Investment Weekly

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Earnings season may give markets a reality check

- **The US second quarter earnings season starts in earnest this week.**

- **Investors will be watching the commercial banks carefully for indications of mortgage and consumer loan delinquencies.**

- **While investment banks have benefited from record activity in the new issue market, commercial banks could see bigger losses from provisioning for bad debt.**

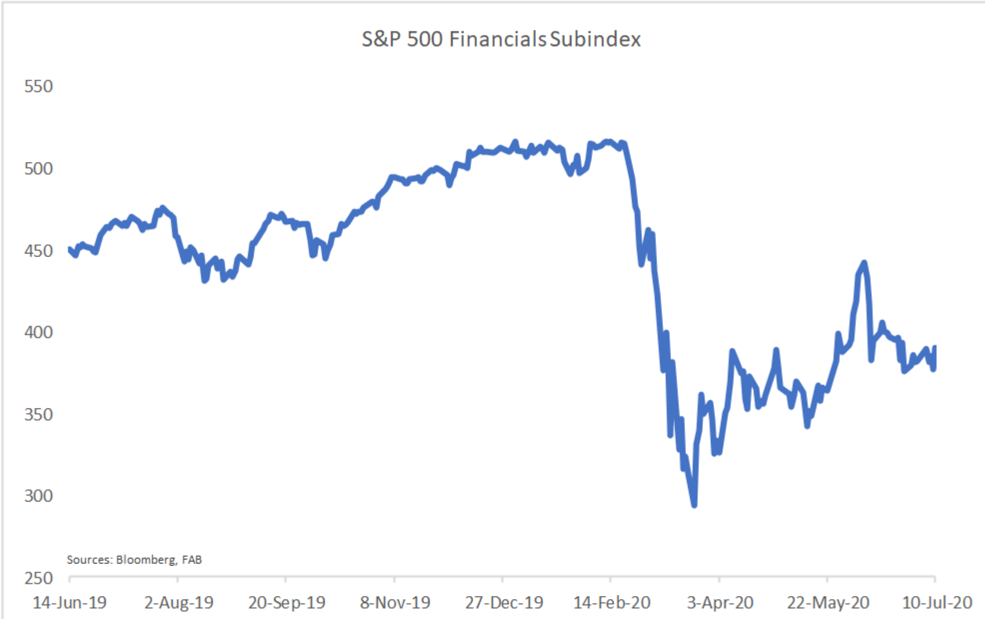
- **The consensus analyst estimate for earnings per share of the S&P 500 in 2020 has dropped 28% since the beginning of the year.**

- **The ECB meeting will also be in focus as investors assess whether the dollar weakness can continue further.**

- **The FAB AAC remains underweight in global equities and overweight investment-grade corporate bonds.**

Banks are often seen as the lifeblood of an economy. In that sense, investors will receive a test result on the US this week as many of the country's largest banks kick off the second quarter earnings season. While much of the information that banks will release is idiosyncratic to their businesses, there will be plenty of news that will help gauge how Main Street is faring as the US reopens.

The provisions reported by commercial lenders such as Bank of America, Citigroup and Wells Fargo will be watched closely. There still is no aggregate data on residential and commercial mortgage delinquencies after March, although it is to be expected that these have been rising.



The basket of commercial real estate loans is expected to have suffered from the rapid succession of bankruptcies and downsizing in the retail industry, while residential mortgages will have suffered from what has been happening in the labour market.

At least 111 large companies with assets adding up to US$142.3 billion have filed for bankruptcy protection since March, according to a Bloomberg report. The list is skewed to retail, featuring names such as JC Penney and Brooks Brothers. Brick-and-mortar retail companies which were already struggling to compete with their online peers, were delivered a death knell by the lockdowns. Some that did not file for protection from creditors have also been announcing store closures.

Many of these chains own the stores, and have mortgages on them. Even if they do not, they may rent from malls which have loans outstanding with banks.

The S&P 500 financials subindex remains 24.4% below its 14 February recent peak

The extent of the financial damage will start to become evident in the numbers presented by the largest commercial lenders. The quarterly reports of regional banks such as First Republic or Citizens Financial will also be more important than normal, given their involvement in financing small and medium enterprises, which have been the worst hit by the economic slump.

The bank reports will also shed light on the divergence of experiences between Main Street and Wall Street, as investment banks such as Goldman Sachs and Morgan Stanley are expected to show improved revenues from record bond issuance in the second quarter, driven by Federal Reserve programs.

According to Bloomberg, there was US$756.1 billion of investment grade issues and US$218.7 billion of high-yield in the US corporate market alone. Emerging markets added US$1.47 billion to that tally in the same period. All of these paid fees to investment banks and those will show in this earnings season.

If anything, investors will have to brace themselves for the guidance coming from these banks, should they confirm that the coming quarters are unlikely to be as good. Still, investment bank reports may look better than those for more traditional commercial lenders.

The start of the earnings season should also begin to provide a view of what is really happening with the outlooks for corporations across the world. Nearly 80% of companies in the S&P 500 did not give guidance on their future earnings in the first quarter as they assessed the damage from the lockdowns spurred by Covid-19.

Investors, though, have been willing to look past the lockdown period and to write off this year and focus on next year instead. As guidance reappears, they will be able to measure whether their current expectations for what might happen in 2021 require adjustment or not.

This will be reflected in analyst estimates for future earnings. The current consensus estimate is for the companies in the S&P 500 to end the year having reported earnings of US$125.3 per share, roughly a 28% drop from the same estimate at the beginning of the year. That may still be too rosy, given what happened in the 2008 financial crisis, when earnings dropped more than 50%.

Hence, the coming weeks will allow analysts to better assess whether they need to rerate the stocks in the index, something that could prompt a correction. The reverse, however, is also true. With the worst of the economic slump now in the past, companies may give more upbeat guidance than is currently baked into stock prices and spur a further rally.

The negativity in the market is such that this is also likely. If that pans out, the S&P 500 may breach its upside resistance at 3,232, and that event would likely provide renewed momentum to the rally.

The make-up of the stock gains could also shift as the earnings season moves ahead. So far, technology names have led the gains as investors reflected the behavioural changes that the Covid-19 lockdown accelerated. Better news from banks on the provisions front could provide a tailwind to financials and other cyclical industries, which have so far lagged technology. These cyclicals are also the ones which offering the best value, especially when signs eventually appear that the global economy is recovering.

While most of the focus will be on company earnings in the US, investors will also watch closely the policy meeting of the European Central Bank. Data for Germany, the region's biggest economy, came in worse than expected last week, and the ECB could pump more stimulus into the bloc to revive its economy.

German industrial production did not recover as fast as economists expected in May

Economists are mostly expecting no significant move from the ECB, after it doubled the size of its asset purchase program in its June meeting. However, as some fiscal stimulus measures start to expire in the eurozone and the economy still seems far from recovery, the ECB could feel compelled to act further.

What Chairwoman Christine Lagarde says will be important, too, in setting the direction of the dollar, and by proxy for emerging market currencies. The dollar index has fallen 6% since its recent high on 20 March, thanks to monetary stimulus from the Federal Reserve.

Most of that dollar index depreciation was driven by the 5.7% appreciation of the euro, which is one of the key components of the index. This has hurt the trade-oriented German economy. Last week, the country reported that exports increased only 9% in May compared to April, far less than the 14% consensus estimate. As a result, industrial production in the country was down 19.3% compared to a year earlier, much worse than the 16.9% economists expected.

Such bad numbers could nudge the ECB to surprise with more stimulus. And, in these stimulus-oriented days, that might give markets further upward impetus.

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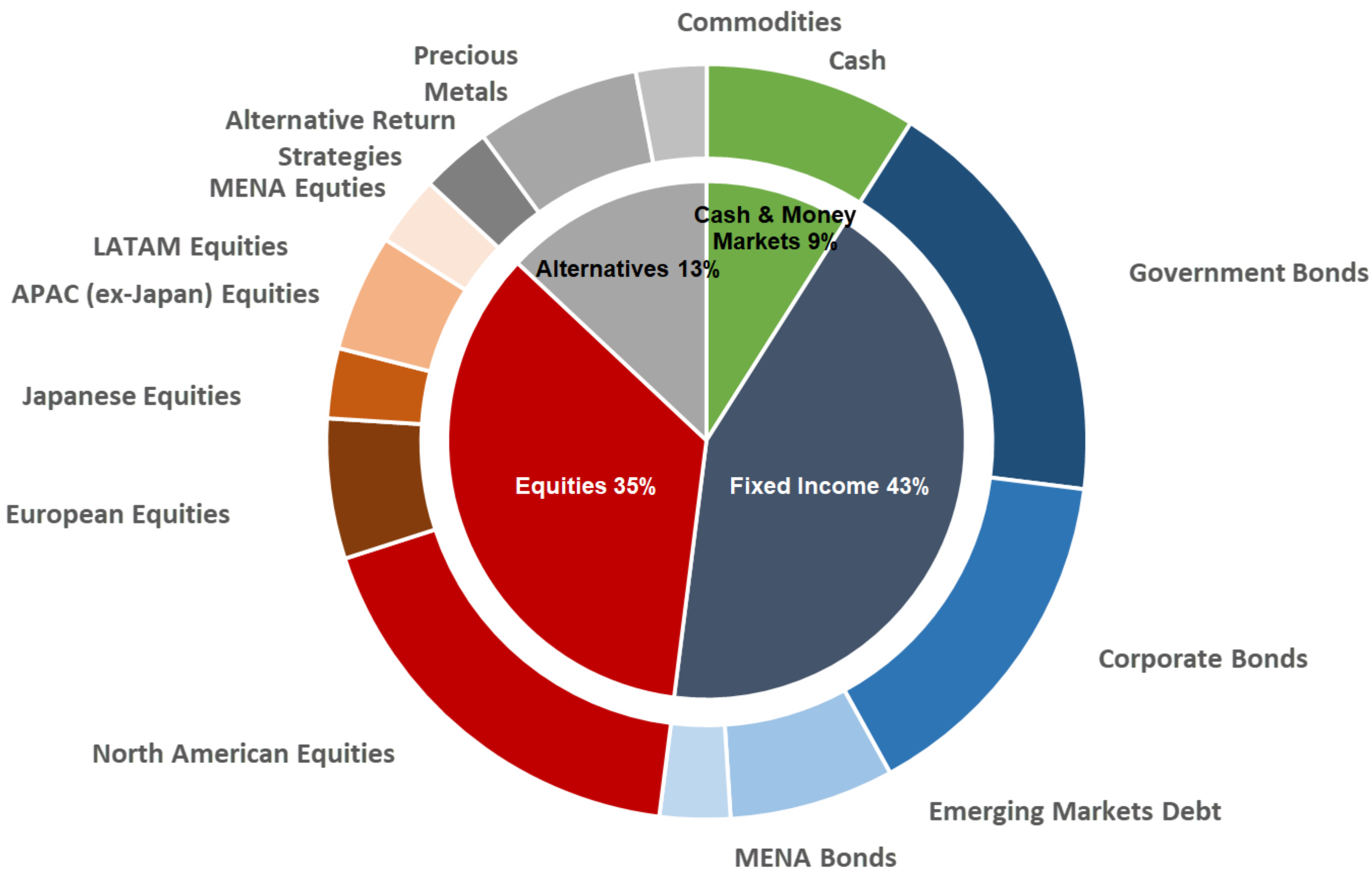
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Overweight	After taking profits on some equity positions.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Underweight	After taking profits on part of the US and European equity exposures
Alternatives	Underweight	However, overweight on precious metals specifically

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