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'False alarm, everyone – that WAS the microwave'

Paul Thomas, 'The Pingdemic', 14 July 2021

Earnings vs Delta

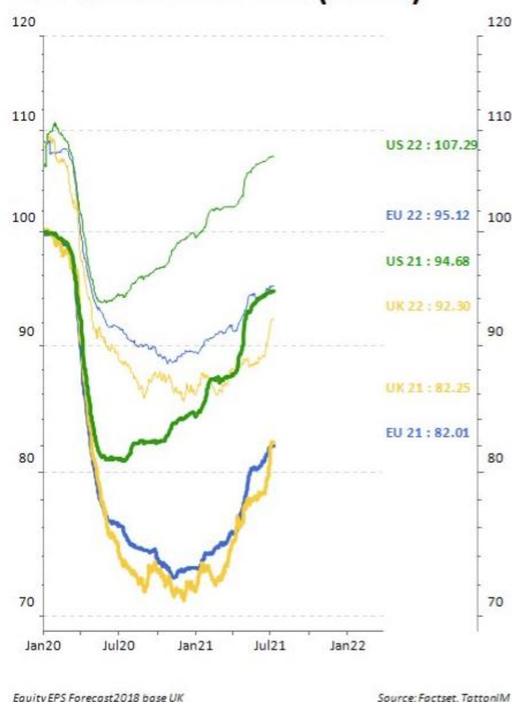
It has been a quiet week in equity markets. The world's major stock indices mostly continued their recent holding pattern, awaiting news on where things will go from here. As we have written before, the global transition phase we find ourselves in – between a forced economic ice age and whatever comes next – makes it more challenging to know how to interpret the variety of signals on display. On the one hand, we have rapid vaccination programs, continually supportive policy and more liquidity flowing around than anyone knows what to do with. On the other hand, a surge in Delta variant cases, fears of an abrupt end to fiscal support and the hugely uncertain long-term economic effects of the virus are weighing down on sentiment.

This has led to a partial unwind of the 'reflation trade' that had boosted cyclical assets earlier in the year. It was why, in May, we decided to realise the profits from our (temporary) allocation to global small cap equities. As we discuss in a separate article today, risky assets are being repriced due to investors' appetite for positive yields. As we go through the transition, this brings both opportunities and risks for investors.

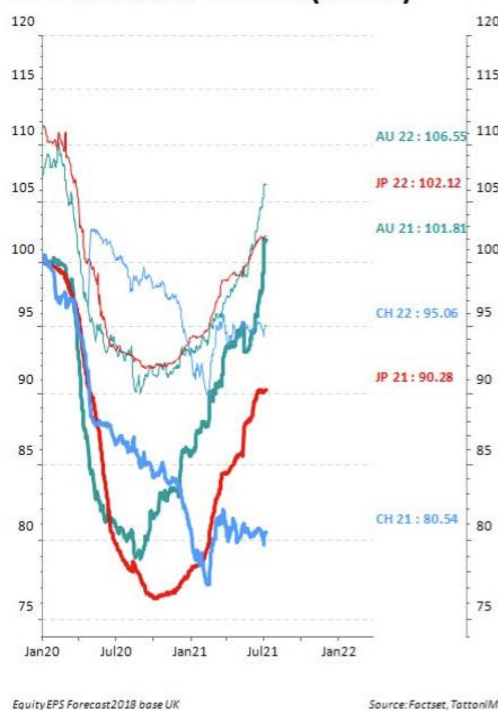
In the shorter term, markets could do with some positive news then, which they can hopefully find from the corporate earnings reports trickling in. Last week, US companies began unveiling their results for the second quarter of the year, with analysts expecting some phenomenal numbers. According to the consensus expectations, firms in the S&P 500 will reveal a 61% year-on-year increase in earnings, up from a 48% jump last quarter. This is driven by both an increase in sales growth – up to 22% year-on-year – as well as an expansion of profit margins to just over 11%.

Of course, these eye-watering growth figures are mostly driven by base effects. In Q2 2020, the world was in lockdown and the sharpest global recession on record, and earnings growth sunk severely into negative. The current results certainly show the strength and speed of the rebound – propelled by an impressive recovery in economic growth – but future earnings seasons will not be able to boast such impressive figures even if the recovery continues smoothly.

Western economies



Asian economies



This can be seen in the breakdown of the results. While aggregate earnings have soared from last year's depths, the median S&P stock is forecasted to expand earnings per share (EPS) by a more modest 24%. That is still a respectable figure, but it shows the dispersion in the results of American corporates. The same was also true during last year's downturn, as aggregate EPS fell by 32% in Q2 2020, while the median figure was only down 12%.

The main drivers of these varied results are cyclical companies, who were most vulnerable to the downturn, and most likely to do well through the recovery. Just like in the first three months of the year, the financial sector is playing a significant part in Q2's earnings rebound. Forecasts put EPS growth for financial firms at 116%, making up 25% of the EPS growth for the entire S&P 500.

Not all of this outperformance was a purely cyclical story though. JPMorgan saw its profits soar from a combination of deal-making, and a release of $3bn in reserves – even if overall revenues and loan activity were lacklustre. Analysts at Goldman Sachs estimate that reserve releases will boost banks' EPS up 18% by the end of this year. Banks that engaged in more traditional lending activities have fared noticeably less well.

This is a result of shifting market sentiment over the quarter. Investors were excited about the so-called great reflation earlier this year, as rebounding activity and ample liquidity pushed inflation expectations substantially higher. That excitement has since pulled back, with markets now taking a more muted outlook.

US technology giants – the stock market's big winners last year – have benefitted a lot from the recent mood swing. The S&P's five largest stocks – Apple, Google, Microsoft, Amazon and Facebook – are actually expected to post less than their usual share of earnings growth. The mega-tech sector is expected to deliver 14% of the index level earnings in Q2, according to analysts, despite making up 22% of the index's total market cap.

Their performance is nevertheless expected to be rather healthy, with average EPS growth of 52% in Q2 2021 (the companies will release earnings later this month). This is made all the more impressive when you consider that the tech giants were some of the few companies to actually grow their earnings through the pandemic – and so did not have the lower base level that others had. Their reliable and seemingly covid-proof revenue streams are what make the stocks so popular among investors, especially given the weakening of near-term growth sentiment. Whether it will stay that way will depend on the levels of regulatory scrutiny politicians will put them under. If Western governments follow China's recently very repressive lead, then this would not bode well for the US tech giants.

Regardless, the earnings season should be a positive one, and is unlikely to do any harm to market sentiment. That will especially be the case if we see a raft of results that beat current expectations. We have written in the past that the so-called 'surprise' measures for EPS (measuring how much actual profit reports exceed or fall below forecasts) can be a bit of a game for companies, particularly in the US. Companies sometimes have a habit of forecasting lower growth figures, only to beat them and get a subsequent boost to share prices. Nevertheless, positive surprises will likely go down very well in the current context, with plenty of cautiously optimistic investors looking for reasons to ditch their caution.

Caution could be a wise option, however. Earnings reports are by their very nature a picture of the past rather than a vision of the future. And with the recent surge in Delta cases all across the world, the last three months might be a bad indicator of what will happen now. The outlooks that firms report in the coming weeks will therefore be even more important than past profits. These self-predictions could be crucial as the world economy navigates another leg of the pandemic. We will have to watch them closely.

How negative are yields?

Investors chase returns. That statement may seem too obvious to be interesting, but over the last decade it has had a special significance. For a year and a half now, Central Banks around the world have pinned interest rates down, and poured historic amounts of liquidity into the global financial system. But the era of loose monetary policy long predates the pandemic. The financial world has experienced an era of low rates since the global financial crisis. More ingredients have been added in the last 18 months, but the recipe is the same: Central Banks prescribe zero or even negative interest rates, coupled with vast and seemingly unlimited asset-purchase programs, in the hope of reflating their economies. There have been exceptions to this (such as China, which has remained relatively tight throughout the pandemic), but the policy has been ubiquitous in major developed markets.

Not all Central Banks apply their easing in the same way, however. We wrote last week about the Federal Reserve's (Fed) raising of rates in money markets to above 0%, in order to stop cash from leaking out of money market funds and destabilizing the financial system. The Fed opted to give money market funds a dividend so that they would not dry up from a zero-rate policy – essentially a recognition that rates cannot fall to, or below the zero bound, without negative consequences. Similarly, the Bank of England (BoE) has refrained from negative interest rates even during the pandemic.

In Europe, the situation is different. The European Central Bank (ECB) has long pursued a policy of negative interest rates, instead shoring up financial stability by offering banks incentives to lend to particular borrowers. Interestingly, Sweden's Central Bank – one of the first in the world to allow benchmark rates to fall below zero – lifted rates from their negative level just ahead of the pandemic, and has kept them at 0% despite the world being in its sharpest recession on record. Elsewhere on the continent, however, rates have been allowed to go negative – effectively forcing banks to pay for their deposits.

As we have seen in Europe over the last decade, negative interest rates make life very difficult for banks, who increasingly pass on the cost to consumers. To avoid losing out on deposits, investors look for any avenue that might offer positive returns, even just marginal ones. Positive yields, particularly for relatively safe assets, are snatched up as soon as they come on offer. This is what we referred to above: Investors of all varieties are forced to chase yields, because the alternative is a cost on cash.

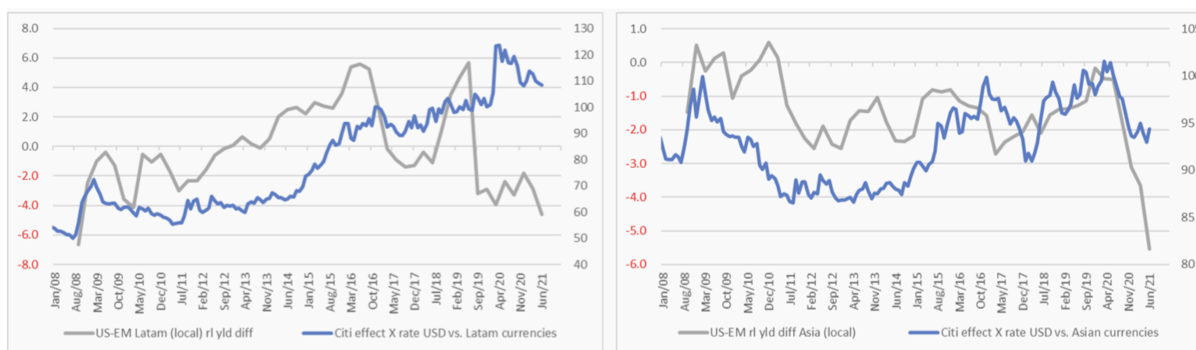
This yield-chasing has pushed credit spreads – the difference between 'risk-free' government bonds and private debt – down to extreme lows. The opposite was true in the beginning of the pandemic, as capital markets panicked over the financial health of the corporate world, but spreads came steadily down as traders realized the financial system was awash with liquidity, and government support curtailed the risk of widespread corporate failures. The result of this is that investors of all stripes and colours are moved up the risk ladder: With risk-free rates pinned down, the relative attractiveness of risky assets increases. To avoid being lumped with negative rates, investors therefore have to take on increased levels of risk.

As the past few years have shown, this can lead to some painful adjustments when the backdrop changes. At the moment, there is more than enough liquidity to go round, pushing down the cost of capital for all. But when liquidity tightens, it can have an outsized effect on more risky assets, as investors quickly move back down the risk ladder. We have seen this many times in European bond markets, with the spread between German and Italian bonds swinging at various points over the years. Fortunately, a tightening of liquidity is not something we see on the radar, but we should be aware of the dangers that could come with it.

As mentioned, nominal rates in the US and Britain have not been allowed to fall into negative territory. That does not mean that yields are positive from an investment perspective, however. Real interest rates – adjusted for expected inflation – are negative almost everywhere, including in the US. This is why, even in those areas where central banks are keeping some semblance of positive yields, investors are pushed into riskier markers. This is reflected in the tightness of credit spreads and generally rising equity markets.

In fact, when you look at real yields, the difference between US returns and those elsewhere is much less impressive – given the higher inflation expectations in the world's largest economy. This factor speaks against a sharp appreciation in the dollar: Even with higher nominal yields, the difference between short-term US real yields and those of its global counterparts is much smaller. This is because the Fed keeps short-term rates anchored to zero, while inflation readings continue to come in strongly.

There does seem to be a limit to the extra risks investors are willing to tolerate, however. This is seen in the popularity of emerging market (EM) assets, or lack thereof. EMs currently offer an advantage when it comes to real yields, which are significantly higher than has been historically available. This is partly linked to their less accommodative monetary stance (some Central Banks have even tightened monetary policy this year), but EM currencies have had a mixed performance this year, and EM equities have gone mostly sideways.



Source: Tatton IM, Bloomberg

There is a similar situation playing out in so-called 'value' stocks in the US (and globally) which, after their strong rally at the beginning of the year, are underperforming once again. For both EM and value assets, investors show a reluctance to go too far down the risk spectrum. We suspect that markets may need assurance that reflationary policies have done more than just support them through tough times – and instead will support the real economy over the next few years. In the EM case specifically, there is almost certainly a virus factor too: With relatively lower vaccination rates, developing countries – as India experienced already - are potentially in an extremely difficult position, as the Delta variant surges through the world.

If policymakers can offer that reassurance, the good mood should spread to riskier parts of the market and the world. In any case, these regional and style areas are where the world's ample liquidity has not yet led to a relative re-pricing of assets. They therefore represent a pool of investment opportunities that should be kept in mind as the transition progresses.

Global Equity Markets

Market	Fri 13:55	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7019	-1.4	-103	→	↗
FTSE 250	22506	-1.8	-403	→	↗
FTSE AS	4009	-1.5	-60	→	↗
FTSE Small	7286	-1.1	-78	→	↗
CAC	6463	-1.0	-66	→	↗
DAX	15616	-0.5	-72	→	↗
Dow	34987	+1.6	+565	→	↗
S&P 500	4360	+0.9	+39	⬀	↗
Nasdaq	14543	-0.1	-17	↗	↗
Nikkei	28003	+0.2	+63	⬂	↗
MSCI World	3044	-0.3	-10	⬀	↗
CSI 300	5095	+0.5	+25	→	↗
MSCI EM	1348	+2.3	+30	→	↗

Top 5 Gainers

Company	%
Avast	+21.5
Admiral	+4.6
Experian	+4.5
Brit-AM Tobacco	+3.3
Auto Trader	+3.1

Top 5 Decliners

Company	%
Just Eat Takeaway.com N	-11.6
Int'l Consol Air	-8.8
Rolls-Royce	-7.5
JD Sports Fashion	-7.1
Assoc. Brit. Foods	-6.5

Currencies

Pair	last	%1W
USD/GBP	1.381	-0.7
GBP/EUR	0.855	-0.0
USD/EUR	1.18	-0.6
JPY/USD	110.33	-0.2
CNY/USD	6.47	+0.1
Bitcoin/$	31,828	-6.0

Commodities

Cmdty	last	%1W
Oil	73.94	-2.1
Gold	1823.8	+0.9
Silver	26.12	+0.1
Copper	433.4	-0.4
Aluminium	2518.0	+3.1
Soft Cmdties	446.3	+0.4

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.4	19.0	13.1	14.1
FTSE 250	2.4	17.8	23.9	15.7
FTSE AS	3.2	18.6	14.0	14.3
FTSE Small x Inv_Tsts	1.8	17.2	-	15.3
CAC	2.2	25.4	17.4	14.8
DAX	2.3	18.5	15.1	13.4
Dow	1.7	21.0	19.8	16.3
S&P 500	1.3	27.1	22.7	17.4
Nasdaq	0.6	33.7	33.5	22.6
Nikkei	1.6	17.3	18.7	17.6
MSCI World	1.7	24.6	20.6	16.4
CSI 300	1.7	17.6	15.6	12.5
MSCI EM	2.0	15.0	14.3	12.5

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	0.64	-0.01
UK 15-Yr	0.96	-0.04
US 10-Yr	1.32	-0.04
French 10-Yr	-0.01	-0.06
German 10-Yr	-0.34	-0.05
Japanese 10-Yr	0.03	-0.01

UK Mortgage Rates

Mortgage Rates	Jul	Jun
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	1.37	1.43
3-yr Fixed Rate	1.64	1.69
5-yr Fixed Rate	1.60	1.65
10-yr Fixed Rate	2.57	2.57
Standard Variable	3.62	3.62

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values
** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

If anybody wants to be added or removed from the distribution list, please email
enquiries@cambridgeinvestments.co.uk

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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