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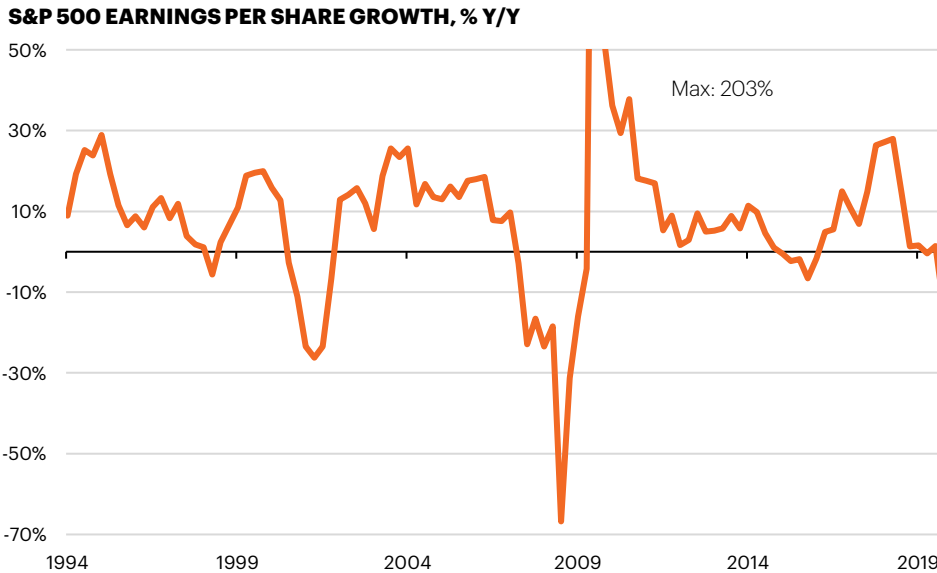
Q1 earnings: Back to the future

The first earnings season in the age of COVID-19 is wrapping up, and company reports gave a glimpse into how the pandemic is impacting corporate America. First quarter earnings per share for S&P 500 firms fell -14% year over year, the worst quarter since the global financial crisis. Additionally, a record number of companies withdrew earnings guidance, reinforcing the sense that investors are flying blind. We put Q1 earnings into context and analyze why equities have bounced sharply even as economic data continues to collapse.¹

Top of mind for many investors has been solid S&P 500 performance in the face of an unprecedented economic downturn. Equities rallied off their March 23 bottom at the same time that iconic American companies were reporting their worst results in more than a decade. Aside from a few warnings from major tech companies, markets largely took the earnings season in stride.

KEY TAKEAWAYS

- Q1 S&P 500 earnings declined -14% y/y, making it the worst quarter since the GFC. Q2 is expected to be even worse.
- Many companies withdrew earnings guidance for the rest of the year, leaving investors in the dark.
- Markets have not yet priced in a large decline in future years' earnings as they had by the peak of the GFC. This opens stocks up to further potential volatility.



Source: Bloomberg Finance, L.P., as of May 14, 2020.

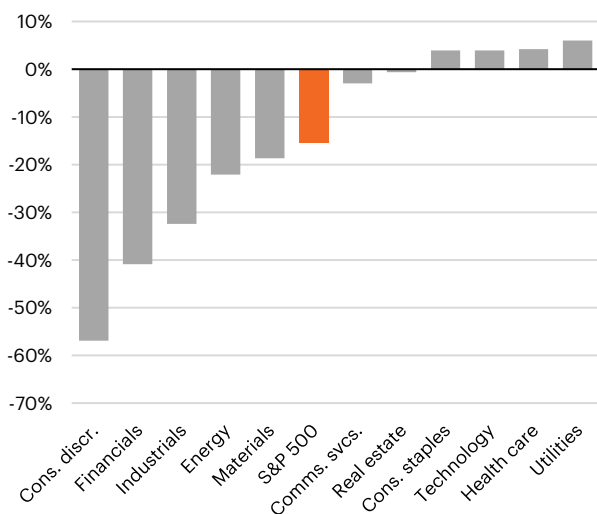
¹ Bloomberg Finance, L.P., as of May 15, 2020.

The guidance dance

It may now seem like ancient history, but earnings began 2020 on tepid footing as rising labor costs ate into margins just as global growth was challenging the revenue outlook.

Beginning in March, the coronavirus pandemic of course completely shifted the narrative. States began issuing stay-at-home orders, in effect shutting down large portions of their economies. The unique nature of this crisis has had a disproportionate impact on certain industries. The technology sector, buoyed by stay-at-home darlings like Amazon and Netflix, has become the ultimate defensive sector. Meanwhile, the consumer discretionary, financials and energy sectors have each been rocked by their specific challenges: shuttered stores, ultralow interest rates and plunging oil prices, respectively.

S&P 500 SECTOR EPS, % Y/Y



Source: Bloomberg Finance, L.P., as of May 14, 2020.

While earnings season was closely watched by market participants trying to glean insight into the winners and losers of the current circumstances, it didn't fundamentally alter the behavior of equities. Markets are relentlessly forward looking, and companies have never been as unsure of their own future prospects as they are right now.

In fact, companies are so unsure that a record 137 of the S&P 500 constituents—or nearly 30% of the index—withdraw earnings guidance for 2020.² To be fair, forward guidance has always been a bit of a dubious practice. Companies tend to set targets at a level they feel they can just barely beat, and some see

² FS Investments, Bloomberg Finance, L.P., as of May 13, 2020.

the targets as incentivizing short-term earnings management.

Still, the act of removing guidance for the entire year speaks volumes about the current environment. Companies and the analysts who cover them have essentially thrown up their hands and said, "We have no idea." Even more astonishing, markets—which are theoretically disinclined to reward uncertainty—did not punish firms for this lack of guidance. Firms pulling guidance underperformed the broader index by only 0.3%, on average, in the succeeding trading session, versus a 2.1% drop for an earnings miss.²

AVERAGE NEXT-SESSION PRICE CHANGE

Relative to S&P 500 Index performance



Source: FS Investments, Bloomberg Finance, L.P., as of May 14, 2020.

Back to the future

Markets are living in what feels like an alternate dimension, where future earnings for multiple years down the road appear more certain (or at least less volatile) than earnings this year. We believe this recession, which has been caused by a deliberate economic shutdown imposed to combat a health crisis, has been treated differently by markets because it is different. After plunging into the quickest bear market in history, the stock market has rallied to recover more than half of that drawdown.¹ Data would imply that there are two main reasons equity markets have rebounded the way they have.

First, while expectations for earnings this year have fallen precipitously, earnings expectations for two years down the road (2022) have not declined nearly as much. This stands in contrast to what happened during the GFC. In 2008, at the height of the crisis,

expectations for current-year earnings fell by 28% throughout the year. In 2020, we've seen something similar—EPS expectations for this year have fallen by 27% since January. However, when we look at future earnings expectations, a gap appears. In 2008, expectations for earnings two years ahead (2010) declined by 26% throughout the year. So far in 2020, expectations for 2022 EPS have only fallen by around 13%.¹

CHANGES IN EARNINGS EXPECTATIONS, PEAK TO TROUGH

GFC and COVID crises



Source: FS Investments, Bloomberg Finance, L.P., as of May 14, 2020.

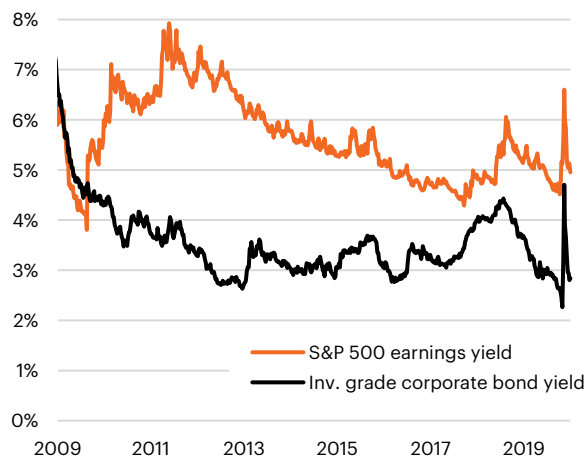
There is an argument that this crisis unfolded so rapidly that expectations haven't had time to catch up. Two months in, however, there appears to be an air of "temporaryness" within markets that didn't exist in 2008. Optimism around reopening is likely a contributing factor, along with a belief that massive fiscal and monetary intervention will be able to carry the economy to the other side.

Second, there are powerful valuation dynamics at play that make investors willing to pay more for future earnings than they were a decade ago. The 10-year Treasury yield currently sits close to 0.65%, compared to more than 4.00% at the beginning of 2008. This has caused a decline in firms' cost of capital, which is used to discount future earnings. In a basic equity valuation model, discounting future earnings at lower rates increases the present value of those future cash flows, reducing the relative importance of current-year earnings.¹

In a similar vein, such low interest rates have caused equity risk to appear more attractive on a relative basis. Investors have been left with the choice of either a certain stream of paltry yield by investing in safe bonds, or an investment in equities that offers a

potential for earnings upside. Earnings yield, the inverse of the P/E ratio, still looks relatively attractive compared to corporate bonds.

EARNINGS YIELD VS. BOND YIELD



Source: Bloomberg Finance, L.P., ICE BofAML U.S. Corporate Index, as of May 14, 2020.

No doubt a significant factor is the power of the mega-cap tech companies, which have led the market rebound. The FANG+ stocks, which now comprise a whopping 24% of the S&P 500 market cap, seem to be viewed as almost invincible. The gravitational pull of the expectation that large, healthy companies will continue to deliver impressive earnings growth when this crisis is over continues to determine market movements.¹

Earnings still matter

The tone of earnings calls highlighted uncertainty more than market pricing would imply. Many companies talked in their earnings calls about heightened COVID-19-related costs dealing with worker safety, cleaning and investments in new technology. The economic recovery from such a devastating labor market downturn is far from certain. And once we finally do get to some sort of "post-COVID-19" world, there will be massive unknowns waiting. A fresh round of U.S.-China tensions could cause further uncertainty around supply chains to erupt.

It is true that what has driven stock markets during this expansion has continued to drive markets today. As the mega-cap tech companies go, so goes the market. A massive injection of liquidity from the Fed has also helped push interest rates down and drive investors into equities.

RESEARCH NOTE MAY 2020

However, fundamentals still matter. Markets have so far priced in a massive hit to 2020 earnings—consensus estimates project a -42% y/y decline in Q2.¹ We believe the biggest question on investors' minds is not whether earnings fall -40% or -50% in Q2, but whether or not this crisis will continue to hamper earnings in the coming years.

The impetus for markets to experience further volatility is unlikely to be poor economic data in the near term, but rather a realization that this crisis will have more lasting negative impacts. These risks include not only uncertainty related to the path of the pandemic and an economic recovery, but also uncertainty around how the world will look post-crisis.

We see potential for major economic, geopolitical and domestic political change. Trade tensions with China could reappear, heightened over disagreements around how the pandemic was handled. There could be further calls to break up "Big Tech," who it appears may come out of this crisis as an even more dominant force than before. Each of these risks could lead to significant volatility in future earnings expectations and, by extension, equity prices—earnings do still matter, after all.

Lara Rhame

Managing Director, Chief U.S. Economist

Lara is Chief U.S. Economist and Managing Director on the Investment Research team at FS Investments, where she analyzes developments in the global and U.S. economy and financial markets. Her fresh take on macroeconomic issues helps to inform and develop the firm's long-term views on the economy, investment trends and issues facing investors. Lara is committed to the Philadelphia community and serves on the boards of the Economy League of Greater Philadelphia, Hyperion Bank and Starr Garden Park.

Andrew Korz

Associate

Andrew is an associate on the Investment Research team at FS Investments, where he leads research efforts on the energy sector and the U.S. commercial real estate market. He also assists in the development of the firm's long-term views on the economy and the impacts on the investing environment. Andrew holds a BBA in Finance and Economics from Villanova University and has prior experience with structuring and pricing interest rate derivatives.

INVESTMENT RESEARCH

Robert Hoffman, CFA

Managing Director

Lara Rhame

Chief U.S. Economist

Managing Director

Andrew Korz

Associate

Kara O'Halloran, CFA

Associate

Contact

research@fsinvestments.com

Unless otherwise stated, all references to high yield bonds refer to ICE BofAML U.S. High Yield Master Index. References to equities refer to the S&P 500 and references to senior secured loans refer to the S&P/LSTA Leveraged Loan Index.

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