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Earnings Season: Surprise Me

Equity markets rebounded this week as concerns about the state of the global recovery faded somewhat, and bargain hunters stepped in to do some buying. The S&P 500 rallied 4.9% by noon Friday, led by a rebound in the depressed banking sector, while all other sectors posted gains. Despite the bounce, the S&P 500 remains about 3% below its 50-day moving average, which has now broken well below the 200-day trend. Sentiment is one thing that has turned in favour of the bulls (the contrarian bulls that is). This week's Investors' Intelligence Survey reported that just 37% of advisors are bullish, versus 56% at the end of April when stocks ran out of steam. The bull-bear ratio is now just 1.06, the lowest level since July-09, which so happened to be the start of strong rally. The TSX added a more modest 2.7% on the week as gold stocks were a drag, down almost 2%. Still, the gold sector has helped buffer the correction in Canadian stock, rallying almost 6% in the past three months and helping to limit the TSX's decline to 5.6%—the S&P 500 has shed more than 10% over the same period.

EarningsWatch… The Q2 earnings season officially gets underway next week, and the consensus view is for 27% y/y growth in S&P 500 profits, down from 58% y/y in Q1. Materials (+94%), energy (+71%) and technology (+57%) are expected to lead, while telecom and utilities are the only sectors expected to see earnings below year-ago levels. Profitability will be one key to watch this season given that expanding margins have been a major driver of the earnings recovery. For example, the 27% y/y growth in S&P 500 profits is expected to be helped by only 9% y/y growth in revenues (i.e., cost cuts are doing most of the work), and the profit share of GDP has rebounded to the highest level since the heady days of mid-2007. The problem now for stocks, as is often the case at this stage in the cycle, is that the pace of margin expansion and resulting earnings growth will inevitably slow.

Another key to watch this season will be how earnings fare relative to expectations. The last three quarters have been absolute blowouts with respect to earnings surprises, as about 80% of S&P 500 companies have topped the consensus call (the historical norm is just 66%). But the market can only be fooled for so long, and 2010 earnings expectations have indeed been ratcheted up—the 34% y/y consensus growth rate for the S&P 500 is up from expectations of an 8.6% decline at the start of the year. So, it won't be surprising if the rate of earnings surprises seen in the past three quarters marks the high watermark of this cycle.

The bottom line is that the bull market has matured. A slowdown in the rate of earnings growth combined with higher expectations means less frequent upside earnings surprises and, in turn, a less bountiful equity market.

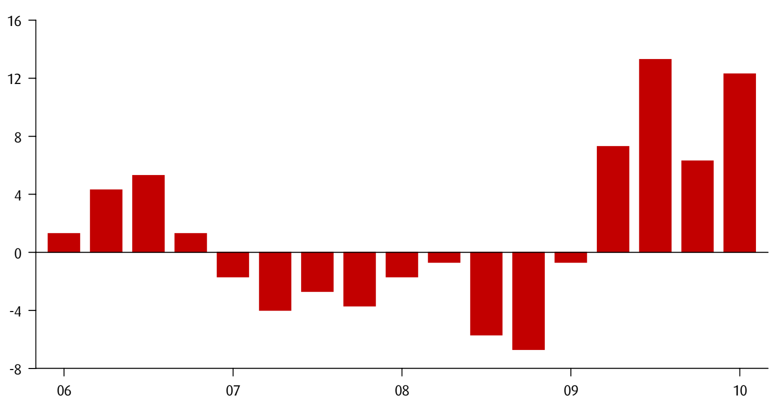
Market Performance as of July 9, 2010

	Current Price	Performance (percent)					
		1 Week	1 Month	3 Months	1 Year	YTD	2009
CAC 40	3,554	**6.2**	3.1	-12.2	17.5	-9.7	22.3
FTSE 100	5,133	**6.1**	0.9	-11.1	23.4	-5.2	22.1
S&P 500	1,072	**4.9**	1.6	-10.2	21.5	-3.8	23.5
Dow Jones	10,145	**4.8**	2.5	-7.7	24.0	-2.7	18.8
NASDAQ	2,181	**4.3**	1.1	-11.1	24.5	-3.9	43.9
NIKKEI 225	9,585	**4.1**	1.5	-14.4	3.2	-9.1	19.0
DAX	6,065	**4.0**	1.3	-3.0	31.0	1.8	23.8
S&P/ASX 200	4,415	**3.5**	0.3	-11.2	17.4	-9.6	33.4
S&P/TSX	11,498	**2.7**	0.4	-5.6	17.7	-2.1	30.7

Source: Bloomberg (as of 12:30 pm)

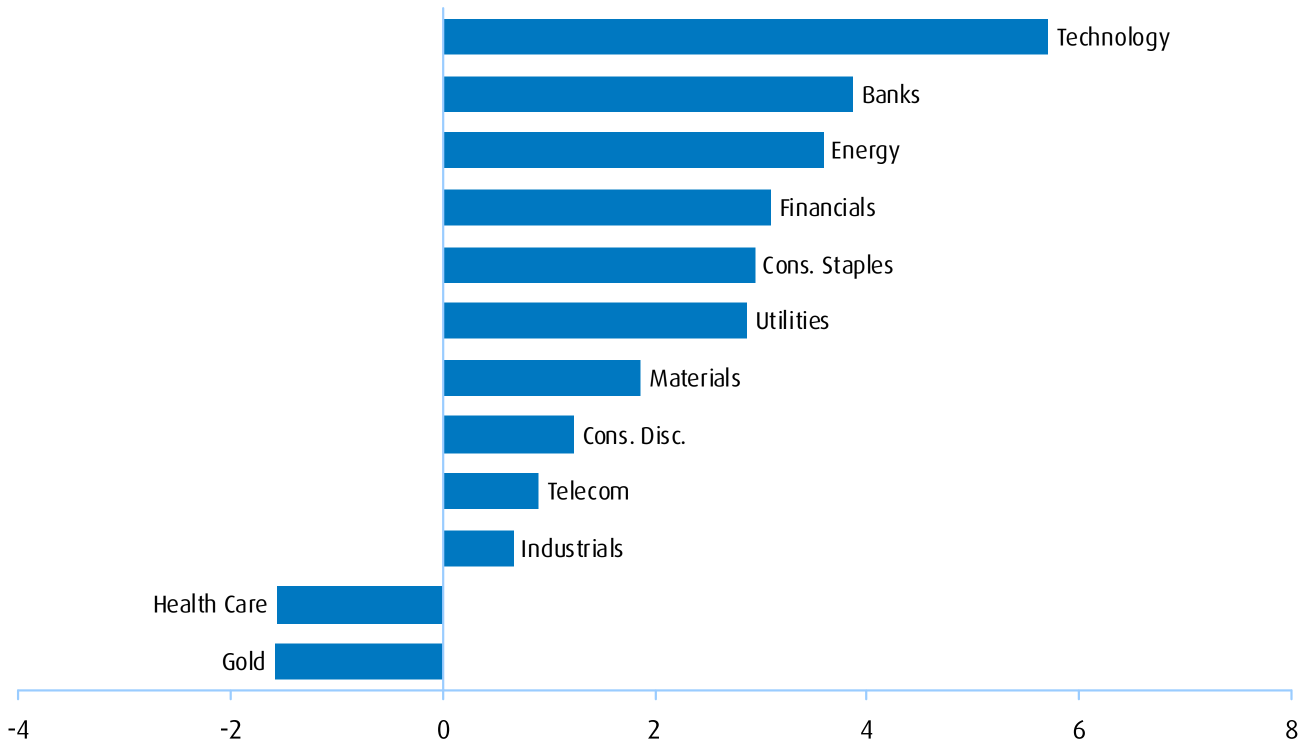
Have Earnings Surprises Peaked?

S&P 500: % of companies beating expectations versus historical norm

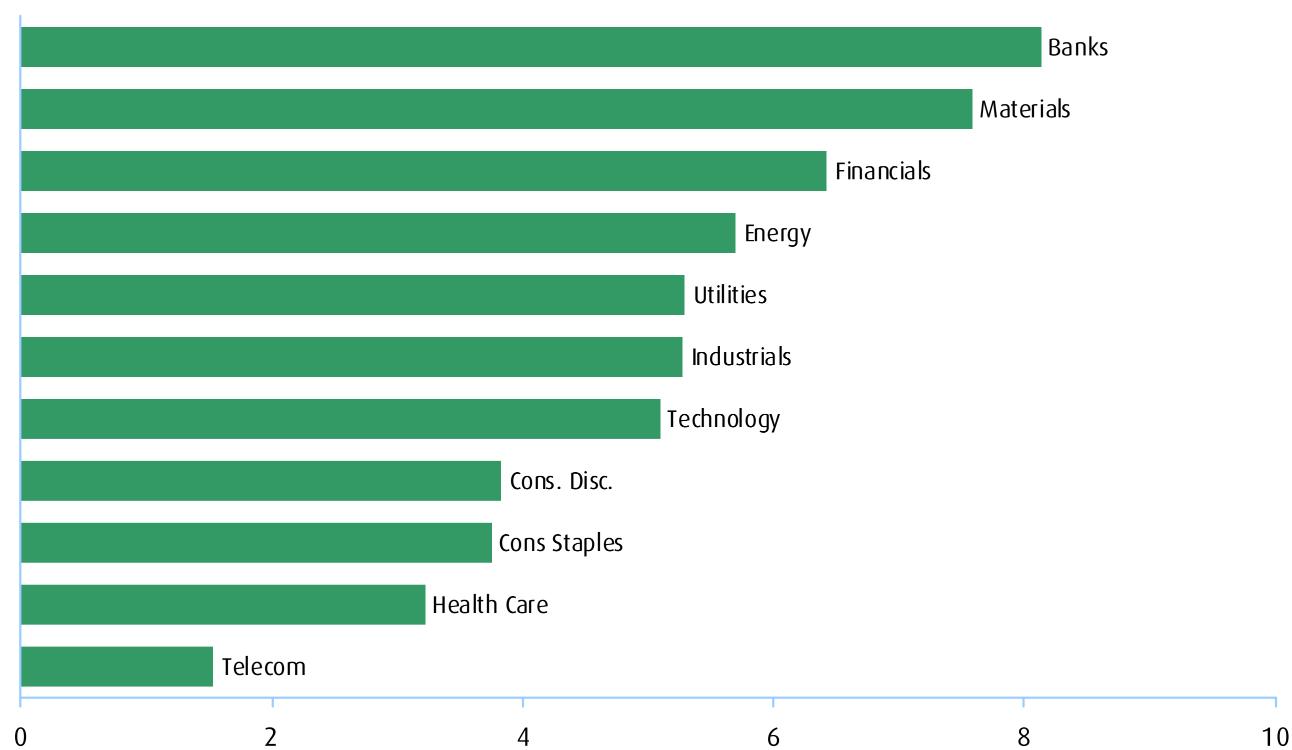


Weekly Sector Performances as of July 9, 2010

TSX (percent)

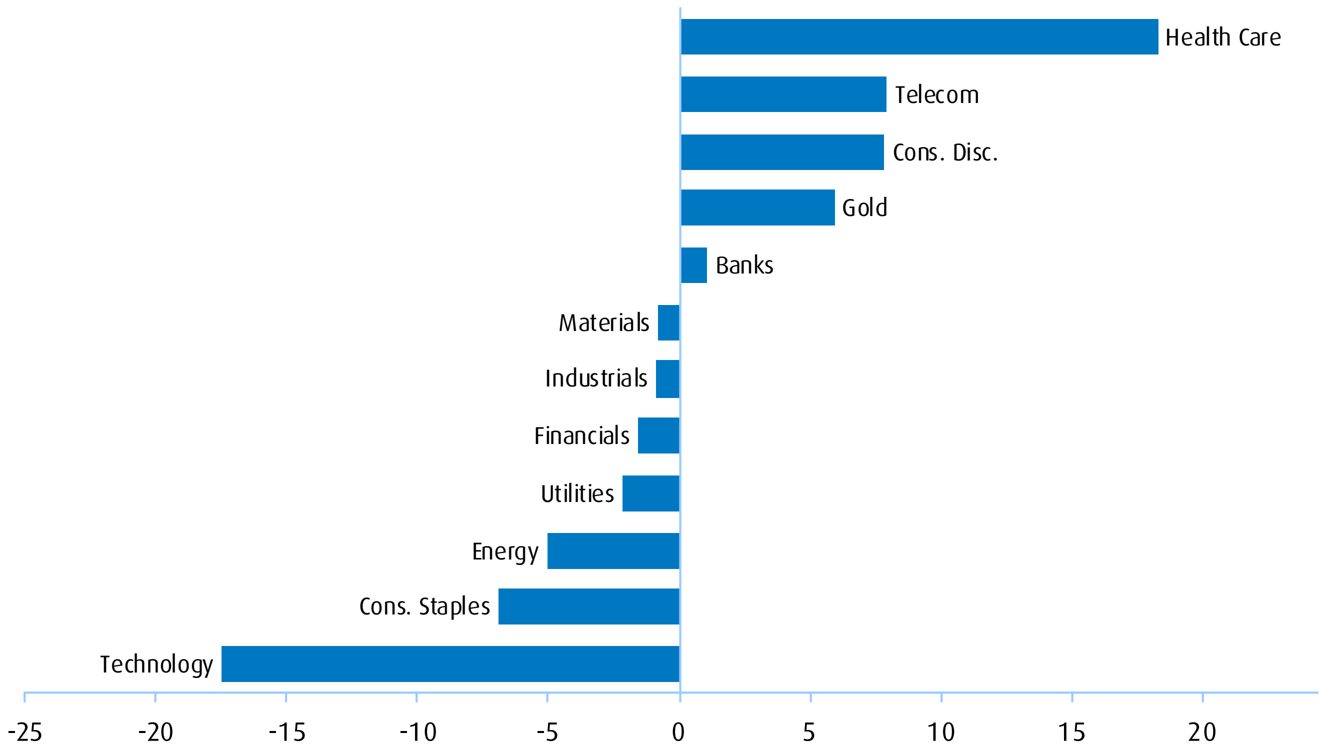


S&P 500 (percent)

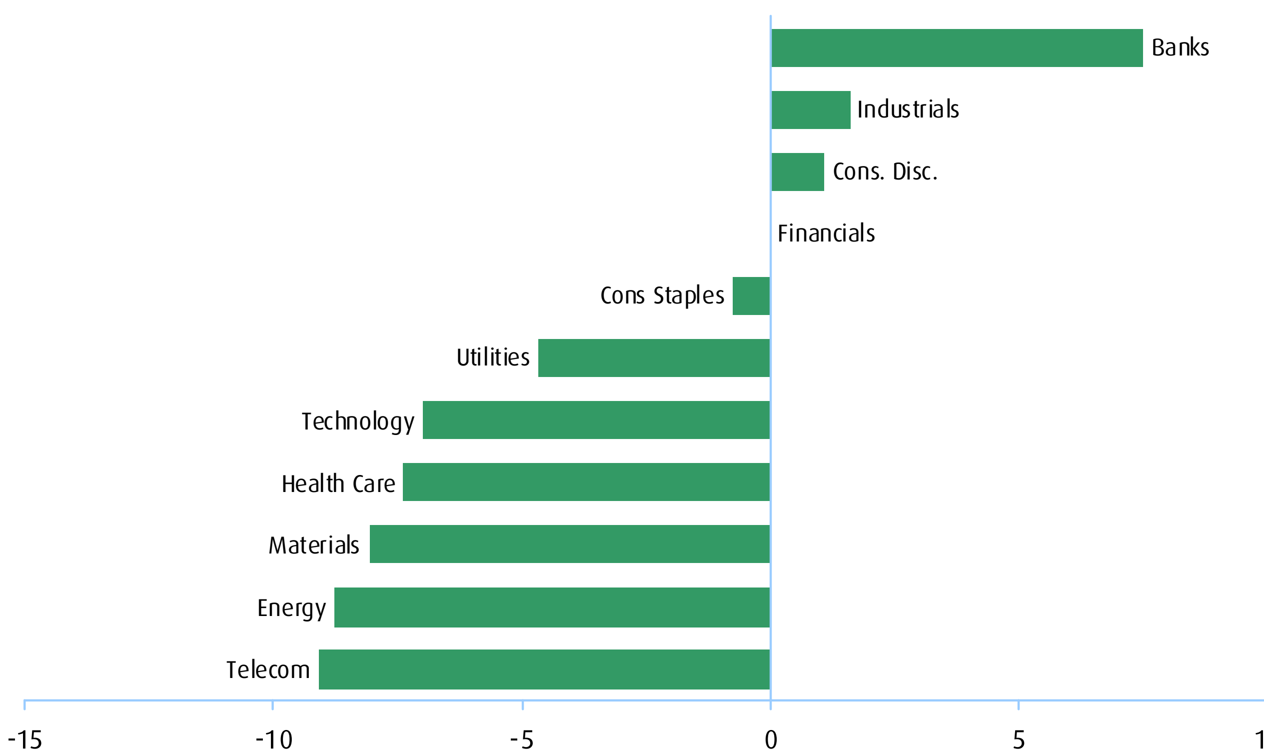


Year-to-Date Sector Performances as of July 9, 2010

TSX (percent)



S&P 500 (percent)



North American Sector Performances as of July 9, 2010

S&P 500 Sectors	1 Week	1 Month	3 Months	1 Year	YTD	2009
Banks	**8.1**	1.3	-13.8	31.9	7.5	-8.9
Materials	**7.6**	3.9	-12.9	25.3	-8.1	45.2
Financials	**6.4**	2.9	-13.0	28.1	0.0	14.8
Energy	**5.7**	1.8	-12.4	11.5	-8.8	11.3
Utilities	**5.3**	5.0	-1.8	9.6	-4.7	6.8
Industrials	**5.3**	1.8	-11.1	36.8	1.6	17.3
Information Technology	**5.1**	1.6	-10.2	24.7	-7.0	59.9
Cons Discretionary	**3.8**	-3.1	-11.2	36.4	1.1	38.8
Cons Staples	**3.7**	1.1	-5.7	14.1	-0.8	11.2
Health Care	**3.2**	2.5	-9.8	11.8	-7.4	17.1
Telecom Services	**1.5**	0.7	-4.3	6.4	-9.1	2.6
S&P 100 Large Cap	**4.8**	1.6	-10.9	17.4	-5.5	19.1
S&P 400 Mid Cap	**4.6**	1.1	-9.8	34.1	1.1	35.0
S&P 600 Small Cap	**3.7**	1.0	-10.1	31.0	0.7	23.8
S&P 500	**4.9**	**1.6**	**-10.2**	**21.5**	**-3.8**	**23.5**

TSX Sectors						
Information Technology	**5.7**	-6.8	-17.7	-18.5	-17.5	44.3
Banks	**3.9**	1.5	-5.5	22.5	1.1	54.4
Energy	**3.6**	1.1	-5.7	16.8	-5.0	35.0
Financials	**3.1**	0.8	-7.4	17.6	-1.6	38.3
Cons Staples	**2.9**	-0.1	-3.4	1.6	-6.9	6.1
Utilities	**2.9**	2.6	-3.0	16.7	-2.1	12.7
Materials	**1.9**	-0.7	-5.1	23.1	-0.8	33.4
Cons Discretionary	**1.2**	0.8	1.7	24.8	7.8	11.1
Telecom Services	**0.9**	-0.4	3.9	24.0	7.9	0.7
Industrials	**0.7**	1.9	-5.2	28.5	-0.9	23.7
Health Care	**-1.6**	14.6	8.1	36.4	18.3	28.6
Gold	**-1.6**	-2.7	5.8	20.5	5.9	5.7
Income Trusts	**2.0**	2.5	-3.2	29.4	1.9	29.5
REITs	**1.1**	4.4	3.2	37.5	4.4	42.4
S&P/TSX 60 Large Cap	**2.9**	0.4	-5.5	13.9	-2.7	27.9
S&P/TSX Mid Cap	**2.2**	0.6	-5.8	33.3	-0.1	41.7
S&P/TSX Small Cap	**2.2**	0.3	-7.0	42.5	-0.6	56.2
TSX	**2.7**	**0.4**	**-5.6**	**17.7**	**-2.1**	**30.7**

Source: Bloomberg (as of 12:30 pm)