Zacks
INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY August 19, 2021

2021 Surprises: Earnings Higher, Rates Lower Than Expected

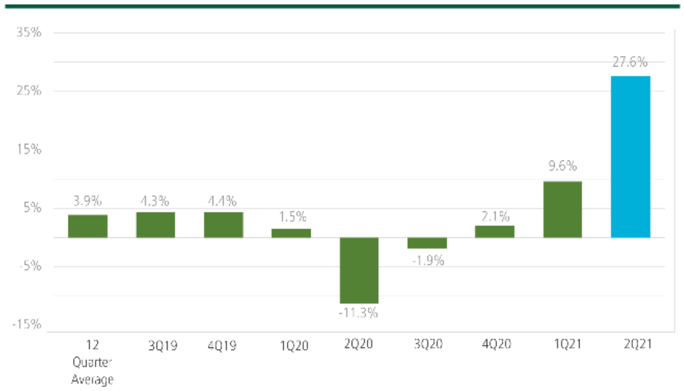
At the beginning of 2021, there was broad consensus U.S. corporations would post a strong earnings' rebound, and many believed interest rates would move higher alongside economic growth and rising inflation. Market participants set expectations for both outcomes.

Checking in a little more than halfway through the year, I think we can make two observations: earnings have been higher-than-expected, while interest rates continue to be lower-than-expected. If you're looking for a succinct explanation for why the S&P 500 index is up close to 20% for the year, I think that's it.

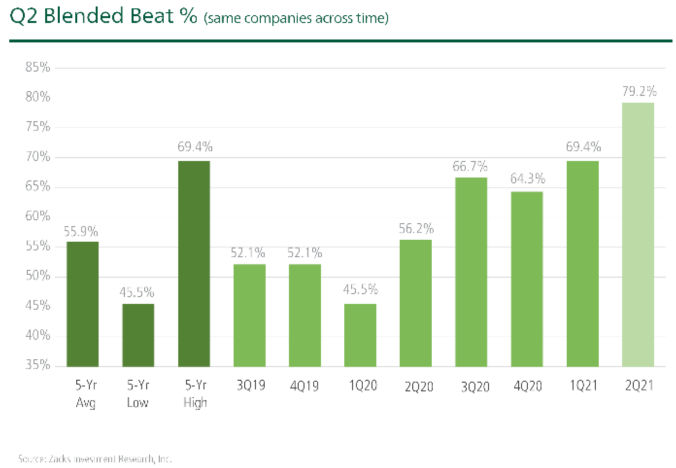
There are always many moving parts when it comes to analyzing the equity markets, of course, but the two factors I think that matter the most are earnings and interest rates. Everything else we see and read in the financial news—the good and the bad, the valued fundamental indicators and the noise—only matter, in my view, *if they affect how earnings and/or interest rates will change in the future*. The current situation in Afghanistan, for instance, may feel like a huge deal, but I see very little possibility of it affecting U.S. earnings or interest rates in 2021. To me, it is an important geopolitical event, but it has no pricing power.[1]

On the other hand, when U.S. corporations are performing much better than most analysts expect them to, that does have pricing power. In this Q2 earnings cycle, revenue momentum has been particularly notable, with aggregate quarterly totals on track to reach an all-time high. The charts below show revenue growth rates and earnings and revenue beat percentages for companies that have reported so far, and the percentage of companies beating (right-hand side) really stands out. That's what "better-than-expected" looks like.

Q2 Revenue Growth Rates Compared (same companies across time)



Source: Zacks Investment Research, Inc.



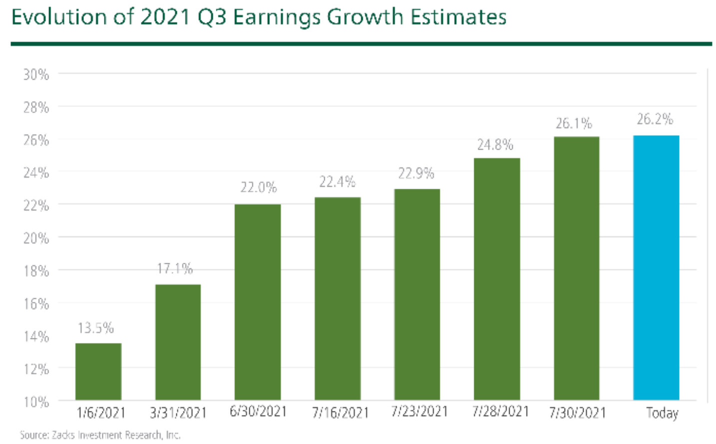
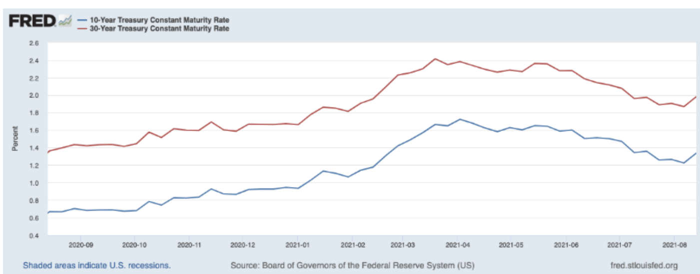


Image Source: Zacks Investment Research

Many point out – correctly – that the strong revenue and earnings growth rates are due to the base effect, i.e., comparing Q2 2021 revenue to Q2 2020 revenue, when the economy was largely shut down. But even when we compare Q2 2021 earnings to Q2 2019 earnings, we find that corporations are on track to post earnings +30.9% higher than they were in 2019, pre-Covid. That is a very significant point that is not discussed often enough, in my view.

This largely better-than-expected performance from corporations has also resulted in upward revisions to Q3 earnings expectations, which started the year at 13.5% y-o-y growth and have since climbed to 26.2% y-o-y growth. This sustained optimism from corporate America comes even as the Delta variant is dealing a few setbacks to travel, hospitality, restaurant, and other in-person business operations. It's a strong signal that companies feel able to navigate their way through the next few months.

On the interest rate front, everyone expected longer duration U.S. Treasury bonds to drift higher over the course of the year, and some even expected yields would spike as growth surged and inflation expectations went up. But so far, interest rates have been doing just the opposite. As you can see below in the chart of the 10-year and the 30-year U.S. Treasury bond yields, interest rates briefly drifted higher earlier in the year but have since fallen back.



Source: Federal Reserve Bank of St. Louis

When interest rates ultimately end up lower than everyone expects them to – as we saw in the first half of the year – stock prices usually rise. This time was no different.

Bottom Line for Investors

In my view, the stock market has performed well and reaching new all-time highs because aggregate earnings are coming in higher than expectations, while interest rates are far lower than expectations set earlier in the year. Positive surprises are great for stocks, in my view.

Looking ahead to the second half of the year, I think current expectations are that interest rates should eventually respond to higher inflation, while the corporate profit cycle has reached a peak and is likely poised to decelerate from here. Expecting higher rates and lower earnings may ultimately be a good thing, as it sets the stage for even more positive surprises.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Zacks.com. August 11, 2021. https://www.zacks.com/commentary/1780608/taking-stock-of-the-impressive-earnings-picture

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Corporations are sitting on record amounts of cash
- U.S. GDP growth surges past China
- Concerns of U.S. retail sales dip in July

Corporations are Sitting on Record Amounts of Cash

U.S. corporations have by and large been enjoying a strong 2021. Aggregate S&P 500 earnings are up close to 100% from Q2 2020, and companies are outperforming revenue expectations at a strong clip. Corporations are also sitting on a record amount of cash – data from Q2 2021 earnings reports shows a balance sheet with a record $6.84 trillion in cash and short-term investments, which marks a 45% increase from the average over the previous five years. At one point earlier in the year, many investors bet that cash-rich corporations would increase spending on technological upgrades, factories, and personnel as the vaccination rate moved higher and as pandemic risks waned. There is still some evidence CEOs are planning to invest cash – businesses like Tyson Foods, Morgan Stanley, and Constellation Brands have made statements recently citing their desire to spend on expanding research budgets, building factories, and boosting shareholder equity via share buybacks and dividend payments. With the Delta variant spreading quickly, some businesses appear – for now – to be pulling back slightly on their plans.[1]

The U.S. Pulls Ahead of China in Growth

The U.S.'s GDP growth surge in Q2 outpaced

China's, and many economists expect the U.S. to edge out the second-largest economy in growth for the next few quarters. The U.S. expanded at a 12.2% pace in the second quarter compared to a year ago, while China posted a 7.9% gain. If the U.S. continues to grow at a faster pace than China for a few more quarters, it would be the first sustained period of outperformance since the 1990s. A few factors are driving faster U.S. growth in 2021. For one, the U.S. has a relatively high vaccination rate and an economy that largely has no economic restrictions related to the pandemic. In China, however, low vaccination rates and the appearance of the Delta variant have led the country to install drastic measures to stop the spread, in some cases locking down completely. The U.S. also poured more fiscal and monetary resources into the economic recovery than China did, which has played a role in the sharp growth rebound experienced in the first half of 2021.[2]

U.S. Retail Sales Dip in July. Cause for Concern?

U.S. retail sales, which measure purchases at stores, restaurants, and online, fell 1.1% in July compared to June levels. If auto purchases are pulled from the figure – which has been a volatile category in 2021 – then sales declined a more modest 0.4%. Restaurants and bars saw a summer jump as consumers ventured back out, with sales rising 1.7% from June. The data suggests that consumers continue to shift spending away from big-ticket items and towards services, an expected outcome as restrictions fell away and people re-engaged with the physical economy. Market watchers will be looking to August numbers to measure if the economic impact of the Delta variant, which has to date led to a sharp drop in consumer sentiment as measured by University of Michigan data.[3]

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[1] Wall Street Journal. August 16, 2021. https://www.wsj.com/articles/companies-are-hoarding-record-cash-amid-delta-fears-11629106380?mod=searchresults_pos9&page=1

[2] Wall Street Journal. August 15, 2021. https://www.wsj.com/articles/u-s-economy-likely-to-outgrow-chinas-due-to-contrast-in-pandemic-responses-11629036000

[3] Wall Street Journal. August 17, 2021. https://www.wsj.com/articles/us-economy-july-2021-retail-sales-delta-variant-11629153243

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