PORTFOLIO MANAGER INSIGHTS

WEEKLY INVESTOR COMMENTARY | JULY 7, 2021

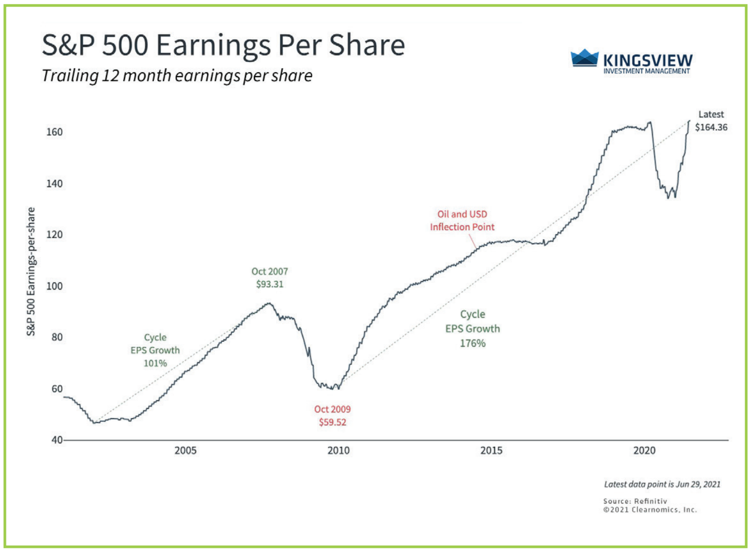
Investment Committee

As the earnings season for the second quarter begins, investors will be looking for new signs of growth in corporate revenues and profits. In countries like the U.S., the conversation continues to shift from recovery to expansion as the economic impact of the pandemic fades and inflation heats up. Whether the bull market can continue and lofty valuations can be justified will depend largely on whether the economy can find a new gear to sustainably grow. What can investors expect from company profits in the quarters ahead?

Current Wall Street estimates suggest that S&P 500 profits returned to pre-pandemic levels of $164 per share during the second quarter, mirroring the expected recovery in GDP across the broader economy. This is faster than expected and would represent a 38% growth rate in 2021 and 21% over the next twelve months. As recently as the beginning of the year, the market did not expect a full recovery until the fourth quarter. A full recovery during the second quarter means that the recession in earnings only lasted four full quarters, rather than nearly two years.

This is especially important since the recovery, driven in no small part by pent-up demand, is most likely already incorporated into stock prices. The ongoing bull rally, which has generated double-digit percentage gains across major indices this year, has kept valuations such as the price-to-earnings ratio high even as earnings growth has accelerated.
The economy may need to reach a new gear of organic growth in order to propel markets further. Growth expectations can become self-fulfilling prophecies if businesses invest to meet new demand and consumers spend because they feel more financially confident.

CORPORATE EARNINGS HAVE LIKELY STAGED A FULL RECOVERY



KEY TAKEAWAY:

1. **U.S. large cap earnings are believed to have regained pre-pandemic levels during the second quarter. This is a significant milestone and, if true, means that the recovery took place two quarters faster than expected. Earnings are expected to grow at a rapid pace as the economy continues to expand.**

Of course, investors do not invest in the economy directly. Instead, when the economy grows, investors benefit as companies earn more which supports stock prices over time. Some sectors saw immediate earnings boosts one year ago due to the acceleration of digital transformation, the spending of stimulus checks, buying goods online, and more. This growth has broadened as commodity prices and interest rates have risen, benefiting sectors such as energy, materials, financials and more.

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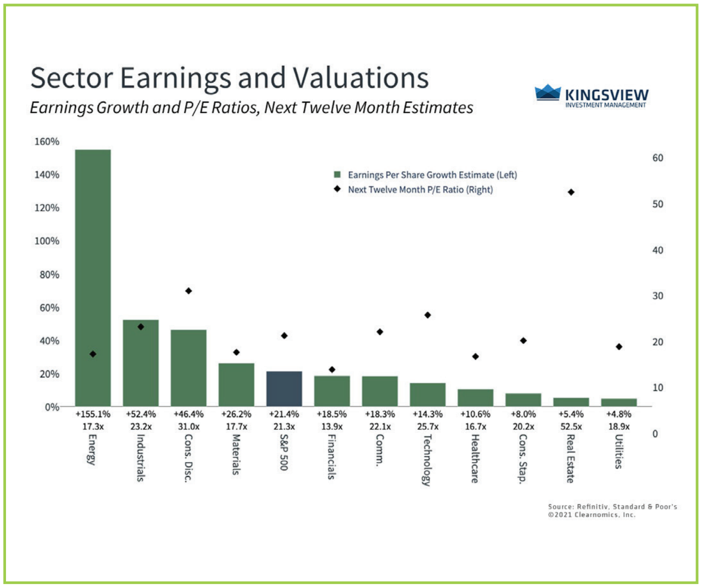
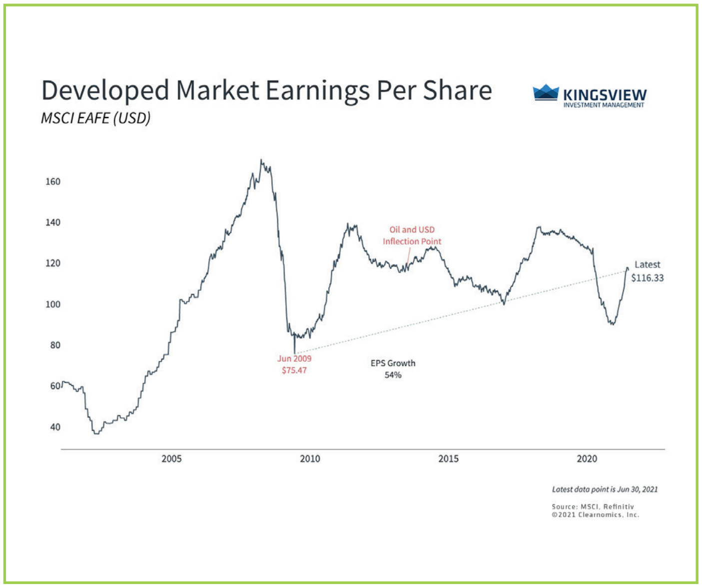
This pattern of recovery is not unique to the U.S. but can be seen across major regions, albeit with a lag. Developed and emerging markets are expected to grow their earnings by 13% and 36%, respectively, over the next year. Whether this comes to fruition will depend on many factors that have already played out in the U.S. including boosts to company hiring, consumer spending and COVID-19 vaccinations. Despite delayed recoveries, these other regions are still more attractively valued than the U.S.

MANY SECTORS ARE BENEFITING FROM ECONOMIC GROWTH



OTHER REGIONS ARE CATCHING UP



KEY TAKEAWAY:

1. **While sector leadership was narrow at the start of the recovery, many parts of the market are now benefiting. This is especially true among sectors such as energy and financials which have outperformed this year.**

KEY TAKEAWAYS:

1. **Although their recoveries still lag behind the U.S., other regions are catching up.**
2. **Developed market earnings, for instance, are expected to regain pre-pandemic levels over the next twelve months. This could help to support long run valuations and returns.**

Ultimately, investors should continue to focus on earnings and valuations since, in the long run, they are what drive stock market returns. Although there are always uncertainties, history shows that those who can stay invested throughout the business cycle can improve their odds of financial success. Upcoming earnings reports will be followed closely for signs of continued growth. Long-term investors ought to stay diversified across sectors and regions as the market shifts from recovery to expansion.

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