

GIAM Macro & Market Research - Market Commentary

July 30, 2021

Q2 reporting season is doing well but annual growth has peaked

- As the reporting season is close to 50%, positive surprises are appreciable. Indeed, expectations on quarterly growth were flat providing good positive revisions, given the upgrade of the economy in the last three months.
- Margins are on the rise as capacity utilization is increasing and unit labour costs are still under control.
- Such positive revisions ultimately increase the fair value of equities more rapidly than expected, with additional support coming from lingering low yields. We see total returns of 6% in 12 months for EMU and 4% for the US.
- That said, Q2 will represent the peak of the yearly earnings growth in this cycle. This is due to a less positive base effect in the quarters ahead, toppish economic acceleration and confidence indicators in addition to the peak in policy support.
- For this reason, we maintain a prudent OW in equities, with only a slight OW of EMU vs US and a more defensive sector allocation within Europe.

With around 50% of companies having reported (20% in Japan), the Q2 reporting season is proceeding well and above expectations.

Sector	earnings growth, yoy: Q2 2021				sales growth, yoy: Q2 2021			
	S&P	Stoxx	Euro Stoxx	Topix	S&P	Stoxx	Euro Stoxx	Topix
Energy	-	378%	2939%	7%	69%	76%	58%	7%
Materials	284%	13958%	-	65%	48%	37%	42%	27%
Industrials	2921%	346%	-	287%	30%	24%	26%	18%
Cons. Discretionary	-	-	-	-	56%	59%	60%	35%
Consumer Staples	22%	68%	100%	239%	13%	7%	13%	3%
Health Care	16%	23%	33%	9%	21%	11%	10%	20%
Financials	221%	29%	84%	61%	7%	-6%	5%	8%
IT	50%	52%	55%	129%	24%	11%	12%	23%
Comm. Services	82%	46%	24%	322%	28%	2%	2%	54%
Utilities	9%	57%	56%	-36%	9%	23%	23%	-16%
Real Estate	20%	172%	-	185%	13%	-9%	-23%	14%
Market	95%	142%	496%	961%	24%	28%	32%	17%
Median (all sectors)	50%	62%	56%	97%	24%	11%	13%	18%
Median, ex. Energy & Materials	36%	55%	55%	157%	21%	11%	12%	18%

Sector	earnings surprise: Q2 2021				sales surprise: Q2 2021			
	S&P	Stoxx	Euro Stoxx	Topix	S&P	Stoxx	Euro Stoxx	Topix
Energy	27%	13%	10%	0%	17%	-8%	-7%	0%
Materials	5%	16%	19%	1%	4%	5%	5%	3%
Industrials	14%	10%	17%	19%	3%	4%	4%	6%
Cons. Discretionary	38%	43%	49%	100%	8%	7%	8%	4%
Consumer Staples	9%	0%	3%	13%	6%	-2%	-4%	0%
Health Care	9%	16%	19%	-4%	3%	4%	4%	1%
Financials	29%	35%	12%	51%	5%	3%	4%	4%
IT	16%	3%	4%	16%	5%	3%	4%	4%
Comm. Services	24%	62%	62%	79%	5%	3%	3%	14%
Utilities	6%	26%	26%	42%	-1%	11%	12%	-19%
Real Estate	8%	109%	-	30%	4%	0%	0%	6%
Market	19%	22%	21%	29%	5%	2%	4%	2%
Median (all sectors)	14%	16%	18%	19%	5%	3%	4%	4%
Median, ex. Energy & Materials	14%	26%	18%	30%	5%	3%	4%	4%

Annual earnings growth in Q2 2021 should end at 141% in Europe and 86% in the US, due to reopening, restocking, and strong pricing power, offsetting weaker China, production bottlenecks and higher production costs.

The quarter-on-quarter Q2 earnings growth was expected to be flat, providing good positive surprises and revisions, given the upgrade of the economy in the last three months.

Revisions for Q2 and Q3 are increasing rapidly both in the US and in Europe. For the latter, the year-on-year earnings growth for Q2 moved from 80% in April to 120% currently.

Such positive revisions ultimately increase the fair value of equities more rapidly than expected, with **additional support coming from lingering low yields**.

The median sector yearly growth is around 56% for the euro area while it is 62% for Europe and 50% for the United States. For Europe and the US, materials and industrials are leading in terms of earnings growth, while staples, pharma, tech and utilities should underperform.

US financials have also very high growth contrary to European ones (221% vs 29%).

Earnings surprises are around 22% for Europe and 19% for the US: Discretionary, financials and communication services have beaten analysts' estimates the most. Materials, industrials, pharma, and staples show the lowest earnings surprises. In Europe, energy and IT surprises are also lower than the index, while in the US, it is utilities and real estate. The surprise in consumer discretionary is the highest among US sectors.

Analysis of the median stock: Q2 2021 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q1 2021	Q2 2021	Q1 2021	Q2 2021	Q2 2021
	S&P	30.0 %	44.5 %	8.7 %	21.0 %
Stoxx	29.5 %	45.7 %	1.8 %	14.4 %	53.1%
Euro Stoxx	20.1 %	50.0 %	1.1 %	17.5 %	46.1%
Topix	20.0 %	33.4 %	2.4 %	13.5 %	20.7%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q1 2021	Q2 2021	Q1 2021	Q2 2021	Q2 2021
	S&P	12.2 %	10.3 %	2.6 %	3.4 %
Stoxx	9.9 %	7.8 %	1.5 %	2.2 %	53.1%
Euro Stoxx	10.6 %	9.8 %	1.3 %	2.7 %	46.1%
Topix	14.8 %	12.6 %	0.9 %	2.6 %	20.7%

At the median stock level we notice a lower earnings surprise vs the median sector: in the US 10.3% vs 19% for the market and in Europe, the surprise is at 7.8% vs 22% for the market.

Overall, Q2 returns are showing a big discrepancy between earnings growth and sales growth with increasing margins as capacity utilization is increasing, too. That said, the sales growth and the sales surprises are also very high.

Earnings are to remain strong but with an increasing peaking momentum.

Q2 reporting season is ok but it will represent the **peak of earnings growth in this cycle**. This is due not only to a **less positive base effect** in the quarters ahead but also to signs of **toppish economic acceleration**. Such environment is reflected in some brokers' cycle indicators which turned south very recently, pointing to a **"slowdown" phase**. **Delta mutation** is adding to the negatives together with **stalling leading indicators**: the ISM, the IFO expectations, the yearly changes of the macro surprise index and Chinese M2. Finally, we are close to a peak in quarterly GDP growth and in the **speed of policy support**.

For these reasons, investors could be tempted in the next weeks to fully discount the end of the economy acceleration, keeping defensive and growth sectors in the spotlight at least in the short term: we maintain a **prudent OW in equities**, with only a slight OW of EMU vs US and a more **defensive sector allocation** within Europe.

We see total returns of 6% in 12 months for EMU and 4% for the US. As real rates remain low, the equity yield gap vs 10-year real rates stays attractive. Besides, higher US buybacks add 1.3% to the dividend yield of 1.4%, for a total cash yield of 2.7%. **Buyback activity** looks fully sustainable as cash-to-assets ratio for US firms is the highest since 1980.

Our fair value of 4,400 for the S&P uses a 10-year yield target of 2% in 12 months. So, in the short term a higher fair value level could be justified albeit with increased volatility given the above-mentioned risks.

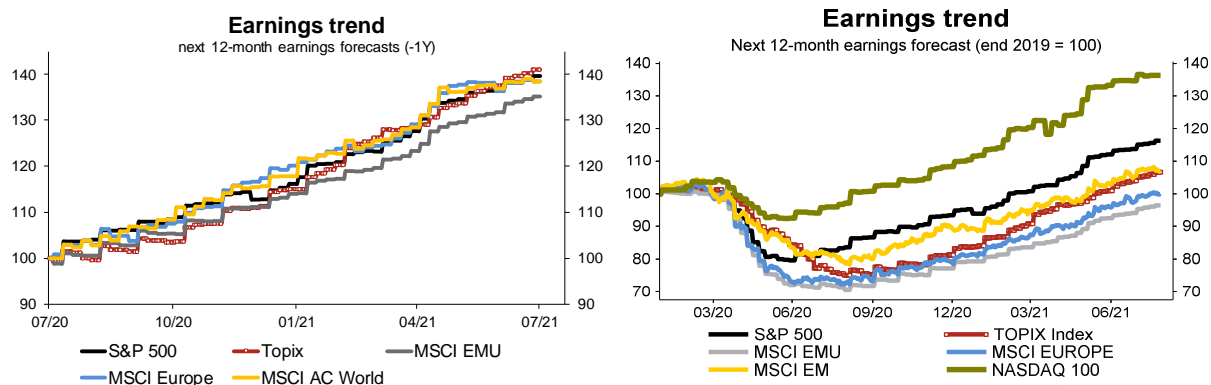
WHEN CHARTS TALK

Revisions fully sustained market rally: earnings upgrades more than compensated for positive total returns, resulting in lower PEs.

Index	%TR	DY	%Price	%Earnings	%PE
MSCI World	15.4	1.27	14.1	20.4	-5.2
S&P 500	18.1	0.95	17.2	23.7	-5.3
MSCI EMU	17.5	2.19	15.3	21.2	-4.8
TOPIX	7.6	1.19	6.4	26.8	-16.1
FTSE100	10.7	2.09	8.6	26.3	-14.0
SMI	15.9	3.12	12.8	8.7	3.7
FTSE MIB	16.0	2.33	13.6	22.2	-7.0
MSCI EM (\$)	-0.4	1.42	-1.8	16.1	-15.4
MSCI Brazil	7.2	2.89	4.3	50.3	-30.6
MSCI Russia (\$)	19.2	4.60	14.6	47.4	-22.3
MSCI India	15.3	0.89	14.5	22.5	-6.6
MSCI China	-14.0	1.01	-15.0	-0.9	-14.3

* changes are YTD, earnings and PEs are 12-month forward

Good revisions together with lower rates produced higher fair valuation since May (our Fair Value Indicator = 12-month fwd earnings/10-year yields): our **Fair Value Indicator increased by 14% in the US** (since more recent yield peak in mid-May), made of -46 bps of 10-year yield (+7-10% discounted fair value increase) and 4.6% earnings upgrade. **EMU** by +11% (less sensitive to yields) and **Amazon** by +66% (much more sensitive to declining yields).



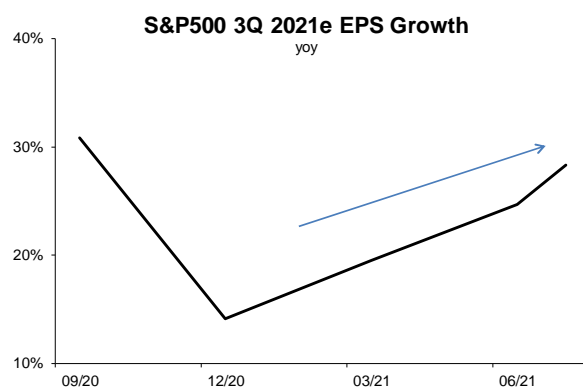
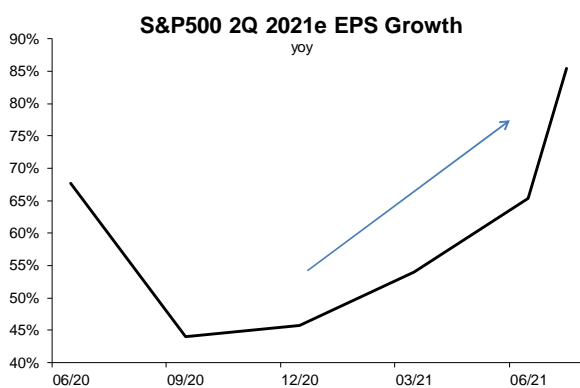
Total Return decomposition and PE expansion from 12/5/2021 to 27/7/2021

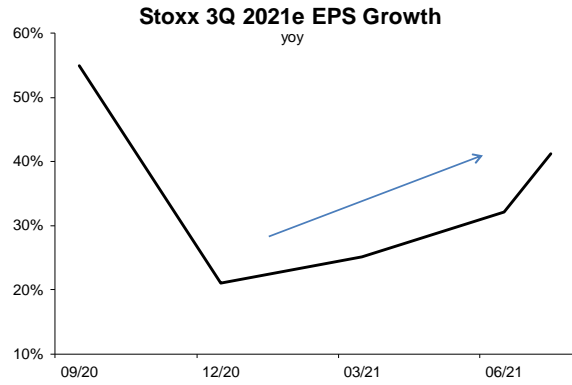
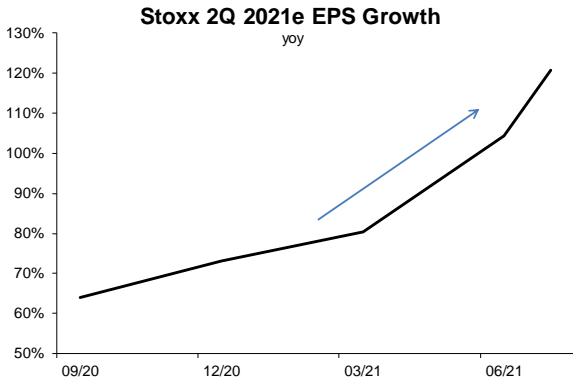
Index	%TR	%PR	%DR	%EPS	%PE	10-Year Yld Chg (BPS)	Fair Value Indicator Change %
MSCI World	7.0	6.7	0.4	3.6	2.9	-25	8.4
S&P 500	8.6	8.3	0.3	4.6	3.6	-46	14
MSCI USA Inf. Technology	17.2	17.0	0.2	3.1	13.5	-46	13
FACEBOOK	21.6	21.6	0.0	19.1	2.0	-46	43
AMAZON.COM	15.1	15.1	0.0	21.2	-5.0	-46	66
APPLE	19.5	19.5	0.0	16.0	3.1	-46	24
NETFLIX	7.0	7.0	0.0	8.1	-1.1	-46	49
GOOGLE (Alphabet)	19.9	19.9	0.0	26.2	-5.0	-46	42
MSCI EMU	4.6	3.9	0.7	5.8	-1.8	-34	11
TOPIX	3.4	3.2	0.2	7.9	-4.3	-6	8.8
FTSE100	0.4	-0.1	0.5	8.7	-8.1	-33	14.1
SMI	9.0	8.9	0.1	3.2	5.5	-25	7.6
MSCI ITALY	3.4	1.8	1.6	5.6	-3.6	-36	11.3
MSCI EM (\$)	-4.0	-4.8	0.8	3.1	-7.7	2	2.9

Exhibit 3. 2021Q2 Blended (Reported & Estimated) Earnings Growth

Sector	Today	1 Jul	1 Apr	1 Jan	1 Oct	1 Jul
Consumer Discretionary	312.1%	270.9%	237.4%	216.8%	187.9%	721.0%
Consumer Staples	14.5%	10.1%	9.0%	9.2%	10.8%	17.7%
Energy →	226.7%	225.5%	196.1%	152.6%	159.8%	141.2%
Financials →	149.0%	100.3%	82.1%	63.7%	48.6%	56.7%
Health Care	20.3%	10.8%	10.5%	6.6%	6.8%	32.7%
Industrials	649.7%	568.5%	512.8%	498.3%	435.8%	574.0%
Materials →	126.7%	115.2%	85.5%	56.6%	47.5%	58.0%
Real Estate	27.4%	24.7%	12.5%	12.9%	13.1%	15.6%
Technology	45.5%	31.6%	20.3%	14.6%	13.2%	25.7%
Communication Services	61.3%	39.8%	29.4%	27.2%	29.9%	45.9%
Utilities	1.0%	-0.9%	2.8%	0.0%	3.0%	8.5%
S&P 500	85.5%	65.4%	54.0%	45.7%	44.1%	67.7%

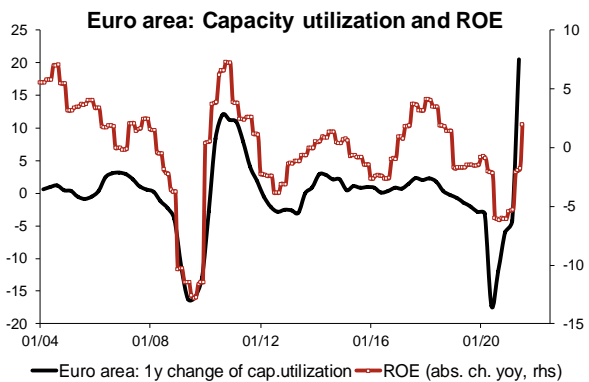
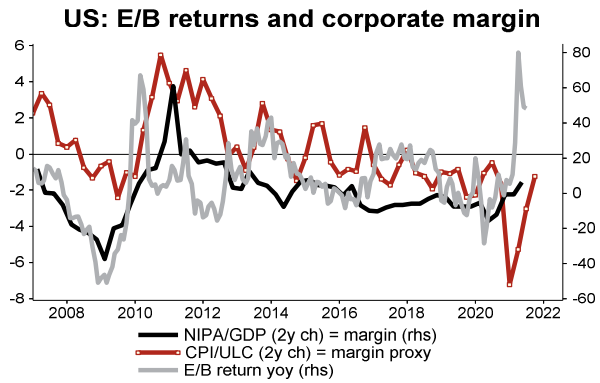
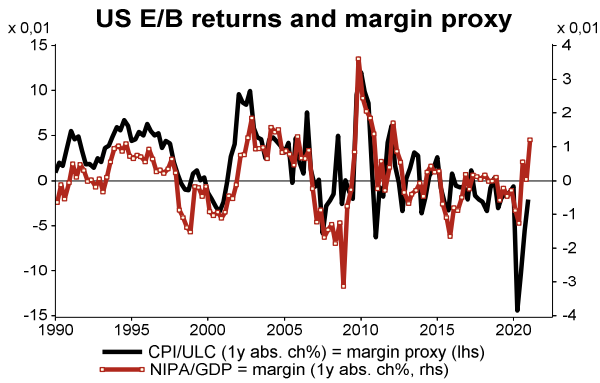
Source: I/B/E/S data from Refinitiv

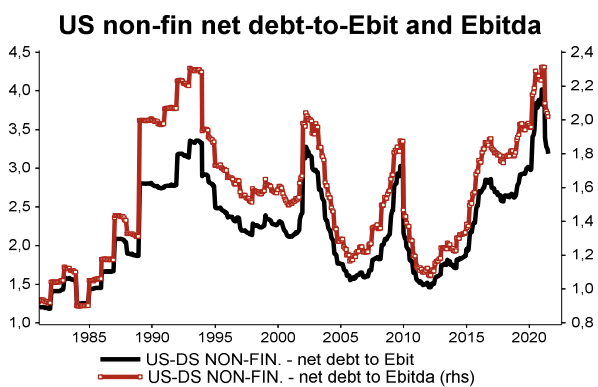




Margins are also doing ok as capacity utilization increases. Debt sustainability (debt/EBITDA) is improving, too:

Indeed, the Fed is also “not worried about increasing wages as unit labour costs are under control”.





That said, while remaining decently robust, the earnings momentum (yoy variations) has reached the peak of the cycle.

Annualised growth will decline sensibly from Q2 onward:

HISTORICAL/CURRENT/FUTURE EARNINGS GROWTH RATES

Exhibit 10. Historical/Current/Future Earnings Growth Rates

Sector	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2
Consumer Discretionary	-64.6%	-2.3%	-5.0%	226.1%	312.1%	17.1%	32.2%	15.6%	40.2%
Consumer Staples	-4.2%	6.3%	5.4%	11.1%	14.5%	2.7%	4.3%	5.8%	7.4%
Energy	-168.1%	-108.2%	-105.0%	28.0%	226.7%	1336.7%	3992.5%	91.1%	39.1%
Financials	-46.7%	-2.8%	20.4%	138.0%	149.0%	17.8%	-1.0%	-20.2%	-15.6%
Health Care	6.8%	11.8%	10.6%	26.7%	20.3%	13.4%	17.5%	2.2%	2.4%
Industrials	-85.3%	-54.7%	-37.7%	3.0%	649.7%	93.0%	71.0%	64.0%	35.3%
Materials	-28.6%	-1.5%	22.7%	62.4%	126.7%	83.7%	47.4%	18.3%	-6.8%
Real Estate	-15.2%	-12.8%	-10.7%	5.8%	27.4%	15.1%	11.9%	6.5%	1.3%
Technology	5.6%	9.9%	20.4%	44.9%	45.5%	24.5%	13.3%	3.6%	3.5%
Communication Services	-16.8%	3.7%	10.1%	53.1%	61.3%	17.6%	7.9%	0.7%	-1.0%
Utilities	6.4%	0.9%	-2.6%	-0.9%	1.0%	1.7%	4.2%	6.3%	5.0%
S&P 500	-30.6%	-6.5%	3.8%	52.8%	85.5%	28.3%	20.3%	4.4%	4.9%
S&P 500 Ex-Energy	-24.1%	-2.3%	7.8%	53.4%	71.3%	22.0%	15.1%	2.4%	3.8%

Source: I/B/E/S data from Refinitiv

Exhibit 13A. STOXX 600 Eurozone Earnings Growth Rates

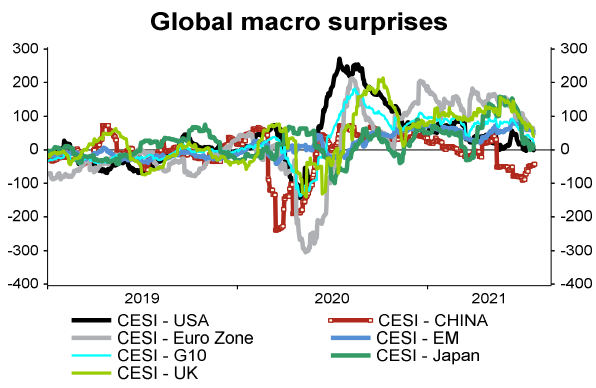
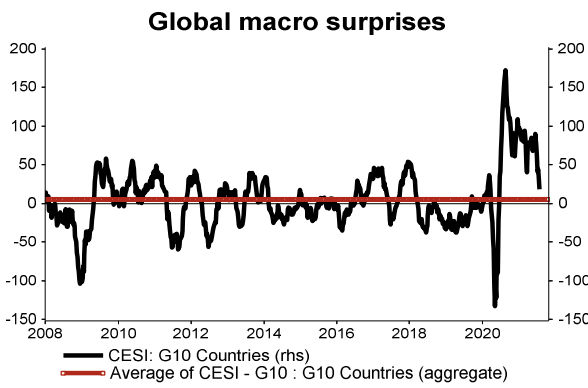
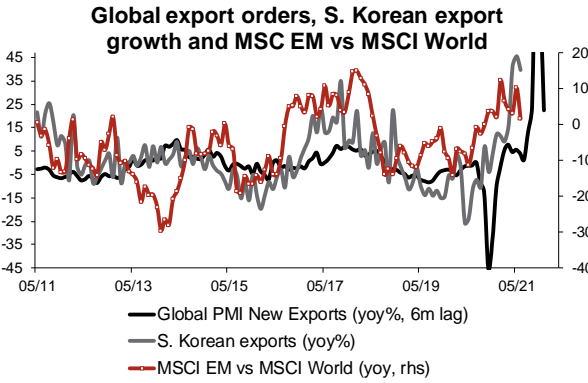
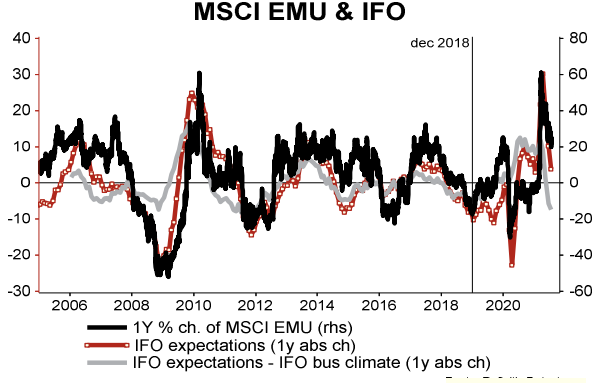
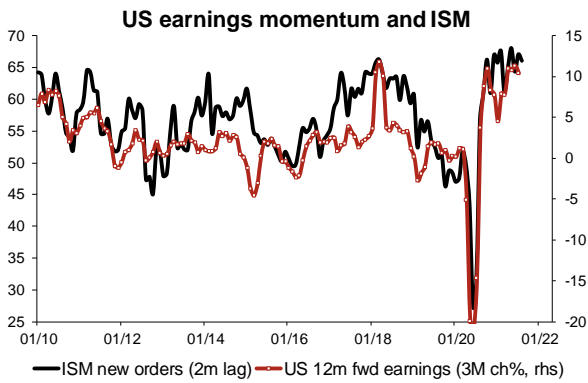
Sector	2021Q2	2021Q3	2021Q4	2022Q1	CY2021
Basic Materials	353.9%	101.3%	49.8%	6.2%	86.7%
Cyclical Consumer	360.1%	5.8%	9.9%	-37.7%	210.9%
Non-Cyclical Consumer	22.5%	-23.8%	0.3%	-22.9%	18.7%
Energy	960.6%	501.5%	88.2%	55.8%	215.4%
Financials	47.5%	16.0%	29.1%	-9.8%	41.4%
Healthcare	7.2%	0.0%	-4.3%	1.4%	0.5%
Industrials	17836.7%	106.7%	14.7%	19.9%	107.5%
Technology	52.1%	8.8%	-1.0%	5.9%	8.0%
Real Estate	-52.8%	25.0%	-33.0%	33.1%	-0.2%
Utilities	14.2%	31.3%	24.8%	-20.6%	13.9%
Total	140.9%	30.1%	18.1%	3.6%	54.8%
Number of constituents with estimates	180	178	176	90	279

Source: Refinitiv I/B/E/S data

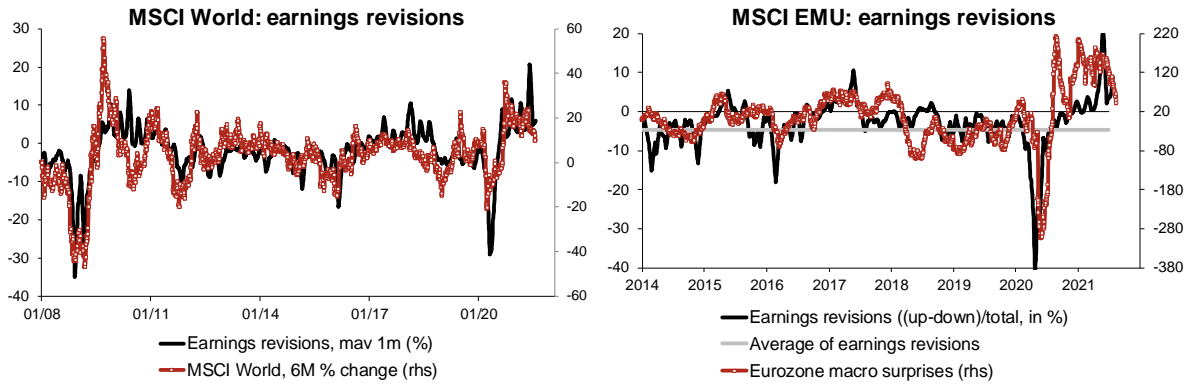
Note: Includes only constituents domiciled in Eurozone.

Peaking signs also from macro surprises and confidence indicators (and money growth in China):

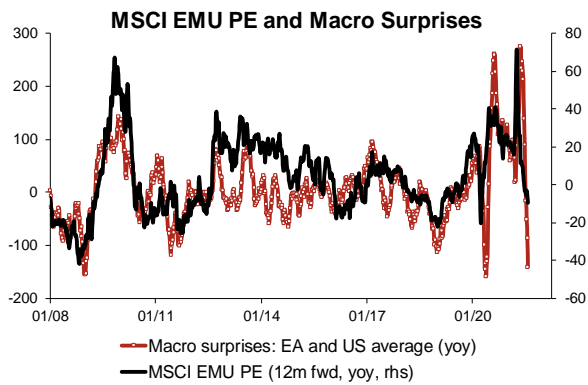
Investors could be tempted in the next weeks to fully discount the end of the economy acceleration. Such phase could keep defensive and growth sectors in the spotlight. Indeed, since May our sector allocation has moved progressively into defensive names, having lower overweight on Value.



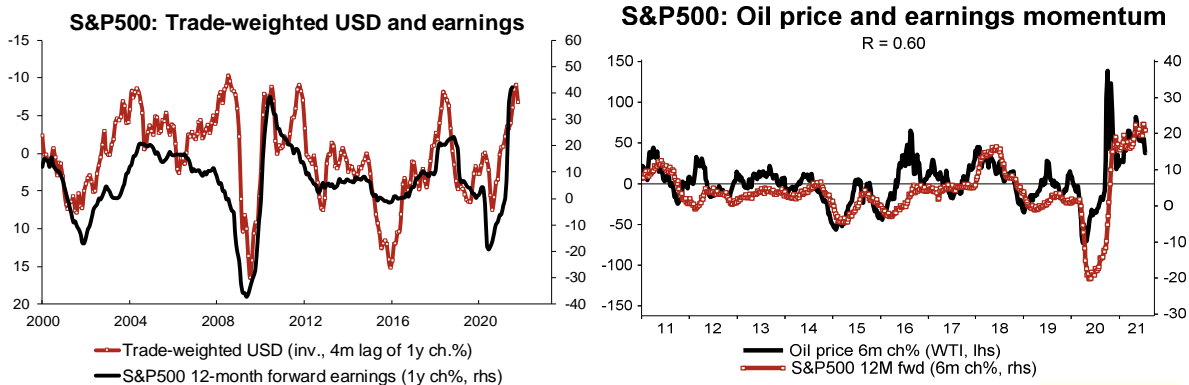
Such that revisions should do less well going forward:



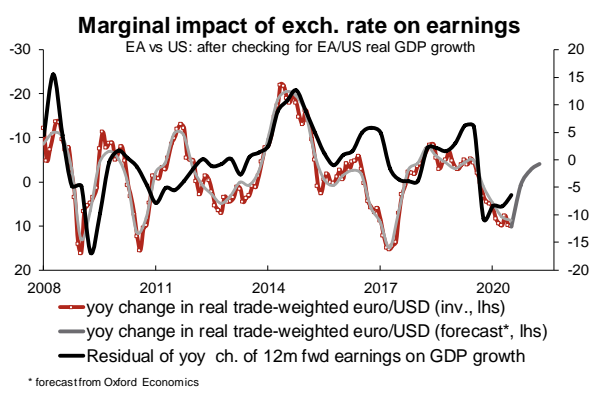
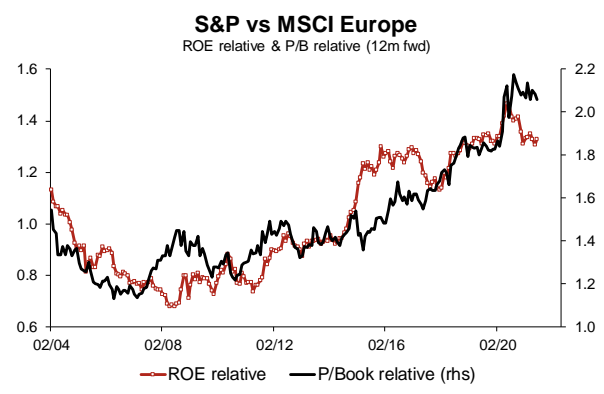
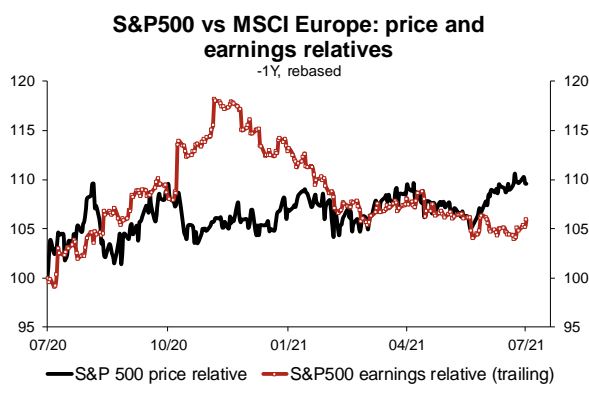
...and market multiples would continue to deflate:



US earnings are also less supported by the USD and oil prices:



But the EU profit recovery should turn out to be more resilient, also because it is at an earlier stage.



World Markets: Forecast Earnings Growth (IBES Consensus)				
29-Jul-2021				
	A12FE vs 2020	2021/2020	2022/2021	2023/2022
MSCI AC WORLD	49.9%	41.9%	9.4%	9.1%
MSCI WORLD	48.3%	40.2%	9.4%	9.1%
S&P 500 COMPOSITE	50.4%	40.9%	10.4%	10.2%
FTSE-100	82.3%	75.0%	6.8%	4.1%
TOPIX	34.7%	29.6%	11.0%	9.1%
SWISS MARKET INDEX	15.5%	9.3%	9.9%	8.3%
MSCI EUROPE	55.5%	47.8%	8.6%	7.8%
MSCI EMU	62.2%	51.8%	11.7%	10.2%
STOXX 50 (EURO)	46.1%	39.0%	8.6%	6.5%
EURO STOXX 50 E	50.6%	41.6%	10.7%	9.2%
MSCI USA IT	42.3%	30.6%	11.4%	10.4%
MSCI EM	58.5%	50.9%	9.6%	9.2%

Earnings revisions since the start of the Q2 reporting season:

15/06/21 - 29/07/21					
Consensus eps estimates: (IBES)	changes (%) since 15/06/21				
	2020	12m fwd eps	2021	2022	2023
MSCI AC WORLD	-1.7%	0.7%	0.3%	-0.6%	-0.8%
MSCI WORLD	-1.6%	0.9%	0.6%	-0.3%	-0.6%
S&P 500 COMPOSITE	-0.5%	2.5%	2.2%	1.1%	0.6%
FTSE 100	2.0%	6.8%	6.8%	5.4%	4.2%
TOPIX	0.1%	3.4%	2.8%	1.6%	1.8%
SWISS MARKET INDEX	1.2%	2.6%	1.7%	1.8%	1.8%
MSCI EUROPE	-1.1%	2.2%	2.3%	0.8%	0.3%
MSCI EMU	0.2%	3.1%	3.3%	1.2%	1.1%
STOXX 50 (EURO)	1.5%	5.2%	5.1%	3.8%	3.4%
EURO STOXX 50 E	0.3%	3.3%	3.6%	1.5%	1.6%
MSCI USA IT	0.1%	1.7%	0.5%	0.8%	0.7%
MSCI EM	-1.9%	-0.4%	-0.8%	-1.5%	-1.8%

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