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MARCH 31, 2022

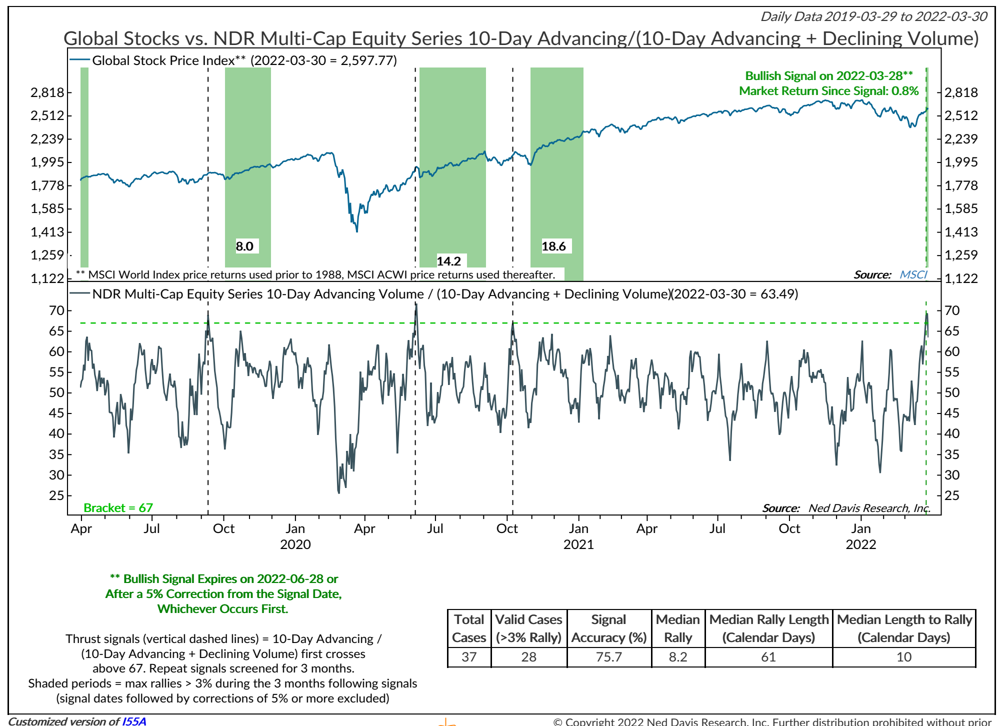
email us

The earnings influence in Q2

Key Takeaways

- As uptrend has strengthened with more indicator confirmation, sentiment and valuations have yet to threaten.
- During next earnings season, watch trailing and forward earnings growth, rates of positive revisions, beat rates and spreads between earnings yields and bond yields, which have been widest in Europe and Japan.
- As stock/bond ratio has returned to records, spread between stock and bond flows reaching new highs.

Another thrust signal



Total Cases	Valid Cases (>3% Rally)	Signal Accuracy (%)	Median Rally	Median Rally Length (Calendar Days)	Median Length to Rally (Calendar Days)
37	28	75.7	8.2	61	10

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What has become increasingly evident is the **renewed strengthening of the global market uptrend**. What's less clear is the **impact of the first quarter earnings season that lies ahead**.

Since last week's focus on thrust indicators and the broader Rally Watch Report, the rally has gained more confirmation. A fourth thrust indicator has produced a signal based on the percentage of 10-day advancing volume (right) and the Crowd Sentiment Poll component has confirmed a significant sentiment reversal. The Rally Watch aggregate now stands at 50%, its highest level in 11 months.

If the aggregate rises further (which is now very likely), the majority reading will be the seventh that has followed a Global Sentiment Composite extreme pessimism reading of less than 10 and signals from at least two of the report's breadth thrust indicators. Last week we showed that after the six previous sentiment extremes followed by a bullish majority in the Rally Watch, the ACWI has been up by medians of 8% after three months, 17% after six months, and 28% after 12 months, gaining in every case over each period. Since the sentiment extreme on March 7, the ACWI has gained 9% yet the sentiment composite remains well **below the extreme optimism levels** at which the rally's exhaustion would be more likely.

Also yet to threaten are **valuations**. While down from their early-March highs and below their medians levels since 2003, the ACWI's 12-month trailing and forward earnings yields are above their three-year medians at 5.1% and 5.9% respectively. Both are thus providing a far less threatening valuation message than they did at last year's respective lows of 3.3% and 4.8%.

Entering the second quarter, a key consideration will be the extent to which valuations will remain supported by earnings growth, which has helped keep earnings yields elevated. Our Global Earnings

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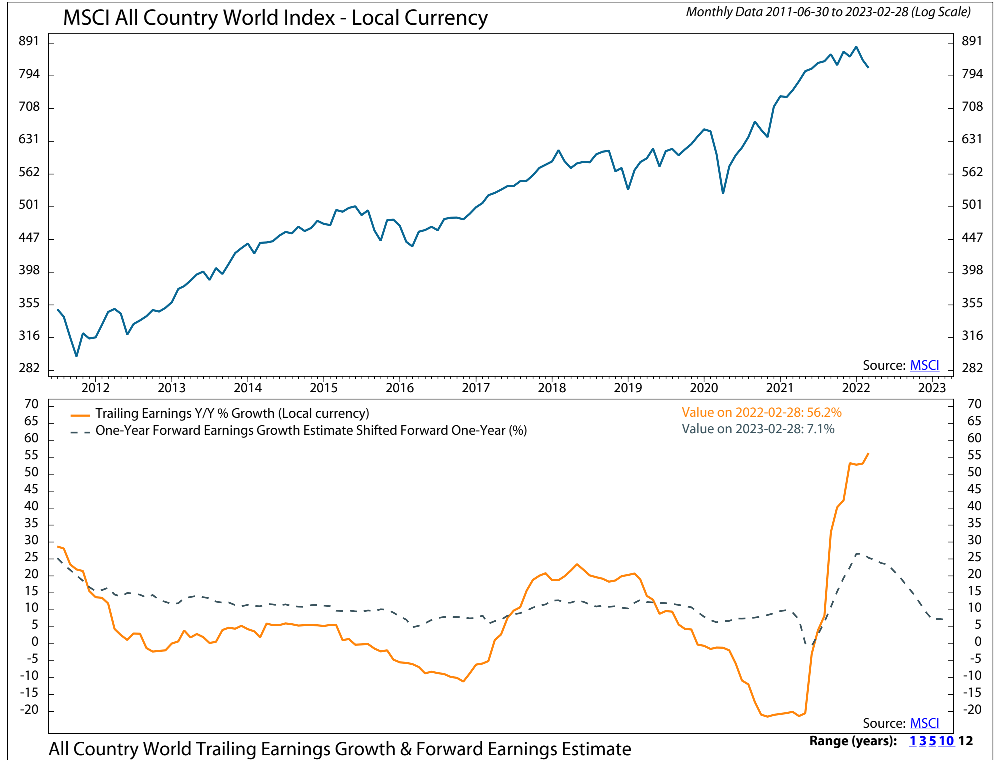
Summary indicates that for the ACWI (right) and six of the seven regional indices in our seven-way framework (all but the U.K.), the year-to-year change of trailing earnings has been far stronger than the growth expected a year earlier.

For the rest of the year, the earnings growth rate has been expected to drop for the ACWI and all of the regional indices. The market's fortunes could therefore have a lot to do with **whether the earnings growth continues to defy the expectations or instead recedes**, sending valuations to more threatening levels more quickly than they would with earnings growth remaining strong.

Earnings growth still reaching new highs



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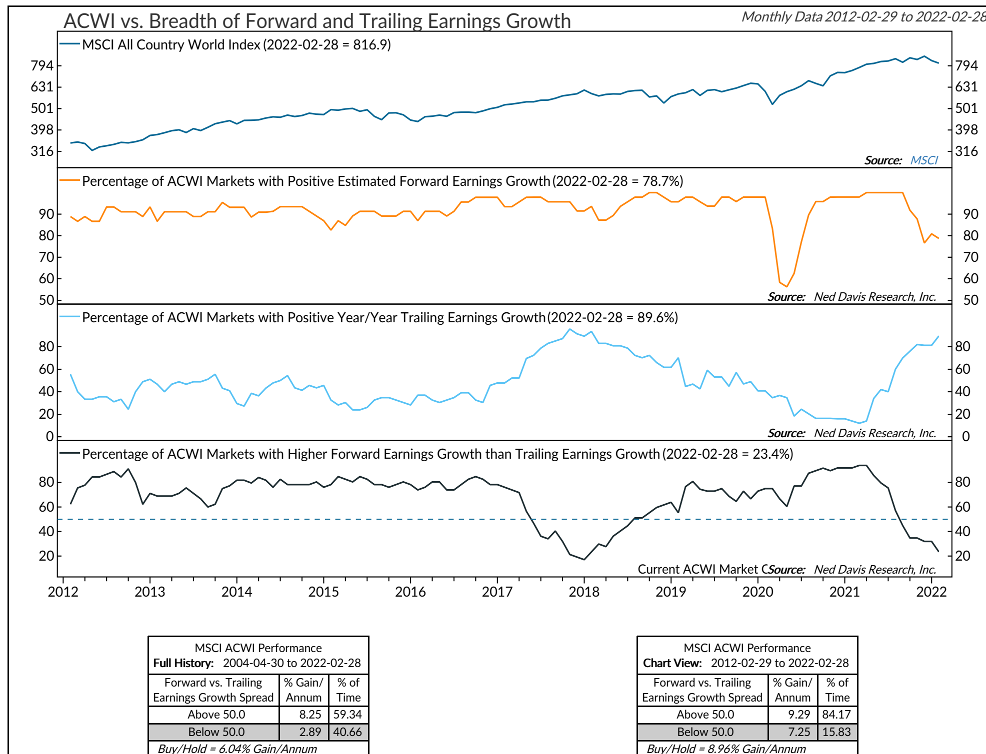
Better trailing than forward earnings growth breadth



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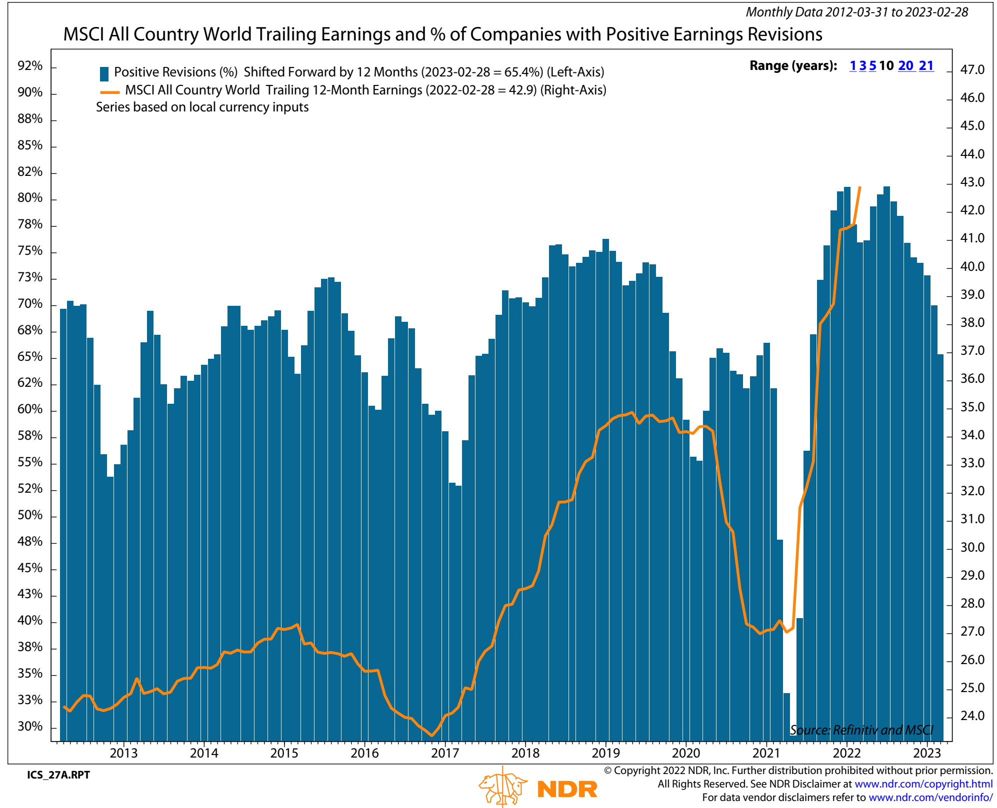
Based on the 48 ACWI component markets, the chart at left shows that a year ago, the percentage of markets with positive year-to-year trailing earnings growth (third clip) started to follow the rising percentage of markets with positive forward growth rates (second clip). The trailing percentage continued its ascent in the fourth quarter and into 2022 as the forward percentage declined.

As equities are forward looking, the market tends to perform better when the forward earnings breadth exceeds the trailing earnings breadth. Equities will therefore stand to benefit if **the forward breadth percentage stabilizes or improves even as the trailing breadth percentage rolls over**. That will be more likely if global economic conditions hold up in the face of the current inflation and interest rate pressures, and especially if those pressures recede.

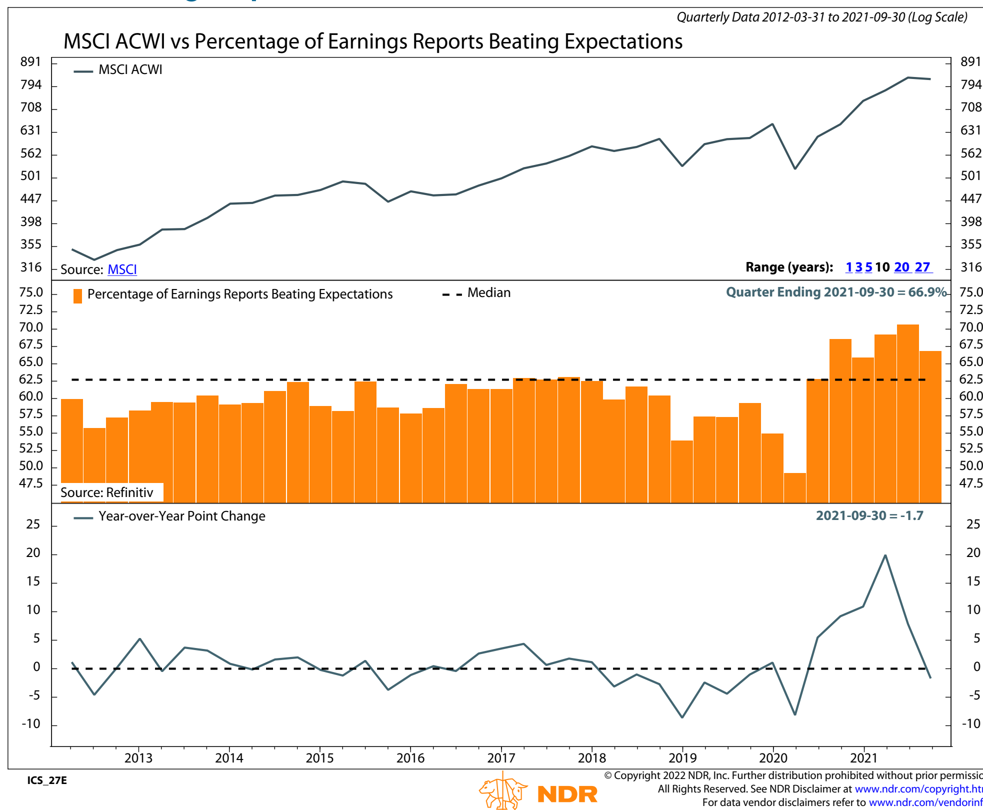
The current message from earnings is that the **upcoming season will be more challenging**. Shifted forward by a year to demonstrate how the revisions rate tends to lead the earnings growth rate, the chart at right indicates that the percentage of ACWI companies with positive revisions has dropped from a record high of 81% to 65% through February.

Our Earnings Revisions Summary indicates that over the past year, the ACWI's percentage has dropped by 11 points. And it has declined for all seven regional indices, ranging from a one point decline for Europe ex. U.K. to a drop of 18 points for Emerging Markets. If the revision rates stabilize or start rising again, we will be more likely to see forward earnings growth improvement and trailing growth coming through better than expected.

Declining rate of positive earnings revisions



Still beating expectations



We will also be watching our report on Earnings Beat Rates, which updates the percentage of earnings reports beating expectations. At 65%, the ACWI's earnings beat rate has remained above its historical median but has been losing momentum, now down two points from a year ago (left). That's also the case for the regional indices with more than 45% coverage – the U.S. (a beat rate of 76%, down four points from a year ago), Canada (69%, up two points), Europe ex. U.K. (64%, down two points), and Japan (62%, down nine points).

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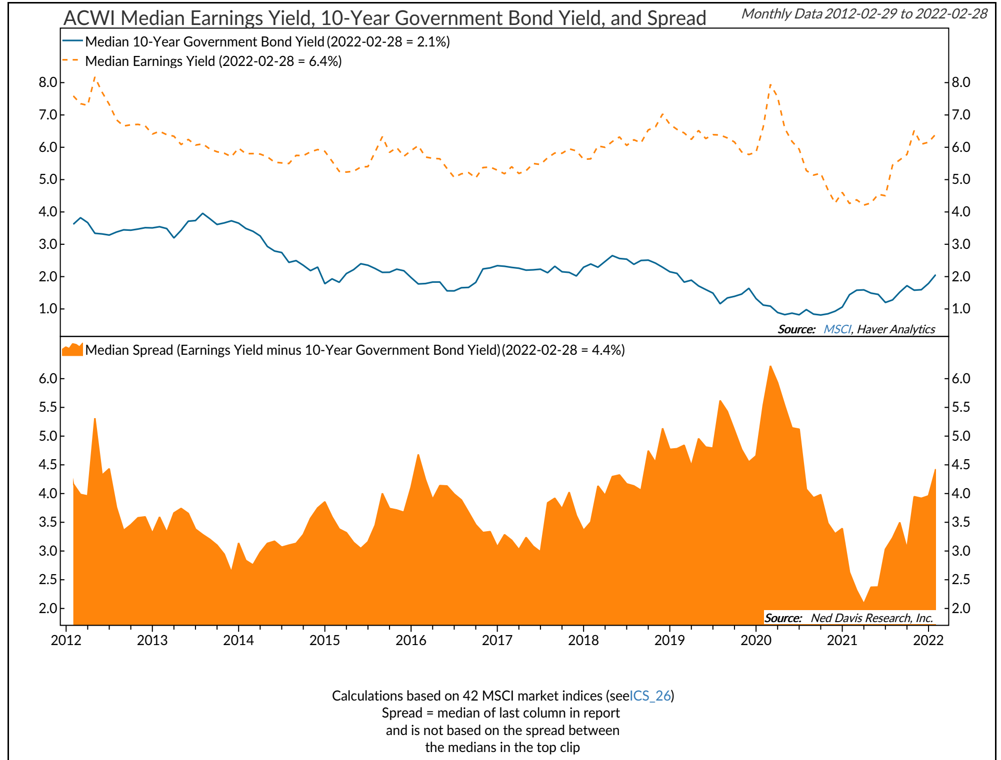
It has long been the case that among the MSCI regional indices, the forward and trailing earnings yields have been highest for the Emerging Markets Index and lowest for the U.S. Index, as shown in our report on Global Stock Market Valuation. When **earnings yields are compared to bond yields**, however, the EM Index ranks last among the regional indices, below the U.S. Index. That's attributable to a median bond yield of 5.3% among the 18 EM components.

Yet even the EM spread has been positive, as it has been for 34 of the 42 markets in our report comparing earnings yields and bond yields. The median spread through February was 4.4 percentage points, the highest since July 2020 (right, bottom clip).

While the spreads between earnings yields and bond yields will be likely to narrow with their March updates, most of the spreads should still be decisively positive, indicating that despite the bond yield advance, **stocks are reasonably valued relative to bonds**. That helps explain why stocks and bond yields remain positively correlated in the rising rate environment.

Record highs can again be seen in the ratio of the global equity benchmark to the global bond benchmark. And with bond holdings losing money as equities trend higher, **more money is shifting from bonds to stocks**. The improving equity returns and worsening bond performance has led to net inflows to U.S. and international equity funds and ETFs and net outflows from the comparable bond funds. The spread between the stock flow and the bond flow has reached levels last seen in April 2020 on a 13-week average basis and since January 2016 on 40-week average basis (left).

Earnings yields remain above bond yields



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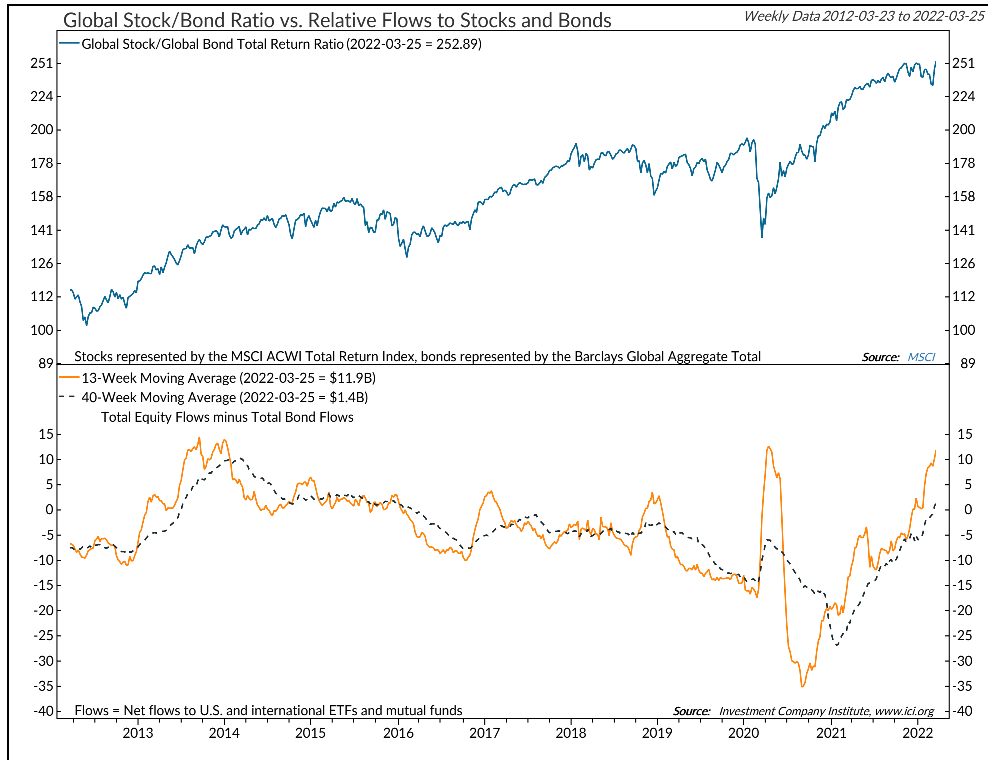
Rising spread between stock and bond flows



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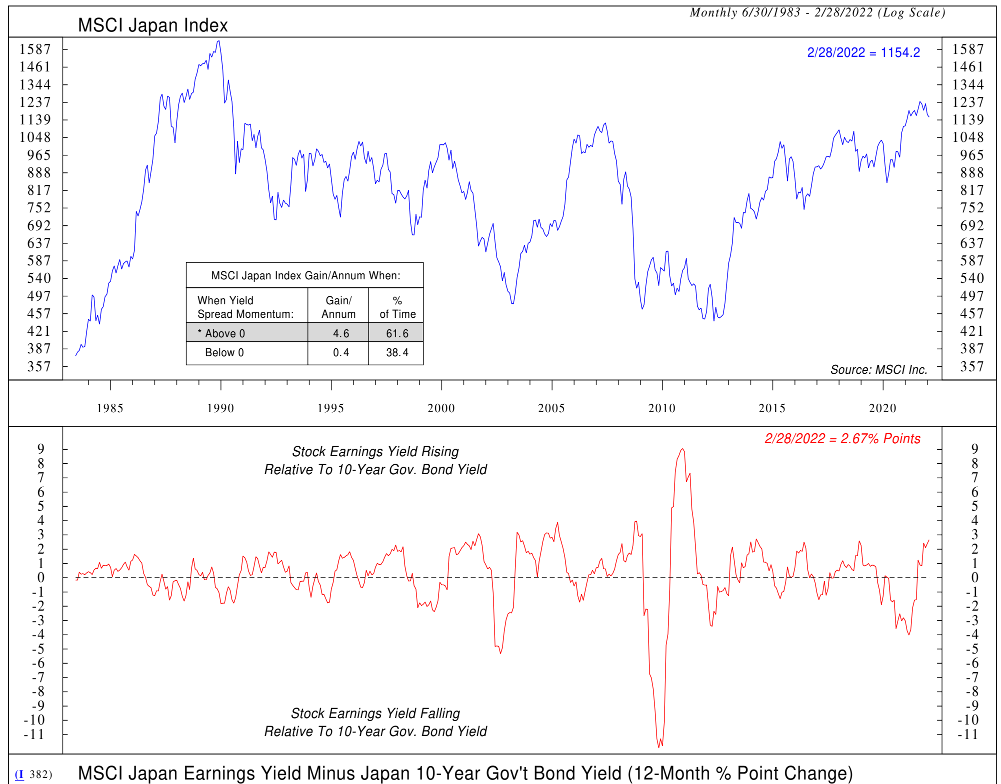
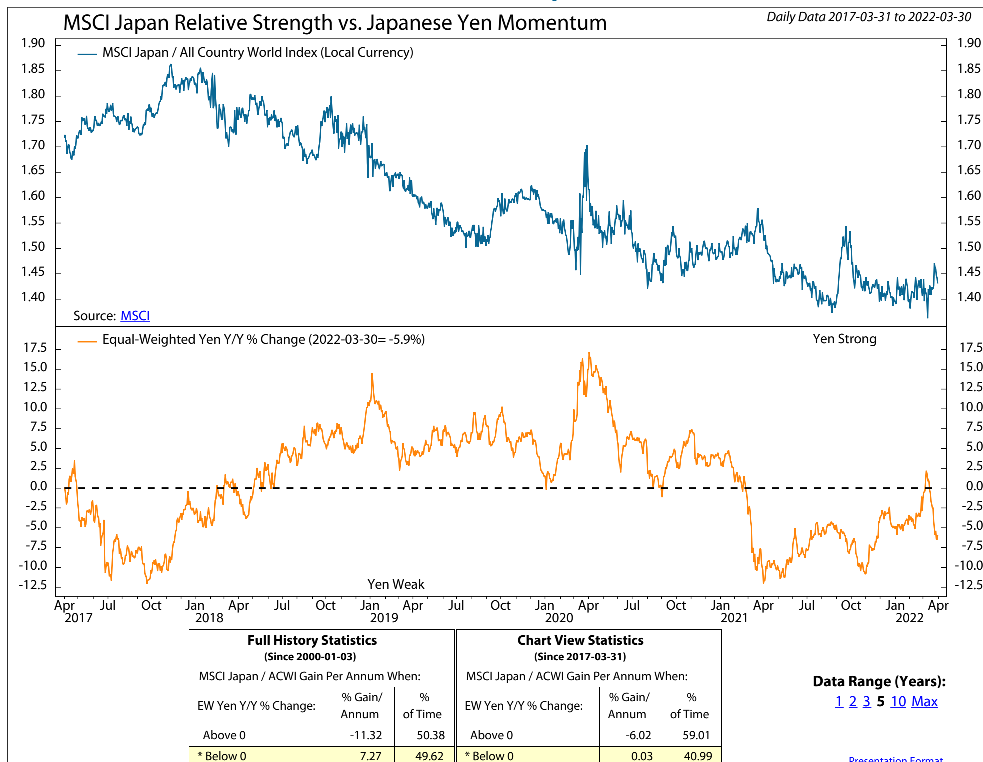
Of the eight markets with the widest relative valuation spreads, seven are European markets, while the eighth is Japan. And Japan has the widest spread among the indices in our seven-way framework. The spread between Japan's earnings yield and 10-year government bond yield has gained 2.7 percentage points over the past year, the **biggest 12-month gain in 11 years** (right).

The Bank of Japan's accommodative monetary policy has not only been holding down bond yields, but also sending the yen lower against the dollar and other currencies supported by central banks that have been removing accommodation. The yen weakness bodes well for the export-dependent Japanese market, which has tended to outperform when the equal-weighted yen has had negative year-to-year momentum (below).

Japan's earnings yield to bond yield spread rising



Yen weakness tends to benefit Japanese market



Full History Statistics (Since 2000-01-03)			Chart View Statistics (Since 2017-03-31)		
MSCI Japan / ACWI Gain Per Annum When:			MSCI Japan / ACWI Gain Per Annum When:		
EW Yen Y/Y % Change:	% Gain/ Annum	% of Time	EW Yen Y/Y % Change:	% Gain/ Annum	% of Time
Above 0	-11.32	50.38	Above 0	-6.02	59.01
* Below 0	7.27	49.62	* Below 0	0.03	40.99

For equities globally, a positive second quarter scenario would include moderating inflation, non-recessionary economic growth, more positive earnings revisions, and better than expected earnings growth, with earnings yields remaining well above stabilizing bond yields. A negative scenario would include more inflation disappointment and recession evidence, a continued decline in positive earnings revisions, and worse than expected earnings growth that would become a negative influence on valuations, hastening a narrowing gap with accelerating bond yields. Considering the last three weeks of breadth improvement evident in the Rally Watch, **the second quarter scenario currently appears more likely to be positive than negative**.

Anoop Nath, CFA, has provided research support for this report.

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NDR HOUSE VIEWS (Updated March 21, 2022)

For global asset allocation, NDR recommends overweight allocation to cash, marketweight allocation to stocks and underweight allocation to bonds. Equities remain in the secular bull market started in 2009. But we have been expecting increased volatility and recognize the possibility of a cyclical bear market.

Equity Allocation

U.S. | Our intermediate-term outlook for U.S. equities is neutral. On an asset allocation basis, we are overweight cash and underweight bonds. We favor large-caps over small-caps and are neutral on Growth versus Value.

INTERNATIONAL | We are overweight Europe ex. U.K. and Canada, underweight Pacific ex. Japan and the U.S., and marketweight on all other regions.

Macro

ECONOMY | The global economy is poised for slower, but still strong growth in 2022, as high savings and wealth, pent-up demand, and the broadening of vaccines globally support growth. The COVID pandemic, supply chain issues, elevated inflation, and tighter global monetary policy present risks to the outlook.

FIXED INCOME | We are 85% of benchmark duration and expect the yield curve to flatten. We are overweight CMBS, ABS, and HY corporates, and marketweight everything else.

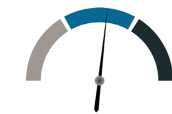
GOLD | Long-term uptrend intact. We are bullish.

DOLLAR | Our long-term technical composite is positive. We are neutral, also recognizing real interest rate differentials.

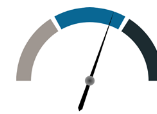
Economic Summary

March 28, 2022

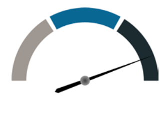
Near term activity: ● Accelerating ● Neutral ● Decelerating



Global Economy (4.3%)



U.S. Economy (3.0%-3.5%)



U.S. Inflation (4.0%-4.5%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2022 forecasts.

Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ● Cash (15%)
- ● Stocks (55%)
- ● Bonds (30%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Equities — Regional Relative Allocation

- ● Europe ex. U.K. (16%) | Canada (6%)
- ● Japan (6%) | Emerging Markets (13%) | U.K. (4%)
- ● U.S. (54%) | Pacific ex. Japan (1%)

Benchmark – U.S. (59.5%), Europe ex. U.K. (12.7%), Emerging Markets (12.2%), Japan (6.0%), U.K. (3.7%), Pacific ex. Japan (2.9%), Canada (2.9%)

Global Bond Allocation

- ● Europe (30%) | Japan (20%)
- ● U.K. (5%)
- ● U.S. (45%)

Benchmark: U.S. (52%), Europe (27%), Japan (15%), U.K. (6%)

U.S. Allocation

- ● Cash (15%) | Large-Cap
- ● Stocks (55%) | Growth | Value | Mid-Cap
- ● Bonds (30%) | Small-Cap

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

Sectors

- ● Energy (5%) | Materials (4%) | Consumer Staples (9%) | Health Care (16%)| Utilities (4%)
- ● Consumer Discretionary (10%) | Communication Services (8%) | Technology (23%)

Benchmark: Technology (27.4%), Health Care (12.9%), Financials (10.9%), Communication Services (10.9%), Consumer Discretionary (13.1%), Consumer Staples (6.4%), Industrials (8.2%), Energy (2.8%), Utilities (2.4%), Real Estate (2.5%), Materials (2.5%)

U.S. Bonds — 85% of Benchmark Duration

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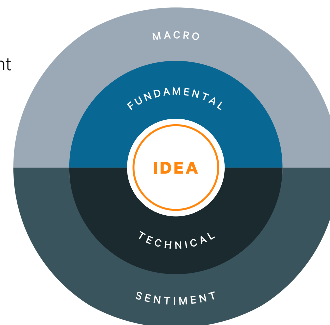

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