On the Mark – Multi Asset Strategy

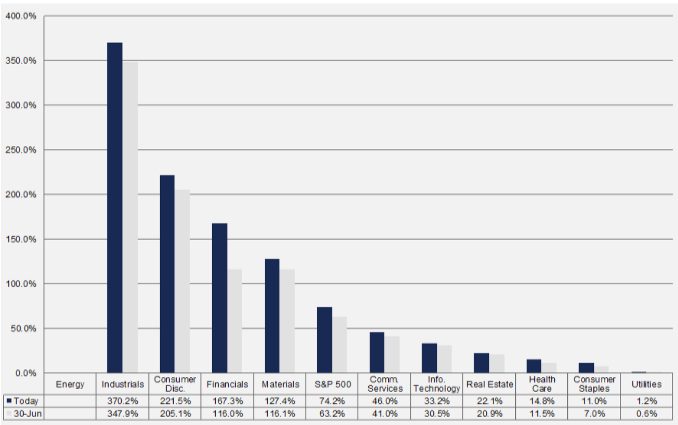
Mark Harris – Head of Multi Asset

August 2021 – Earnings Galore!

Given the pandemic and the massive fiscal and monetary responses around the world as a backdrop, perhaps we should not be surprised that this is a most unusual earnings cycle, as amply illustrated in the US. Ned Davis Research (NDR) point out that "This year, earnings have not followed the typical script. Consensus estimates for FY21 S&P 500 operating EPS have risen by a record 14% since the end of 2020 to $187.60. 87% of companies beat consensus in Q1, also a record".

We are now in the midst of the second quarter US earnings season and several observations can be made. Results continue to beat forecasts by a wide margin, and estimates for the third, fourth quarter '21, and even for 2022 are rising. Earnings have powered ahead, led by industrials at this stage (Figure 1). FactSet state that "overall, 24% of the companies in the S&P 500 have reported actual results for Q2 2021 to date (23rd July). Of these companies, 88% have reported actual EPS above estimates, which is above the five-year average of 75%. If 88% is the final percentage for the quarter, it will mark the highest percentage of S&P 500 companies reporting a positive EPS surprise since FactSet began tracking this metric in 2008."

Figure 1: S&P 500 Earnings Growth: Q2 2021.

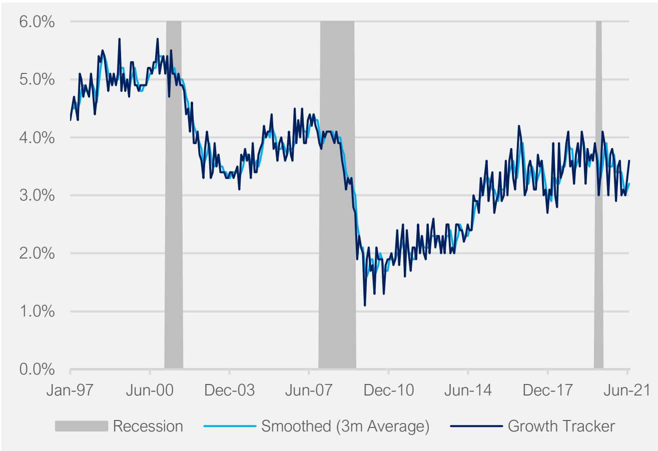


Source: Garraway, FactSet as at 23 July 2021.

So far, the balance of results show that S&P profit margins remain close to record levels at just below 13% for the second quarter. However, as we previously pointed out, many companies are now suffering input price pressures, most notably from substantial commodity price increases. Whilst some companies intend to pass these on to the consumer, some are having to absorb these and suffer margin compression. We previously opined that the more cyclical sectors would face the worst of this pressure, but it is becoming evident that staples are suffering with some 20% of reported earnings coming under expectations this quarter. Many of these companies have been highly rated, due to their earnings resilience but some of their stock prices are now coming under pressure because of their worsening profit outlook.

We also pointed to the threat of higher wages compounding the issues for companies, and at a wider level the inflationary trend for the economy. Whilst there appear to be pockets of wage uplift it has yet to translate into widespread wage growth, as shown below (Figure 2). However, the ending of furlough schemes around September in the US will mark out a significant period when we may witness such pressures if they are to happen.

Figure 1: Atlanta Fed Wage Growth Tracker.

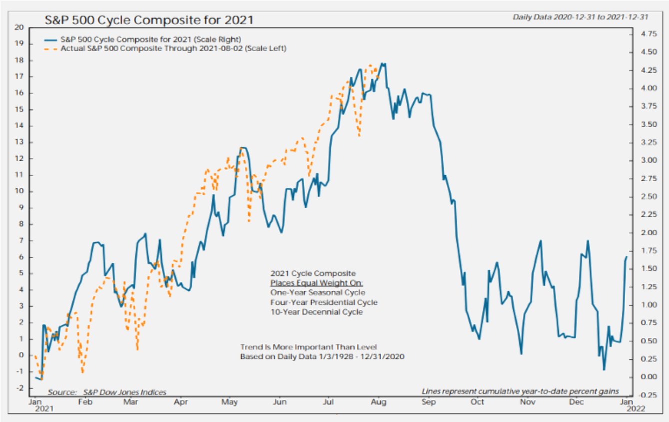


Source: Garraway, Atlanta Fed as at June 2021.

Whilst this is all very positive, we must remain aware that markets are discounting mechanisms, and a lot of this good news is 'priced in'. As NDR state "Previous peaks in earnings growth have not been digested well by the market. S&P 500 performance has been weaker than average for up to three quarters after peaks in EPS growth. Peak growth may be more of a 2022 issue than a 2021 issue, but signs that growth is slowing sooner than expected could be a headwind for stocks, especially since by the time high earnings growth numbers are reported, much of the good news has been priced in.

Equally, several strategists are concerned that the high valuation of the market (more than 20 times 2022 earnings estimates), combined with typical August to October seasonal weakness, may be the greatest near-term risk to the market. A map of what may be if that is the case is shown below (Figure 3) with the NDR Cycle Composite for the S&P 500.

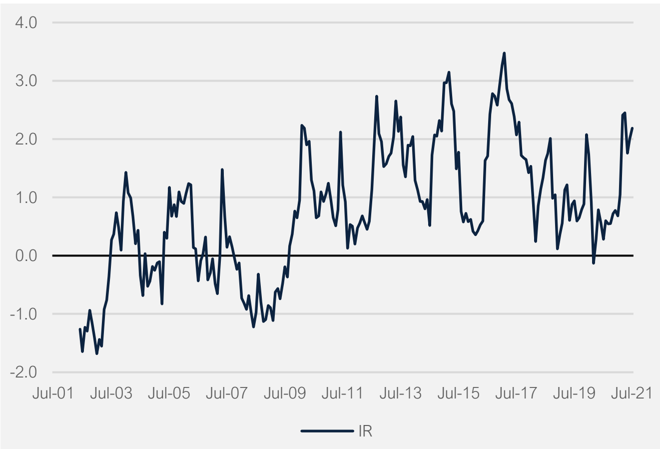
Figure 3: NDR Cycle Composite for the S&P 500 for 2021.



Source: Garraway, NDR.

Whilst we should not take too much from the Ned Davis Research Composite, it does feel that the equity market has pushed a little too far ahead, optimism is very high and market breadth is deteriorating. We can see from the chart below (Figure 4) that the information ratio of the S&P500 is elevated and close to previous peaks. Whilst a deterioration in this ratio does not necessarily equate to negative returns, it does mean that the risk reward ratio is relatively unfavourable. Consequently, in our eyes a small correction of 5-8% would be a healthy move at this stage before we start the next move up.

Figure 4: Information Ratio for S&P 500 vs Cash.



Source: Garraway, Bloomberg L.P.

We still maintain that inflationary concerns will abate by the end of the year and that this will be very positive for growth style equities. We are positioned accordingly.

The Multi Asset Team.

Important Information

This document is for general information purposes only and does not take into account the specific investment objectives, financial situation or particular needs of any particular person. It is not a personal recommendation and it should not be regarded as a solicitation or an offer to buy or sell any securities or instruments mentioned in it. This document represents the views Garraway Capital Management LLP at the time of writing. It should not be construed as investment advice. Full details of VT Garraway Multi Asset Balanced Fund, VT Garraway Multi Asset Growth Fund (the 'Funds'), including risk warnings, are published in the Key Investor Information documents, Prospectus and Supplementary Information documents, all available from http://www.valu-trac.com/administration-services/clients/garraway/multi-asset. The Funds are subject to normal stock market fluctuations and other risks inherent in such investments. The value of your investment and the income derived from it can go down as well as up, and you may not get back the money you invested. Investments in overseas markets may be affected by changes in exchange rates, which could cause the value of your investment to increase or diminish.

There is no guarantee of future performance and past performance is not a reliable indicator of future performance. Every effort is taken to ensure the accuracy of the data used in this document, but no warranties are given. All sources: Garraway Capital Management LLP unless otherwise stated.

This marketing material has been approved in the UK by Garraway Capital Management LLP, which is a limited liability partnership incorporated and registered in England and Wales under partnership number OC303626 with its registered office at 200 Aldersgate Street, London EC1A 4HD. Garraway Capital Management LLP is authorised and regulated by the Financial Conduct Authority. Distribution of this material and the offer of the Fund are specifically restricted in certain jurisdictions. In particular, but without limitation, neither this material nor shares in the Fund are available to US persons.