MARKET COMMENTARY

Reporting season in Q4: decent results are likely, but expect some poorer company guidance for Q1

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- **The Q4 earnings reporting season has just started in the US (13 reported), with yoy growth being so far slightly below Q3 (25% vs 26%). Overall, analysts expect yoy growth to be 22% in Q4 vs 43% in Q3.**
- **With increasing signs of a peaking cycle and lower momentum in capacity utilization, the yoy growth will decelerate till 2022Q2.**
- **The Omicron variant would affect companies' earnings guidance through some additional restrictions, lingering supply chain disruptions and lower propensity to buy during Christmas holidays.**
- **That said, we still expect a positive backdrop for earnings in Q4, as macro surprises have increased since September. EA earnings will benefit from weaker TW euro, while US ones are penalized by stronger TW USD.**
- **Furthermore, solid pricing power and growth will keep margins upbeat. Amid strong demand and high excess savings, rising input costs are passed to consumers.**
- **In our base scenario of Omicron representing a non-disruptive event, the 2022 will be positive for equities due to a sustained nominal GDP growth triggering an earnings growth of 10% (around consensus). We stay below our models' results (+12-14%) due to possible lower margins via the cited lower capacity utilization, high-for-longer input costs, wage lifts and lower deficit spending vs 2021.**
- **We see an average total return of 7%, notwithstanding a mild PE compression (-4%) due to a more mature phase of the cycle, lower policy support and high inflation environment. Negative real bond yields will continue to score badly vs. positive equity ones.**

The Q4 reporting season has just started in the US (13 companies reported). The yearly earnings growth has been so far slightly below that of Q3 with comparable number of results reported (25% vs 26%). The same is true when we look at the results of the median stock (15% vs 20%).

S&P	*14 reported*	*13 reported*		
Sector	earnings growth, yoy		sales growth, yoy	
	Q3 2021	Q4 2021	Q3 2021	Q4 2021
Energy	-	-	-	-
Materials	-	-	-	-
Industrials	-4.0%	-0.4%	13.7%	14.2%
Consumer Discretionary	48.4%	61.8%	19.4%	17.9%
Consumer Staples	13.4%	6.1%	16.4%	15.6%
Health Care	-	-	-	-
Financials	-1.2%	12.7%	7.4%	9.4%
Information Technology	33.4%	31.3%	19.9%	20.7%
Communication Services	-	-	-	-
Utilities	-	-	-	-
Real Estate	-	-	-	-
S&P	**26.0%**	**25.4%**	**17.3%**	**17.0%**
Median (all sectors)	13.4%	12.7%	16.4%	15.6%
Median, ex. Energy & Materials	13.4%	12.7%	16.4%	15.6%

Source: Bloomberg, GIAM calculations

S&P	*14 reported*	*13 reported*		
Sector	earnings surprise %		sales surprise %	
	Q3 2021	Q4 2021	Q3 2021	Q4 2021
Energy	-	-	-	-
Materials	-	-	-	-
Industrials	-8.5%	13.3%	0.5%	4.8%
Consumer Discretionary	-9.4%	4.2%	-1.4%	0.4%
Consumer Staples	7.2%	6.8%	2.1%	1.8%
Health Care	-	-	-	-
Financials	5.3%	7.7%	1.7%	1.2%
Information Technology	3.7%	4.8%	0.2%	2.6%
Communication Services	-	-	-	-
Utilities	-	-	-	-
Real Estate	-	-	-	-
S&P	**0.9%**	**5.8%**	**0.8%**	**2.3%**
Median (all sectors)	3.7%	6.8%	0.5%	1.8%
Median, ex. Energy & Materials	3.7%	6.8%	0.5%	1.8%

Source: Bloomberg, GIAM calculations

Analysis of the median stock: Q4 2021 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q3 2021	Q4 2021	Q3 2021	Q4 2021	Q4 2021
S&P	20.1 %	14.7 %	17.4 %	20.0 %	2.6%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q3 2021	Q4 2021	Q3 2021	Q4 2021	Q4 2021
S&P	3.7 %	5.8 %	0.5 %	1.5 %	2.6%

Source: Bloomberg, GIAM calculations

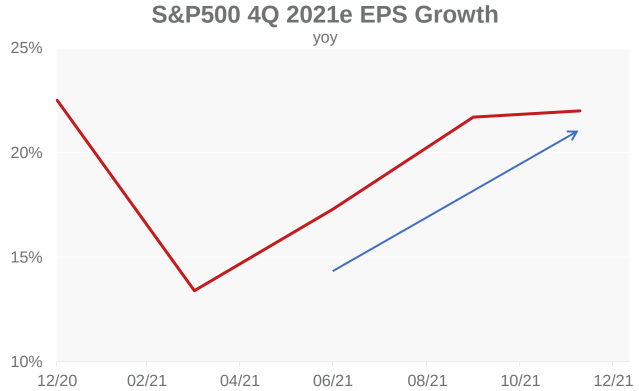
Currently, analysts expect the annual earnings growth in Q4 to be 22% compared to 43% in the previous quarter. Within sectors, energy is expected to have the highest yoy earnings growth (base effect), being followed by materials and industrials. The lowest (but positive) growth is forecast in utilities and consumer staples.

Since the beginning of October, annual earnings growth expectations have hardly changed for the US. On the other hand, **European growth has been revised up** by 12pp.

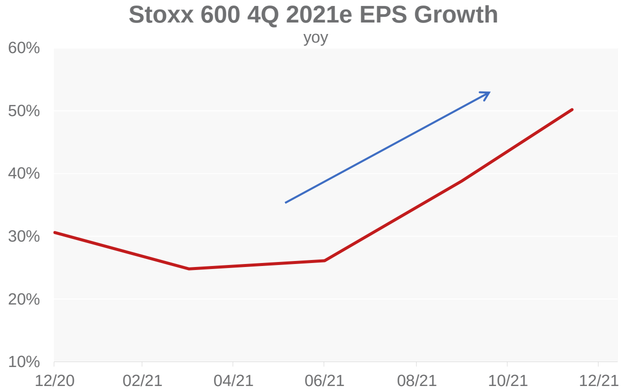
Historical/Current/Future Earnings Growth Rates

Sector	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3
Consumer Discretionary	-2.3%	-5.0%	226.1%	380.5%	19.4%	6.8%	0.3%	22.6%	39.0%
Consumer Staples	6.3%	5.4%	11.1%	20.4%	7.4%	2.4%	5.3%	4.3%	7.0%
Energy	-108.2%	-105.0%	28.0%	243.3%	1793.1%	10422.9%	163.8%	59.5%	3.8%
Financials	-2.8%	20.4%	138.0%	158.2%	36.0%	2.9%	-18.7%	-16.3%	-4.8%
Health Care	11.8%	10.6%	26.7%	27.2%	29.0%	19.1%	12.5%	7.5%	4.0%
Industrials	-54.7%	-37.7%	3.0%	698.4%	87.3%	49.0%	54.5%	32.9%	32.5%
Materials	-1.5%	22.7%	62.4%	139.5%	89.2%	62.6%	35.0%	3.6%	-3.2%
Real Estate	-12.8%	-10.7%	5.8%	38.7%	34.5%	13.7%	10.0%	-0.9%	0.5%
Technology	9.9%	20.4%	44.9%	49.6%	38.2%	15.6%	5.8%	3.7%	6.1%
Communication Services	3.7%	10.1%	53.1%	72.8%	35.6%	9.5%	-0.1%	0.5%	7.4%
Utilities	0.9%	-2.6%	-0.9%	12.6%	10.3%	1.0%	6.3%	-10.3%	-3.4%
S&P 500	**-6.5%**	**3.8%**	**52.8%**	**96.3%**	**42.6%**	**22.0%**	**7.6%**	**5.2%**	**7.4%**
S&P 500 Ex-Energy	-2.3%	7.8%	53.4%	80.6%	34.3%	14.1%	3.8%	3.2%	7.6%

Source: I/B/E/S data from Refinitiv, GIAM



Source: Refinitiv I/B/E/S data, GIAM



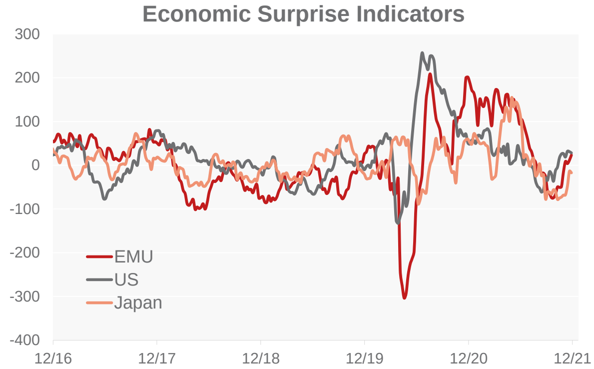
Source: Refinitiv I/B/E/S data, GIAM

The Omicron variant would affect companies' earnings guidance through some additional restrictions, lingering supply chain disruptions and lower propensity to buy during Christmas holidays.

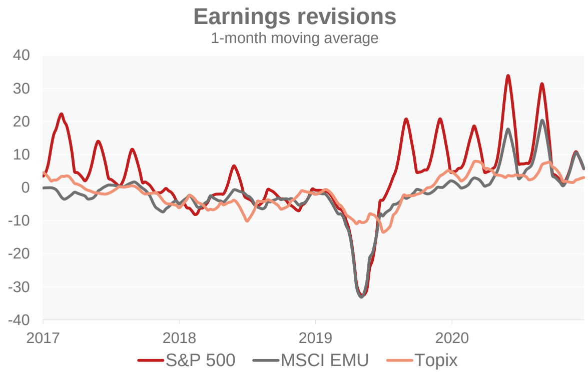
That said, we still expect a positive backdrop for earnings in Q4, as macro surprises have increased since September. EA earnings will benefit from **weaker TW euro**, while US ones are penalized by stronger TW USD.

With increasing signs of a peaking cycle and lower momentum in capacity utilization, the **yoy growth is forecasted to decelerate till 2022Q2**.

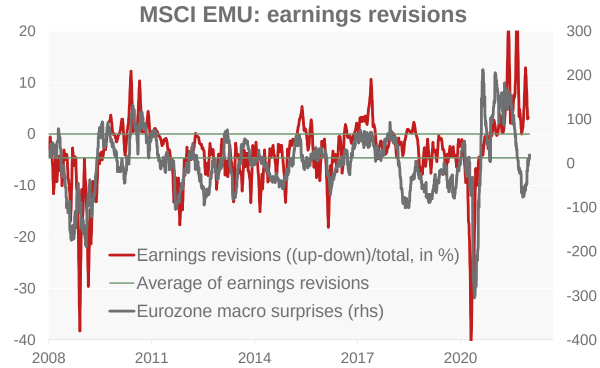
Earnings revisions are peaking or going down.



Source: Datastream, GIAM



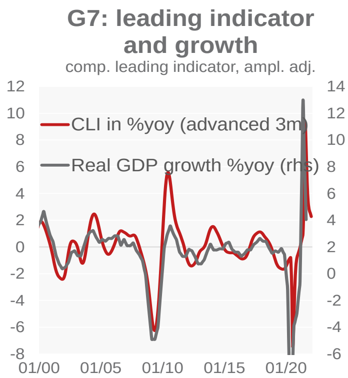
Source: Datastream, GIAM calculations



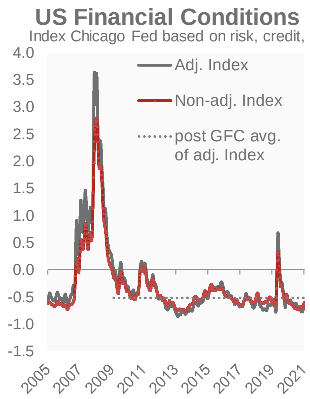
Source: Datastream, GIAM

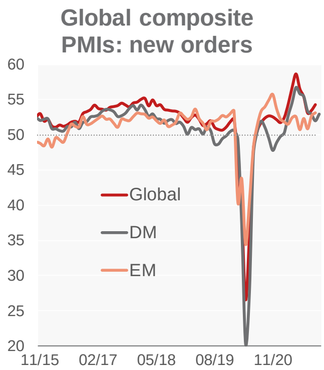
While global trend growth is slowing, the H2 deceleration was likely a speed bump (Covid, supply bottlenecks).

The Global leading indicator is still signalling healthy growth, financial conditions remain highly supportive, boding well for capex. The fiscal drag in the US is meaningful, but support in Europe is still solid.



Source: OECD, Datastream, GIAM calculations





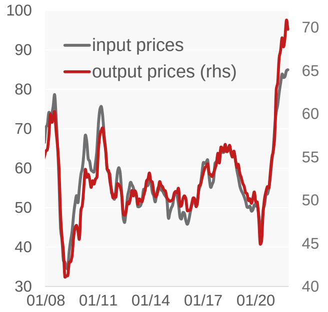
Source: Markit, Datastream, GIAM calculations

Rising input costs are passed to consumers. Pricing power protects margins.

Earnings are buoyed by high pricing power of firms (contrasting the GFC aftermath) amid strong demand and high excess savings of consumers.

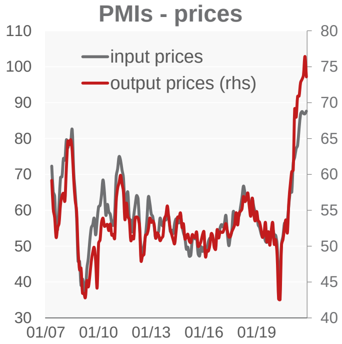
Firms‘ leeway to pass higher input prices to consumers appears highest in the US, but is also discernible in Europe.

Advanced economies: man. PMI - prices



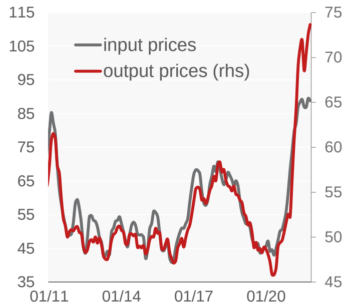
Source: Markit, Datastream, GIAM calculations

US manufacturing PMIs - prices



Source: Markit, Datastream, GIAM calculations

Euro area manufacturing PMI - prices



Source: Markit, Datastream, GIAM calculations

For 2022, we expect an earnings growth of 10% (average of the US and the EA), which incorporates the assumption of slightly decreasing margins in the next quarters. They are expected to remain overall solid, coherently to **both high CPI/ULC ratio** and **upbeat companies' statement**. Indeed, firms see reasonable pricing power due to **strong demand** and are using **workarounds and tech investments** to enhance productivity to offset cost increases.

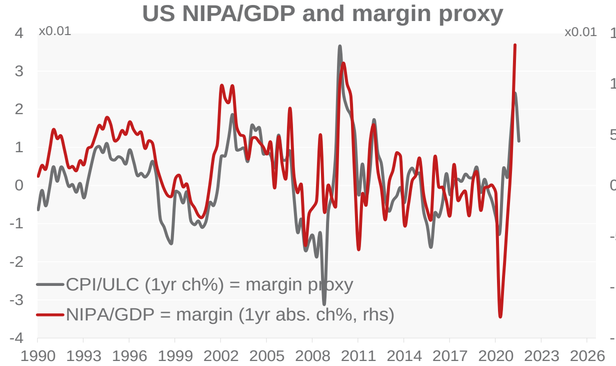
Our earnings expectations are also consistent with decreasing ISM and are based on the following considerations:

- our **NIPA** profits projections - **remaining sustained at around 20% in both 2021Q4 and 2022Q1 but decreasing to 10% in 2022Q2** - see an average of 6%-8% earnings growth in the US. This corresponds to an IBES 2022 figure for the S&P 500 which could be theoretically quite high: 225 USD p.s. vs 202 of 2021 (+12.5%).
- We run also specific **IBES models** for the S&P 500 earnings which outcomes are lower, at nearly +10%. As we could see surprising pressure from input costs and wages, we prefer this last forecast.
- Even an earnings growth of 15% should not look unrealistic when we forecast an **above-potential GDP** growth in excess of 4%. Indeed, the earnings multiplier for a given real GDP growth is around 3X.
- Such growth will offset the PE compression that we expect next year (about 1 point EMU, or -6% from current PE level, and -4% for the US) due to a more mature phase of the cycle, lower policy support and sticky inflation.

Under current macro expectations, earnings growth is tilted to the upside. But we see **increasing pressure** by less strong momentum in **capacity utilization**, **high-for-longer input costs**, **wage** lifts and **lower deficit spending** vs 2021. ROE is probably peaking.

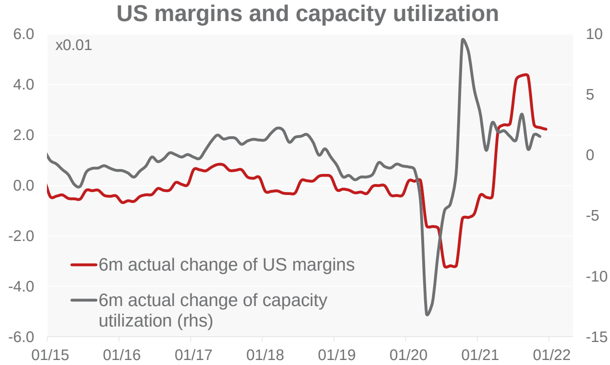
For this reason, we prefer **not to exploit all the potential** (+12%-15% EPS growth) from high nominal GDP growth. Indeed, US Q/Q growth ex-energy has been already -1% in Q3 and Q4 revisions have been slightly negative since the Q3 season started.

US NIPA/GDP and margin proxy



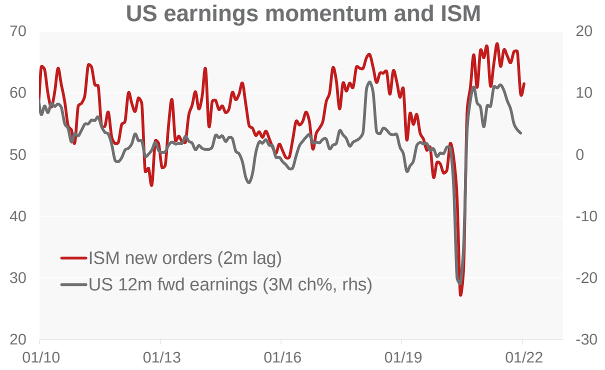
Source: Datastream, GIAM

US margins and capacity utilization



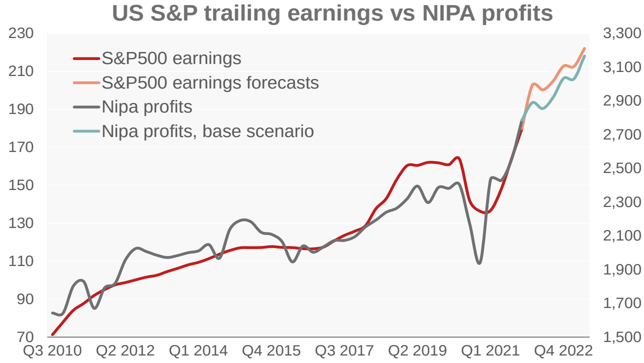
Source: Datastream, GIAM

US earnings momentum and ISM



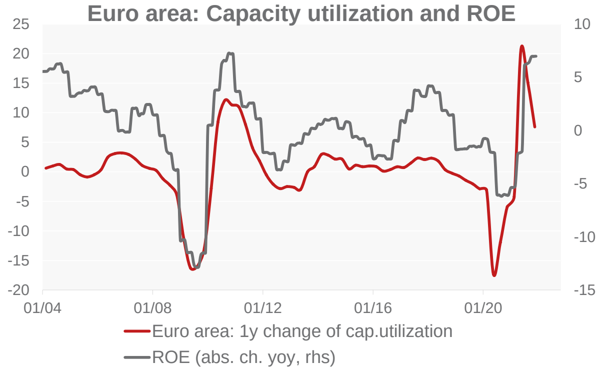
Source: Datastream, GIAM

US S&P trailing earnings vs NIPA profits



Source: Datastream, GIAM calculations

Euro area: Capacity utilization and ROE

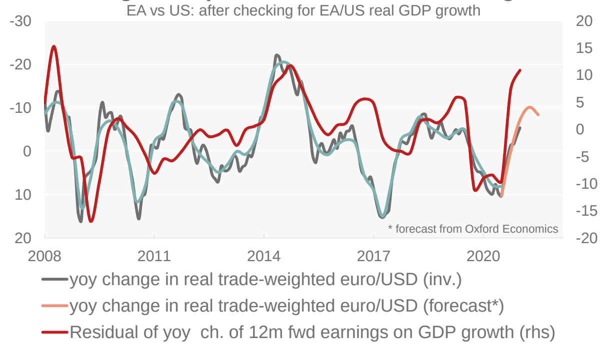


Source: Datastream, GIAM

EA earnings will benefit from weaker TW euro, while US ones are penalized by stronger TW USD. Oil price in momentum is going down and should be negative for both US and EMU earnings. Overall, EA earnings are developing better than US ones.

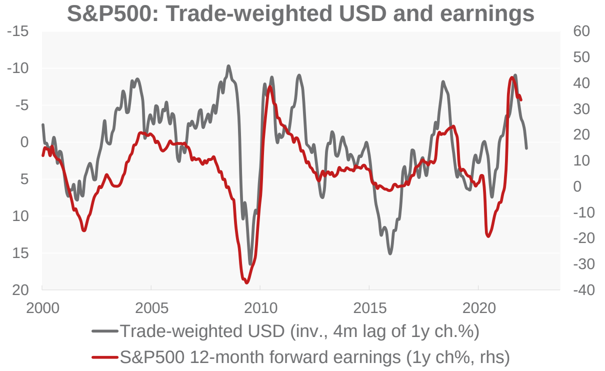
Marginal impact of exch. rate on earnings

EA vs US: after checking for EA/US real GDP growth



Source: Datastream, GIAM calculations

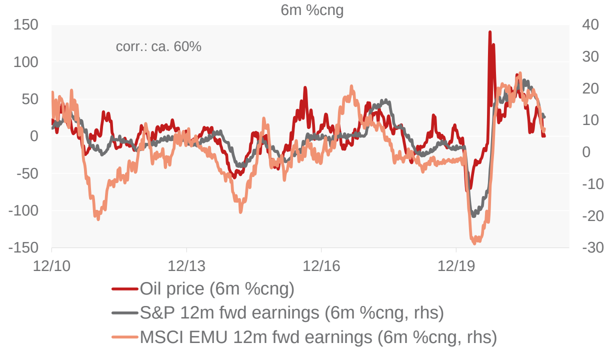
S&P500: Trade-weighted USD and earnings



Source: Datastream, GIAM

S&P500 & MSCI EMU: oil price and earnings

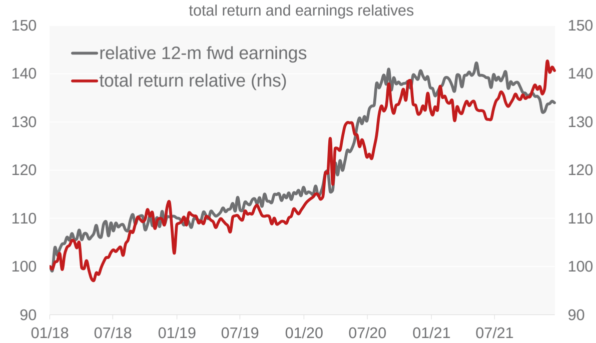
6m %cng



Source: Datastream, GIAM calculations

S&P vs MSCI EMU

total return and earnings relatives



Source: Datastream, GIAM calculations

The Omicron variant would **affect companies' earnings guidance through some additional restrictions, lingering supply chain disruptions and lower propensity to buy during Christmas holidays**.

However, **Omicron represents a non-disruptive event** in our base scenario, and the 2022 will be positive for equities due to the cited **sustained nominal GDP growth triggering a respectable positive momentum in earnings**.

That said, we see **higher uncertainty ahead** due to Covid waves and the less predictable response by central banks in a context of high inflation for the next 6 months, triggering higher yield volatility.

All in, **we expect an average total return of 7%**, notwithstanding a mild PE compression (-4%) due to a more mature phase of the cycle, lower policy support and high inflation environment. Negative real bond yields will continue to score badly vs. positive equity ones.