MARKET COMMENTARY

Q3 reporting season: back to norm, expect smaller positive surprises versus the last 5 quarters

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- **The just-started US reporting season will back to norm after the positive excesses of the last 5 quarters for both qoq growth and positive surprises.**
- **Some results and guidance will be negatively affected by a slowing macro momentum, bottlenecks and higher input costs. That said, while guidance is trending down, it currently remains above historical average. Similarly to Q2, net positive preannouncements are good, too.**
- **Since early September, analysts have already become cautious, reducing their expectations for the quarter appreciably. But still supporting confidence indicators and resilient high margins provide scope for positive earnings surprises in line with history, albeit much lower than during last year (5% vs 15-20%). The first 35 US firms reported already confirm such trend.**
- **Indeed, unit-labour costs remain well contained and cyclical sectors (including financials) are benefitting from a positive operating leverage during recovery, triggered by higher capacity utilization.**
- **Still, we think that toppish macro momentum and increasing input costs can cause negative revisions beyond the Q3 reporting season which we expect to be overall good.**
- **Thus, we remain below consensus by 4.5% and 6.5% in 2022 and 2023 (average US and EMU), respectively, having some scope to absorb future negative earnings revisions without impacting our fair value target.**
- **The cautious estimate for the latter points to a total return of 5-6% in the 12 months ahead (average US and EMU). The risks mentioned above keep such targets potentially more volatile than in the past, that is why we have recently lowered further our OW position in equities.**

Analysts expect the US Q3 reporting season to show a year-on-year growth of +29%, thus remaining solid after +96% in Q2. They also see **a negative sequential growth** around 5% qoq (in line with history), or even more negative when pandemic losers, hurricane effects and expected higher loan loss reserves are included. Indeed, ahead of the reporting season, revisions occurred starting from September 1st declined, coming back to historical norm of -0.5% in the month ahead of the beginning of the reporting season (instead, revision average in the last 5 reporting seasons has been on average positive at +1.2%).

Given still high confidence indicators (albeit decreasing) **such pessimism should give chance to a surprise around the historical average, i.e. +5%,** which is indeed very low compared to the 15-20% averaged in the seasons over the last year. Such lower positive surprise in Q3 should originate from the already advanced recovery in earnings, chain disruptions, labour shortages and resulted economic headwinds.

On the positive side, **guidance** is declining but still score much higher when compared to the last 10 years. Similarly to Q2, net positive **preannouncements** are good, too: 0.8 is the ratio of negative to positive ones.

After this trend of negative revisions which occurred in September, we expect some “back to normal” surprises (nearly 5%) as confidence indicators currently remain well in positive territory albeit declining (and expected to continue to do so). Furthermore, our **margin proxy** (CPI/ULC) **continues to linger at cyclical highs** as capacity utilization momentum skyrocketed. We expect it to decline in the future but the Q3 season should see a limited negative impact. Finally, banking fees and commodity prices are fuelling the earnings momentum of 3 important Value sectors (banks, energy, material) while industrials still enjoy the benefit of the operating leverage.

The first 35 US firms, which already reported, show a positive earnings surprise of 12.5% against sales one of 2% (**margins** surprised on the upside).

Still, we think that toppish macro momentum and increasing input costs will be **able to cause negative revisions beyond the current reporting season which we expect to be decently good**.

Thus, **we remain below consensus by 4.5% and 6.5% in 2022 and 2023**, respectively, having some scope to absorb negative earnings revisions without impacting our fair value target.

The cautious estimate for the latter points to a total return of 5-6% in the 12 months ahead (average for the US and EMU). The risks mentioned above, **keep such targets potentially more volatile than in the past, that is why we recently lowered further our OW position in equities.**

<u>Charts plus additional details:</u>

Notwithstanding a declining qoq growth, the yearly growth remains wealthy at nearly 30%:

Exhibit 3. 2021Q3 Blended (Reported & Estimated) Earnings Growth

Sector	Today	1 Oct	1 Jul	1 Apr	1 Jan	1 Oct
Consumer Discretionary	7.7%	8.0%	15.0%	14.9%	11.5%	50.7%
Consumer Staples	3.5%	3.5%	4.7%	5.9%	6.0%	11.0%
Energy	1487.8%	1391.9%	1233.5%	923.2%	804.3%	527.2%
Financials	18.1%	17.4%	14.8%	5.7%	-4.4%	14.4%
Health Care	15.3%	15.3%	7.9%	9.6%	7.3%	22.5%
Industrials	75.9%	79.0%	85.2%	80.8%	83.2%	134.1%
Materials	92.4%	92.9%	70.2%	40.3%	22.9%	32.8%
Real Estate	17.2%	17.5%	15.5%	7.9%	10.4%	11.5%
Technology	28.8%	28.8%	22.1%	16.3%	12.1%	20.2%
Communication Services	23.8%	23.8%	15.7%	11.8%	12.0%	36.9%
Utilities	0.3%	0.2%	2.7%	3.8%	1.8%	5.1%
S&P 500	**29.6%**	**29.4%**	**24.7%**	**19.5%**	**14.1%**	**30.9%**

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

In the month preceding the reporting season, **market prices declined while eps increased.**

As a result, PE contracted by 4% in the US and 7% in the euro area (EA) in one month.

Total Return decomposition and PE expansion from 1/9/2021 to 11/10/2021 - in local currency

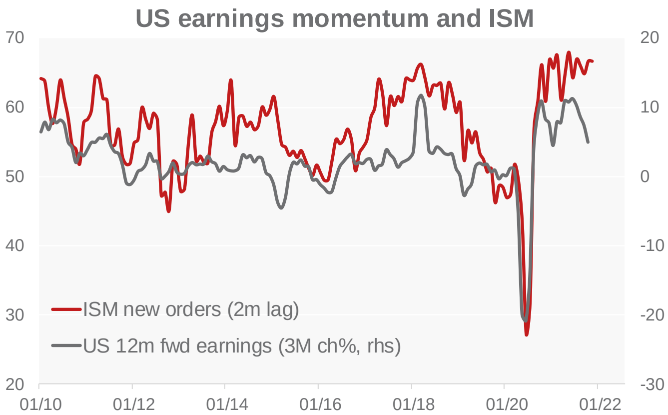
Index	%TR	%PR	%DR	%EPS	%PE	10-Year Yld Chg (BPS)
MSCI World	**-3.6**	-3.8	0.2	**0.1**	**-3.9**	**20**
S&P 500	**-3.5**	-3.6	0.1	**0.4**	**-4.0**	**30**
MSCI EMU	**-3.7**	-3.9	0.2	**3.4**	**-7.0**	**23**
MSCI EUROPE	**-2.6**	-2.8	0.2	**2.9**	**-5.6**	**23**
TOPIX	**1.6**	0.8	0.8	**2.8**	**-2.0**	**6**
FTSE100	**0.3**	0.0	0.3	**2.6**	**-2.6**	**50**
SMI	**-5.2**	-5.3	0.1	**1.4**	**-6.6**	**26**

Since September 1st, markets became wary notwithstanding good 12-month forward eps revisions: US experienced a +0.4% eps revision and -3.6% in price, so PE declined. EMU saw + 3.4% for 12m fwd eps and -3.9% in price. For **EU sectors, 12m fwd PE** registered the following changes: retail -21%, semi -15%, IT -12%, transportation -12%, hardware -11%, services -6%. Finally, the MSCI EU index showed a PE decline of -6% (-2.7% in price and +3.4% eps revisions).

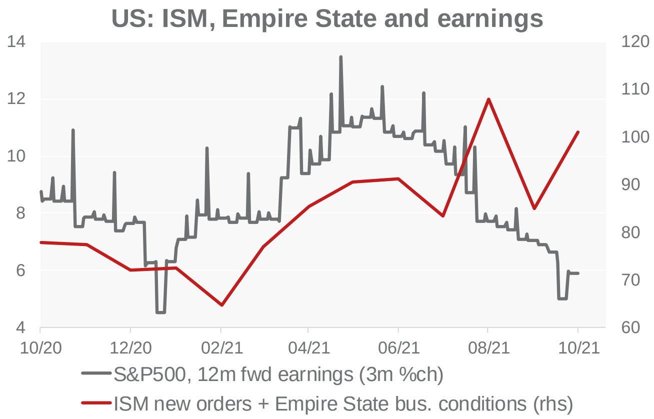
Positive PE changes came from: EU energy and food retail, +8% each, and banks +0.8%.

Confidence indicator like ISM is still at the top of the cycle, albeit we expect it to decline. Earnings forecasts are anticipating such a trend and are already on their way down. For the time being, **changes** of both **unit labour costs and total unit costs** are still pointing south (look chart below, with inverted scale), supporting the NIPA profits upsurge.

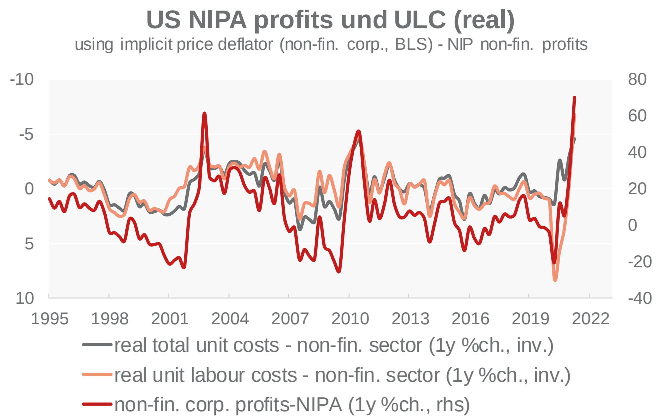
When ULC are adjusted for the CPI (CPI/ULC = our proxy for pricing momentum), we can see that **margins** remain also well supported in the short term.



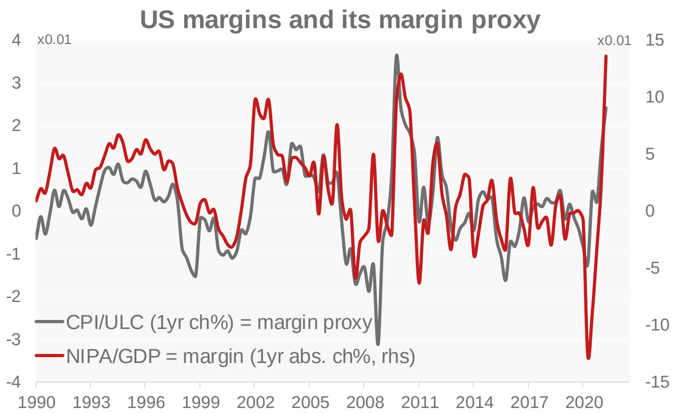
Source: Datastream, GIAM



Source: Datastream, GIAM calculations

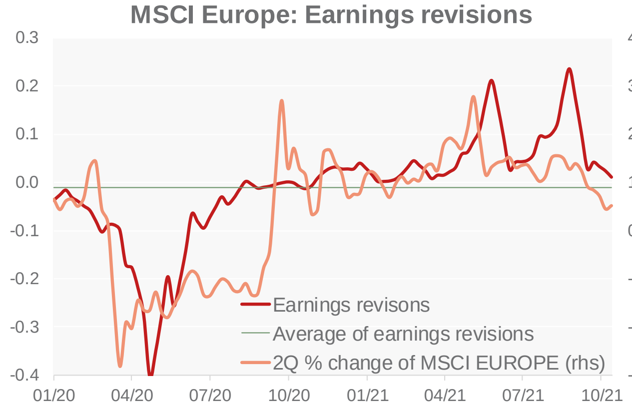


Source: Datastream, GIAM calculations

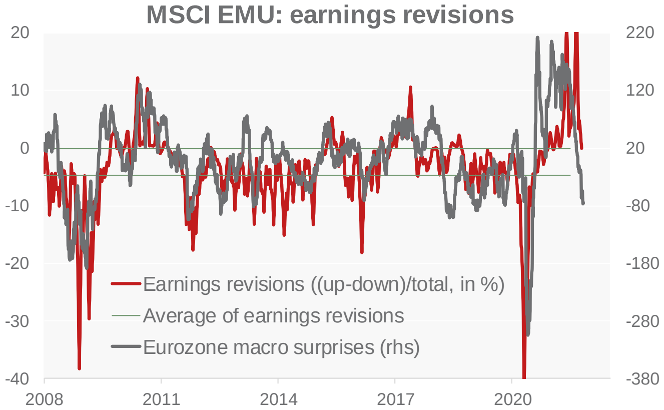


Source: Datastream, GIAM

In Europe, eps **revisions** are declining, too, albeit the **capacity utilization** and EBITDA momentum (**gross operating surplus** here) remain both in solid territory.

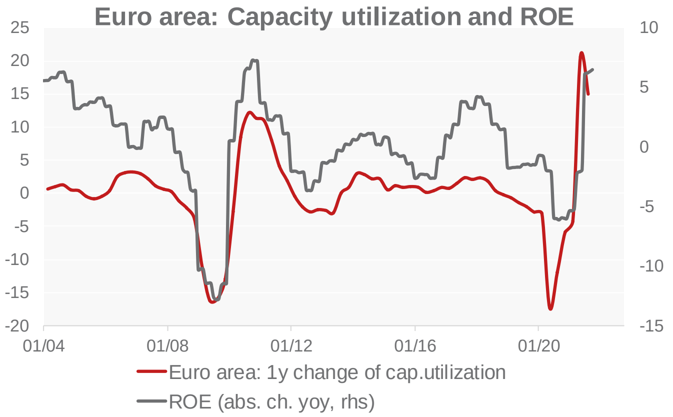


Source: Datastream, GIAM calculations



Source: Datastream, GIAM

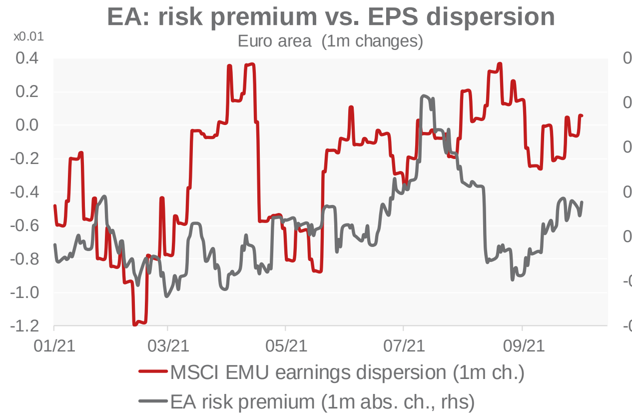
Source: Datastream, GIAM calculations



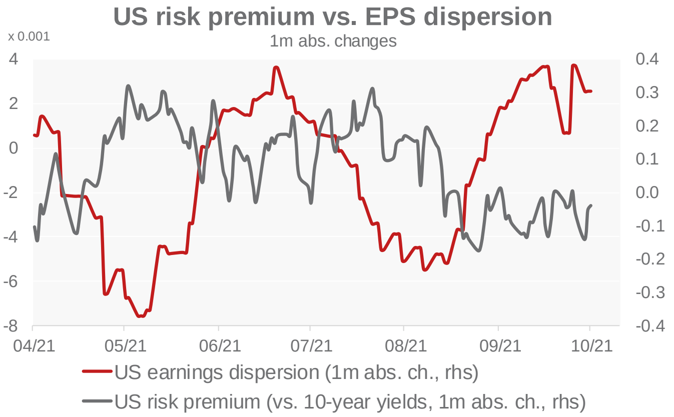
Source: Datastream, GIAM

Due to the cited risks (confidence slowdown, bottlenecks, China and inflation), **the dispersion of earnings estimates** (a proxy for – analysts – uncertainty) **remains high.** This in the short term **could maintain the risk premium under pressure.**

On the positive side, the **TW euro is not more a drag for EU stocks**:



Source: Datastream, GIAM calculations



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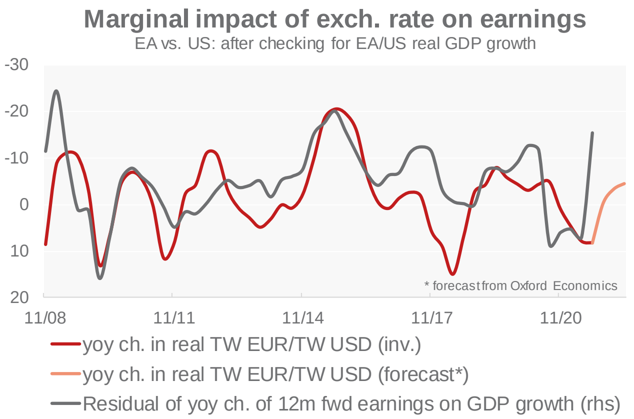
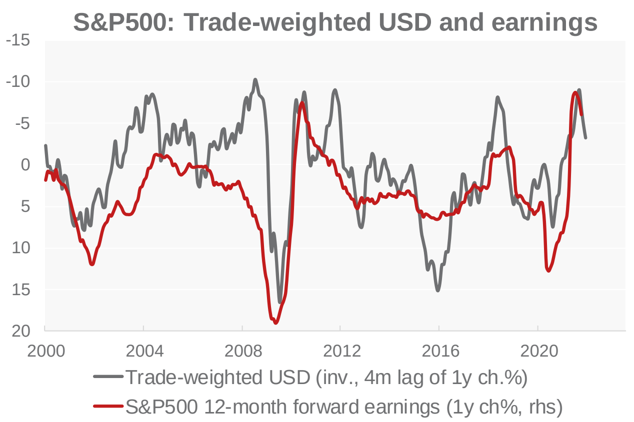
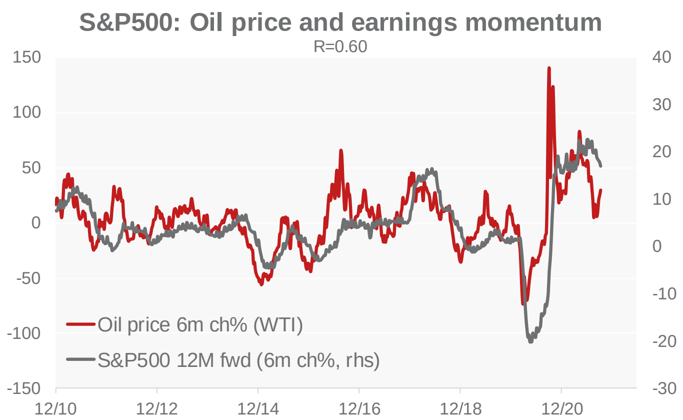


Source: Datastream, GIAM calculations

In the US, while the **stronger TW USD** is less supportive to earnings growth, on the other side the **oil price** increase favours the energy sector's profit momentum, and the S&P's one:



Source: Datastream, GIAM



Source: Datastream, GIAM

Decent **guidance** and **net positive preannouncements** are, for the time being, confirmed by decent results and surprises for the **first 35 firms** which reported so far:

Reporting season tables: sector growth and surprises + median stock results.

S&P	38 reported	35 reported		
Sector	earnings growth, yoy		sales growth, yoy	
	Q2 2021	Q3 2021	Q2 2021	Q3 2021
Energy	-	-	-	-
Materials	-	-	-	-
Industrials	N.M.	28057.3%	48.9%	34.5%
Consumer Discretionary	N.M.	37.3%	71.0%	24.3%
Consumer Staples	14.1%	5.2%	1.5%	9.7%
Health Care	-34.3%	27.8%	14.8%	11.1%
Financials	220.9%	42.0%	1.9%	6.4%
Information Technology	35.3%	33.7%	19.0%	19.8%
Communication Services	-	-	-	-
Utilities	-	-	-	-
Real Estate	-	-	-	-
S&P	**138.0%**	**39.2%**	**10.9%**	**12.5%**
Median (all sectors)	24.7%	35.5%	16.9%	15.4%
Median, ex. Energy & Materials	24.7%	35.5%	16.9%	15.4%

S&P	38 reported	35 reported		
Sector	earnings surprise %		sales surprise %	
	Q2 2021	Q3 2021	Q2 2021	Q3 2021
Energy	-	-	-	-
Materials	-	-	-	-
Industrials	20.0%	-0.9%	6.1%	2.5%
Consumer Discretionary	385.7%	-8.8%	11.4%	1.9%
Consumer Staples	12.2%	4.3%	2.9%	2.7%
Health Care	6.1%	2.9%	2.7%	1.7%
Financials	29.7%	21.1%	5.8%	2.8%
Information Technology	12.3%	4.1%	2.9%	0.3%
Communication Services	-	-	-	-
Utilities	-	-	-	-
Real Estate	-	-	-	-
S&P	**24.9%**	**12.5%**	**4.7%**	**2.3%**
Median (all sectors)	16.1%	3.5%	4.3%	2.2%
Median, ex. Energy & Materials	16.1%	3.5%	4.3%	2.2%

S&P				
Sector	Eps Surpr. Ratio pos/tot		Sales Sur. Ratio pos/tot	
	Q2 2021	Q3 2021	Q2 2021	Q3 2021
Energy	-	-	-	-
Materials	-	-	-	-
Industrials	100.0%	75.0%	100.0%	100.0%
Consumer Discretionary	80.0%	71.4%	80.0%	42.9%
Consumer Staples	85.7%	75.0%	100.0%	87.5%
Health Care	100.0%	100.0%	100.0%	100.0%
Financials	92.9%	100.0%	85.7%	88.9%
Information Technology	100.0%	100.0%	100.0%	100.0%
Communication Services	-	-	-	-
Utilities	-	-	-	-
Real Estate	-	-	-	-
S&P	**91.9%**	**84.8%**	**91.4%**	**81.8%**
Median (all sectors)	96.4%	87.5%	100.0%	94.4%
Median, ex. Energy & Materials	96.4%	87.5%	100.0%	94.4%

Analysis of the median stock: Q3 2021 reporting season

Median stock	Earnings Growth		Sales Growth		availability
	Q2 2021	Q3 2021	Q2 2021	Q3 2021	Q3 2021
S&P	28.3 %	20.0 %	13.3 %	11.6 %	7.0%

Median stock	Earnings Surpr		Sales Surpr		availability
	Q2 2021	Q3 2021	Q2 2021	Q3 2021	Q3 2021
S&P	9.4 %	5.8 %	3.7 %	1.8 %	7.0%

Earnings forecast table:

30/10/2022	IBES stated 2020	IBES 12mFWD earnings	IBES 2021 earnings	IBES 2022 earnings	IBES 2023 earnings	GI Forecast 12mFWD earnings	GI stated (2020)	GI Forecast 2021 earnings	GI Forecast 2022 earnings	GI Forecast 2023 earnings	GI Forecast 2024 earnings	GI Forecast 2025 earnings
Weights												
S&P 500	134.7	213.9	197.3	215.8	237.3	223.3	134.7	197.0	210.0	226.0	230.5	235.1
MSCI EMU	7.6	13.3	12.4	13.5	14.8	13.6	7.6	12.0	12.9	13.8	14.1	14.4
MSCI EUROPE	80.0	131.5	124.6	132.7	142.2	132.0	80.0	121.0	127.0	133.0	135.7	142.4
FTSE 100	308.0	584.0	565.8	589.3	607.0	547.5	308.0	525.0	550.0	547.0	557.9	569.1
SMI	563.6	669.3	622.7	679.6	736.7	699.1	563.6	610.0	670.0	705.0	715.6	726.3
Weights												
TOPIX	95.1	138.9	132.6	142.9	154.8	142.6	95.1	128.0	136.0	144.0	145.4	146.9

Forecast delta vs IBES	GI Forecast/ IBES 12mFWD		GI Forecast/ IBES 2021	GI Forecast/ IBES 2022	GI Forecast/ IBES 2023	Top trailing Eps 2019	Current GI 12m fwd/ 2019 peak	GI Forecast 2021 / stated (2020)	GI Forecast 2022/ 2021	GI Forecast 2023/ 2022	GI Forecast 2024/ 2023	GI Forecast 2025/ 2024
S&P 500	4.4%		-0.2%	-2.7%	-4.8%	157.2	42.0%	46.2%	6.6%	7.6%	2.0%	2.0%
MSCI EMU	2.3%		-2.9%	-4.6%	-6.9%	10.9	25.2%	57.2%	7.5%	7.0%	2.0%	2.0%
MSCI EUROPE	0.4%		-2.9%	-4.3%	-6.4%	112.8	17.0%	54.9%	7.0%	4.4%	2.0%	5.0%
FTSE 100	-6.2%		-7.2%	-6.7%	-9.9%	515.1	6.3%	70.4%	4.8%	-0.5%	2.0%	2.0%
SMI	4.5%		-2.0%	-1.4%	-4.3%	550.8	26.9%	8.2%	9.8%	5.2%	1.5%	1.5%
TOPIX	2.7%		-3.5%	-4.8%	-7.0%	83	71.9%	34.6%	6.3%	5.9%	1.0%	1.0%

Forecast delta vs IBES	2022 GI eps premium vs 2019 peak	2023 GI eps premium vs 2019 peak	Curr. trend eps - based on last 20/25y	Curr. Ibes TE eps vs curr. trend eps 20/25y	1y ahead trend eps - based on last 20/25y	GI eps 12m fwd vs 1y ahead trend eps
S&P 500	34%	44%	174	9%	182	23%
MSCI EMU	18%	27%	15	-23%	16	-12%
MSCI EUROPE	13%	18%	150	-22%	155	-15%
FTSE 100	7%	6%	603	-13%	620	-12%
SMI	22%	28%	670	-9%	688	2%
TOPIX	64%	73%	112	6%	115	24%

Our targets are still cautiously pointing to a 5-6% total return in the 12 months ahead. Models could see even more for EU and Japan. For the US we see a floor of 4,230 **but our analysis of the risk premium, using the long-term Shiller series, gives us a higher 12-month target at 4,600 with the 10-year yields at 1.9% or even 4,900 with 10-year yields at 1.6%.** By the way, the CAPE yield gap vs 10-year real yields remains well below the levels corresponding to the market peaks in 2000, 2007 and 2018.

Yield assumption in 12m (10-year yield)	2021 eps (2019 = 100)	2022 eps (2019 = 100)	Long-term models - April 2022	PEs 12m: 21X for US, 18.5X for SMI, 16X for EMU & Japan, 14x for UK	fair value (12-m EPS/10-year yield)	eq./bond yield gap	DDM	Gordon 3 stage DEV	Current average valuation in 1 year	Current average price up/downside by next 12 m	DY 12m	TR 12m (incl. Bback)
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%	100.0%	**LT Models**		
1.90%	**125.3**	**133.6**	**S&P 500**	**4,689**	**3,987**	**3,987**	**3,688**	**4,025**	**4,229**	**-3.1%**	**1.4%**	**-0.1%**
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%				
0.15%	**109.1**	**117.3**	**MSCI EMU**	**218**	**222**	**222**	**208**	**200**	**215**	**4.3%**	**2.9%**	**7.2%**
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%				
0.40%	**107.2**	**112.6**	**MSCI EUROP**	**1,855**	**1,923**	**1,934**	**2,048**	**1,748**	**1,890**	**8.8%**	**3.1%**	**11.9%**
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%				
1.25%	**101.9**	**106.8**	**FTSE 100**	**7,665**	**8,760**	**9,050**	**8,017**	**7,951**	**8,133**	**13.9%**	**4.2%**	**18.1%**
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%				
0.15%	**110.7**	**121.6**	**SMI**	**12,933**	**11,367**	**10,838**	**11,099**	**10,739**	**11,780**	**-0.3%**	**2.9%**	**2.6%**
			Weights	40.0%	15.0%	15.0%	15.0%	15.0%				
0.15%	**152.5**	**162.0**	**TOPIX**	**2,282**	**2,052**	**1,995**	**2,428**	**2,110**	**2,201**	**11.5%**	**2.2%**	**13.7%**

Shiller-based approach to valuation

US CAPE-based valuation (adj. for inflation)	10Y	CPI	Real 10Y Rate	EPS	Current (e/p - 10y real)
Scenario 1 (current input with consensus CPI & 12m fwd earnings)	1.56	2.64	-1.08	196.5	4.43
Scenario 2 (consensus 12m forward in 1 year)	2.00	2.25	-0.25	219.0	4.94
Scenario 3 (GI 12m fwd in 1 year)	1.90	2.30	-0.40	223.0	4.71
Scenario 4 (downside macro scenario)	0.90	1.60	-0.70	128.0	2.61
Scenario 5 (upside macro scenario)	2.80	2.50	0.30	228.8	4.86

using 20% of risk (SD)	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	25.3	28.1	25.5	16.5	27.6
Avg S&P500 valuation	4,035	4,489	**4,573**	2,628	4,408
	-4.1%	6.7%	1.8%	-37.6%	4.8%

Note: **Base risk** scenario: using 20% of risk premium's stand. deviation (SD=2.7%) adds around 50 bps to the average risk premium calculated since 1872 (4.6% + 50 bps = 5.1%). Target ERP (4.6) is calculated assuming CPI in the range b/w 1.3% and 2.3%.

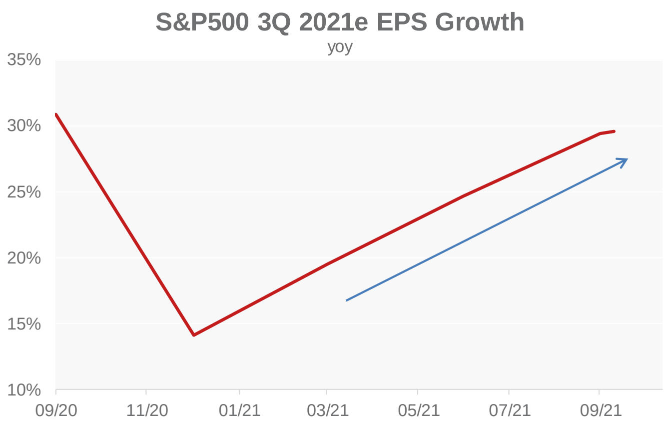
Scenario 3 (GIE) with lower yields at 1.6%	Scen. 1	Scen. 2	Scen. 3	Scen. 4	Scen. 5
Implied PE Trailing IBES	25.3	28.1	27.2	16.5	27.6
Avg S&P500 valuation	4,035	4,489	**4,891**	2,628	4,408
	-4.1%	6.7%	8.9%	-37.6%	4.8%

World Markets: Forecast Earnings Growth (IBES Consensus)
13-Oct-2021

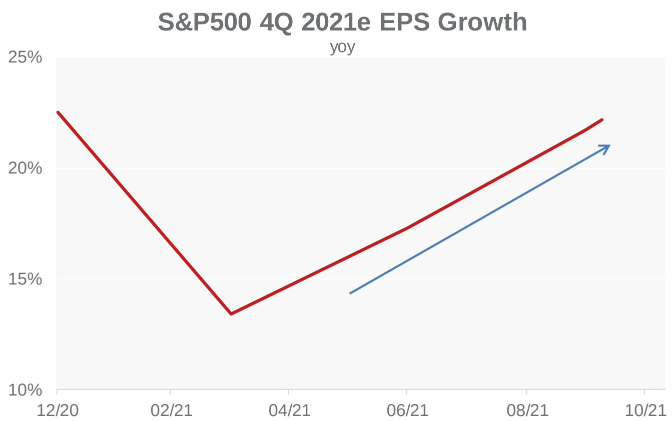
	A12FE vs 2020	2021/2020	2022/2021	2023/2022
MSCI AC WORLD	58.6%	49.0%	7.6%	8.9%
MSCI WORLD INDEX	58.0%	48.0%	7.8%	8.9%
S&P 500	58.8%	46.4%	9.4%	10.0%
FTSE-100 INDEX	89.6%	83.7%	4.2%	3.0%
TOPIX	46.1%	39.5%	7.7%	8.3%
SWISS MARKET	18.7%	10.5%	9.1%	8.4%
MSCI EUROPE	64.3%	55.7%	6.4%	7.2%
MSCI EMU	74.8%	62.0%	9.4%	9.6%
STOXX 50 (EURO)	51.7%	43.5%	7.1%	6.8%
EURO STOXX 50 E	60.9%	50.0%	8.7%	9.1%
MSCI USA IT	50.5%	36.1%	10.1%	10.9%
MSCI EM	62.0%	54.4%	6.4%	9.4%

30/07/21 - 13/10/21

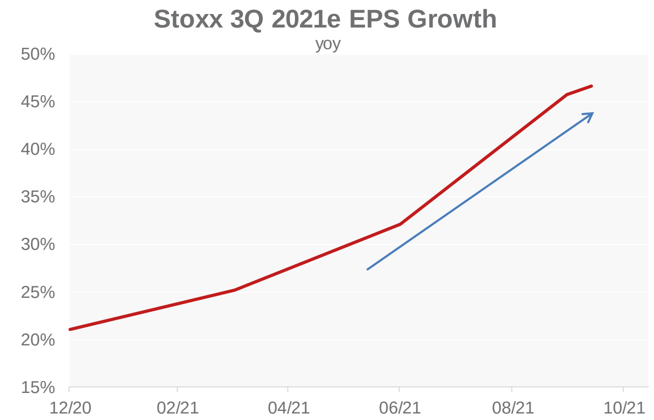
Consensus eps estimates:	changes (%) since 30/07/21				
(IBES)	2020	12m fwd eps	2021	2022	2023
MSCI AC WORLD	-2.2%	2.5%	1.4%	0.2%	0.3%
MSCI WORLD INDEX	-2.5%	2.7%	1.4%	0.5%	0.5%
S&P 500	-0.5%	3.4%	1.2%	1.1%	1.2%
FTSE-100 INDEX	1.6%	5.2%	6.0%	3.8%	2.8%
TOPIX	-0.3%	7.9%	7.1%	3.9%	3.2%
SWISS MARKET	0.5%	3.8%	3.2%	0.6%	0.8%
MSCI EUROPE	0.7%	5.6%	5.2%	3.5%	3.0%
MSCI EMU	-0.4%	6.3%	4.8%	3.5%	2.9%
STOXX 50 (EURO)	2.5%	5.7%	4.8%	3.9%	4.2%
EURO STOXX 50 E	3.0%	8.9%	7.3%	6.4%	6.4%
MSCI USA IT	-0.8%	3.1%	0.9%	0.6%	1.1%
MSCI EM	-0.1%	1.8%	1.8%	-1.0%	-0.6%



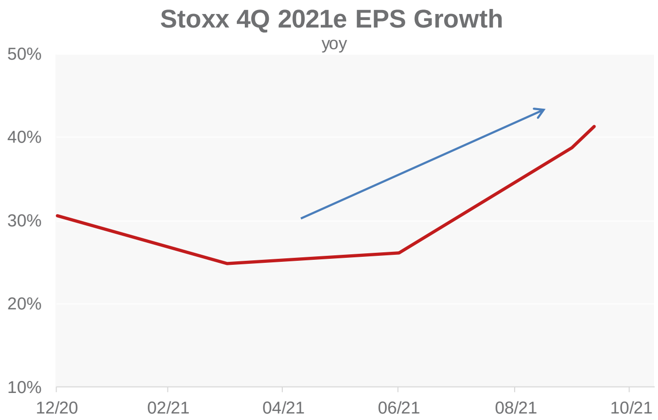
Source: Refinitiv I/B/E/S data, GIAM



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



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



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