August 13, 2020

RBC WEALTH MANAGEMENT

Global Insight Weekly

Digging out of a deep hole

Kelly Bogdanova – San Francisco

Cornerstones of the U.S. stock market are moving in the right direction. With corporate earnings in Q2 better than feared, what does this mean for the 2020–21 earnings outlook? But as the market has rallied to pre-crisis levels, is the current valuation a sticking point?

It's not just the all-important monetary and fiscal stimulus programs that have been driving the U.S. equity market lately, or even the improvement in economic data.

The latest part of the rally has some meat on the bones.

As the S&P 500 has pushed back up near its all-time high reached last February, the market has been driven by better-than-feared profits and revenues, and an upward shift in earnings estimates not only for next quarter but also for the full year and 2021.

Finding some footing

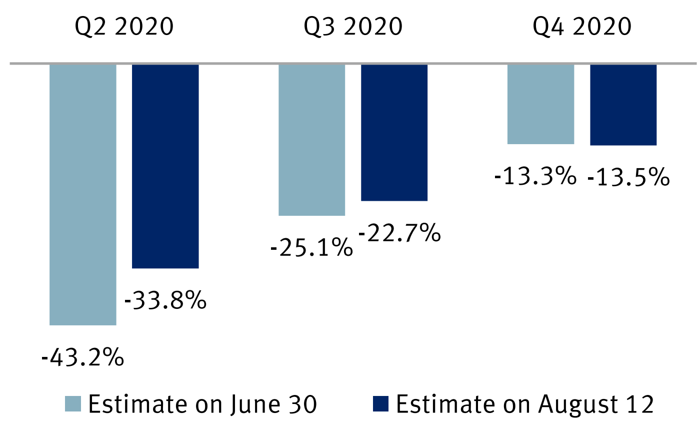
Heading into the Q2 reporting season, expectations were low. The consensus forecast was for a deep 43 percent decline in earnings compared to the same period a year ago—a Grand Canyon, of sorts.

While a big profits hole is still there, some positive developments have transpired:

- The percentage of earnings "beats" in Q2—those companies that have exceeded the consensus forecast—has wildly exceeded norms. With about 90 percent of companies having reported results, 81 percent have overshot profit estimates. This is much higher than the 65 percent long-term average. As a result, the Q2 slide in earnings is now pacing at about -34 percent instead of -43 percent.
- Q2 revenue beats have also been strong, at 63 percent.
- While management teams are still guarded with projections for future quarters, more issued formal estimates than were

U.S. earnings estimates have moved in the right direction

S&P 500 consensus earnings growth by quarter: Previous vs. current forecast (% change year over year)



Source - RBC Wealth Management, national research correspondent, Refinitiv I/B/E/S

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expected, and the guidance was largely positive. This helped push up the Q3 consensus forecast.

- 2020 earnings estimates for eight of 11 sectors have improved, as the table shows. The biggest positive percentage point change occurred for Consumer Discretionary, Health Care, and Financials—three important sectors.
- S&P 500 annual profit estimates for 2020 and 2021 pushed higher rather than lower, as the chart shows.

Future perspective

We find the upward movement in 2021 S&P 500 profit estimates to $166 from $163 per share particularly interesting.

First, it catches our attention because 2020 is increasingly being viewed as a "lost year" for profits due to the COVID-19 shutdowns. The "less bad" Q2 results and revisions for Q3 indicate that the upwardly revised 2020 consensus forecast of $130 per share has some potential to move higher.

This is all well and good. But at this point on the calendar, even if the COVID-19 shutdowns and a recession had not occurred, heads would naturally turn toward the profit scenarios for next year. That's just how "the market" thinks—it looks forward, not backward. 2020 results are almost yesterday's news.

Second, the higher 2021 forecast strikes us because the sentiment among many market strategists heading into this reporting period was that this estimate was at risk of heading down, not up. This is because of elevated economic risks associated with the recovery in the wake of a pandemic. Just the opposite occurred—the 2021 estimate inched up.

The sticking point

Certainly, the $166 per share consensus forecast for 2021 would be at risk if the economic recovery stalls or additional COVID-19 shutdowns suffocate growth. We think it's too soon to etch that estimate in stone because there are legitimate economic headwinds.

RBC Global Asset Management Inc. Chief Economist Eric Lascelles believes it will take until mid-2022 for the U.S. economy to get back to where it was before COVID-19, and until early 2024 to sop up the excess economic slack.

But we think the positive earnings and revenue trends in Q2, along with the upward revisions to Q3 and 2021, signal that a wider range of earnings possibilities should be considered, including more optimistic outcomes.

On the low end of the range, our strategists estimate earnings of $149 to $155 per share for 2021. We think there is upside potential to these estimates, stretching to the $165 consensus level and perhaps even a bit higher if earnings in the next couple quarters exceed expectations.

The market's lofty valuation remains a sticking point. Even if 2021 earnings were to exceed the consensus forecast, the market's valuation would still be stretched.

2020 earnings estimates have improved for 8 of 11 sectors

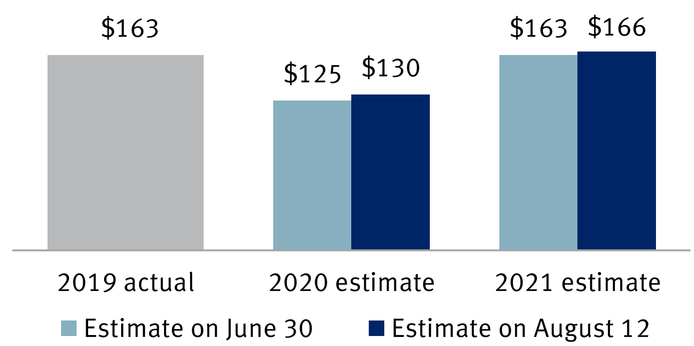
S&P 500 and sector consensus earnings growth for 2020: Previous vs. current forecast (% change year over year)

	Estimate on June 30	Estimate on August 12	Difference
S&P 500	**-23.6**	**-20.4**	**3.2**
Cons. Discretionary	-59.4	-49.4	10.0
Health Care	-1.6	3.3	4.9
Financials	-36.5	-32.2	4.3
Materials	-20.3	-17.2	3.1
Energy	-108.6	-105.5	3.1
Info. Technology	-0.6	2.5	3.1
Communication Svcs.	-16.8	-14.2	2.6
Consumer Staples	-3.7	-2.2	1.5
REITs	-9.7	-11.0	-1.3
Utilities	1.6	0.2	-1.4
Industrials	-52.8	-55.4	-2.6

Source - RBC Wealth Management, national research correspondent, Refinitiv I/B/E/S

Annual EPS estimates have pushed higher, not lower

S&P 500 annual consensus earnings per share (EPS): Previous vs. current forecast



Source - RBC Wealth Management, national research correspondent, Refinitiv I/B/E/S

For example, if we use a wide earnings range for 2021 with $150 on the low end and $170 on the high end, the S&P 500 valuation would range from 19.8x to 22.5x, which is still well above the long-term 15.0x average.

Yes, there are multiple reasons to justify a high valuation, in our view: ultralow interest rates that seem entrenched, ultra-loose monetary policies, earnings and economic growth have troughed and seem set to improve, lack of investment alternatives, etc. Even so, such elevated valuations are hardly compelling.

The bottom line is: Corporate and market fundamentals are moving in the right direction, along with the economy. But the market's valuation already reflects it.

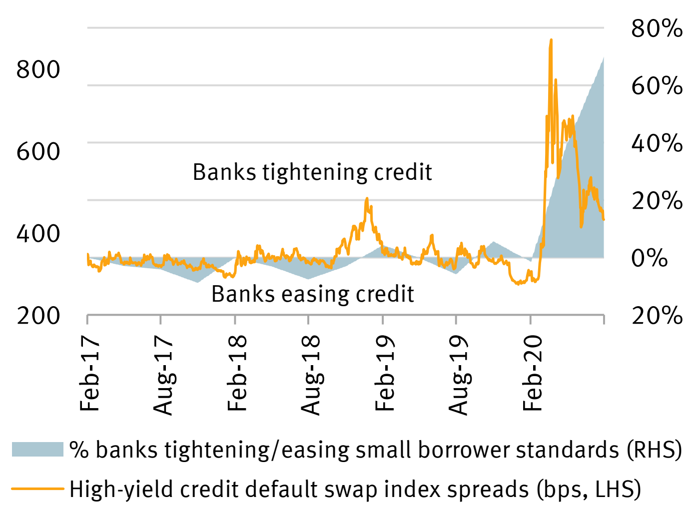
United States

Atul Bhatia, CFA – Minneapolis

- **Recent economic data has shown a faster-than-anticipated rate of improvement**, with non-farm payroll numbers growing by 1.7 million in July and consumer prices increasing 1.0% since July 2019. Although welcome news, even this faster pace **leaves the U.S. economy in an 11.5 million jobs deficit since March**. With unemployment above 10% and inflation below the Federal Reserve Board's unofficial 2% target, we see a clear imperative for the Fed to maintain its accommodative monetary stance.
- **The path for fiscal policy, however, remains unclear.** The $600 weekly federal supplement to unemployment benefits expired at the end of July and has yet to be extended by Congress. President Trump signed executive orders designed to provide some measure of federal relief, but for a variety of legal and logistical reasons, the economic impact is likely to be muted. **Both political parties seem content with the stalemate**, particularly as financial markets have not registered any concern.
- **Sub-investment-grade bonds will soon need a new name as "high yield" is quickly losing relevance.** The latest evidence is this week's $1.3 billion, 10-year debt offering from Ball Corporation, a BB+ rated packing company; **the debt sold with a 2.875% coupon, a record low for a high-yield issue of that size and maturity**. Despite the low coupons, over $274 billion in sub-investment-grade bonds have been issued this year, surpassing the sum raised by high-yield issuers in all of 2019.

Diverging interest

Tightening banks vs. easing credit markets



Source - Bloomberg, U.S. Federal Reserve Board

- **The picture is less rosy for smaller companies dependent on bank financing.** Over two-thirds of banks tightened credit standards for corporate borrowers with less than $50 million in sales, according to the Fed's latest Senior Loan Officer Opinion Survey on Bank Lending Practices. This is the **highest level of credit restriction since 2008**. The Fed's sole intervention for borrowers reliant on bank financing—the Main Street Lending Program—has funded less than $300 million in loans to date, due in part to complicated rules and mixed incentives.

Canada

Meika McKelvey – Toronto

- The Canadian economy added approximately 418,000 jobs in July, the third consecutive month of employment gains, bringing the cumulative number of jobs added since May to 1.7 million. This means 55% of the jobs lost during the COVID-19 crisis have been recovered. The pace of the labour market recovery has been encouraging, but the progress is tempered by the reality that the Canadian economy **has still lost well over a million jobs cumulatively since the COVID-19 outbreak**, and RBC Capital Markets expects the job market to continue operating below capacity well into next year. It's also noteworthy that **approximately 83% of July's job gains were in part-time work**, which could be a trend going forward if employers opt to grow payroll cautiously given continued uncertainty in the economic outlook. As the recovery continues, we would look for more consistent full-time job growth as a sign the economy is acclimating to its new normal.
- Consistent with the move across global government yield curves this week, **the broader Government of Canada (GoC) curve steepened about 10 basis points (bps) over the past four trading days**, and has experienced almost 20 bps of steepening this month. This move has been driven by a rise in the long end of the curve as record amounts of government stimulus and bond supply have placed strong upward pressure on long-term rates. As the GoC and other developed market yield curves have been re-steepening, **real yields have remained anchored and market-based inflation expectations have been grinding higher**. The Canadian 10-year breakeven rate, which represents the level of inflation compensation priced into traditional government bonds, rose to about 1.3% as of Aug. 13, just 20 bps below pre-COVID-19 levels. Despite the rebound off of March lows, inflation expectations remain historically low, meaning the cost of protecting against inflation has rarely been cheaper than it is today. **This has been a key driver behind our relative preference for inflation-linked bonds** over the past approximately 18 months.

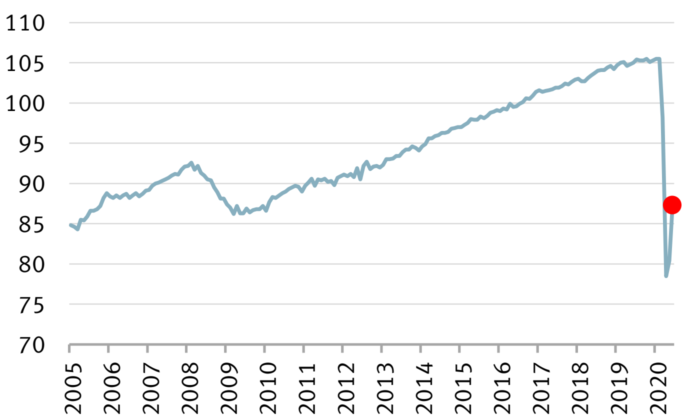
Europe

Frédérique Carrier & Thomas McGarrity, CFA – London

- **The decline in UK GDP in Q2 dominated headlines with the steepest quarterly contraction on record**, collapsing by 20.4% q/q and 21.7% y/y. This was roughly in line with consensus expectations, though eye-catching nonetheless.
- Much was made of the fact that this fall in economic activity is **much more pronounced than that experienced in the major economies of Continental Europe**. Indeed, only Spain recorded a worse fall, with GDP contracting 22% y/y in Q2. Other countries fared less poorly, with German GDP contracting 11.6% y/y, Italy—despite being the epicentre of the virus for much of the spring—falling 17.3% y/y, and France retreating by a less severe 19% y/y.
- According to RBC Capital Markets' economists, **the UK underperformed its peers due to its greater dependence on consumer-facing services and to the later start of its lockdown**, in the last days of Q1, so that the brunt of the impact centred on Q2. Other European countries locked down earlier, spreading the impact into Q1. Moreover, as the UK's lockdown was less strict, it also lasted longer, and the reopening of the economy was slower than elsewhere in Europe.
- Still, given the UK had been lauded for having had one of the most coordinated fiscal and monetary policy responses, the performance of the economy is somewhat disappointing, in our view. **The economy bounced back by a relatively strong 8.7% m/m in June, but it still has a long way to go** to return to pre-crisis levels.

A long way back up for UK GDP

ONS Monthly GDP Index



Source - Haver Analytics, Office for National Statistics, RBC Capital Markets

- Meanwhile, the prospect of **Brexit continues to hang over the country**. Negotiations with the EU have produced little result, and **time is running out on the transition period that ensures the status quo until the end of December**. RBC Global Asset Management Chief Economist Eric Lascelles has increased the probability of a no-trade-deal Brexit to 55%, making this his central scenario. A no-trade-deal Brexit would be an additional challenge for the UK economy to overcome.

Asia Pacific

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

- The Asia Pacific equity market traded mostly higher during the week, led by Japan and South Korea. **The Nikkei 225 Index is trading near a six-month high**, almost fully recovering from its decline since the start of the COVID-19 pandemic. The rally this week has been driven by the semiconductor group, likely on hopes for more chip demand related to new technologies following strong gains in global peers.
- **The Chinese government announced the resumption of mainland China tourist visas to Macau.** Macau's secretary for social affairs and culture said the city is working with mainland authorities to resume the full visa program, but warned the plan could be disrupted if virus transmissions re-emerge. News of the return of Chinese tourists sent the Macau casino stocks (Sands China, Galaxy Entertainment, MGM China, Wynn Macau) soaring by at least 7% this week.
- **Australia added 114,700 jobs in July, four times the expected increase**, as the economy continues to recover in areas where COVID-19 is under control. The unemployment rate edged up to 7.5%, as more people re-entered the labor force. Observers believe **Australia is showing increasing signs of a three-speed labor market**: Victoria began to founder as surging infections forced the reintroduction of tough restrictions; New South Wales slumped as Sydney contended with outbreaks; and Western Australia, virus-free and sealed off, kept improving.
- **Tencent's (700 HK) Q2 FY2020 results were ahead of consensus expectations.** Gaming boosted overall revenue while Tencent saw some weakness in its advertising business. Management cautioned it expects in-game consumption to normalize going forward. On the earnings call, Tencent executives tried to reassure investors that U.S. President Donald Trump's ban on the company's WeChat messaging service may apply only to its overseas operations, and stated they are "in the process of seeking further clarification from bipartisan parties in the U.S."

MARKET SCORECARD

Data as of August 13, 2020

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	3,373.43	3.1%	4.4%	15.3%	19.5%
Dow Industrials (DJIA)	27,896.72	5.6%	-2.2%	6.2%	10.8%
NASDAQ	11,042.50	2.8%	23.1%	37.7%	41.2%
Russell 2000	1,579.79	6.7%	-5.3%	4.6%	-5.7%
S&P/TSX Comp	16,530.06	2.2%	-3.1%	1.1%	1.7%
FTSE All-Share	3,447.01	5.0%	-17.9%	-13.0%	-17.9%
STOXX Europe 600	372.53	4.5%	-10.4%	0.0%	-3.2%
EURO STOXX 50	3,342.85	5.3%	-10.7%	-0.4%	-2.0%
Hang Seng	25,230.67	2.6%	-10.5%	-0.2%	-9.7%
Shanghai Comp	3,320.73	0.3%	8.9%	18.7%	19.2%
Nikkei 225	23,249.61	7.1%	-1.7%	13.7%	6.4%
India Sensex	38,310.49	1.9%	-7.1%	3.7%	1.8%
Singapore Straits Times	2,595.97	2.6%	-19.5%	-17.5%	-20.0%
Brazil Ibovespa	100,460.60	-2.4%	-13.1%	-2.7%	29.6%
Mexican Bolsa IPC	38,615.62	4.3%	-11.3%	-2.2%	-20.8%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,953.46	-1.1%	28.7%	30.1%	63.7%
Silver (spot $/oz)	27.36	12.2%	53.3%	61.3%	82.5%
Copper ($/metric ton)	6,434.50	0.2%	4.6%	10.9%	5.1%
Oil (WTI spot/bbl)	42.24	4.9%	-30.8%	-26.0%	-37.1%
Oil (Brent spot/bbl)	45.10	4.2%	-31.7%	-26.4%	-37.9%
Natural Gas ($/mmBtu)	2.19	21.8%	0.1%	2.1%	-25.2%

Govt bonds (bps chg)	Yield	MTD	YTD	1 yr	2 yr
U.S. 10-Yr Tsy	0.716%	18.8	-120.2	-98.8	-216.3
Canada 10-Yr	0.639%	17.2	-106.3	-60.2	-166.2
U.K. 10-Yr	0.243%	13.9	-57.9	-25.1	-100.9
Germany 10-Yr	-0.412%	11.2	-22.7	19.7	-72.3
Fixed Income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.13%	-0.5%	7.2%	7.9%	18.0%
U.S. Invest Grade Corp	1.90%	-0.4%	8.0%	10.0%	23.3%
U.S. High Yield Corp	5.40%	0.6%	1.3%	5.3%	11.7%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.2670	-0.1%	-3.2%	-4.6%	-3.2%
CAD/USD	0.7566	1.5%	-1.7%	0.1%	-0.6%
USD/CAD	1.3217	-1.5%	1.7%	0.0%	0.6%
EUR/USD	1.1813	0.3%	5.4%	5.7%	3.5%
GBP/USD	1.3058	-0.2%	-1.5%	8.3%	2.2%
AUD/USD	0.7147	0.1%	1.8%	5.1%	-1.7%
USD/JPY	106.9400	1.0%	-1.5%	0.2%	-3.4%
EUR/JPY	126.3300	1.3%	3.7%	5.9%	0.0%
EUR/GBP	0.9047	0.5%	6.9%	-2.3%	1.2%
EUR/CHF	1.0748	-0.1%	-1.0%	-1.5%	-5.2%
USD/SGD	1.3729	-0.1%	2.0%	-0.8%	-0.2%
USD/CNY	6.9451	-0.4%	-0.3%	-1.4%	0.8%
USD/MXN	22.1712	-0.5%	17.1%	14.4%	16.0%
USD/BRL	5.3595	2.7%	33.0%	41.8%	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 9:35 pm GMT 8/13/20.

Examples of how to interpret currency data: CAD/USD 0.75 means 1 Canadian dollar will buy 0.75 U.S. dollar. CAD/USD -1.7% return means the Canadian dollar fell 1.7% vs. the U.S. dollar year to date. USD/JPY 106.94 means 1 U.S. dollar will buy 106.94 yen. USD/JPY -1.5% return means the U.S. dollar fell 1.5% vs. the yen year to date.

Authors

Kelly Bogdanova – San Francisco, United States
kelly.bogdanova@rbc.com; RBC Capital Markets, LLC

Atul Bhatia, CFA – Minneapolis, United States
atul.bhatia@rbc.com; RBC Capital Markets, LLC

Meika McKelvey – Toronto, Canada
meika.mckelvey@rbccm.com; RBC Dominion Securities Inc.

Frédérique Carrier – London, United Kingdom
frederique.carrier@rbc.com; RBC Europe Limited

Thomas McGarrity, CFA – London, United Kingdom
thomas.mcgarrity@rbc.com; RBC Europe Limited

Jasmine Duan – Hong Kong, China
jasmine.duan@rbc.com; RBC Investment Services (Asia) Limited

Nicholas Gwee, CFA – Singapore
nicholas.gwee@rbc.com; Royal Bank of Canada, Singapore Branch

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