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An earnings season better than expected but the valuation issue has not yet been resolved...

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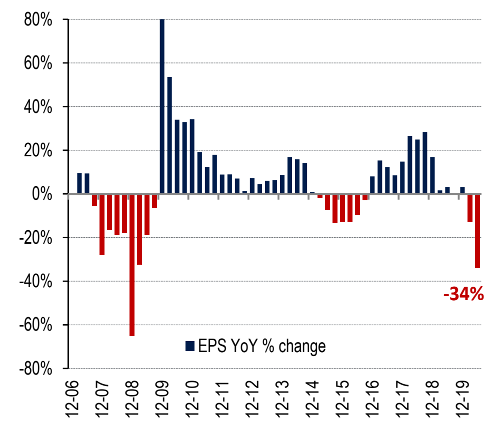
There was a substantial decline in Q2 earnings but they turned out to be better than expected; their decline being ultimately less pronounced than during the Great Financial Crisis (GFC) of 2008-2009, whereas the current recession is much more severe. This surprising resilience is due in large part to sector aspects. Financial stocks have generally proved more resilient than during the GFC. Furthermore, the Healthcare and Technology sectors have emerged remarkably unscathed. The other side of the coin is that, without these last two sectors, the decline in earnings would have been much more pronounced. Given the revisions made and the achievements in H1, barring a new general lockdown episode, most of the consensus adjustment seems to be behind us. However, the valuation debate - excessive or not - is still far from being resolved. The duration of the crisis will be the key parameter in responding to this question.

An unprecedented decline since the Great Financial Crisis

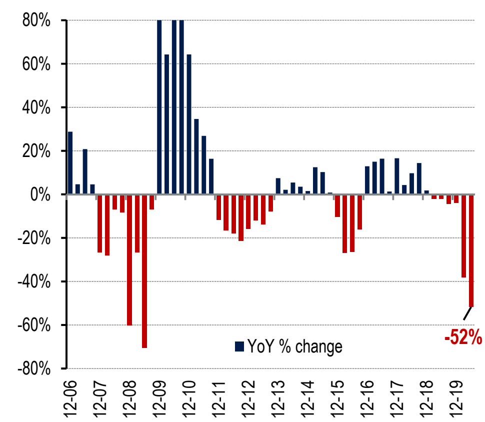
The publications for Q2 2020 literally collapsed, with a much more pronounced decline in revenues (-10% for the S&P 500 and -20% for the Stoxx 600) and earnings (-34% and -52%) than in Q1 and unprecedented since the Great Financial Crisis of 2008-2009, with the subprime crisis and the bankruptcy of Lehmann Brothers. Given the much longer duration of the lockdown than in Q1 – six weeks on average vs. two weeks - this further deterioration in earnings compared with the first three months of the year is not surprising.

1/ **S&P 500 Quarterly results**



Source: IBES, Amundi Research, August 11 2020

2/ **Stoxx 600 Quarterly results**



Source: IBES, Amundi Research, August 11 2020

The fall could have been worse...

Better than expected earnings following a combination of sector effects

Although substantially lower, these earnings were nevertheless much **better than expected** both in the United States (-34% vs. -44%, or +10 points) and Europe (-52% vs. -66%, or +14 points). Given the extent of the downgrades since 1 April (-30% in Europe, -22% in the United States), this "pleasant surprise" nevertheless needs to be **put into perspective**.

However, the real **"pleasant surprise"** stems from the fact that **the current decline is ultimately less pronounced than during the GFC,** whereas the current recession is much more severe than at that time. Accordingly, in Q2 2020, US GDP contracted by -9.5% year-on-year vs. -3.9% at the height of the GFC (Q2 2009). Similarly in the eurozone - the EU average not yet being known - GDP declined by -12.1% vs. -3.1% at its peak in Q1 2009 (and -5.5% for the EU).

This "good relative resilience" can be attributed primarily to a **combination of sector effects**. Firstly, unlike the GFC, **Financials are no longer at the centre of the crisis** this time. Moreover, **the Healthcare and Technology sectors have emerged remarkably unscathed** during the pandemic.

In the case of the **Financial sector**, its earnings plummeted (-54% in the United States and -43% in Europe in Q2) but there is no comparison with the extent of the losses incurred during the subprime

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Financials proved more resilient than in 2008-2009

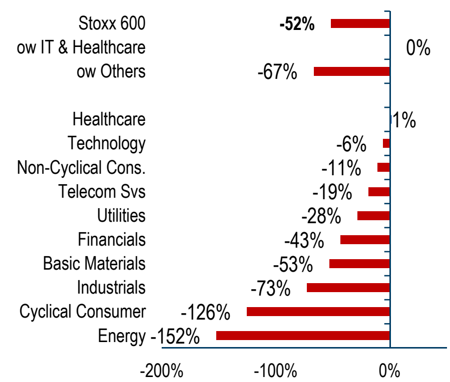
crisis. Accordingly, in Q2 20, Financials only accounted for 30% of the decline in the earnings of the S&P 500 and 29% of those of the Stoxx 600. This remains significant but there is no possible comparison with 2008, where Financials alone caused 84% of the decline in the earnings of the S&P 500 and more than 100% of those of the Stoxx 600 (106%). Finally, not only have Financials proved more resilient, but their relative weighting is also much less than at the time of the GFC. Accordingly, at 30 June 2020, the sector accounted for only 15% of the capitalisation of the Stoxx 600 vs. 24% eleven years previously Similarly, Financials' share of the S&P 500 has declined by a quarter, from 13.5% to 10.1%.

Conversely, the weighting of the **Technology** sector has increased substantially over the same period, from 18% to 27% for the S&P 500 and from 3% to 8% for the Stoxx 600. Moreover, the forced lockdown and the enthusiasm for home-working have been a tremendous accelerator for this sector, from upstream (semi-conductors) to downstream (end-users). Consequently, both revenues (+13% for the Stoxx, +4% for the S&P) and earnings in the sector in Q2 (-6% for the Stoxx, +2% for the S&P) stand out significantly from the general trend (Revenues: Stoxx -20%, S&P -10%, Earnings: Stoxx -52%, S&P -34%).

Given the nature of the crisis, **Healthcare** is the other major sector that has managed to emerge unscathed. Accordingly, on both sides of the Atlantic, the Healthcare sector has proved to be very resilient with earnings rising by +1.4% in Europe and +5.5% in the United States. In Europe, it is even the only sector to have seen an increase in its earnings in Q2 2020. However, the resilience of the Healthcare and Technology sectors conceals **a deteriorated situation in large areas of the market**. The average declines of the S&P 500 (-34%) and Stoxx 600 (-52%) therefore need to be put into perspective since, without these two sectors, the average falls by 15% to 20% (see charts 3 &4).

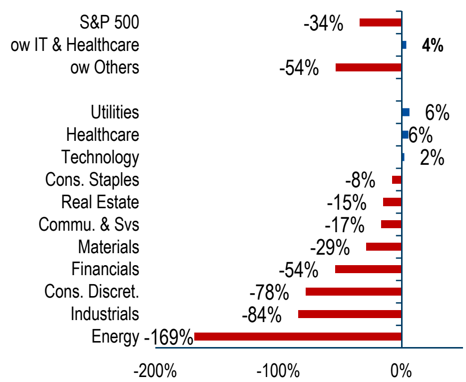
In addition to the generally highlighted macroeconomic aspects, **these sector aspects also largely explain the differences in earnings between the United States and Europe**. The S&P 500 benefits from much greater **exposure to the Technology** sector than the Stoxx 600 (27% of its weighting vs. 8%). Conversely, the weighting of the **Energy, Capital Goods, Luxury and Automotive** sectors, which have borne the full brunt of the crisis, is generally twice as high in Europe (20% vs. 9%).

3/ Stoxx 600: Q2 20 Earnings, (% chge YoY)



Source: IBES, August 11 2020, Amundi Research

4/ S&P 500 Q2 20 Earnings (% chge YoY)



Source: IBES, August 11 2020, Amundi Research

Energy, Consumer Discretionary and Industrials have been particularly hit

The same sectors in the front line on both sides of the Atlantic.

On both sides of the Atlantic, three sectors have been particularly affected: Energy, Consumer Discretionary and Industrials. We will return in more detail to the case of the first two which we consider to be very revealing.

In the case of the **Energy** sector, the Majors have not only been hit by plummeting crude oil prices and the decline in demand due to Covid-19 but they have also had to book massive provisions to take account of a sustainably lower price for a barrel of oil.

Accordingly, BP anticipating "the potential for weaker demand for energy for a sustained period … (or even)…an energy transition that could accelerate under post-Covid-19 stimulus plans" wrote down its assets by USD 17.5 billion in Q2, representing the equivalent of 20% of its balance sheet. ENI (USD 3.0bn), Total (USD 8.1bn) and Shell (USD 16.8bn) having basically done the same, the **European Majors** have booked no less than USD 45 billion of provisions in their accounts in a single quarter, representing (on average) the equivalent of 73% of their total EBIT for the whole of last year! Admittedly, these asset write-downs do not generate

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any cash outflow but, by reducing equity, they automatically increase debt ratios. In turn, this casts a shadow over the outlook for dividends, whereas this was one of the sector's main attractions. In the **United States,** while Exxon Mobil and Chevron both plunged into the red in Q2 (-USD 1.1bn and -USD 8.3bn respectively), it is mainly the situation of the shale oil or gas producers that is worrying. According to a study by Deloitte on 22 June[1], the sector may need to provision the equivalent of 50% of its net assets if low prices were to persist…

The **Consumer Discretionary** sector - which has also gone into the red in Europe and is among the largest declines in the United States - covers different **sub-sectors** with widely varying characteristics such as Luxury, Consumer Electronics, Automotive and Consumer Services. While the **Luxury** sector is usually a fast-growing sector and relatively immune to the cycle, this time it has been heavily impacted by the collapse of international tourism and the virtual disappearance of offshore purchases. Accordingly, after -15% in Q1, the total revenues of LVMH, Hermès and Kering plummeted by 39% in Q2, or -27% over the whole of H1. Similarly, their H1 earnings plummeted on average by -75%, which - even if these groups do not publish quarterly earnings - points to a loss in Q2, which would be unprecedented for this sector. More accustomed to crises, the **Automotive** sector was unsurprisingly also hard hit, with revenues down by -9% in Q1 and -38% in Q2, or -26% over the whole of H1. With sector margins very sensitive to volumes, this resulted in the collapse of the total Ebit (-61%) and net income (-88%) of BMW, Daimler, Fiat Chrysler and BMW from Q1 (Michelin, Peugeot and Renault not publishing quarterly financial statements). Given the further deterioration in activity in Q2, the decline in earnings for the whole of H1 was even sharper, with -108% for EBIT and -171% for net income. Finally, the prize goes to **Consumer Services** which covers in particular Hotels & Restaurants and Air Transport, two sectors affected first and foremost by the lockdown and the travel bans. Accordingly, Air Transport's total revenues fell by 87%(!) in Q2 2020, with peaks up to 99.6% for Easy Jet. Consequently, all the companies in the sector, including the most profitable hitherto such as Ryanair, have plunged into the red. Similarly, in the hotel sector, the two European companies in the global top 10 experienced a massive decline in their RevPar (revenue per available room) in Q2, with -75% for InterContinental and -88% for Accor.

Even Luxury was under pressure this time around

In the **United States**, Consumer Discretionary earnings also plummeted (-78%) albeit to a lesser extent than in Europe (-126%). However, here again, the differences can be attributed to a large extent to sector weightings. Thus, in Europe, the Automotive (22%), Luxury (46%) and Hotel-Leisure (11%) sectors together account for nearly 80% of Consumer Discretionary but only 26% in the United States. The remainder, corresponding to Retail (74%), and in particular to Internet Sales and direct marketing; a sub-category dominated by **Amazon**, which alone accounts for 43% of Consumer Discretionary and 4.8% of the S&P 500! Amazon having been much in demand during the lockdown, its Q2 earnings soared, with revenues (+40%), and net income (+100%) well above the consensus. Note, however, that without Amazon, Consumer Discretionary earnings would have plummeted by 98%, instead of 78%, thus approaching the 126% recorded in Europe.

The consensus has now largely adjusted ...

With nearly 5 billion of the planet's inhabitants simultaneously in lockdown at the beginning of May, the circumstances of **Q2 2020** were quite exceptional and this is therefore expected to durably mark the **low point** of the next publications.

However, the environment over the next eighteen months remains very uncertain. Between the unknown health factors (developments in the easing of the lockdown, second wave or not, discovery and availability of a vaccine, etc.), economic factors (developments in household and corporate confidence, etc.) and geopolitical factors (US elections, taxation, protectionism, etc.), economic analysts are balancing between all kinds of symbols to characterise the future recovery: V, W, U, L, square-root or even inverted-comma shaped recovery. In these circumstances, it is clearly difficult to give an opinion on the growth of future earnings.

However, barring a new general lockdown episode, most of the consensus adjustment seems to be behind us. Therefore, over the months, EPS revisions have reduced (see chart 5) and analysts' net-up has recovered (see chart 6). The net-up corresponds to the net balance of upward EPS revisions in total revisions. This indicator, which varies from -100% (all revisions are negative) to +100% (all revisions are positive), is more sensitive than EPS revisions as such. Consequently, it is used in addition to the latter in order to better anticipate trend changes. In the chart 6, we clearly see that after reaching a low point at -81% in mid-April, the net-up has now returned to neutral territory.

[1] *https://www2.deloitte.com/us/en/pages/about-deloitte/articles/press-releases/the-great-compression-implications-of-covid-19-for-the-us-shale-industry.html*

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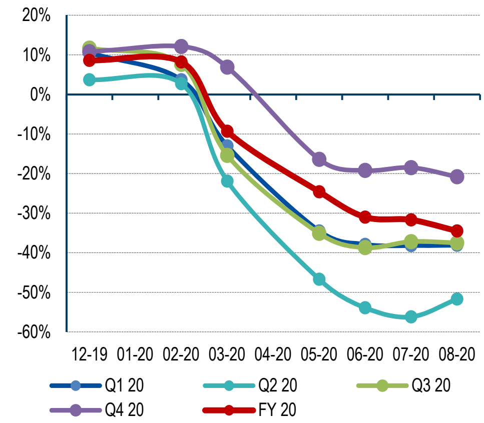
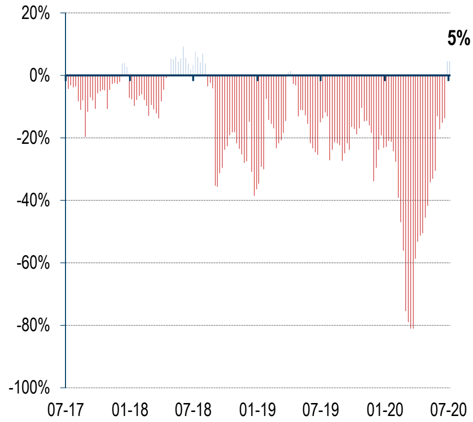
5/ Stoxx 600 Earnings estimates over time



Source: IBES, Refinitiv as August 11 2020

6/ Europe Earnings Revision momentum



Source: Datastream, Amundi Research, Aug 11 2020

The **Stoxx 600's bottom-up consensus** is currently expecting a **decline in EPS of -35% in 2020**, followed by a rebound of **+38% in 2021**. In other words, 2021 EPS is expected to be 10% lower than the EPS of the 2019 pre-Covid departure point. In our case, **we remain slightly more cautious regarding 2020** (-45%) due to the divergences in Q4 to which we will return. **However, we converge with regard to level for 2021**, where we forecast EPS down by 12.5% vs. 2019. (vs. -10% for the Consensus).

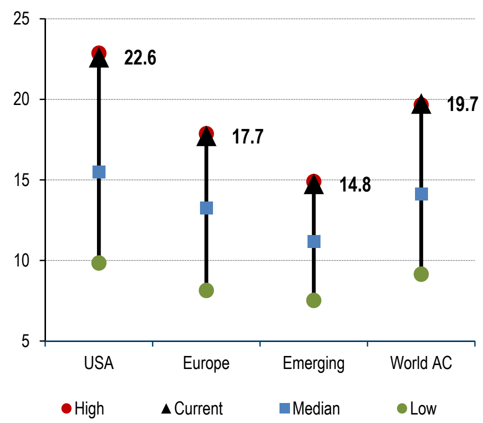
In the case firstly of **Q3** earnings, after the decline in Q2, they should see a sequential rise but continue to significantly decline year-on-year. In this respect, we share the view of the Consensus (-38% according to IBES, -40% according to our estimates). Apart from very defensive sectors such as Utilities, Healthcare and Telecoms, or Technology which is currently on a roll, the other sectors which together represent more than 70% of total revenues in Q2 2020, will be far from returning to their level of last year. However, we diverge significantly from the Consensus for **Q4**, with the Consensus expecting a decline of 21% vs. 50% for us.

In reality, the difference is less spectacular than it seems and is more of an accounting than an economic difference. Firstly, like the majority of observers, we assume that there will not be a second general lockdown and that the pandemic will be gradually controlled. Consequently, it seems logical to conclude like the consensus that the decline in earnings in Q4 should diminish (-21% in Q4, after -38% in Q3 and -52% in Q2). However, we believe it necessary to include significant **exceptional items** to this relative improvement in **operational performance**. Given visibility that is likely to remain very limited at the end of the year, we would not actually be surprised if companies made further asset write-downs (goodwill, deferred tax assets, brands, reserves, etc.) or restructuring provisions. Finally, half of the 50% fall in Q4 earnings that we anticipate, would correspond to current items and for the other half to exceptional items.

... but the valuation debate has not yet been resolved...

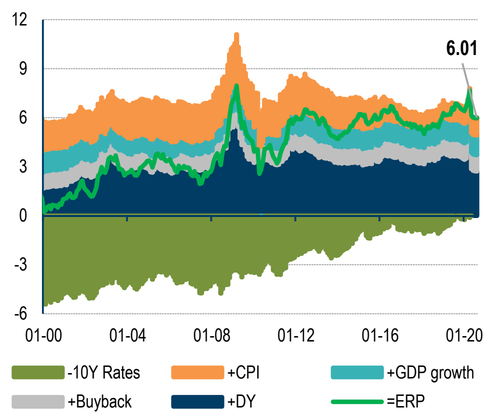
Whatever the precise trend in EPS in 2020 and 2021, given the extent of the earnings

7/ 12M Fwd PE from 2008 to 2020 (Aug 13)



Source: Datastream, Amundi Research

8/ European Equity Risk Premium (Aug 13)



Source: Datastream, Amundi Research

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downgrades over the last six months and the rebound in the markets since mid-March, valuation multiples have increased significantly. Accordingly, whether it is the 12M forward PE (chart 7) or the CVI[2], these indicators are at the highest or virtually highest level for twelve years, or even twenty years in the United States. However, the equity risk premium (chart 8) sends a completely different signal due to the nosedive in long term interest rates which makes it attractive. What should we therefore conclude? The response is not clear and the duration of the crisis will be crucial for deciding between these two views. If the crisis is intense but relatively short, investors, reassured by the monetary and fiscal support measures, should be able to wait. In other words, given the few alternatives (TINA), they would continue to overlook the poor earnings and rely on the conclusions of the risk premium. However, if the normalisation of the economy were to be disappointing next year or even worse durably called into question, then the market would have no alternative but to consolidate. Therefore, the next few months will be crucial. Q4 in particular will need to be closely monitored. However, for the moment the message of Q2 earnings is rather that of the glass half full.

Finalised on 14 August 2020

[2] *The CVI is an indicator combining Trailing PE, Fwd PE, Price to Book, Dividend Yield and Price Cash Flow*

Emerging markets Q2 earnings

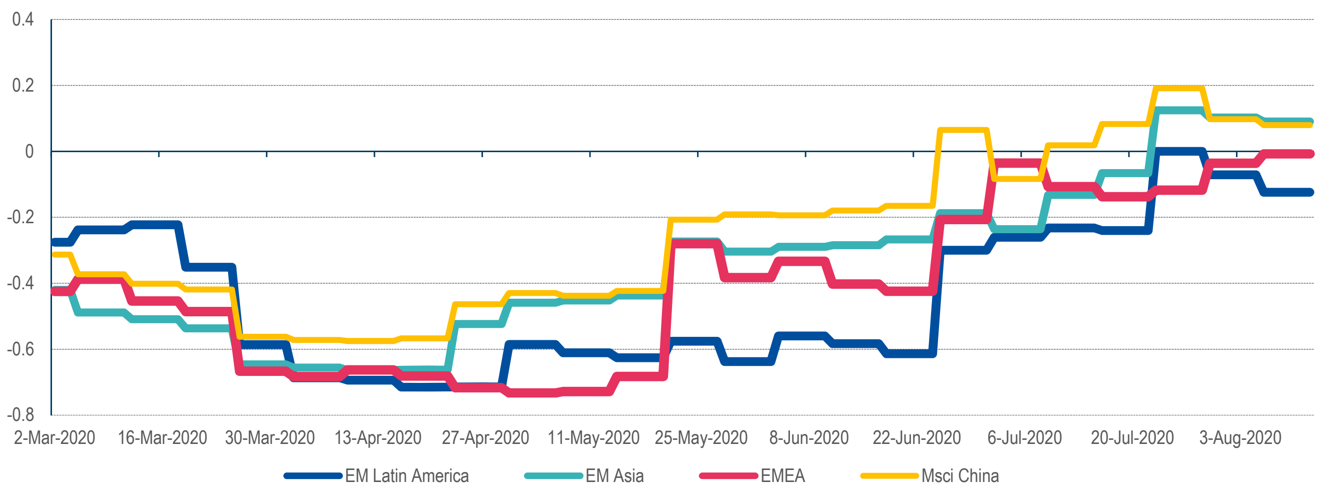
DEBORA DELBO', *Global EM Senior Strategist*

In the ongoing reporting season, Q2 2020 net YoY income growth is negative (at -6.6%) in local currency. Percentage YoY growth is negative almost everywhere, with the exception of few countries like Poland, Taiwan, Greece, China and Malaysia. Some 59% of total MSCI EM stocks put out positive surprises. Overall, the average percentage of surprises among all companies is positive and close to 20%. At the country level, negative average percentage surprises were in Russia, the Philippines, Malaysia and, marginally, Indonesia.

FY2020 earnings revisions continue to bottom out everywhere. MSCI China and EM Asia earnings revisions are now back into positive territory. In EMEA, they are close to zero. They are still negative (though improving) in Latam.

Trailing MSCI EM EPS growth decreased slightly to -19% (from -18% in July). Twelve-month forward expectations (Source: IBES) increased from +10% to +13% and are still high in China (+12%), Korea (+33%), South Africa (+29%), Turkey (+23%) and Taiwan (+12%). Expectations increased last month in Brazil (+18% from +2%) and Mexico (from +10% to +16%), as well. Our internal 12-month MSCI EM EPS forecasts (in USD) are still negative, though improving, at -6.9% YoY on weak world trade and Emerging exports dynamics in 2020, with a recovery expected to begin in 2021. Our oil price outlook is very close to the current level in 2020 and slightly higher in 2021.

FY2020 Earnings Revisions (IBES)



Source : IBES, Amundi Research

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