

Wentz Weekly

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Third Quarter Earnings Preview



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Third quarter earnings season is set to kick off this week with big banks and several industrials the first to report. Much of the focus this quarter will center around supply chain issues, labor shortages, the accompanying inflationary pressures and its impact on profits. Profits on the S&P 500 are expected to have grown 27.3% from a year prior in the third quarter, and 21.2% from the same quarter 2019. Markets are forward looking so the most notable stock reaction will likely come as a result of management forecasts for the current quarter and into 2022. One positive heading into the third quarter earnings is more companies are providing upside earnings guidance for a record fifth consecutive quarter. According to FactSet, 103 S&P 500 companies have provided Q3 guidance with 56 issuing positive guidance, a number above the historical average (and follows Q2 where a record 67 companies issued positive guidance).

Now the negative – among companies that have already reported results so far, 71% of them are citing negative impacts from supply chain issues. The results include comments about higher labor costs and shortages, transportation and freight costs, raw material and commodity costs, and oil and gas prices. A common trend we have observed lately is businesses are having troubles finding labor, impacting hours of operations or services provided which will directly impact sales. Per the Department of Labor's employment report last Friday, job gains slowed in September and there are still 2 million more people unemployed compared to pre-pandemic levels. Worse is more people have left the labor force, whether it be childcare issues, Covid concerns, or other issues, as there is 3.1 million less people in the labor force compared to pre-pandemic levels while a record 11 million jobs remain open compared to 7 million pre-pandemic. If there is something to slow the stock market gains we have made, we believe it will be the aforementioned issues. However, these issues are more supply related and despite these issues consumer demand remains very strong and we still favor the U.S. equity markets, particularly small caps and cyclicals.

A headline disappointment on the September jobs report may not have been all that bad if July and August revisions are included, along with excluding the difficult to seasonally adjust education sector. The Department of Labor said 194,000 jobs gains were seen in September, well below the expected range of 300k-600k. A positive out of the report was an upward revision to the July and August job gains resulting in an additional 169k jobs. In addition, much of the miss for September was due to a 161k decrease in government jobs, mainly education. If you add back July and August revisions plus exclude the decline in government jobs, that amounts to another 524k jobs. Most of the job gains occurred in sectors that lost the most jobs in March and April 2020, including leisure/hospitality, retail, professional services, and transportation and warehousing, which are also important sectors for the reopening of the economy. A weak part of the report, beside government jobs, was an additional 183k individuals left the labor force, bringing the labor force participation rate to 61.6%. The labor force has 3.1 million less people than it did prior to the pandemic. Above average wage growth continued in September, with a 0.6% increase in the average wage in the month, with the average wage 4.6% higher than a year ago, compared to the 3.0% wage growth trend prior to the pandemic. Historically and theoretically, higher wages lead to higher inflation as employers look to pass the higher costs on to consumers through higher prices.

WTI Crude oil was trading for nothing in March 2020 over demand concerns due to the effects of the pandemic but fast forward about a year and a half and at that time it would be hard to believe the price of oil would be trading over \$80/barrel. Energy is the best performing sector over the last 12 months, with the sector trading 80% higher as it has benefited from efficiency gains made during the low oil price environment along with higher energy prices now, resulting in significant cash flows. Several factors have influenced energy prices recent move higher. Last week OPEC and its allies agreed to gradually increase oil production instead of increasing supply more rapidly despite the growing imbalance between supply and demand. Natural gas prices experienced an even more extreme move higher, especially in Europe and Asia where prices have hit record highs because of transportation issues and increased demand. Shortages are being seen across the world with other commodities as well. India said it only had a couple days of coal reserves left, a German power plant was shut down after running out of coal, and China was reportedly importing coal from Australia despite an import ban on the commodity.

A political headwind with the debt ceiling approaching was avoided last week after Congress came together to find a temporary solution, alleviating concerns for the fixed income and equity markets. Around mid-week, Senate Minority Leader Mitch McConnell offered a new stopgap bill to suspend the debt limit for a short period of time, giving Democrats more time to put together a more permanent solution. Under the agreement, the debt ceiling is waived until December 3, essentially delaying a potential U.S. default and easing near-term pressure on Congress. Now Democrats have the task of coming up with a longer-term solution and include it in its reconciliation package, or continue to find a solution via a standalone bill which Republican hint they will continue to filibuster.

Company News

- Heavy/construction machine company Oshkosh said it has cut its guidance citing significant supply chain and logistic disruptions as well as material and freight cost inflation. It also said it has implemented multiple price increases over the last 6-9 months to combat raw material inflation and freight cost escalation.
- Auto parts maker Aptiv said it is reducing its annual sales guidance by 6% reflecting a 7% decrease in global vehicle production rates compared to when it announced its previous guidance.
- Recently, Merck said results from its Phase 3 trial of its oral antiviral medicine molnupiravir for patients with covid showed the drug reduced the risk of hospitalization or death by 50%. This morning the company said it submitted an Emergency Use Authorization application to the FDA.

The Week Ahead

The calendar picks up this week as multiple economic data reports are released, and third quarter earnings season kicks off with big banks and several industrials reporting which will give the first indication on inflation and supply chain impacts for the second half of 2021. On Monday, the bond markets will be closed in observance of Columbus Day while equity markets will be open for trading. Notable companies reporting results this week include Fastenal on Tuesday, Delta and JPMorgan on Wednesday, Bank of America, Citigroup, Morgan Stanley, Wells Fargo, and Walgreens on Thursday, and Goldman Sachs, PNC, and JB Hunt on Friday. On the economic calendar the first report of the week is the job openings and labor turnover survey which should continue to show a record amount of job openings. The September consumer price index report is due out on Wednesday, where inflationary pressures are expected to remain evident with an expected 5.3% increase in price from a year ago. Then on Thursday an update on weekly unemployment claims will be released along with the producer price index where the current expectation is for a 8.7% increase in prices for producers, up from 8.3% in August. Finally on Friday, data on September retail sales are expected to show no growth from August, along with a measure on business inventories, and results from the consumer sentiment survey. Sentiment is expected to have improved slightly for the first week of October as Covid worries ease. On the Covid front, a panel of FDA advisors will meet at the end of the week to discuss whether it is necessary to recommend Covid booster shots.

The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered representative of the U.S. stock market. The Dow Jones Industrial Average (DJIA), commonly known as "The Dow" is an index representing 30 stock of companies maintained and reviewed by the editors of the Wall Street Journal. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index. The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system. Every investor's situation is unique and you should consider your investment goals, risk tolerance and time horizon before making any investment. Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification. Information contained herein was received from sources believed to be reliable, but accuracy is not guaranteed. Information provided is general in nature and is not a complete statement of all information necessary for making an investment decision and is not a recommendation or a solicitation to buy or sell any security. Investing always involves risk and you may incur a profit or loss. Keep in mind that individuals cannot invest directly in any index. Past performance does not guarantee future results. There is no assurance these trends will continue, or forecasts will occur.