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If This Earnings Season Has Been So Great...

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...then why haven't consensus earnings -- or stocks -- tracked on the upside?

It's been a good earnings season so far, with the average company reporting a 19% upside surprise. Last season, even big beats were universally met with sharp negative price reaction, but this time around, most stocks have jumped on good news. The tell for that was the forward earnings "upgrade rate," which we have reported has fallen significantly over the last quarter (see "Obamacare: Do Markets Care?" March 18, 2010). At this point last earnings season, forwards were being upgraded at an unsustainable 52% annual rate, which we said was a backdrop of unbeatable whisper numbers (see "Under-Seasoned" January 15, 2010). At the onset of *this* earnings season, the "upgrade rate" had fallen to less than half that -- still quite elevated by historic norms, but no longer an impossible expectational hurdle (please see the chart below).

Now, from the bottom in early May 2009, the *dollar value* of S&P 500 year-ahead consensus operating earnings has recovered 38%, following a 39% fall from the peak in early October 2007. The arithmetic of percentage losses followed by percentage gains leaves us still 18% from peak

Update to strategic view

US STOCKS, US FINANICAL STOCKS: This earnings season looks great, but it's been dominated by just a few companies, most of which are financials that beat estimates with only transient growth factors -- still lacking a long-term growth model. Consensus year-ahead estimates have treated these surprises as non-recurring, and stocks -- near peak multiples -- have failed to track growth in the consensus. We continue to expect correction or consolidation in stocks.

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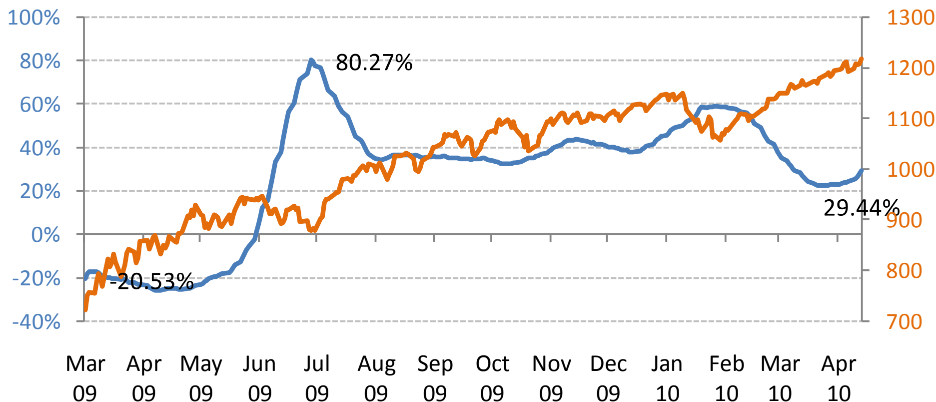
"Upgrade rate" S&P 500 Index
Month-over-month change in year-ahead S&P 500 consensus forward operating earnings, annualized, smoothed, cap-weighted



Source: Zacks, Standard & Poor's, TrendMacro calculations

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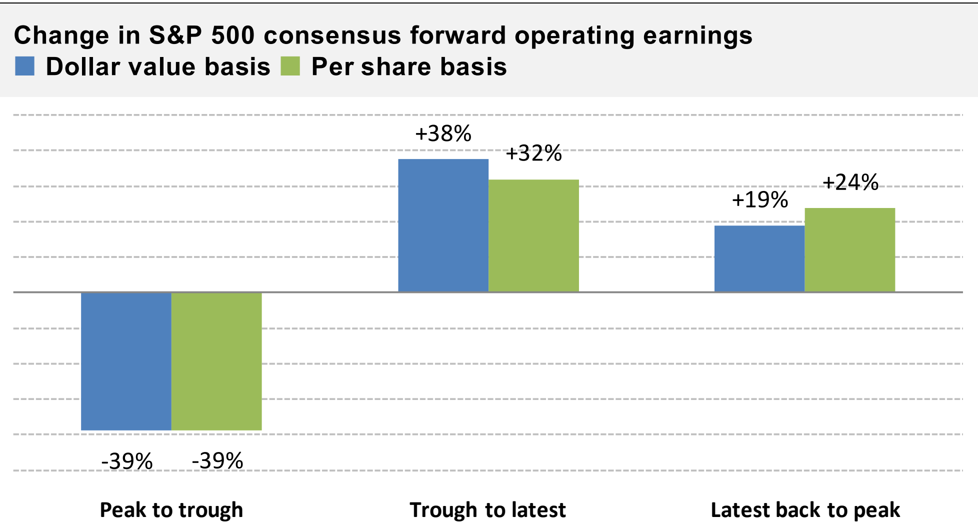
earnings, but at the present "upgrade rate," at least if we imagine it can be sustained, we could be there this calendar year. But again, that's *in dollar terms*. In *earnings per share* terms it's not quite as pretty, considering the intense share dilution that has occurred in the S&P 500 financial sector. Seen that way, after the same 39% drop, forward earnings have recovered only 32%, and would have to recover a further 24% to match the 2007 peak (please see the chart below). Even if the current torrid "upgrade rate" is sustained, that would be a 2011 event. But that's not to diminish the significance of what has already been a stellar earnings recovery. Can there be any doubt that the recession has long been over? Maybe in the NBER's mind, but not in ours (see ["The Consumer: QED"] April 16, 2010).



Source: Zacks, TrendMacro calculations

In this earnings environment stocks have moved to new highs, sustaining a rally of 79.9% over 410 days (measured by the S&P 500, without dividends) -- the seventh best rally in the recorded history of daily US stock prices. The percentage gain in stocks has far outstripped the percentage gain in forward earnings because, obviously, multiples were so depressed at the 2009 lows. At this point -- and as we've been pointing out all year (see ["New Year, Same Old Fed"] January 4, 2010) -- stocks are bumping up against the peak forward multiple established at the top in 2007. Unless you expect the market multiple to expand beyond that peak (we don't), further progress in stock prices has to come from forward earnings growth. But stocks so far this year have slightly underperformed forward earnings growth -- the S&P 500 is up 9.2%, while forward earnings are up 10.5%. So the forward multiple has slipped a bit.

We suppose that could imply a little room on the upside for stocks, which we happily acknowledge have continued to defy our long-standing expectation for correction or consolidation. But we retain our skeptical attitude. We note that forward estimates themselves have underperformed, failing to track the big upside surprises that have been pouring forth this earnings season. That is, year-ahead numbers have not been, on average, upgraded by the full amount of last quarter's surprise -- indicating that the

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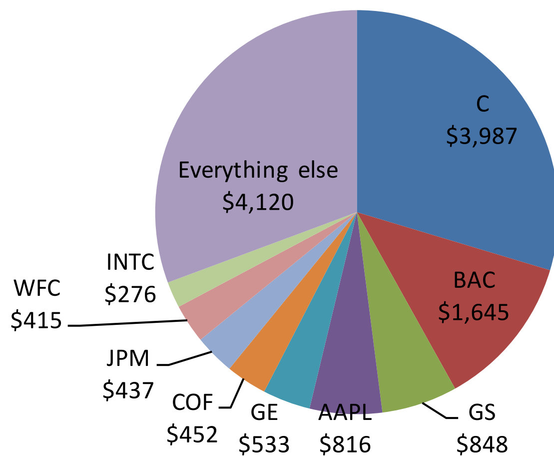
consensus has doubts that last quarter represents a new platform, and certainly not suggesting a new higher rate of growth. Specifically, with the S&P 500 having collectively reported so far an upside surprise of $13.5 billion, based on the sector market cap proportions that have reported so far, you'd expect the overall forward consensus to have risen by $23.9 billion, yet it has risen only by $19.8 billion.

- To summarize so far, this earnings season's upside surprise hasn't been fully taken on board by the forward earnings consensus -- and further, the consensus itself hasn't been fully taken on board by stock prices. In the face of very good news, the message seems to be: curb your enthusiasm.

Pretty much the entire shortfall between earnings surprise and growth in forward earnings has been in the financial sector. But for that matter, pretty much the entire dollar value of this season's upside surprise has been in the financial sector, too. Of the $13.5 billion in total net surprise, $8.9 has come from the financial sector, and of that, 87% has come from just five companies (Citigroup, Bank of America, Goldman Sachs, Capital One, JPMorgan and Wells Fargo -- we are treating General Electric, which contributed a $0.53 billion surprise, as an industrial). Another $2.0 billion has come from the technology sector, of which 53% was just two companies (Apple and Intel). So removing just nine companies, there's hardly been an earnings surprise at all. The dollar value of Citi's surprise alone is about equal to the combined dollar value of all the other companies' surprises reported so far this season, outside the top nine (please see the chart below).

Dollar value of S&P 500 earnings surprises
Q1 2010

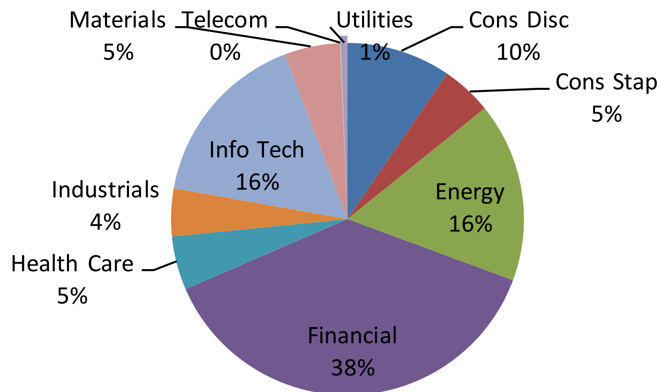


Source: Zacks, TrendMacro calculations

The dominance by financials over this earnings season's surprises maps to that sector's dominance in growth expectations. Before the onset of earnings season, at last month-end, of the 39% implied earnings growth

rate (that is, the difference between consensus forward earnings and actual trailing earnings), more than a third was expected to come from the financial sector (please see the chart below). True, results since month-end have not disappointed -- far from it. But we think it is a challenge on the face of it to continue to expect a sector representing only about a sixth of total S&P 500 market cap to generate a third of earnings growth.

Sector sources of implied S&P 500 earnings growth
Consensus forward operating earnings versus trailing actuals, March 31, 2010



Source: Zacks, TrendMacro calculations

It's all the more so when, in our judgment, the financial sector has little true long-term earnings growth potential. We've said over and over that financials weren't even a growth sector in the best of times, three years ago, when they represented a third of market cap. Remember, then they had to eke out earnings growth by relying on business lines such as sub-prime and private equity lending that turned out to be the height of foolishness (see, most recently, "Goldman Sucks" April 19, 2010).

Now the financial sector faces massive regulatory and litigation risk, in addition to the ongoing challenge of developing profitable business lines in a world no longer seeking new ways to create leverage, but rather ways to deleverage. Does earnings growth from trading, from lower loan loss provisions and from net interest income with the fed funds rate at zero constitute a viable new business model? We think not, and to the extent that the financial sector is dependent on such transient factors -- and further, to the extent that the S&P 500 is depending on the financial sector -- we retain our cautious outlook on stocks, still expecting correction and consolidation.

Bottom line

This earnings season looks great, but it's been dominated by just a few companies, most of which are financials that beat estimates with only transient growth factors -- still lacking a long-term growth model.

Consensus year-ahead estimates have treated these surprises as non-recurring, and stocks -- near peak multiples -- have failed to track growth in the consensus. We continue to expect correction or consolidation in stocks.