BETTER THAN FEARED SECOND-QUARTER S&P 500 EPS ON JUNE BOUNCE AND TECH & HEALTH-CARE IMMUNITY

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IN A NUTSHELL

_ Bottom-up second quarter S&P 500 EPS is now 23.88 dollars, -41.4% year-over-year.
_ Sales -11.0% year-over-year.
_ Second week: tech & health care strong, telecommunication & industrials disappointed, consumer mixed.
_ Very diverging growth among sectors continues as the pandemic persists.
_ Tech and health-care earnings appear immune and their 2020 EPS might be up.
_ The fair normal S&P 500 P/E remains very controversial and source of uncertainty.

BOTTOM-UP SECOND QUARTER S&P 500 EPS IS NOW 23.88 DOLLARS, -41.4% YEAR-OVER-YEAR. SALES -11.0% YEAR-OVER-YEAR

128 S&P 500 companies reported second-quarter results, which is 41% of index earnings. 74% beat on earnings per share (EPS) at an aggregate of 7.9% and 66% beat on sales at an aggregate of 3.9%. To avoid distorted beat measures from last minute cuts, we compare results to consensus estimates at the end of the quarter. Earnings are coming in better than the 23 dollars consensus at quarter end and our 15 dollars estimate set in early April. Earnings helped by states reopening and unprecedented fiscal packages. From mid-May to June, jobs, retail sales, manufacturing Institute of Supply Management (ISM), service ISM, and durable goods orders all had strong bounces from depressed lows. Oil climbed to 40 dollars per barrel and housing sprung in spring after winter's cabin fever and an urbanite rush to the suburbs. We see upside to our 110 dollars 2020 estimated (E) S&P 500 EPS, it will probably be 120-125 dollars owing to a better second quarter and mostly at tech and health care. Many risks remain for the second half of 2020 and 2021. The recent jump in new U.S. coronavirus cases and deaths prompts many local second-round restrictions and precautions taken by individuals even without lockdown orders. This will probably pressure the labor market and elongate the trajectory of economic recovery. Last week's uptick of initial jobless claims is a cautionary sign.

SECOND WEEK: TECH & HEALTH CARE STRONG, TELECOMMUNICATION & INDUSTRIALS DISAPPOINTED, CONSUMER MIXED

First week of the earnings season was mostly banks. Another quarter of very large loan loss provisions from the banks largely offset very strong capital-market revenues. Second week is mostly tech, telecommunication, and industrial companies and some consumer and health-care companies. Tech topped estimates so far with its strong resistance to the pandemic and virtual solutions to social distancing. Health care also delivered strong results so far across industries. We are surprised by the broad strength at health care given the disruptions caused to normal procedures and care. Large telecom and hard-hit airlines disappointed. Consumer companies are mixed, household durables, some fast-food restaurants and large retailers are better than feared. Next week (third week) is the heaviest week with 189 companies reporting, comprising 1/3 of S&P 500 total earnings.

VERY DIVERGING GROWTH AMONG SECTORS CONTINUES AS THE PANDEMIC PERSISTS

The "young & healthy" or virtual and essential sectors (tech, communications, health care, consumer staples and utilities) bottom-up second-quarter EPS growth is -10.6% year-over-year with -0.5% sales growth. The "old & vulnerable" (financials, real estate, energy, materials, industrials, and consumer discretionary) second-quarter EPS growth is -76.8% year-over-year with -16.8% at sales. The diverging trend of these two groups continues in the second quarter from the first quarter. At sectors, utilities (-0.9%), tech (-4.5%) and health care (-5.3%) have the smallest EPS declines and energy (-158%), consumer discretionary (-114%) and industrials (-85%) have the worst EPS decline. Best and worst sales growth are at the same sectors. Sales growth is strongest at health care (1.6%), tech (1.0%) and utilities (-1.8%). The worst sales decline is at energy (-41.4%), industrials (-26.2%), and consumer discretionary (-20.0%). Second-quarter S&P 500 pro-forma net margin is expected to decline to 7.8%, compared to 10.0% in the first quarter and 11.7% a year ago.

TECH AND HEALTH-CARE EARNINGS APPEAR IMMUNE AND THEIR 2020 EPS MIGHT BE UP

There are still many important tech and health-care companies yet to report, but these two sectors are demonstrating an unprecedented resilience to a sharp recession. We expected resilience, but it appears to be outright immunity for the sectors and a net positive for many of the firms. We are overweight these two sectors for this earnings strength. When we look at our 2020E S&P 500 EPS of 110 dollars vs. 125 dollars consensus by sector, we see about 6 dollars of upside at tech and 4 dollars at health care. Our financials estimate is at risk by 1-2 dollars and the rest of the sectors have about 5 dollars of upside if economic activity can at least moderately improve from June levels through the rest of the year. Our 2020E S&P 500 EPS by quarter is $33+$15+$28+$34= $110, but now $33+$25+$32+$35= $125 is reachable. We will carefully review our 2021E S&P EPS after the second-quarter reporting, but 150-160 dollars is likely.

THE FAIR NORMAL S&P 500 P/E REMAINS VERY CONTROVERSIAL AND SOURCE OF UNCERTAINTY

Although S&P 500 EPS is down 40% year-over-year this quarter, this is very resilient vs. history relative to the severe gross-domestic-product (GDP) hit. This improved resilience on composition shifts, which might also bring better long-term economic profit growth potential to the S&P 500 vs. its history, is favorable to the fair price-to-earnings ratio (P/E) on recovery or normalized S&P 500 EPS. Low interest rates help support a 20 S&P 500 P/E on mid-cycle EPS. However, this comes with its own risks. Investors must carefully consider the very long-term sustainability of earnings, including economic profits, given that low interest rates make distant years earnings a larger part of today's present value. Moreover, the uncertainty around the drivers and outlook for interest rates is greater than ever, while economic and political risks to earnings remain high. Topics for next time.

GLOSSARY

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Institute of Supply Management (ISM) Indices track different areas of the U.S. economy, such as manufacturing activity and industrial production.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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