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SUMMARY

- From our perspective, Q2 earnings season was a solid one in the US in the face of a tough economic backdrop.
- However, we are concerned about deterioration of forward earnings guidance.
- We remain conservatively positioned but are watching closely for signs of technical improvement.

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Q2 Earnings Summary: The Good, The Bad, And The Uncertain

This Season Had Something for Both the Bulls and the Bears

As of the end of last week, we are nearing the conclusion of second quarter earnings season in the US. Occurring smack dab in the middle of the debate surrounding whether we are in 'recession' (see *Recession: It's Not The Name, It's The Magnitude Weekly View* for more on that topic), earnings have contained a little something for both the 'bulls' and the 'bears', in our opinion. **In our view, quarterly results have reflected the admirable flexibility and resiliency of the US consumer and corporate sector under duress– one potential reason for the strong market rally experienced in July.** However, forward-looking indicators suggests to us a more difficult earnings trajectory for the 2nd half of the year and likely continued uncertainty for stock markets.

The Good: Most Companies Beat, and Earnings Grew Year-Over-Year Despite Economic Pressures

With close to ninety percent of S&P 500 companies now having reported Q2 results, year-over-year earnings growth registered around +10%, with sales growth even higher at approximately +16%, according to Refinitiv. Approximately 73% of all reporting companies registered a positive earnings 'surprise' –results that were higher than their pre-earnings consensus estimate - according to data compiled by ETF Action. In addition, 69% of companies also beat their sales estimate. Strength was shown in energy, technology, materials, and health care, all of which topped the S&P 500 average - both in terms of percentage earnings and sales surprises (see table, right). This suggests to us a corporate sector that remains robust despite economic headwinds, including continued high levels of inflation, labor market tightness, and

S&P 500: Q2 2022 EARNINGS AND SALES

SECTOR	Earnings: % beat	Sales: % beat
Energy	90.0	90.0
Information Technology	86.9	75.4
Industrials	80.3	62.1
Materials	76.9	80.8
Health Care	76.8	69.6
Consumer Staples	70.8	75.0
Real Estate	70.0	70.0
Consumer Discretionary	66.7	64.3
Utilities	64.3	89.3
Financials	63.5	55.6
Communication Services	50.0	55.0

Source: ETF Action, Factset Data Systems. Data as of8/5/22. Chart shown for illustrative purposes. ETF Action is affiliated with RiverFront.

declining levels of consumer and business confidence. This performance reinforces a point that we have made before in our 2022 Outlook and recent Chart Pack; the US corporate sector is among the most flexible and dynamic of its type in the world. We believe US managers are highly skilled in adapting to unexpected issues – in this case, spiraling input and wage costs.

We would focus investors on the better-than-average beats on both earnings and sales by energy, tech, materials, and health care. We believe this shows that these types of business models - which we tend to favor - may be well-positioned to deal with this uncommon macro backdrop of strong *nominal* but weak *inflation-adjusted* economic growth. In contrast, communication services, financials, and consumer cyclicals appear to us to be business models struggling right now.

***The Bad:* Guidance Suggests Tougher Results Going Forward...and Potential Signs of Margin Pressure**

However, a closer look at Q2 results suggests the results were not uniformly rosy. While a full three-fourths of all reporting companies beating earnings appears positive, when compared to history it is lower than in most recent quarter's past (see bar chart, below). This condition may be a harbinger of more difficult sailing ahead for stocks.

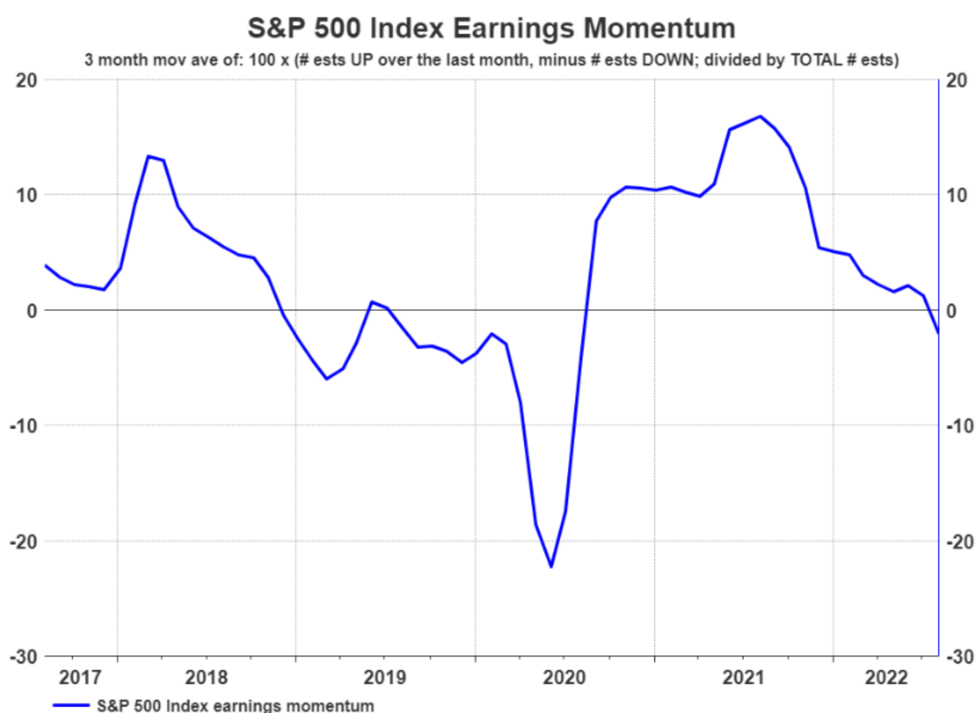
A quantitative research study of US large-cap stocks going back to June 1995 by NDR Research suggests that if companies' surprise percentage in the present quarter is lower than it was a year ago, this condition tends to correlate to lower-than-average annualized forward returns in stocks. This condition has now been in place since Q4 of 2021, after a long period of positive year-over-year point changes going back to mid-2020.

It also bears noting that revenue growing faster than earnings – the current situation in Q2 - is a sign of profit margin pressures. We think this is indicative of an environment where sales can be inflated by higher prices, even as companies may struggle to generate cost efficiencies and pass along higher inflation to end consumers.

Source: ETF Action. Data as of 8.5.22. Chart shown for illustrative purposes. ETF Action is affiliated with RiverFront.

***The Uncertain:* Earnings Momentum Will Tell the Tale of the Second Half of 2022**

We closely track a metric we call 'earnings momentum' – a smoothed average of the number of net positive analyst *revisions* over the last month, divided by the *total* number of estimates for a particular index. We believe these earnings momentum lines tend to trend, and that those trends – positive or negative - can have persistence. This matters for the stock market because, for the market to accelerate from here, an earnings recession needs to be avoided, in our view. As Q2 earnings season comes to an end, we note a concerning trend; for the S&P 500, earnings momentum is now below zero for the first time since the pandemic selloff of 2020 (see blue line on chart, next page). In parsing the data by sector, it appears that weakness is fairly widespread but driven predominantly by communication services and consumer-facing companies guiding down for the future. This included some high-profile guidance reductions from well-known social media companies and a slew of consumer companies



Source: Refinitiv Datastream, RiverFront. Data as of 8.5.22. Chart shown for illustrative purposes.

that cater to lower-end consumers. Energy and materials companies continue to buck the trend by seeing more upward revisions than downward. We believe this declining earnings momentum line is a function of forward-looking estimates deteriorating; a trend visible in Q2 earnings guidance. Forward guidance given for the upcoming quarter for Q3 across the S&P 500 declined, according to Refinitiv data. Analysts have cut estimates for 2022 earnings to $216.88 (down -$7.18 since June 30) and 2023 estimates were cut to $241.59 (down -$7.42 since June 30), according to data on S&P 500 operating earnings-per-share from S&P Global.

CONCLUSION

We are impressed with the resiliency of US corporate results this quarter. However, looking forward, we believe the 2nd half of the year could prove more difficult for earnings.

We are heartened by the recent stock market rally in July, off highly oversold conditions, with some improvement in underlying market breadth indicators. We view 4,200 on the S&P 500 as an important level. We would consider a definitive break above this level as a meaningful sign that the current bounce could be more than just the typical sharp, but short-lived rebounds often seen in cyclical bear markets. Our portfolios remain fairly conservatively positioned, particularly in our shorter-time-horizon portfolios, where we continue to carry somewhat elevated levels of cash as a risk shock absorber.

Our tactical portfolio positioning will continue to be driven by our motto of 'Process Over Prediction' and our unemotional assessment of both the technical and fundamental investing backdrop.

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Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.
In a rising interest rate environment, the value of fixed-income securities generally declines.

Earnings momentum occurs when corporate earnings per share (EPS) growth is accelerating or decelerating from the prior fiscal quarter or fiscal year.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero).

Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

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