

Buy the Rumor, Sell the News

To say that Corporate America had a nice start to 2021 would be an understatement. With roughly 60% of the S&P 500 index having reported first quarter earnings, profits are up 46% over a year ago. This astronomical figure is largely attributed to the fact that the first three months of last year marked the beginning of the pandemic lockdown, but the magnitude of the rebound is amazing nonetheless.

Not surprising are the sectors on the top of that growth leaderboard. Consumer Discretionary is on top, a direct result of the impacts of the vaccine on re-opening efforts.

Financials have been able to post strong results as well. The extreme uncertainty surrounding the lockdown caused Banks to over-reserve for potential credit losses; as the economy re-opens, borrowers have been able to stay current on their loans at a much higher rate than expected, allowing lenders to “release” these reserves (with these reserve releases boosting profits).

What is surprising about first quarter earnings reports is how soundly they have beaten expectations. As you can see in the chart at right, companies typically top earnings estimates (by nearly 4% on average since 1994). So far, first quarter earnings have been coming in 23% higher than what was expected. This is a

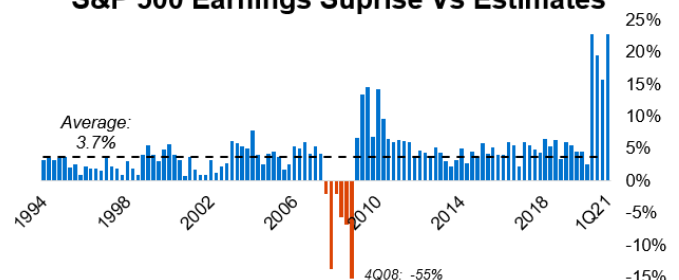
EARNINGS SEASON RECAP

Data Through April 30, 2021

	# Companies Reported	Year-Over-Year Growth Rate	
		Sales	Earnings
Consumer Discretionary	31 / 62	17%	170%
Financials	55 / 65	31%	130%
Materials	13 / 28	11%	55%
Communications	12 / 22	12%	48%
S&P 500	303 / 500	12%	46%
Technology	37 / 75	21%	43%
Health Care	37 / 62	10%	23%
Energy	12 / 23	-3%	8%
Consumer Staples	21 / 32	3%	7%
Real Estate	20 / 29	0%	3%
Utilities	9 / 28	7%	3%
Industrials	56 / 74	1%	-2%

Source: Strategas

S&P 500 Earnings Surprise Vs Estimates



Source: Strategas

continuation of the trend since the pandemic started (2Q20 +23%, 3Q20 +20%, 4Q20 +16%).

What is also surprising is how investors have been reacting to these impressive “beats.”

For some time now, many investors have been looking back to the early part of 2020 as the trough for the earnings cycle. Going back to the middle of 2020, investors saw these “easy comparisons” as a reason for potentially significant earnings growth in the first half of 2021. As such, investors bid up the shares of companies that were hit worst by the lockdown in anticipation of strong earnings growth. Once this earnings growth became a reality, investors booked their gains.

Thus, “buy the rumor and sell the news.”

Investors are more worried about the future trend than what’s happened in the recent past. As the pace of the pandemic has slowed and the economy has re-opened, many investors began looking back at early 2020 as the worst part of the earnings cycle while also positioning themselves for broad-based earnings growth ahead. This anticipation of brighter days ahead has been the driving force behind the broader rotation from “growth” stocks to “value” stocks.

As we’ve mentioned before, the market’s performance in late 2019 / early 2020 was driven by just a few stocks that could reliably deliver robust earnings growth. Starting in July of 2020, investors realized that trough earnings were in the rearview mirror and earnings growth would be easier to come by as the calendar progressed. Therefore, investors began buying up shares of more cyclical “value” stocks in anticipation of future earnings growth. This rotation from “growth” to “value” was particularly strong through March, only to pause during April as investors “sold the news.” Going forward, we would expect this rotation will continue on its previous path.

One reason for this belief is that inflationary pressures, which typically benefit more cyclical “value” stocks, are becoming stronger. In fact, rising inflation has been one of the major themes in management comments during this earnings season. Whether it be because of raw material shortages or bottlenecked supply chains, companies across a

large swath of Corporate America have begun to report rising price pressures. The quick lockdown-related economic stoppage, followed by a relatively quick restart, has caught some businesses flatfooted. Executives from diverse companies like Apple, consumer products giant Procter & Gamble and mattress seller Tempur Sealy have all commented about how rising prices and supply-chain issues could hamper growth in the near term. Tight labor markets in some areas of the economy are also contributing to rising prices.

For its part, the Federal Reserve seems unfazed. Just this week, John Williams, President of the Federal Reserve Bank of New York, had the following comments about inflation and the current environment:

“The economy is now positioned to grow quickly... with accommodative financial conditions, strong fiscal support, and widespread vaccinations, I expect that the rate of economic growth this year will be the fastest that we’ve experienced since the early 1980’s... We are still far from our goals of maximum employment and price stability... let me emphasize that the data and conditions we are seeing now are not nearly enough for the FOMC to shift its monetary policy stance.”

Rising inflation and robust growth are two pillars of the “reflation reset” theme we laid out several months ago. With equities trading at fairly rich valuations, earnings growth will be the primary driver of stocks going forward. To us, this means that cyclical “value” stocks should lead the market higher from here, but there could be some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients’ exposure to larger, more developed international markets. We’ve also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative

market segments, we recently increased our exposure to “real assets” (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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