Taking stock
A five-part series placing trends in context for today’s new world

Part 2: Earnings and recessionary averages

Corporate earnings are front and center as investors attempt to navigate the COVID-19 recession, particularly when accounting for the limited visibility into 2020 profits and GDP. Time has become “compressed” of late as large trends play out far more quickly today than during past recessionary experiences, at least partially due to the unprecedented nature of a pandemic-driven contraction. Given that the stock market typically moves in accordance with earnings over prolonged periods of time makes it all that much more important to have context around profits as this recession plays out.

While the stock market typically leads actual changes in earnings, it is important to highlight that the relationship does in fact exist, and is a cornerstone for equity markets. Hence, when earnings surprisingly change course and fall, equities react swiftly, and oftentimes, more aggressively.

Per RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina, stocks generally bottom approximately five months ahead of the end of a recession. Her work also shows that the average recessionary decline in equities is 32 percent. If the Mar. 23 low, which represented a 34 percent peak-to-trough decline, marks the actual bottom in equity markets during this recession, it logically follows that the middle of Q3 2020 is likely to be the end of the recession. However, there is still risk that the recession extends into the back half of the year and stocks find a new bottom. This risk is small, in our view, but not non-existent.

Additionally, markets appear to be compressing the time it takes for new trends to play out. This means that the selloff happened much more quickly than in normal recessionary periods. In fact, the average peak-to-trough decline takes approximately 14 months. This time, it took just one, assuming the March lows hold. That’s an amazing amount of time compression for investors to stomach.

Shifting to corporate earnings, 2020 consensus expectations have fallen nearly 30 percent, while 2021 expectations are down more than 15 percent. Clearly, earnings have already been liberally slashed, and in a common theme for the COVID-19 recession, the pace was uniquely rapid. In fact, the decline witnessed in 2020 was the fastest in at least the last 30 years.

Unfortunately, there may be further downside to earnings estimates to come, particularly on the 2021 front, but the...
other side of that coin is the fact that the pace of upcoming potential declines will be hard-pressed to replicate the sharply painful decline seen in March. The silver lining to this loss of earnings is that the rebound, when it ultimately hits, should provide well-above-average earnings growth.

To demonstrate, earnings have historically grown in the mid-single-digit range. However, that range increases to the high teens in post-recessionary years. The average recovery-year growth rate is 18.9 percent. It’s evident that today’s consensus estimates are pricing in a better earnings recovery bounce than average, but the rebound expectation is not out of bounds by some drastic order of magnitude, in our view. Rather, it’s interesting to look at an above-average expectation on the pending recovery in earnings in light of the worst calendar-year contraction since at least 1991.

Finally, the peak-to-trough decline in earnings for the S&P 500 during the Great Recession was 31.2 percent, followed by two years of 40 percent and 14 percent growth, respectively. Currently, S&P 500 earnings are on pace to contract by more than 20 percent in 2020. Maybe a slightly better-than-average rebound that falls well short of 2010’s growth trajectory isn’t out of bounds. Perhaps, as with volatility, the question isn’t if earnings will ever grow again, but rather, when will they? Certainly, we’re in the midst of a recession right now, but with economic reopening in its infancy and a steep decline in economic activity ongoing, a big bounce in earnings in the back half of 2020 and continuing into 2021 is not impossible, in our opinion.
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As of March 31, 2020

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