November 24, 2020

GREAT EXPECTATIONS REVISITED

GREGORY M. DRAHUSCHAK | Equity Market Strategist

Years ago, renowned investor Sir John Templeton broke the equity market into four stages. He said bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. As 2019 ended, the first two stages were behind us. Stage three appeared to be unfolding. The S&P 500 ended 2019 on a four-month winning streak, as investors anticipated that 2020 S&P 500 earnings were on track for an 8% increase. Great expectations for 2020 turned to great disappointment as the spread of the COVID-19 virus overwhelmed sentiment.

SECTORS	2020 EARNINGS ESTIMATES % CHANGE			2021
	Feb. 22	March 22	Nov. 22	% change
Comm Services	4.3	2.8	-11.6	17
Discretionary	8.2	-1.3	-36	58.3
Staples	4.4	3.5	1.5	6.5
Energy	15	-49.1	-106.9	NM*
Financials	2.8	0.4	-23	13.3
Health Care	6.4	6	4.3	11.9
Industrials	5.9	-3.9	-50.1	76.1
Technology	9.4	6.9	4.9	14.1
Materials	4	-0.2	-11.2	28.6
Real Estate	-19.8	-21	-33.5	-1.2
Utilities	4.6	4.1	3.7	3.7
S&P 500	3337.50	2237.40	3557.54	

**NM – Not Meaningful*
(Source: Janney Investment Strategy Group)

The adjustment for earnings expectations happened slowly at first. Around the February 19 high for the S&P 500, only the REIT sector was expected to experience an earnings dip. A month later, with the S&P 500 down more than 1,000 points, the Discretionary, Energy, and Industrials sectors joined REITs in the list of sectors likely to post lower year-over-year earnings. Eight months later, seven of the S&P 500 sectors were projected to show 2020 earnings below their 2019 levels. Nonetheless, a record-setting recovery rally that set multiple all-time highs pushed the S&P 500 62% above its March 23 low.

(Source: Janney Investment Strategy Group)

The apparent disconnect between the stock market and expected corporate results partially is explained by the market's willingness to discard 2020 and look ahead to 2021 when nine of the 11 sectors are expected to show positive year-over-year results as high as 76.1% for the Industrials sector. Although the tech sector is only expected to post a 14.1% earnings gain next year, the sector is 27.3% of the entire capitalization-weighted S&P 500, which makes its projected earnings gain much more formidable than the 14.1% might otherwise suggest.

As strong as earnings projections are for 2021, in aggregate they still only point to 2021 earnings of $166.39, which would be just 2.22% above where they were at the end of 2019 and the S&P 500 is trading at a relatively high 21 earnings multiple.

Our primary research correspondent, Credit Suisse, is estimating 2021 S&P 500 earnings of $168 and $190 in 2022, which would put the current S&P at 21.2 and 18.7 times earnings, respectively, for 2021 and 2022. Our view is that their 2021 estimate will prove to be a little too low, but the 2022 number looks in line with reality.

The timeline for the anticipated earnings improvement is critical. A relatively modest improvement in the 2021 estimate most likely is due to the slow rollout of vaccines. It easily could take until the second half of next year before any of the current vaccine candidates are available widely enough and accepted sufficiently to allow commerce to return to relative normalcy.

The Federal Reserve's credit policy is a key aspect underlying our market assumptions. The Fed has made it abundantly clear that it intends to maintain a very liberal credit policy, and it will do anything within its power to support the economy. We think interest rates over time will edge up. This normally would weigh on price-earnings ratio, but we highly doubt any rate boost will dampen price-earnings ratios. At some point, multiples actually could expand and allow the S&P 500 to work toward 4500. Short-term, the market may have to contend with excessive investor optimism, continued unknowns about the approval and distribution of vaccines and virus counts that could lead to the widening of temporary shutdowns. Further delays in a stimulus program also temporarily could weigh on the market.

As we mentioned in the opening paragraph of this report, we are in stage three of Templeton's market cycle, but we are far from the final euphoria stage, which is why we approach 2021 with great expectations renewed.