



Market Commentary

Weekly perspective on current market sentiment

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Last week's S&P 500 Index: +1.2%

High stakes earnings season

Key takeaways

- Analysts raised earnings estimates during the second quarter, a rare occurrence that reflects growing confidence.
- But the big question during this earnings season is whether or not companies can outperform very high expectations.

In case you haven't noticed, the second-quarter earnings reporting season begins with high expectations embedded in both analyst forecasts and underlying stock prices. The consensus estimate for the S&P 500 Index now calls for just over 24% year-over-year earnings growth, a rate normally reserved for postrecession recovery periods. Analysts have been raising estimates throughout the quarter, a rare occurrence that reflects growing confidence in corporate profitability and continued strength in artificial intelligence (AI)-related investment.

While strong earnings growth usually is a positive for equity prices, elevated expectations can create a tough backdrop for individual companies and the S&P 500 Index as a whole. In this reporting season, we view the market as increasingly focused not only on whether companies exceed consensus estimates but on whether they can also beat the higher, unofficial "whisper numbers" that largely circulate among institutional investors. Whisper numbers represent the market's expectations after accounting for recent channel checks, management commentary, and investor sentiment. As a result, simply beating consensus estimates, especially in the wake of a big price runup in the shares of many tech and tech-like companies, may no longer be enough to result in positive near-term stock performance if the market is expecting even better results.

Some leading technology companies trade at levels one could argue are justified only if they continue delivering robust earnings growth and optimistic guidance. Any indication of slowing demand, less capital investment, margin pressure, or a more cautious management could trigger selling pressure, even if reported earnings technically beat "Street" consensus.

This week, financial companies set the tone for earnings season followed quickly by some of the major tech firms whose results will heavily influence the overall S&P 500 Index's near-term direction. Of particular interest will be the level of AI capital expenditures (capex), timing of estimated returns on AI investments, and consumer spending. Evidence that earnings growth is peaking or that AI-related spending isn't producing an adequate return could easily prompt a pullback in equities.

We know profits are growing strongly, but the big question during this earnings reporting season is whether or not companies can outperform very high expectations. With consensus forecasts already elevated and whisper numbers even higher, there isn't a lot of room for error. Investors should therefore expect heightened volatility around earnings announcements with companies that fall short being punished. In an environment where beating heightened expectations is the benchmark, good results may not be good enough.

Two sectors that we expect to post robust results this earnings season are Technology and Financials. We see Tech earnings remaining strong in the quarters to come based on our AI capex expectations and impressive margins. Second-quarter Tech sector consensus earnings estimates call for a 65% gain versus the year-ago period according to the Institutional Brokers' Estimate System (IBES). In our view, Financials are in a supportive environment that should foster strong loan growth, increased capital-markets activity, and a steepening yield curve. In addition, credit delinquencies and defaults are at or close to cycle lows. Our forward economic and earnings outlook remains positive. We believe that downside volatility during earnings reporting season might provide attractive entry points in our favored sectors.

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Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. Risks associated with the **Technology** sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks, especially smaller, less-seasoned companies, tend to be more volatile than the overall market.

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