Rising earnings should ease bubble fears

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The adage “sell in May and go away” has not been the case in the summer of 2021. If index returns are any indication, equity investors have not gone away. Not only are they still here, they seem to be quite enthusiastic. At the close of June, the S&P 500 Index was up over 15%, and in late July, we saw all three major U.S. stock indexes reach all-time highs. What is notable, however, is the similarity in equity performance across styles and regions. Whether value or growth, large-cap or small-cap, U.S. or international, returns for the first half of 2021 were solid and generally in line. Investors appear to be embracing all types of stocks.

Mega caps: Second-quarter superheroes

After many treaded water for the past 6 to 12 months, the very largest U.S. companies performed extremely well in the second quarter. “BATMANFAV” is our new acronym for the nine companies with market capitalizations of over half a trillion as of June 30. It consists of equity investors’ favorite superheroes — Berkshire, Apple, Tesla, Microsoft, Amazon, Nvidia, Facebook, Alphabet, and Visa. Together they advanced 14.8% in the second quarter, versus just 8.5% for the S&P 500 Index. These companies represent almost 30% of the S&P 500, so their performance has a significant impact on the index. At mid-year, of the nine companies, only Tesla was down, while graphic chip maker Nvidia was up an astounding 50%.

So, what fueled the solid first half for equities? In our view, it was the combination of improving global economies, low interest rates, and better-than-expected earnings results. We also believe there is potential for further equity market gains. The economic growth outlook continues to improve, buoyed by business re-openings and pent-up demand for leisure travel and other return-to-normal activities.
Bubble talk is back, but earnings have been key

The strength of equities in 2021 follows the market’s remarkable rebound in 2020, when the S&P 500 closed the year at a record high. And let’s not forget 2019, another exceptional year for equities, with the S&P 500 gaining more than 30%. Understandably, we are now hearing talk of overextended stocks, frothy valuations, and equity market bubbles. Notably, the American Association of Individual Investors (AAII) survey’s bullish index recently fell to a low of 30.6% [as of 7/20/21]. This index refers to the percentage of investors who believe the stock market will be higher six months from today. Based on our research, bullish sentiment in this low range can be a good sign for the equity markets. Over the past 30 years, there have been 19 observations when the bullish sentiment fell to 30% or lower. In these instances, the forward one-year average annualized return for the stock market was 13.5%, with a positive return in 17 of the 19 instances.

Also, consider the earnings picture. Businesses, in our view, are operating more efficiently, revenue growth is accelerating, margins are expanding, and earnings have continued to exceed estimates. Counter to perceptions, earnings growth has been the driver of the market, and there has been limited valuation expansion since 2019. Just before the pandemic, in 2019, S&P 500 earnings per share were $157. Today, estimates are $190 for 2021, according to S&P Dow Jones Indices. However, the trajectory of 2021 earnings appears to be even higher, based on the strong first-quarter earnings results, which exceeded consensus by one of the largest margins in the past 15 years. And midway through second-quarter results, the strong earnings surprise trend is continuing. In our view, it’s likely S&P 500 earnings per share will exceed $200 this year — topping 2019 earnings by nearly 30%. Lo and behold, the S&P 500 is up a bit more than 30% versus its pre-pandemic peak, in line with this earnings growth projection.
Equity Insights | August 2, 2021

Projected earnings growth is impressive
S&P 500 Index earnings per share

A Treasury yield retreat typically makes stocks more attractive
In a surprise to many investors, the yield on the 10-year Treasury retreated in the second quarter, making equities even cheaper relative to bonds. A declining 10-year yield is especially constructive for growth stocks. It also sets the market up for price-to-earnings multiple expansion in an environment of improving economic growth and better-than-expected earnings results. Consider that the 10-year yield today is more than 50 basis points lower than where it was at the end of 2019, pre-pandemic.

What could spoil the party?
As always, there are risks we are monitoring, such as the potential for an inventory correction. As demand picked up sharply across industries and sectors, we began to see widespread shortages of almost everything. From labor and raw materials to houses, rental cars, and semiconductors, supplies are short and prices are rising. Businesses are increasing their inventory orders to meet the higher demand, and many are ordering more than they need to build a buffer into their inventories. The risk for businesses is that the acceleration in demand could stall. When shortages are combined with a negative demand shock, we see an inventory correction.

What could cause demand to stall? We’re watching new Covid-19 complications, such as the Delta variant of the virus bringing a new wave of lockdowns. It is too early to determine the impact of the Delta variant, and there are positive signs of its retreat in the United Kingdom and India. However, we are aware that a rollback to increased restrictions for business or leisure activities could lead to significant inventory challenges. Despite this potential setback, however, our near-term outlook remains bullish for equities, supported by robust earnings growth, skeptical investor sentiment, and stimulating bond yields.

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