RBC WEALTH MANAGEMENT
Global Insight
Weekly

# Look past the Q2 'Grand Canyon' in profits

Kelly Bogdanova – San Francisco

Companies are opening up their books on Q2, and yes, it's going to be a grim quarter. But we knew this was coming. So investors should widen their range of vision, and instead look at the contours of the economic recovery and how earnings estimates for 2021 shake out.

As we launch into another earnings season, if you just focus on the consensus projections, the situation looks dismal—a projected decline of 44 percent year over year in S&P 500 profits, which would rank as the worst plunge since the global financial crisis, and revenues slated to drop almost 12 percent. Profit margins could get squeezed down to their worst levels since late 2009.

The severe consequences of the COVID-19 shutdowns and their aftermath mean that Q2 could turn out to be not just a valley for corporate earnings, but something more akin to the Grand Canyon, and the biggest quarterly decline of the pandemic.

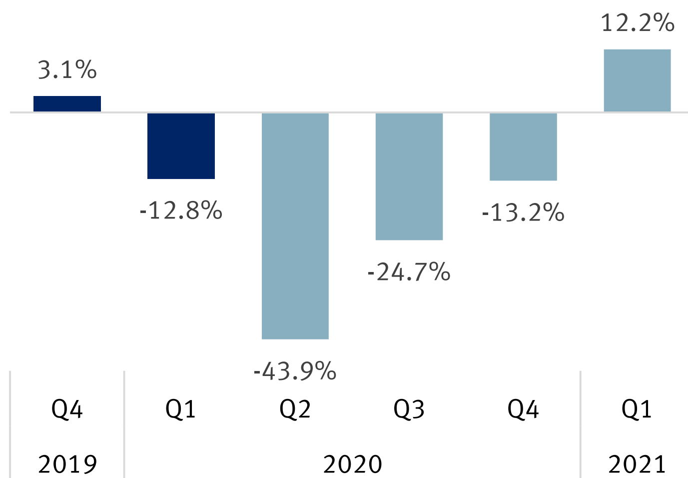
We have little doubt there will be some high-profile earnings and revenue misses as well as ugly forecasts for future quarters by S&P 500 companies given the economic uncertainties. We still don't expect the bulk of management teams to provide full-year 2020 earnings and revenue guidance. They have little incentive to go out on a limb right now.

If more companies stumble than usual during Q2 reporting season, the major U.S. indexes would be at risk of pulling back given the market has rallied a long way in a short time. The S&P 500 has jumped 41 percent since the March low, and we think it's overdue for at least a modest retreat.

RBC Capital Markets, LLC Technical Strategist Bob Dickey wrote, "The rally in the stock market is becoming extended on a short-term basis but the move is not supported by a wider number of stocks, but instead continues to be led by a smaller list of large-cap growth issues … We expect the indexes to test their closest support levels that are around 25,000 on the Dow

### The biggest earnings hit from COVID-19 shutdowns should be in Q2

S&P 500 consensus earnings growth forecast by quarter (y/y % change)*




*Actual results in dark blue; consensus estimates in light blue
Source - RBC Wealth Management, Refinitiv I/B/E/S; data as of 7/8/20

### Market pulse



Click here for authors' contact information. Priced (in USD) as of 7/9/20 market close, ET (unless otherwise stated). **For important disclosures and required non-U.S. analyst disclosures, see page 6.**
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Industrials and 3,000 on the S&P 500 with a fair possibility of breaking those support numbers."

## The bigger picture

Even if the market finally takes a break and pulls back, we don't think Q2 earnings will meaningfully impact the mid- to long-term trajectory of U.S. stock prices.

Earnings and revenue growth should be "less bad" in the third and fourth quarters, and the year-over-year declines seem set to improve. Earnings breadth—the proportion of S&P 500 companies with year-over-year earnings growth—should also move in the right direction. While only 21 percent are expected to grow earnings in Q2, that figure should improve slightly in Q3 and more so to around 36 percent in Q4, according to Bloomberg Intelligence analysts.

We think the downwardly revised consensus earnings per share forecast of $125 for 2020 has fallen about as much as needed. The estimate now seems achievable.

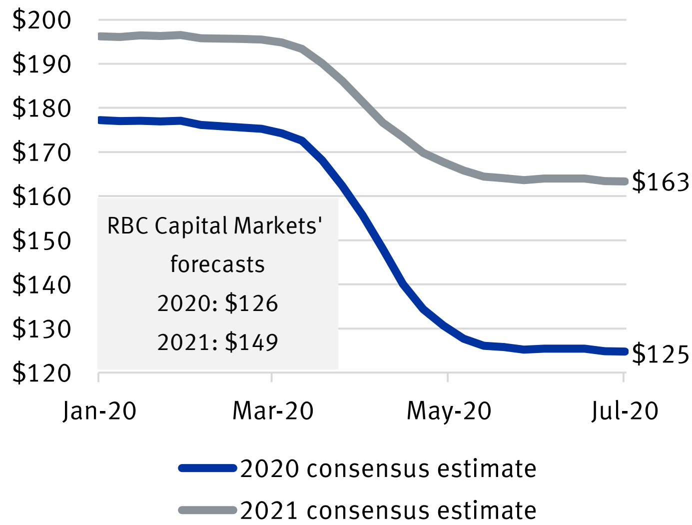
Better earnings and revenue growth and profit margin expansion should materialize in 2021 as the economy recovers. We still think there is downside risk to the $163 per share consensus forecast for 2021, but it's getting closer to a reasonable level. RBC Capital Markets is estimating $149 per share. Estimates have the potential to shift in coming months as a clearer view of the economic landscape takes shape. We are comfortable penciling in a range of $149–$155 per share at this stage.

While the economic recovery remains somewhat dependent on the progression of COVID-19 statistics, thus far, the recent infection outbreaks in select states have not prompted severe, widespread shutdowns of economic activity the way the initial spread of the virus did back in the latter half of March and into April.

Regardless of COVID-19 trends, the recession's duration should be significantly shorter than the contraction that occurred during the global financial crisis. This recession was caused by a unique, transitory health crisis, rather than by severe stress within the financial system. Fiscal and monetary stimulus measures have also been unleased much more quickly and with far greater force.

### We think the 2020 profit estimate has fallen enough, but not 2021

S&P 500 consensus earnings per share forecasts




Source - RBC Wealth Management, Refinitiv I/B/E/S, RBC Capital Markets U.S. Equity Strategy; weekly data from 1/6/20 through 7/8/20

But we remain skeptical about the potential for the U.S. equity market to push much higher in the near term. It seems like the major indexes are assuming the timing of the earnings and economic recoveries will be even faster than is plausible to us.

## Lean against the risks

We think investors should look past the Q2 profits canyon and focus more on the pace and shape of the economic recovery and the trend in 2021 earnings estimates to determine whether the market has the capacity to grow into its rich valuation. Based on our estimated potential earnings range of $149–$155 per share for 2021, the market's price-to-earnings ratio stands at 20.3x–21.2x—a lofty zone.

Given this stretched valuation, the market's big move since March, and the lingering economic risks, we remain comfortable holding a moderately Underweight position in U.S. equities for the time being, with an eye toward becoming more constructive if a pullback materializes.

## United States

Atul Bhatia, CFA – Minneapolis

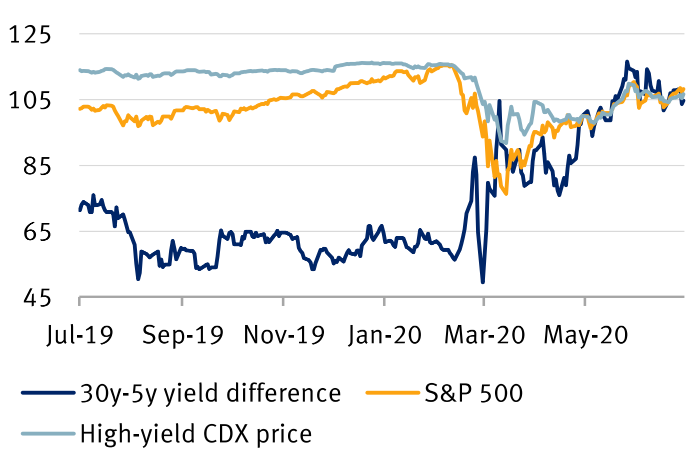
- **Minutes from the Fed's June meeting downplayed the likelihood of yield curve control**, a policy of fixing rates for longer maturities. The Federal Open Market Committee instead indicated a **preference for enhancing policy guidance**, including potentially linking overnight rate setting to employment, calendar, or inflation metrics. Both the minutes and later comments by Fed Chair Jerome Powell and regional Fed presidents stressed that the **economic recovery will likely require years of monetary policy support**.

- **The Fed launched the Main Street Lending Facility this week**, the last of authorized extraordinary support facilities to get underway. Initial loan demand under the program, which allows banks to transfer 95% of the risk of qualifying loans to one of three Fed facilities, has been low, which the Boston Fed president attributed to banks and borrowers needing time to understand the complex requirements. Separately, **Congress extended the application deadline for the Paycheck Protection Program** and is also working on a new round of fiscal stimulus; initial reports from Bloomberg indicate up to $1 trillion of stimulus to be approved in early August.

- **Nonfarm payrolls grew by 4.8 million in June**, ahead of the 3 million job additions forecast in a survey of market economists. Markets reacted positively to the news, although enthusiasm is tempered by unemployment at 11.1% and the cumulative loss of 13 million jobs since April. We believe that the Fed is likely to view unemployment above 5% as warranting an accommodative stance, barring any significant uptick in inflation expectations.

**Yield curve shape as a risk proxy**

Normalized changes in high-yield credit, equity, and curve steepener




Source - RBC Wealth Management, Bloomberg; data through 7/8/20

- The combination of strengthening employment and a Fed focused on keeping short-term rates low typically leads to a steeper yield curve, with rates moving higher on longer maturity bonds than short maturity bonds. Markets had begun pricing this recovery scenario, with the yield difference between 5-year and 30-year bonds hitting a multiyear high in early June. Since then, however, **concerns about COVID-19 infections and a potential pullback in consumer spending have increased demand for long-term Treasuries, driving rates lower and reducing the steepness of the yield curve**. We expect this behavior to continue, with long-term rates and curve steepness closely tracking equity and risk assets.

## Canada

Carolyn Schroeder & Arete Zafiriou – Toronto

- The Q2 editions of the Bank of Canada's Business Outlook Survey and Canadian Survey of Consumer Expectations both reiterated that the economic recovery will take time. **Business expectations for future sales and investment pulled back dramatically** over the survey period (mid-May to early June) to levels that rivaled the trough experienced during the 2007–2009 global financial crisis. About 40% of businesses expected sales to be at pre-shock sales levels by next year, and employment growth was still expected to be positive over the next 12 months. **The main concern was not that businesses would be unable to produce, but rather that demand will be weak** even as social distancing measures are relaxed. The consumer expectations survey mirrored much of what businesses reported. Although household income and spending expectations were lower, both were still expected to grow. Unlike businesses, **households expected inflation to rise** going forward, potentially reflecting a recent divergence in prices for food versus other products.

- According to RBC Economics, **personal spending is slowly recovering** after being down almost 40% y/y in March. An analysis of credit card data shows that retail spending saw a bump up when clothing stores started opening at the end of May, but is still down about 25% from a year ago. **Online spending has remained robust** even after brick-and-mortar stores reopened in late May, with online marketplace expenditures up 80% y/y. Spending in the entertainment, art, and movies industry continues to trudge below prior-year levels amid the closure of galleries, casinos, and theatres, despite renewed strength in golfing and gaming. **Canadians have been travelling more by car** since coming out of lockdown, with gas and automotive expenditures almost back to normal levels after dropping more than 40% y/y in April. However, hotels, airlines, and car rentals are still hurting, with spending down 75% from a year ago.

## Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

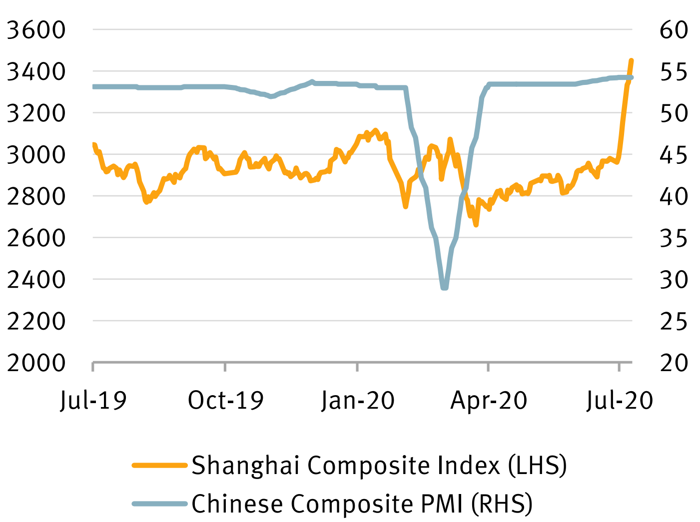
- **UK Chancellor of the Exchequer Rishi Sunak announced a stimulus package to help the UK's recovery from the COVID-19 crisis**. The package, worth some 1.5% of GDP, brings the total COVID-19 stimulus outlay so far to a substantial 8% of GDP. Some measures are innovative, such as cutting the sales tax to 5% from 20% for the struggling hospitality sector. **But the most important measure of the package focuses on supporting employment**. The current signature job retention scheme will end in October, as planned, but the government will now pay a £1,000 bonus per employee brought back from furlough who remains in employment through the end of January 2021.

- The measures will help the jobs market somewhat though they are no panacea for firms heavily affected by the crisis. **The chancellor is scheduled to deliver another budget and spending review in the autumn in which he is likely to tackle the rising fiscal deficit**.

- **The gilt market was stable, and the pound strengthened a little on the back of the announcement**. But RBC Capital Markets expects the currency to continue to underperform those of other G10 countries as markets start to focus on the country's imbalances (budget, current account, and lack of private sector savings). In the short term, currency moves may soon again be dominated by developments regarding the UK-EU trade negotiations.

- The UK government let pass the June 30 deadline to request an extension of the transition period preserving the status quo in its relationship with the EU. The transition period will thus end on December 31, 2020. **Negotiation teams on both sides are still meeting, and the hope is they will come up with some kind of trading agreement before then**. Temporary stopgaps focussed on particular industries are a possibility, though we expect brinkmanship and last minute drama. Should negotiations fail, and the UK have to fall back on unfavourable World Trade Organization trading terms, an event to which we attribute a 30% probability, it would likely shave 1%–2% from GDP growth.

Chinese equities rally after PMI rebounds




Source - RBC Wealth Management, Bloomberg; data through 7/9/20

## Asia Pacific

Jasmine Duan – Hong Kong & Nicholas Gwee, CFA – Singapore

- **The China and Hong Kong markets have rallied sharply this week**. China's Shanghai Composite Index surged 16.5% as of Thursday's close and Hong Kong's Hang Seng Index rose 7.7%.

- **The rally is likely due to Chinese economic data having confirmed the recovery is accelerating**. Data from March through May showed a gradual pick-up of activities, but investors still question whether the recovery is sustainable. We think June's economic data suggests it is, thanks to a **faster recovery in manufacturing and services**, in addition to **continued strength in construction activity**. For example, the official composite Purchasing Managers' Index rose to 54.2 from 53.4, the highest level since mid-2018, which suggests to us the overall pace of the recovery increased in June.

- In addition, **China signaled an acceleration of financial market reforms recently**. Caixin reported that the China Securities Regulatory Commission will start granting securities licenses to commercial banks, likely beginning with a trial of two banks. Other financial reform catalysts include the ChiNext IPO registration scheme launch, Red Chip listing relaxation, and A-share index derivatives products. **The reforms may strengthen China's capital markets and attract more foreign investors**. Compared with the high equity valuations and low yields of U.S. markets, China and Hong Kong may still be relatively undervalued and attractive to investors in H2 2020.

- On the other hand, **investors are keeping an eye on the third wave of COVID-19 outbreaks** in Hong Kong and Australia. Both places have seen surges in new infections, and Australia's second-largest city, Melbourne, went back into lockdown. The third wave shows us that it could take longer than expected for life to return to how it was prior to COVID-19. As such, recovery of some of the hardest-hit sectors, e.g., airlines, hotel, and tourism, may also take longer than previously thought.

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### Data as of July 9, 2020

| Equities (local currency) | Level | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| S&P 500 | 3,152.05 | 1.7% | -2.4% | 5.8% | 13.2% |
| Dow Industrials (DJIA) | 25,706.09 | -0.4% | -9.9% | -4.0% | 3.8% |
| NASDAQ | 10,547.75 | 4.9% | 17.6% | 29.6% | 36.0% |
| Russell 2000 | 1,398.92 | -2.9% | -16.2% | -10.5% | -17.9% |
| S&P/TSX Comp | 15,568.64 | 0.3% | -8.8% | -5.9% | -5.4% |
| FTSE All-Share | 3,353.07 | -1.7% | -20.1% | -18.3% | -20.6% |
| STOXX Europe 600 | 363.64 | 0.9% | -12.6% | -6.3% | -5.4% |
| EURO STOXX 50 | 3,261.17 | 0.8% | -12.9% | -7.1% | -5.8% |
| Hang Seng | 26,210.16 | 7.3% | -7.0% | -6.8% | -8.6% |
| Shanghai Comp | 3,450.59 | 15.6% | 13.1% | 17.8% | 22.6% |
| Nikkei 225 | 22,529.29 | 1.1% | -4.8% | 4.5% | 2.2% |
| India Sensex | 36,737.69 | 5.2% | -10.9% | -5.1% | 2.2% |
| Singapore Straits Times | 2,652.65 | 2.4% | -17.7% | -20.3% | -17.8% |
| Brazil Ibovespa | 99,160.30 | 4.3% | -14.3% | -6.0% | 32.2% |
| Mexican Bolsa IPC | 36,795.95 | -2.4% | -15.5% | -14.1% | -25.3% |

| Commodities (USD) | Price | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| Gold (spot $/oz) | 1,803.08 | 1.2% | 18.8% | 29.0% | 43.4% |
| Silver (spot $/oz) | 18.66 | 2.5% | 4.5% | 23.5% | 15.8% |
| Copper ($/metric ton) | 6,230.25 | 3.8% | 1.3% | 7.3% | -2.4% |
| Oil (WTI spot/bbl) | 39.62 | 0.9% | -35.1% | -31.5% | -46.4% |
| Oil (Brent spot/bbl) | 42.36 | 2.9% | -35.8% | -34.0% | -45.7% |
| Natural Gas ($/mmBtu) | 1.77 | 1.3% | -19.0% | -26.8% | -37.3% |

| Govt bonds (bps chg) | Yield | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. 10-Yr Tsy | 0.614% | -4.3 | -130.4 | -145.1 | -224.3 |
| Canada 10-Yr | 0.532% | 0.4 | -117.0 | -105.1 | -163.7 |
| U.K. 10-Yr | 0.158% | -1.4 | -66.4 | -56.2 | -109.4 |
| Germany 10-Yr | -0.463% | -0.9 | -27.8 | -10.9 | -76.3 |

| Fixed Income (returns) | Yield | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. Aggregate | 1.21% | 0.4% | 6.5% | 9.3% | 17.6% |
| U.S. Invest Grade Corp | 2.07% | 1.1% | 6.2% | 10.8% | 21.9% |
| U.S. High Yield Corp | 6.50% | 1.3% | -2.6% | 1.2% | 8.6% |

| Currencies | Rate | MTD | YTD | 1 yr | 2 yr |
|---|---|---|---|---|---|
| U.S. Dollar Index | 96.8020 | -0.6% | 0.4% | -0.7% | 2.9% |
| CAD/USD | 0.7362 | -0.1% | -4.4% | -3.3% | -3.5% |
| USD/CAD | 1.3583 | 0.1% | 4.6% | 3.5% | 3.6% |
| EUR/USD | 1.1285 | 0.5% | 0.6% | 0.7% | -4.0% |
| GBP/USD | 1.2606 | 1.7% | -4.9% | 1.1% | -4.9% |
| AUD/USD | 0.6964 | 0.9% | -0.8% | 0.5% | -6.7% |
| USD/JPY | 107.2000 | -0.7% | -1.3% | -1.5% | -3.3% |
| EUR/JPY | 120.9800 | -0.2% | -0.6% | -0.8% | -7.1% |
| EUR/GBP | 0.8952 | -1.2% | 5.8% | -0.4% | 1.0% |
| EUR/CHF | 1.0610 | -0.3% | -2.3% | -4.7% | -8.9% |
| USD/SGD | 1.3922 | -0.1% | 3.4% | 2.3% | 2.6% |
| USD/CNY | 6.9942 | -1.0% | 0.4% | 1.5% | 5.7% |
| USD/MXN | 22.6493 | -1.5% | 19.7% | 18.2% | 18.0% |
| USD/BRL | 5.3435 | -2.3% | 32.6% | 41.4% | 38.0% |

Source - Bloomberg. Note: Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Data as of 10:10 pm GMT 7/9/20.

Examples of how to interpret currency data: CAD/USD 0.73 means 1 Canadian dollar will buy 0.73 U.S. dollar. CAD/USD -4.4% return means the Canadian dollar fell 4.4% vs. the U.S. dollar year to date. USD/JPY 107.20 means 1 U.S. dollar will buy 107.20 yen. USD/JPY -1.3% return means the U.S. dollar fell 1.3% vs. the yen year to date.

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As of June 30, 2020

| | | | Investment Banking Services Provided During Past 12 Months | |
|---|---|---|---|---|
| Rating | Count | Percent | Count | Percent |
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| Hold [Sector Perform] | 635 | 42.25 | 130 | 20.47 |
| Sell [Underperform] | 92 | 6.12 | 12 | 13.04 |

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