SKYView: Earnings Surprise

Large cap equities are halfway through Q3'20 earnings season, and thus far most have reported upside earnings surprise despite negative growth on an absolute basis. Historically, earnings growth relative to expectations – rather than absolute growth – has been the stronger driver of total returns, and we expect this to remain the case going forward. Further clouding this analysis, however, is the onset of additional coronavirus cases, which threaten to shut down major portions of the economy if left unchecked. In this *Weekly Briefing*, we seek to identify sectors that are both poised to benefit from upside earnings surprise *and* remain relatively well insulated from a potential re-opening reversal.

Despite a focus on below-investment-grade issuers, our analyst team actively monitors earnings trends among larger corporates that reside outside of our target market. These entities, typically found within the S&P 500 Index, provide valuable insights into macro supply and demand trends given superior reach across global markets. Additionally, S&P 500 constituents often report quarterly results earlier than the balance of high yield issuers, offering an early preview of things to come in the leveraged credit universe given positively correlated earnings trends between the two markets over time. As demonstrated below, half of the S&P 500 has released Q3'20 results thus far, and on average those corporations have reported earnings 15% above consensus expectations. Trends vary by sector (Consumer Discretionary +92% to Utilities -49%), but in aggregate the earnings surprise magnitude is trending well above typical surprise levels in the prior two years.

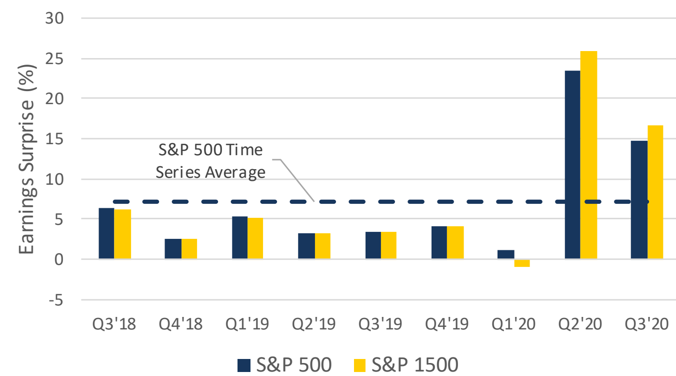
Earnings Continue to Surprise to the Upside in Q3'20

based on companies that have reported through the time of writing

Sector	S&P 500	% Reported	S&P 1500	% Reported
Energy	69%	40%	132%	30%
Materials	21%	36%	22%	35%
Industrials	55%	63%	55%	49%
Consumer Discretionary	92%	37%	88%	33%
Consumer Staples	11%	38%	12%	29%
Healthcare	13%	43%	14%	29%
Financials	23%	72%	25%	70%
Technology	10%	46%	11%	36%
Comm. Svcs / Telecom	2%	23%	3%	21%
Utilities	-49%	18%	-49%	12%
Real Estate	-5%	39%	-3%	31%
Index	15%	46%	17%	40%

Magnitude of Earnings Surprises Remain Elevated

quarterly data

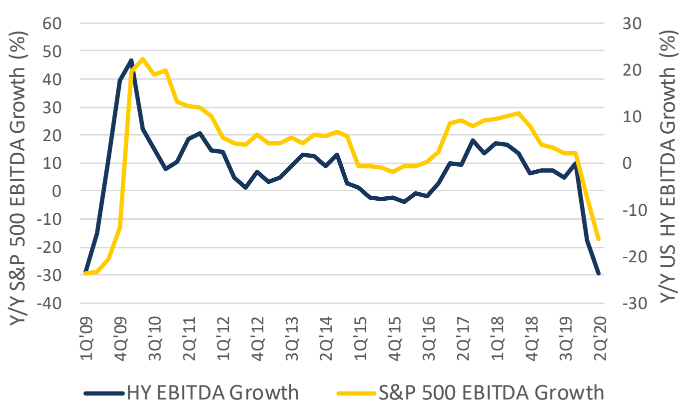


Source: SKY Harbor, Bloomberg

S&P 500 trends are valuable because of the strong read-through provided for high yield issuers, particularly since the latter often report weeks – if not months – later than the former each earnings season. As demonstrated below, quarterly S&P 500 EBITDA growth has been highly correlated to EBITDA growth in the US High Yield market over the last 10+ years, the two tracking closely in both up and down markets. Also of importance, S&P 500 sector-based earnings surprises are highly correlated to subsequent period US high yield sector total returns, as demonstrated in the scatterplot below. While only one period is presented (Q2'20 S&P 500 surprise vs. Q3'20 US HY total returns), the relationship is similarly linked on an historical basis.

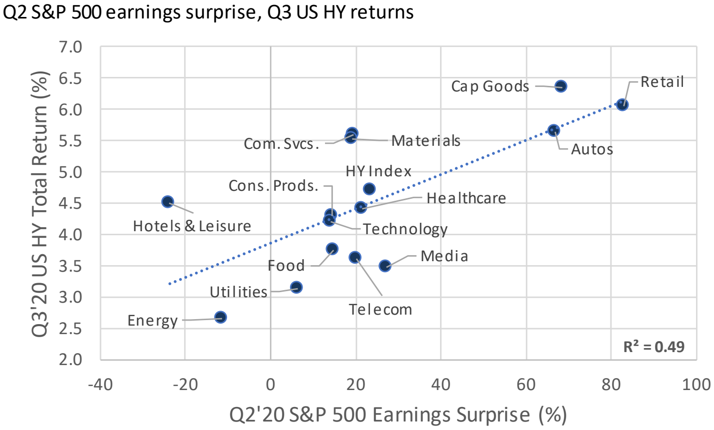
Y/Y EBITDA Growth: S&P 500 vs. US High Yield

quarterly data, since 2009



S&P 500 Earnings Surprise vs. US HY Total Returns

Q2 S&P 500 earnings surprise, Q3 US HY returns

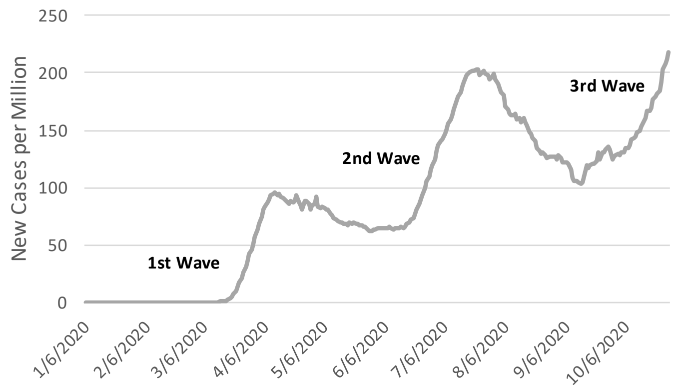


Note: "US High Yield" Y/Y EBITDA growth is based on a subset of companies with publicly available financials contained within the ICE BofA US High Yield Index (H0A0)
Source: SKY Harbor, Bloomberg, BofA Merrill Lynch, Capital IQ, ICE Data Indices

The recent uptick in new COVID-19 cases represents a risk factor separate from the Q3 earnings season. According to a 7-day rolling average of new confirmed cases per million, the US has entered a third wave of the virus which, among other things, threatens to de-rail the already tenuous path to a re-opening. Comparing the market selloff associated with the first wave (1 month ended March 23) to the selloff thus far in the third wave (1 week ended October 28), sector performance appears orderly, albeit with some deviation from expectations (Leisure and Media have underperformed more significantly than the initial wave would have implied, while Autos, Energy and Basics have outperformed).

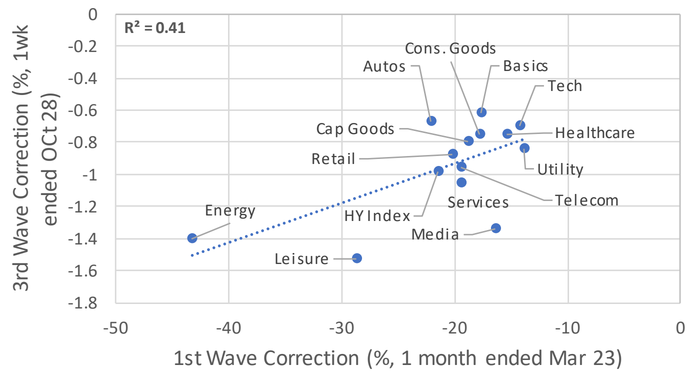
US New Cases Per Million People (Smoothed)

7-day rolling average



Sector Performance: 1st Wave vs. 3rd Wave

1 month ended March 23 (1st wave); 1 week ended Oct 28 (start of 3rd wave)

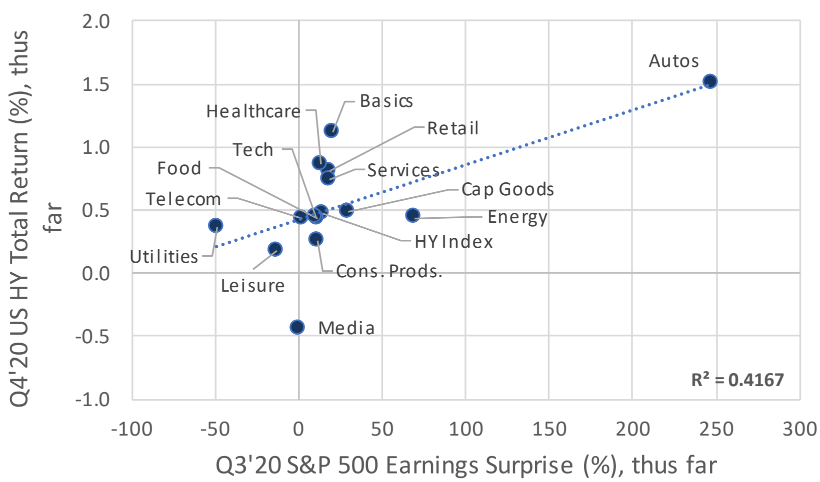


Source: SKY Harbor, ourworldindata.org, ICE Data Indices

We find a reasonably strong correlation between Q3'20 S&P 500 earnings surprise data (the 46% of constituents that have reported at the time of writing) and QTD US high yield sector-based total returns, but the relationship is a bit weaker than in prior periods. In our view, this partial breakdown is being driven by virus-related concerns, and therefore necessitates consideration for the first wave market reaction. In the grid below, we segment sectors into those that fared better and those that fared worse than the index amidst the first COVID-19 selloff, and by those that have generated earnings surprise metrics that are better or worse than the S&P 500 as a whole thus far in Q3'20. Sectors that score favorably across both metrics – and, as such, are assumed to have the strongest earnings tailwinds and weakest virus headwinds – are in the upper right box (Capital Goods, Basic Industry, Retail, and Services), while those that trail in both metrics are in the lower left (Leisure).

S&P 500 Earnings Surprise vs. US HY Total Returns

Q2 S&P 500 Earnings Surprise, Q3 US HY returns



Earnings Surprise & COVID Selloff Matrix

Sector-Level Data

1st Wave Selloff vs. Index	Q3'20 Earnings Surprise (thus far) vs. Index: Worse	Q3'20 Earnings Surprise (thus far) vs. Index: Better
Better	Healthcare Cons. Goods Tech Telecom Media Utilities	Cap Goods Basics Retail Services
Worse	Leisure	Autos Energy

Source: SKY Harbor, ICE Data Indices

In conclusion, we expect Q3'20 S&P 500 earnings to be dominated by upside surprises, which provides a positive read-through for US high yield issuer earnings to come. At the same time, we remain cognizant of risks posed by a third wave of the coronavirus, and refer to the market correction in late March '20 to inform sector-based risks. Through the combination of these factors, we believe Capital Goods, Basic Industry, Retail, and Services are likely to contain some of the best positioned credits in the current market environment (via a combination of greater than index earnings surprise and lesser than index first wave selloff), and are taking a cautious approach when it comes to security selection within the Leisure space (weaker than index earnings surprise and greater than index first wave selloff).

Important Disclosures and Disclaimers

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