This earnings season will be awful. But there’s a silver lining

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The coming earnings season will contain some disturbing content. Investor discretion is advised.

North American companies start reporting second-quarter profits in bulk this month, and the full weight of the global COVID-19 pandemic will be painfully clear from the results.

For both Canadian and U.S. benchmark indexes, analysts are expecting a 44-per-cent decline in year-over-year earnings, which would make it one of the worst quarters on record, according to data provided by Refinitiv.

If there is a silver lining, it is that this earnings season is almost certain to mark the low point for the corporate sector. After this, the pandemic’s impact on the bottom line should start to wane.

Investors got their first glimpse at the corporate carnage from first-quarter results, which only incorporated the very start of the economic deactivation that swept across the Western world in mid-March.

Still, earnings from stocks in the S&P/TSX Composite Index fell by 22 per cent in the first quarter, while S&P 500 Index companies posted a 12-per-cent drop.

But the quarter that started in April for the bulk of companies encompassed several weeks of lockdown, severe travel restrictions and physical-distancing rules.

For the vast majority of Canadian and U.S. corporations that withstood those pressures, the numbers are expected to be ugly.

Consensus second-quarter earnings forecasts put every S&P 500 sector into a year-over-year decline, with economically sensitive sectors hardest hit. The U.S. energy sector is predicted to post a 155-per-cent drop in earnings. For consumer discretionary stocks, the fall is estimated to be 116 per cent. For industrials: 89 per cent.

Over the past three months, sell-side analysts have scrambled to downgrade their earnings outlooks in an attempt to quantify the pandemic. There is bound to be a large margin of error in those estimates.

“We will see if these estimates have been revised enough,” Craig Basinger, chief investment officer at Richardson GMP, wrote in a report. “Nobody has a clue. Many companies have removed guidance – about 80 per cent – due to the unknowns, and analyst forecasts are all over the map.”

But even if the end result turns out to be worse than expected, there’s no guarantee investors will care all that much. The stock market of late has been remarkably resilient to the pandemic’s economic fallout, including the hit to corporate profits.

“The actual earnings number is kind of irrelevant,” said Christine Poole, chief executive officer and managing director at GlobeInvest Capital Management. “The market is obviously looking through these earnings, given the rebound we’ve seen.”

Since April 1, the S&P 500 index has gained 29 per cent, despite 2020 earnings being downgraded from -4 per cent for the year to -23 per cent over that time. The Canadian stock market pulled off a comparable feat, rising by 22 per cent in the second quarter even as this year’s profit estimate dropped from -4 per cent to -28 per cent.

“It’s difficult to pinpoint what exactly market participants are focused on nowadays,” Mr. Basinger said. Monetary stimulus is a leading candidate, as central banks around the world support markets with zero-bound interest rates and trillions of dollars in asset purchases. The worldwide effort to develop COVID-19 vaccines and treatments is probably partly responsible for keeping investor spirits high as well.

Even with the setbacks in getting economies restarted, particularly in some U.S. states and cities, the market appears resolute in anticipating a sharp recovery in the broader economy and in the corporate sector.

The consensus currently implies that U.S. earnings will get back to record levels in 2021, which is probably overly optimistic, Ms. Poole said.

“Until there’s a vaccine, a lot of companies can’t operate at full capacity. And that’s going to impact their margins.”