# The Global Revival in Corporate Earnings Continues

Our weekly view on asset allocation.

15 November 2021

# Earnings a Key Plank in the Global Equity Outlook

While there has been an understandable focus on the outlook for inflation and interest rates in recent months, earnings are a key plank in the global equity outlook.

Read Stagflation – Should Investors be Worried?

The latest batch of earnings results in the US and Europe confirms that the global earnings cycle continues to be strong, with operating leverage (and pricing power) still more than compensating for the widely canvassed pick-up in cost pressures.

The US third-quarter reporting season is now well over 90% complete, with actual earnings soundly beating expectations yet again. Over the past month, Q3 actual earnings growth has been upgraded from 27% to 39% year-on-year (YoY) growth. This compares to the "peak" growth rate of 90% achieved in the second quarter of this year, which was cycling the deeply depressed COVID impacted Q2 2020 quarter.

A strong rebound in the top-line continues to power the US earnings cycle. The Q3 revenue growth rate of 17.3% (Q2 25%) is well above the 5-year average growth rate of 5.8%. The unusually high growth rate in revenues is largely still due to easy comparisons to lower revenues in 2020 due to the negative impact of COVID-19. However, the ongoing strength of the sales line is nonetheless impressive and continues to overshadow the impact of cost input pressures in aggregate terms.

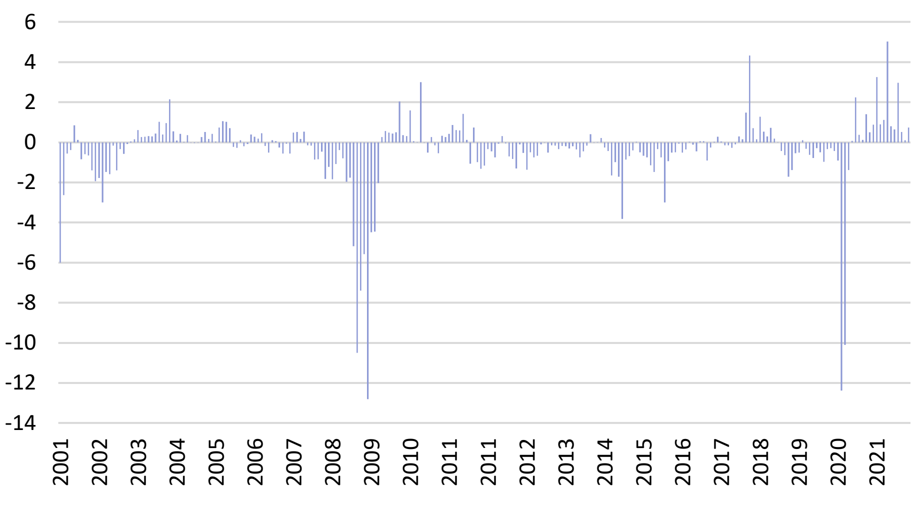
The energy sector saw the most substantial revenue rebound in Q3 (+75%), while the high-flying IT sector saw sales increase 19% on a much less depressed base. Consumer staples delivered the slowest top line growth with a still robust 7.5% lift in sales.

Revenues growth is expected to slow to 12% in Q4, but this is still well ahead of longer-term trends suggesting the operating leverage story should continue to dominate cost increases.

Analysts currently expect earnings growth of just over 20% for Q4 (this is too low in our view), which translates to earnings growth of more than 40% for the full year CY21.

Growth is then expected to moderate significantly in CY22 as year-over-year comparisons become more challenging. The consensus expects 9% earnings growth for CY22 based on trend like top line growth of around 6%.

**Exhibit 1: US earnings upgrades have continued and now stretch to 17 months in a row**




Source: Refinitiv, Wilsons.

## The Long Upgrade Cycle has Further to Run

Apart from the strong trend in US Q3 actual results, consensus estimates for the year ahead continue to lift across a broad front, with 8 of 11 sectors seeing upgrades to forward estimates over the past month.

The US upgrade cycle has now stretched to 17 months. This stretch of upgrades now equals the record run of upgrades seen in the 2003/04 period.

We still see decent upgrade risk to Q421 and CY22 estimates over the next 3-6 months as robust US and global economic growth buoys the revenue line. Cost pressures are certainly bubbling away, but for now, strong demand is driving strong volumes and a decent degree of corporate pricing power.

# The Earnings Bull Market Should Continue into 2022

US CY22 earnings estimates sit well above pre-COVID estimates, with expected margins being pushed to a fresh all-time high.

We see this as plausible as the benefits of operating leverage from the global economic recovery still have further to run, while some of the recent cost pressures should fade over the next 6-12 months.

The risk case is that revenue lines slow faster than expected over the coming year, while costs prove stickier than expected, reducing both operating leverage and pricing power and thereby squeezing profit margins.

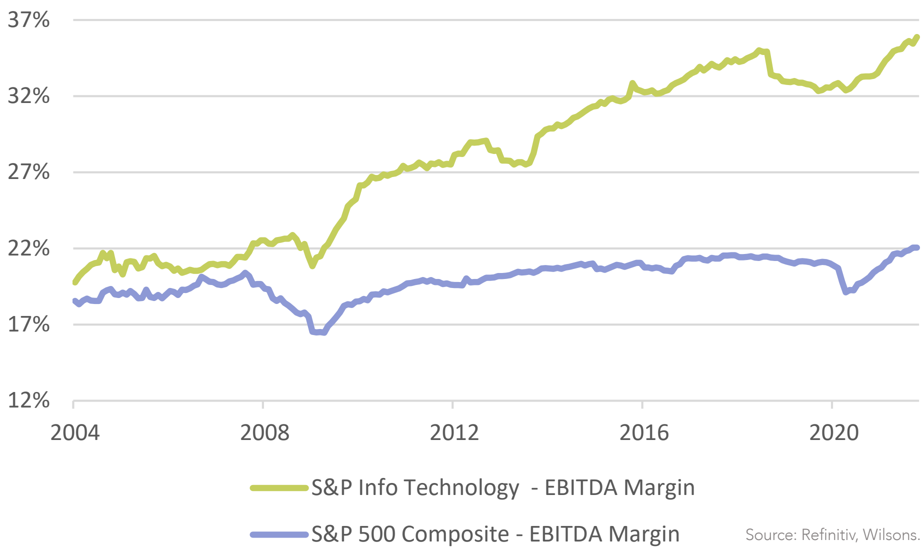
Inflation is proving stickier than expected, but we still think a decent portion of input cost pressures dissipate over the next 6-12 months as demand patterns and supply chains normalise. At the same time, we continue to expect above-trend economic growth over the coming year both in the US (as the US recovers from recent delta headwinds) and globally as a combination of reopening and pent-up demand buoy the growth cycle.

While a number of market pundits have been warning of unsustainable US profit margins for some years now based on high aggregate margins compared to history, we feel this misses the simple compositional shift in the US market. The US tech industry has a significant impact on aggregate margins, with the sector boosting much higher margins than the S&P 500 in aggregate, and the IT sector (calculated in a broad cross-sectoral sense) now representing over 40% of the US market. This compares to less than 30% 5 years ago. While US market valuations are high and vulnerable to a sharp upswing in interest rates the argument that the US corporate has unsustainably high margins has been wide of the mark for some time now. While input cost pressures (and the inflation cycle more broadly) are a key risk to monitor, we retain a constructive central case on US profit margins.

**Exhibit 2: US earnings expectations have rebounded to well above pre-pandemic levels**


Source: Refinitiv, Wilsons.

**Exhibit 3: The rise of high margin tech has lifted US aggregate margins**




Source: Refinitiv, Wilsons.

## US Valuations - Interest Rate Vulnerability but Earnings Cycle Remains Supportive

The US market forward price-to-earnings (PE) multiple has edged higher over the past month as sharp share price increases have outpaced the solid trend in earnings upgrades. Supportive factors beyond the strong earnings backdrop have renewed decline in 10-year bond yields over the past month (up until this past week) and the apparent Democrat pivot away from raising the headline US corporate tax rate.

While the earnings cycle continues to stand as a bullish medium-support for the US stock market, we see the US market as at least short-term overbought. Another above consensus CPI print last week could usher in some renewed nervousness toward equities (and bonds) after the sharp recent run-up. It is possible stocks will encounter more headwinds over the next 2 -3 months, with more stubbornly high inflation prints likely. We continue to expect a drop in inflation on a 6-12 month view alongside ongoing strong profit trends, so our 12-month US market view remains constructive, despite our view that bond yields grind higher.

## European Earnings Also Staging a Dramatic Revival

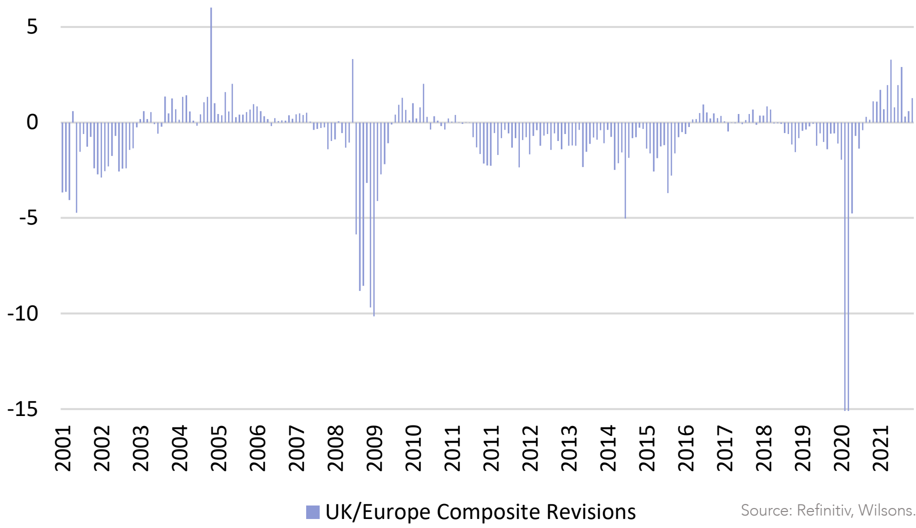
While the US earnings season has captured the bulk of the attention, UK/European earnings remain something of an undiscovered story in our view. European earnings continue a powerful revival with ongoing upgrades. European earnings have been in upgrade mode now for 14 months. This places the current upgrade cycle just behind a record 15 month run in 2003/04.

Ahead of European results, there were concerns that the slowing global economy combined with well-documented input price inflation and supply chain issues would prove a sizeable headwind for European corporate profits.

So far, this has not proved to be the case. There is evidence of specific sectors and stocks where this has been an issue, but there have been widespread beats on corporate margins and bottom-line earnings on aggregate. The energy and financial sectors are leading the upgrade cycle in Europe.

Forward margin expectations are still rising and are now back to previous 2007 peaks (US profit margins are clearly well through previous cycle highs).

**Exhibit 4: UK/European earnings are also in a strong upgrade cycle**




Source: Refinitiv, Wilsons.

## Consensus Earnings Growth for 2022 Looks Too Low

**Exhibit 5: European earnings expectations have passed pre-pandemic levels but are not at record highs**


Source: Refinitiv, Wilsons.

**Exhibit 6: Despite the surge in earnings UK/Europe remains heavily discounted relative to the US**


Source: Refinitiv, Wilsons.

Q3 earnings growth looks set to come in around 60%, and consensus estimates for the full 2021 year are for almost 60% growth. While this is a very strong result, the debate is now shifting to 2022. We think consensus underestimates the residual operating leverage available in 2022 as the European and global economic recovery continues. The consensus 20222 estimate of just 8.5% earnings-per-share (EPS) growth forecast is not much higher than the 5.6% expected top-line growth. We see the potential for a more robust 12-15% EPS growth outcome in 2022.

Unlike the US market, UK/European PE multiples have been relatively static recently, with the discount to the US market widening further. Against this backdrop of continued upgrades and double-digit earnings growth, we see good value in UK/Europe equities with less risk of derating over the coming year than in the US.

One year forward EPS estimates are only just passing pre-COVID levels and are still below the 2007 peaks. While our US earnings view remains upbeat, we see more scope for rebound potential in UK/Europe.

While the US market has surprised with its dogged leadership of the global equity bull market, we stick to our view that more value/cyclical markets of the UK/Europe will have the edge over the coming year as growth remains above trend and interest rates grind higher. We believe this should favour the value style and the more economically sensitive markets of the UK/Europe.

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