – Q224

AUGUST 09, 2024

Executive Summary

- Q2 Earnings season is unfolding in a tense climate with the best-performing stocks of the past 18 months correcting, with losses in the order of -10% to -20%; the Bloomberg Mag 7 Index is down -16% from its highs of early July, while the S&P500 is down -6%;
- For the S&P 500, second quarter YoY earnings growth is expected to be +8% to +9% (the season is not completed as we write), accelerating from +6.3% growth in Q1. The Mag 7 are driving growth; after 76% YoY growth in Q1, a rise of 42% YoY in Q2 is in the cards. Growth is then expected to stabilize in the +20% YoY area for the next 2 years;
- It is very difficult to extract a linear message from the current season, as there are many macroeconomic and geopolitical events that intersect with microeconomic corporate news. Price action in both one and five days following to the earnings publication does not offer any valuable information;
- However, it is clear to us that expectations were very high for Big Techs, where positioning was extreme. On the defensive side, Consumer Staples needs to be monitored closely given its possible macro message on the state of the US consumer.
- The very last days saw the release of some macro data that quickly called into question the assumption of a soft landing in America. Since this is very fresh news, we do not yet see these dangers in the earnings expectations of the S&P 500. But markets anticipate events, and in the coming days we could see an adjustment in earnings forecasts.

NCP remains constructive on the US and global equity markets, and we're modestly overweight equities relative to our model portfolio. We have a target price of 5'480 at year end for the S&P 500, and we will feel comfortable in increasing it once we get more confirmations that the disinflationary trend is intact. The upside should be mainly driven by EPS expansion and a slight improvement in margins, with stable multiples at current levels (20x on next year's earnings level). Consistent with this view, we have taken advantage of this violent corrective move to further increase our positioning in the equity market Monday 5th of August.

We are aware that recession risks have increased marginally in light of the latest data; however, we believe that the US economy is still solid and corporate earnings can continue to grow in line with consensus forecasts. As a result, we believe that the risk/reward in the market has improved in light of the correction, and that the S&P may revisit and then exceed its highs in the coming months.

S&P 500	2023	2024E	YoY	2025E	YoY
Sales	1788	1878	*5.0%*	1980	*5.4%*
EPS	220	243	*10.5%*	274	*12.8%*
Margins	12.3%	12.9%		13.8%	

2024 Price Target = 5'480 => 274 (2025 EPS) * 20 (2025 PE)

Novum’s “Investment Mosaic”

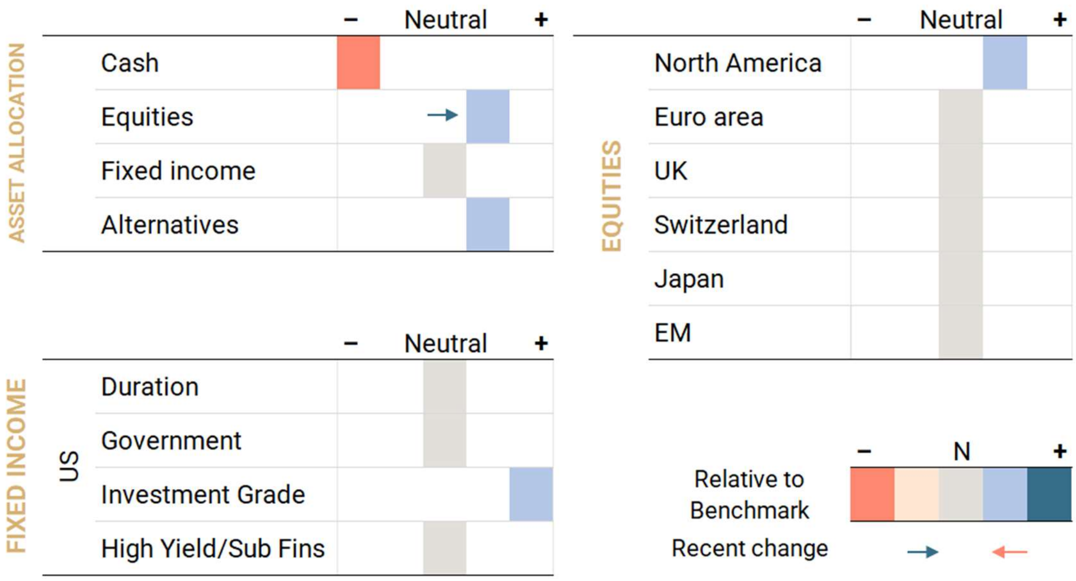


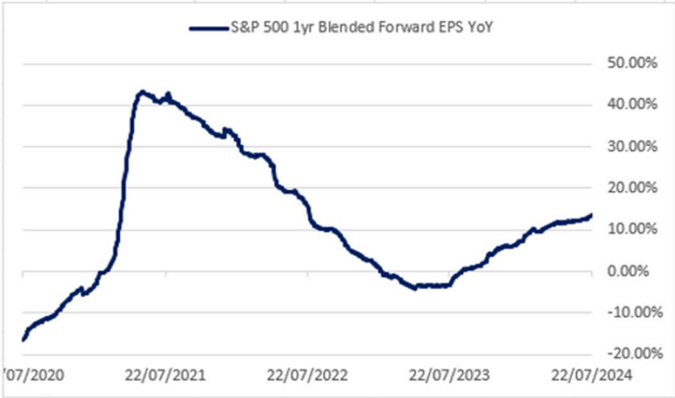
Table 1: Bloomberg consensus YoY changes in earnings for major indices

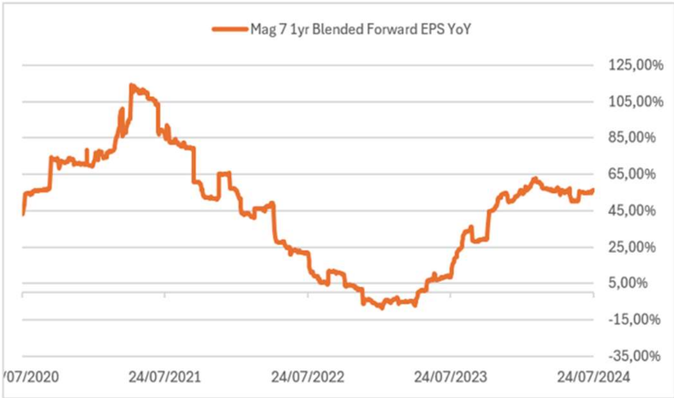
	2020 YoY	2021 YoY	2023 YoY	2024 YoY (Forecast)	2025 YoY (Forecast)
S&P 500	-12.6%	46.8%	1.0%	8.8%	13.8%
Russell 2000	-49.0%	177.9%	-18.1%	4.4%	32.7%
Mag 7	67.7%	77.0%	53.8%	37.1%	18.1%

The above table shows the earnings trends of the three indices we focus our attention on; besides the S&P 500, we selected the Mag 7 and the Small Caps of the Russell 2000, at the centre of the remarkable rotation that started on July 10th. Numbers show earnings in the right direction for this stage of the cycle, with growth for the whole S&P 500 which is expected to improve from a tame +1.0% in 2023 (full year), to +8.8% for the whole 2024, and accelerate to 13.7% in 2025. For the Mag 7 on the other hand, the growth rate is expected to slow down in 2025, with +18.4% YoY expected after +35.7% YoY in 2024.

The Small caps of the Russell 2000, while benefiting from the violent correction in the Mega Caps over recent weeks, are still seeing quarterly earnings (Q2) down -21% YoY, worse than previous quarter (-7% YoY). In line with the change in sentiment and outlook for interest rates, Russell 2000 earnings should finally return to growth in Q3, and then accelerate sharply in the coming quarters, to +32% YoY in 2025 (helped by base effects). Such volatility in earnings is explained with low profitability and high leverage.

The 2 graphs below show the YoY growth of earnings expectations for the next 12 months. Between 2022 and 2023, consistent with a slight decline in real GDP for two quarters, and the rise in interest rates, earnings contracted slightly. This cyclicality is one of the key reasons why we believe the earnings expansion projected by strategists for the next two years is achievable. **This belief does not assume another GDP contraction is coming. Typically, in case of a GDP contraction, earnings tend to fall in the order of -15% to -20%.** The Fed fund cuts that the rates market expects starting in September should help both corporate earnings and the consumer, who is starting to feel the fatigue from past hikes. Lower rates typically also support valuations (PE), which explains much of the Russell 2000's performance after the positive inflation surprise in early July. In fact, in the last few days, expectations for Fed cuts have jumped, predicting 175 bps of cuts over the next 12 months.

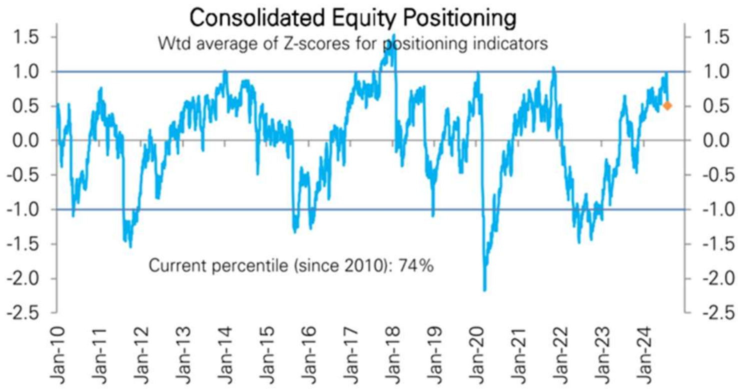


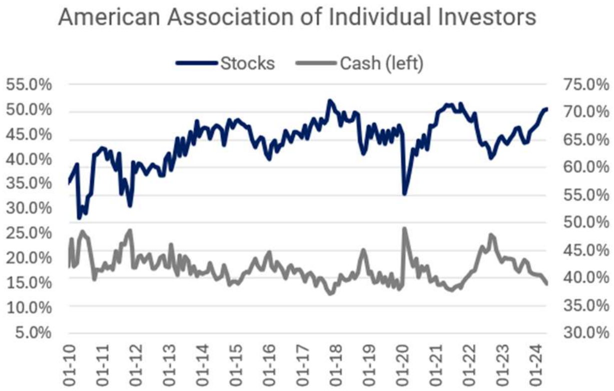


Source : Bloomberg

Before looking in detail at the current season's earnings, we look at market positioning, since we believe that part of the volatility and losses we are witnessing are related to this.

It is clear that investors (first two charts: from Deutsche Bank on the left, and from AAII on the right), are rather long stocks. The second chart from Deutsche Bank (third one, below) helps us to see that the overweight is concentrated on MCG&Tech (Mega Caps Growth and Tech). The second chart from DB (the third in order, on the second level), short-term oriented and updated to the 29th of July, shows that positioning is improving, but possibly not enough to call the correction completed. We don't have yet more updated data that take into account the selloff of the first week of August, but we assume that positioning has significantly improved at this point.

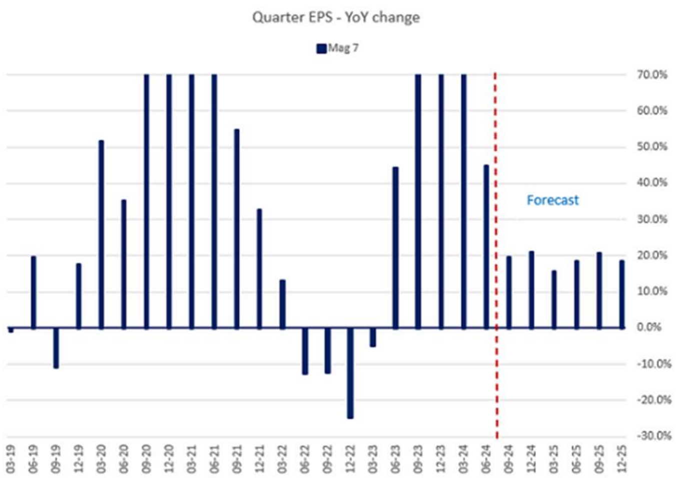


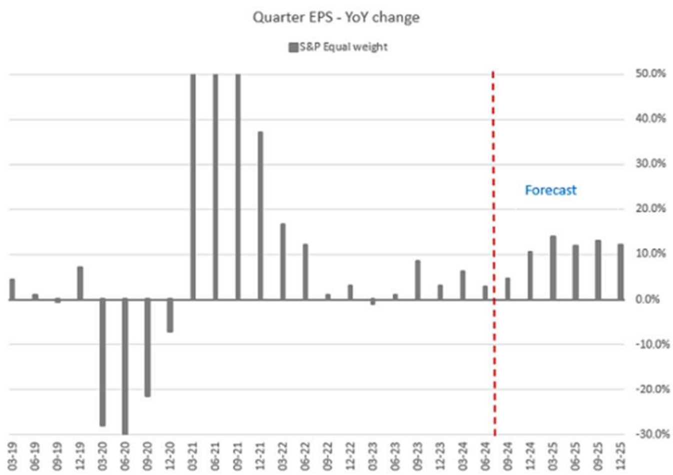


Source : Deutsche Bank (left chart), and AAII, Novum (right)

Source : Deutsche Bank

The unfolding correction in the Mag 7 is supporting a rhetoric of "excesses" in both expectations and valuations. The below chart shows the earnings growth for the Mag 7 and the S&P 500 equal weighted. Earnings growth for the coming quarters is expected to decrease to around +20% for the Mag 7 while increasing to +10% for the equally weighted S&P 500.

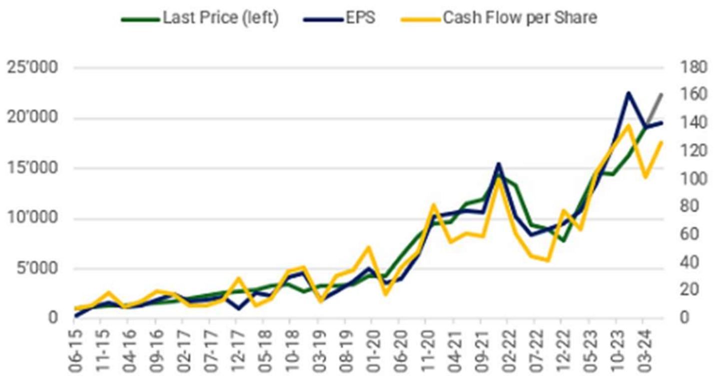


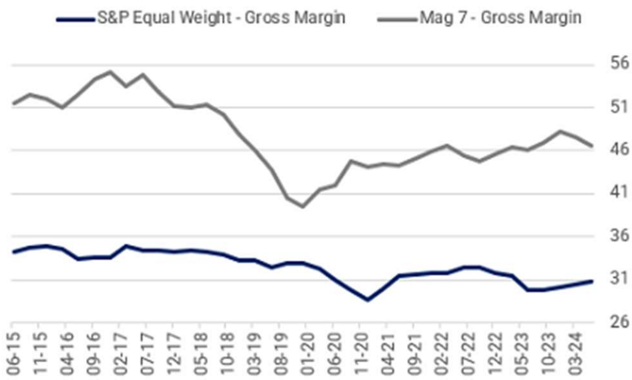


Source: Bloomberg, Novum

On the one hand, it is clear that the earnings growth rates of the last three years (see table on first page) cannot be repeated, and this could normalise in the 15%-20% area as the market predicts. On the other hand, however, we show some charts supporting the fact that we are not in a bubble, and that valuations of these stocks are justified by the fundamentals, especially after the current price correction, in a phase of rising earnings (which helps the forward P/E improve considerably).

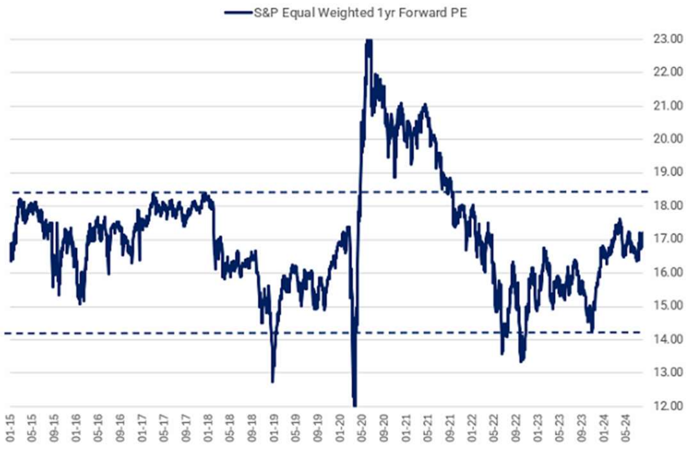
The graph on the left speaks for itself: the performance of the Mag 7 has been underpinned, over the last 10 years, by earnings and, importantly, cash flows.





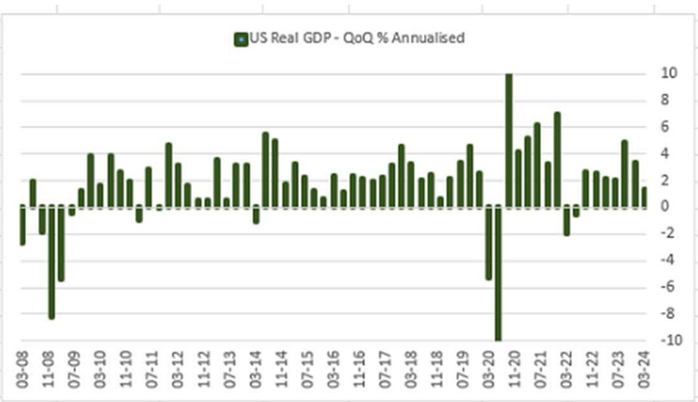
Source: Bloomberg, Novum

The second graph above shows the gross margins of the Mag 7 and the S&P equal weighted (which we use as a proxy for the market net of the Mega Caps impact). It is no coincidence that the multiples of the Mag 7 (in the 30sh area) are almost double the rest of the market (see the two graphs below), in line with the gross margins.



Source: Bloomberg, Novum

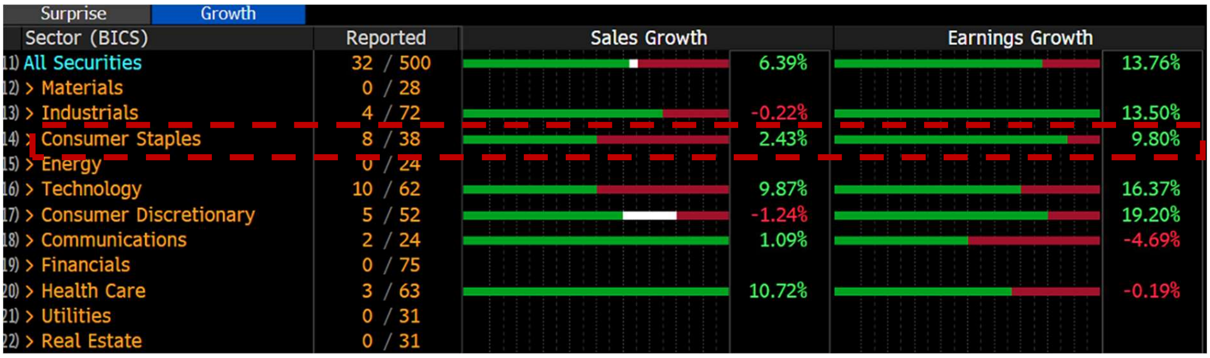
Another potentially disturbing element for the market is a purely macro factor, namely growth, real and nominal. As we see from the GDP graphs below, we are coming from a period of solid real GDP growth, after the 'mini technical recession' of 2022.



Source: Bloomberg, Novum

The market's fear at the moment, in the face of a markedly deteriorating set of data (labour market, ISM survey, durable goods orders), is that the Fed is now late in the rate-cutting cycle, and that growth will contract. Especially in nominal terms, since inflation is also slowing down, towards the 2% target. And as can be seen from the graph on the left, nominal growth is closely linked to the sales of companies in the S&P 500.

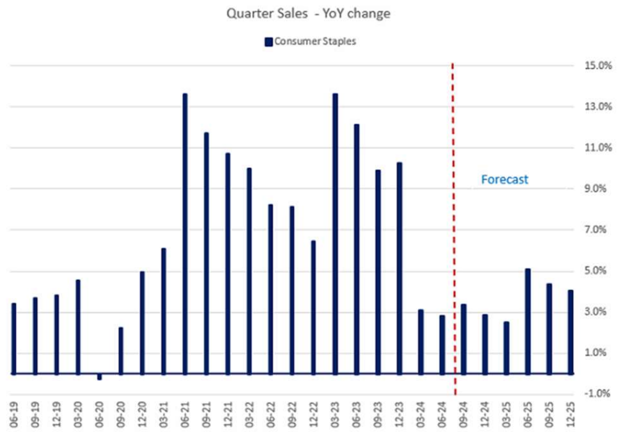
In this respect, an important sector to monitor is Consumer Staples. Several companies have given cautious messages on consumer spending, and in aggregate we see that despite a good earnings performance (Bloomberg chart below), sales are struggling and have tended to disappoint analysts.



Sector (BICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	32 / 500	6.39%	13.76%
12) > Materials	0 / 28		
13) > Industrials	4 / 72	-0.22%	13.50%
14) > Consumer Staples	8 / 38	2.43%	9.80%
15) > Energy	0 / 24		
16) > Technology	10 / 62	9.87%	16.37%
17) > Consumer Discretionary	5 / 52	-1.24%	19.20%
18) > Communications	2 / 24	1.09%	-4.69%
19) > Financials	0 / 75		
20) > Health Care	3 / 63	10.72%	-0.19%
21) > Utilities	0 / 31		
22) > Real Estate	0 / 31		

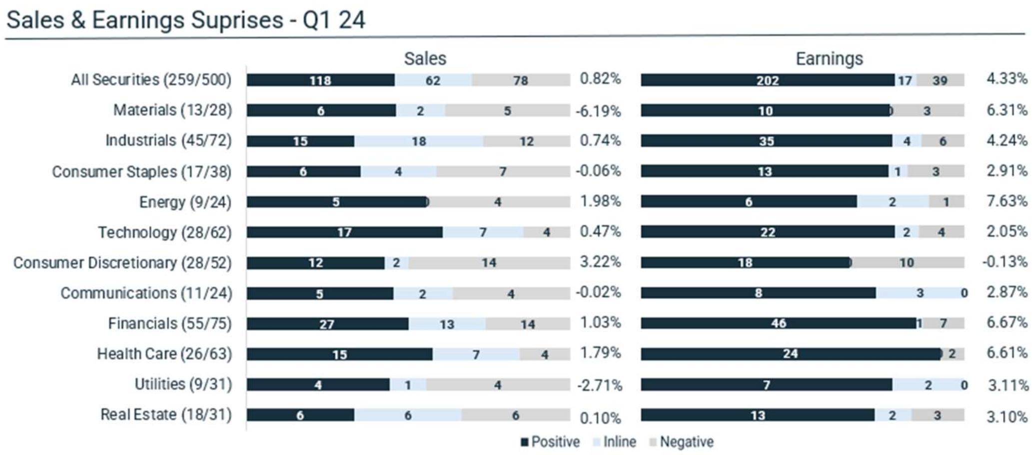
Source: Bloomberg

The second graph shows sales of Consumer Staples in perspective, and one can clearly see the ongoing slowdown after the excellent numbers associated with the post-Covid years.

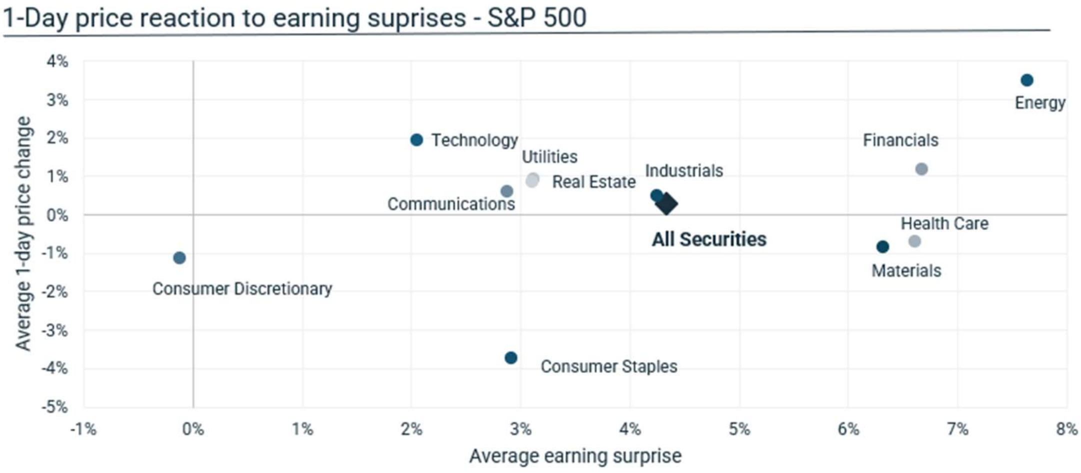


Source: Bloomberg, Novum

The rest of the results, as the next two tables show, do not offer great insights after the publications. Earnings are on average higher than expected, to the tune of a 4.33% surprise. But, as the second table shows, the price reaction is very modest, and in the days following most of the losses were high. But our view is that other factors are driving the market right now, so we will have to wait for new data. It is more interesting to see the performance of the same sectors in the development of the correction, which began on July 10th. (last table).



Source: Bloomberg, Novum



Source: Bloomberg, Novum

Table Performance of S&P 500 sectors from the start of the correction

	Jul. 10 to Aug. 7 (%)	Year-to-Date* (%)
S&P500 Index	-7,71	9,01
Materials	-1,30	1,91
Industrials	-0,45	6,50
Consumer Staples	1,31	10,09
Energy	-1,93	4,77
Information Technology	-16,34	13,68
Communication Services	-10,79	16,55
Consumer Discretionary	-12,63	-3,75
Financials	-0,98	10,17
Healthcare	-0,36	6,89
Real Estate	6,55	2,81
Utilities	5,42	15,53

as of August 7, 2024

Novum Year-to-date Key Trades