5 Hot Stocks to Sell Before They Report Earnings

Plus, takeaways from bank earnings.

David Sekera, CFA and Susan Dziubinski • Jul 15, 2024

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Susan Dziubinski: Hello, and welcome to the Morning Filter. I'm Susan Dziubinski with Morningstar. Every Monday morning, I sit down with Morningstar Research Services' chief US market strategist Dave Sekera to discuss what's on his radar this week, some new Morningstar research, and a few stock picks or pans for the week ahead. Hi, Dave.

Let's kick things off with any economic reports you're watching this week. What's on your radar and why?

David Sekera: Good morning Susan. Good to see you. There's really not all that much on an economic front, in my mind. I think the news in the market this week is really just going to be focused on the beginning of earnings season. Now, having said that, looking at the economic metrics that are coming out, it looks like retail sales are coming out on Tuesday.

That's the one I'm probably going to focus on this week. As we've talked about for several weeks or even over a month now, low-income consumers, we already know they've been under pressure for well over a year from inflation. But what we saw in the first-quarter earnings reports is that we're starting to see and hear more anecdotes of how inflationary pressures are starting to cause the middle-income households to pull back on spending mainly in discretionary categories.

And even more specifically in any items that are considered indulgent. So, in that retail sales number, I'm really going to be watching for any signs of retail sales continuing to trend downward. Of course, if they do, that could indicate that the rate of economic growth is slowing even faster than our economics department is currently forecasting.

Dziubinski: And we also have earnings season heating up this week. From the tech sector, there are a couple of AI-related plays you're keeping an eye on. And those are ASML ASML and Taiwan Semiconductor TSM. So, talk broadly, Dave, about what you'll be listening for during earnings season regarding AI.

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Sekera: Well, it certainly won't be just me. I think these are going to be probably the two most closely watched earnings reports this week. Specifically, we'll be listening for any commentary. As far as the underlying growth rate for their artificial intelligence products and their business lines there. But really especially for their guidance. I think their results here could be an early indication of how much spending on AI is continuing to grow.

Now, when I take a look at these two individual companies, for those that aren't familiar, ASML makes the equipment that is actually used to manufacture semiconductors, including AI-related chips, of course. We'll be watching if their customers are increasing their orders, specifically on that high-end-type of equipment. And then Taiwan Semi, they're the ones that actually make the semiconductors are using the GPUs for Nvidia NVDA for the artificial intelligence.

So, their growth rate and any commentary they may have or share with the market will be especially closely monitored. And any deviation either to the upside or the downside could lead to a great deal of volatility in those AI stocks, not just Nvidia but across all those stocks that really have led the market thus far this year.

And, of course, they're such large mega-cap stocks that they could skew you know the index movements as well.

Dziubinski: These stocks are having a terrific year. We have ASML up more than 40% this year. And then TSM is up almost twice that. From a valuation perspective, Dave, how do ASML and TSM stocks look from a valuation standpoint as we're heading into earnings?

Sekera: ASML actually was one of our picks on our show last October. But as you mentioned that stock has really rallied. And, in fact, since we talked about that pick in October, that stock has almost doubled since then. So at this point, it's moved up so much. It's actually now in 3-star territory, meaning that we think it trades within the range that we consider to be fairly valued.

Our fair value estimate on that stock is $990 a share. And then Taiwan Semi, that was a pick this past February. That stock's up 40% since just then as well. But I know we also increased our fair value relatively recently, I think in June, on that stock. So, between that increase in our fair value, it's still a 4-star-rated stock trading at about a 12% discount to fair value.

Dziubinski: Let's pivot over to the financial-services sector where we have a lot of companies reporting this week, too. There's a couple in particular you're going to be watching. The first is U.S. Bank USB, which is a stock you've talked about quite a bit on the Morning Filter in the past. How does the stock look today heading into earnings? And what are you going to be listening for here?

Sekera: U.S. Bank, that's long been kind of our go-to stock among the US regional banks. In fact, it's up 31% since we first highlighted it on our June 12, 2023, show. It's still undervalued. It's a 4-star-rated stock. Of course, that discount is only 21% at this point compared to where it was in the past.

But the other thing I would just note on this one, it is the only US regional bank that we rate with a wide economic moat. So, similar to all the banks, the three things I'm most focused on coming out of earnings are going to be their net interest margin and their outlook, their delinquency rates, and what they're doing with loan-loss reserves.

Dziubinski: Also from the financial-services sector, we have Discover Financial DFS earnings this week. Why is this one on your radar?

Sekera: I think Discover will provide a really good insight into the strength of the consumer. We're going to be keeping a close eye on a couple of things. First, just the amount of transaction volume; how much are consumers spending? But then also looking at the amount of loan balances: How much can consumers pay off every month to keep their debt down versus how much is that building?

And then lastly, delinquency rates. And we talked about this a number of times. But generally, we do expect delinquency rates should be increasing. But we're looking for them only really to rise up toward where they've averaged historically. We're not looking for a big surge. Yes, the economy is weakening.

The consumers are under pressure. But considering a US economics team is not forecasting a recession, and we're in that soft-landing camp, delinquencies can rise from here. But we're not looking for any kind of big spike up in the short term. However, if there was a meaningful increase over our forecast for delinquencies, that could be an early red-flag warning that the economy might be slowing down more quickly than what we expect.

Dziubinski: Discover Financial is going to be acquired by Capital One COF. Does Morningstar think there's an investment opportunity today in Discover Financial stock?

Sekera: Probably not. This was actually a pick back in May 2023. And if you remember, that was following the bankruptcy of Silicon Valley Bank and that said, you know, all the US regionals and a lot of these financials down. So at this point, the stock is up over 30%, which puts it back in 3-star territory.

I took a look at it this morning. I think it's a stock buyout. And the stock right now trades at a slight discount to where the buyout will actually occur compared to where Capital One stock is trading. So, if you own the stock, if you hold it now, you'll capture that spread differential when the stock gets bought.

But unless you're a risk-arb investor, I think there's really nothing else probably to do here.

Dziubinski: Let's shift over to healthcare. And we have Johnson & Johnson JNJ reporting this week. You've recommended this stock a couple of times on the Morning Filter in 2024. Remind viewers why you like the stock, how the company looks heading into earnings, and what you're going to be listening for.

Sekera: Johnson and Johnson, in my mind, is still just a core holding type of stock for most portfolios. It's currently rated 4 stars, trades at about a 10% discount to our fair value, and also provides a pretty good dividend yield at 3.4%. It's a company we rate with a Low Uncertainty Rating. We also rate the company with a wide economic moat.

When I've spoken to Damien Conover, who's the head of our healthcare equity analyst team, he thinks it's actually one of the widest moats there is in the healthcare sector. What's going on here? The reason the stock is trading at a discount is that they are going to face some competition this summer from a biosimilar product that's coming out that will be a drag on short-term growth.

But we've already factored that into our equity forecasting model. Talking to our analyst team, they forecast that there are enough other new products in the pipeline that will be able to offset that biosimilar competition. When I look at the model over the longer term, our assumptions look relatively conservative to me.

Our five-year revenue compound annual growth rate is only 2.3%. You're only looking for 4.0% average annual earnings growth. So, with the stock at under, I think, 14 times 2024 earnings estimates and only 13 times 2025 estimates, it just looks like a really good solid investment to me.

Dziubinski: The last company that you want to hear from this week and that lots of people will want to hear from, is Netflix NFLX. The stock's up about 30% this year. What does Morningstar think of the stock heading into earnings?

Sekera: I think that stock is back up to its all-time highs once again. And this is a stock that's had a lot of volatility over the years. Over the past three or four quarters, they've cracked down on password sharing. They've launched their ad-supported subscription business.

And they've done a great job of getting new subscribers. But, in our view, we think this is a case of the market taking this short-term growth and pricing it in for too long at this point. In fact, I think we're looking for a pretty strong deceleration of subscriber growth in the second half of this year.

The other thing that's going on is I think Netflix is in the midst of undergoing a change in their business strategy. They had announced, I think it was last quarter, that they're no longer going to report subscriber growth. What that indicates to me is that they're shifting away from that focus on growth and really starting to focus on improving profitability.

At some point, I think that could lead to a dislocation in the market. You know, investors are going to have to change their mindset and adjust from pricing that stock on growth and really starting to price much more on earnings. Taking a look at where it's trading today, I think it trades at about 35 times our 2024 earnings estimates.

Even when I look at 2025 earnings estimates, it's still at 30 times. That's high, even for a company where we're forecasting our top-line growth over the next five years to average 19%. So, net-net it's a 2-star-rated stock trades at almost a 50% premium to our fair value.

Dziubinski: Let's dig into some new research from Morningstar. We had the CPI number come out last week, looking pretty good. The PPI number came in a little higher than expected. Dave, unpack the numbers for us and highlight the key takeaways for investors.

Sekera: The key takeaway is that both headline and core CPI came in well below expectations and the consensus estimates. PPI came in like a tick higher than what was expected. But really what you need to do is look at those underlying components in CPI and PPI that are used to calculate the PCE, personal consumption expenditures.

And that's the one that the Fed is really going to be focused on the most to determine monetary policy. And we look at those components even within the higher PPI number, they were actually lower than expected. So, net-net, when you look at those and of course how they're also weighted in the index, I think it's going to end up bolstering the case that the Fed can begin to start cutting interest rates at that September meeting.

Dziubinski: That was my next question, Dave. What do these numbers mean for Morningstar's interest-rate forecast? We're still expecting a cut in September, is that right?

Sekera: We are. The Morningstar US economic team is still looking for that cut in September. And so is the market. If you take a look at the market-implied probability of a cut in September, it's now up well over 90%. Whereas a week ago, prior to those numbers coming out, it was only a 75% probability.

Dziubinski: We have some new company-specific research to talk about as well, including earnings news and forecasts from JPMorgan JPM, Wells Fargo WFC, and

Citi C. Let's start with JPMorgan. Results were good, but Morningstar's analysts issued a little bit of a warning. Delve into that.

Sekera: I think here you just need to disassociate the results from the valuation. The warning here was really just regarding JPMorgan's valuation for the stock. It's now a 2-star-rated stock, trades at a 22% premium. It's had a really good run yield thus far this year. Now, as far as the earnings go, as you mentioned, the results were pretty good.

I still think JPMorgan's probably the best manager of the mega banks, but we think investors are just over extrapolating this current strength too long into the future. We expect net interest income will probably start to decline once the Fed starts to cut interest rates, which of course then will lead to an earnings slowdown, which then probably will bring the stock back down toward what we think the long-term intrinsic value of that company is worth.

Dziubinski: Wells Fargo stock tumbled a little bit after earnings on updated expense guidance from the company. What's Morningstar's take?

Sekera: I think that stock was down about 6% after earnings. In our minds, we think that selloff was primarily driven by an increase in their guidance regarding their expenses. I think the market had been looking for better expense management out of the company. Now, in our view, it wasn't necessarily enough of a change to revise our long-term assumptions.

So, we did hold our fair value study. It's currently trading at about $56.50 in the market, which is almost right on top of our $58 fair value estimate. So leaves a rating at 3 stars, putting it in that fairly valued category.

Dziubinski: And then there's Citi. What's the progress on the turnaround plan?

Sekera: According to our team, it looks like they're getting pretty close to finishing that turnaround plan. In fact, they're noting that they're starting to see some evidence that those restructuring initiatives are also now near their completion. That's going to allow Citi to start focusing more on growth going forward. Now, having said that, overall, nothing this quarter led us to change our longer-term assumptions.

The fair value was unchanged at $68 a share. The thing here is Citibank is no longer the value play that it once was. We had talked about it back in May 2023 when we originally recommended the stock. It's up 40% since then. And following that runup, it's only at a 5% discount.

So, again, leaves it in that fairly valued territory. It's a 3-star-rated stock.

Dziubinski: We also had a Pepsi PEP reporting earnings last week, and this was a name you said you were keeping an eye on as a read on what's going on with the consumer. Pepsi did beat on earnings but fell short of expectations on revenue. What should investors take away from the report about the state of the consumer?

Sekera: They reported organic growth of 2% companywide. But when you look at where that organic growth came from is really from the international divisions. If you look at their US beverage business, that was only up 1%, whereas the snacks business was down about 1%. What we're thinking is that it is still just another indication that consumers are becoming even more value-conscious. Not nearly as much of a downturn as we've seen in some of the other consumer stocks.

But it's still more anecdotal evidence that spending from middle-income consumers is coming under increasingly more pressure.

Dziubinski: Did Morningstar make any changes to its fair value estimate on Pepsi stock after earnings, and how does the stock look today? Is it a buy?

Sekera: No change to fair value. It's still $176 a share, rated 4 stars. So, it is trading at a discount, but I'd note it's a very thin discount. I think it's only a 5% discount. Any move up from here I think is going to put it in that 3-star range pretty quickly.

Dziubinski: Delta DAL reported last week, and the stock ticked down after reporting earnings. This was another company that you said you were watching. What did Delta have to say and what might that suggest about its competitors, which have yet to report?

Sekera: Last week when we talked about this show, we noted that Delta stock was a 2-star-rated stock at an 18% premium before the earnings. And as we discussed, travel has been running at very high levels going into the summer. So, in this case, we wanted to get a sense of how long travel spending will stay at these elevated levels.

Over the long term, we are looking for more normalized levels of travel and margins across all of the airlines. And according to the earnings here, I think it looks like we're starting to see that play out. The guidance for third-quarter revenue growth was 2% to 4%. In our mind, that indicates slightly softer revenue yields, and that supports the thesis that consumer appetite for travel has begun to normalize.

The stock did fall after earnings. It dropped enough to put it in that 3-star category. Although within that 3-star category, it's still trading at a pretty good premium above our fair value.

Dziubinski: All right. It's time to move on to the picks portion of the program. But instead of bringing along some stocks for viewers to consider buying, this week you've instead brought along some hot stocks investors might consider selling before they report earnings. Any particular reason for the pivot this week, Dave?

Sekera: Susan, you know no one ever went broke taking a profit. All kidding aside, I would say the market is at this point, according to our calculations, starting to move into overvalued territory. Now, when I look over the next couple of months, I don't really foresee any specific catalyst that'll necessarily cause the market to sell off.

We could be in one of those time periods where, even though the market is expensive, it could stay expensive for a little while. When I look at second-quarter earnings coming out, generally the economy's been strong enough that they should be either in line or better than expected. So, the real concern here is going to be what management teams give for guidance for the third quarter and the second half of the year.

We have seen the economy slowing. My concern would be, is the economy potentially slowing faster than expected? And of course that could lead to lower guidance. So it's really just a matter on these specific stocks just how far overvalued have they become as compared to our intrinsic valuation analysis. These are some of the most overvalued stocks in our mind across all of our coverage.

So, if there's any kind of hiccup in the earnings or if there's any kind of downward pressure in there and their guidance, I think these stocks really could gap down pretty hard after their earnings reports and their conference calls.

Dziubinski: All right. So, let's name some names, Dave. Your first hot stock to consider scaling back in is Arm Holdings ARM. The semiconductor stock is up 141% so far in 2024.

Sekera: What a crazy rise that is. A lot of people may not know Arm. Arm was a relatively recent IPO. The company develops the CPU architecture that's used to make semiconductors, and it is the dominant architecture that's used in smartphone CPUs right now. But they are also making inroads into data centers as well.

And to some degree, I think that's the area that the market is really focused on the amount of growth that could potentially be there. Now, they don't manufacture the semiconductors in and of themselves, but they license that intellectual property to the manufacturers that do. Taking a look at our model here, we do forecast top-line growth of 20% over the next five years on a compound annual growth rate basis.

Revenue last year was $3.2 billion. We forecast it's going to increase all the way up to $8.1 billion by 2029. It's still a really strong growth period that we're already baking into our fair value estimate. It's also what's known as an asset-light business. And we do expect that over that same time period margins can expand very significantly as that top-line revenue really can drop right down to the earnings line. We're looking for a 63% compound annual growth rate for earnings year over that same time period. Our projected earnings for this year is $1.51 a share. We're forecasting that to increase to $3.31 by 2029. Right now, that stock sells at a forward P/E of 273 times 2024 earnings.

Now, if you look at 2029 earnings, so five years from now, that PE is still 55 times. So, again, you have to price in just gigantic amounts of growth, even higher than what we're already projecting to get to where that stock is trading today. Having said all that, that stock trades at 175% premium to our current fair value.

So, that puts it in that top, top end of our 1-star category.

Dziubinski: Your second hot stock to consider selling before earnings is also in the tech sector. It's Dell DELL. The stock is up 160% over the past 12 months. How overpriced is this one today, Dave?

Sekera: Very overpriced. This one trades at a 115% premium over our fair value after that extraordinary run that they've had. Again, that certainly puts it well in 1-star territory. You have to think about what's going on here. Dell's primary business is enterprise hardware, so think PCs, displays, servers, and so forth.

They do have a pretty high market share, but hardware overall is pretty economically sensitive. And it's really mainly a commodity type of product. So, in my mind, I think they've just been caught up with the rest of this AI bubble. They do sell hardware to the data centers, which of course is the fastest-growing area in the tech space right now.

That's where all the artificial intelligence is currently being developed. But even when we model that fast-growing piece into their overall business, we just don't think it's a large enough portion of their overall business to make enough of a difference to justify its current valuation. So, we're only looking for top-line compound annual growth rate for the entire company of 4.4% over the next five years.

We are looking for a faster growth rate for earnings. Our earnings compound annual growth rate is 10.9%. But the stock is trading at 19 times earnings, which we think is just you know too much for those types of numbers.

Dziubinski: The next stock to consider selling might surprise some viewers since it's in a sector many consider to be kind of sleepy. It's public utility NRG Energy NRG, and this hot stock is up more than 100% during the past 12 months. What's the story?

Sekera: Well, NRG is actually an independent power producer. Essentially, I would think of it more like an unregulated utility. Now, over the past few years, NRG has actually reconfigured its business, its management team, and its board of directors. Once it was the largest power generator, based mostly in Texas. But following that, they've really shifted out their overall service area.

So, NRG now is really much more of a nationwide retail energy and home services company. And it’s still getting swept up with the AI bubble. You know, AI requires multiple times more electricity than traditional computing. We’re seeing a lot of data centers being built out in Texas. And they still have a significant amount of generation assets in Texas.

When we look at the business model now, in our opinion, we think the market is way overestimating the amount of earnings growth that this firm may generate from the expansion of those data centers. It trades at a 95% premium over fair value, so a 1-star-rated stock. Be really careful of this one if you’re involved in it.

Dziubinski: Now the next act to consider scaling back in is a name you’ve recommended scaling back in before. And that’s Eli Lilly LLY. Another stock that’s up more than 100% during the past 12 months, driven largely, of course, by the strength of its weight-loss-drug portfolio. How overvalued does the stock look today, according to Morningstar?

Sekera: First of all, I have to note we do have a very positive view on Lilly. We rate the company with a wide economic moat. We think they have a very strong pipeline of new drugs in development, and we think management has executed its business plan very well. So, again, this is really just a matter of the valuation having really nothing to do with the underlying story.

However, it is a story stock right now. And I think that’s what caused the stock to ramp up as much as it has. As you mentioned, though, Lilly does make one of these new classes of these diabetes drugs that are being used for weight loss. And so I think you really have to dig into kind of the longer-term projections of the prescriptions for those drugs.

We forecast that by 2031, the overall market for these drugs being used for weight loss, including Lilly’s competitors, will be $180 billion. On top of that, we then use an assumption that 25% of the population that’s obese, and 15% of the population that would be labeled as overweight US adults will be receiving treatment in the next 10 years.

So, pretty high market share numbers based on that overall analysis that we've done for the market. We're looking at $60 billion a year for Lilly for the GLP-1 drugs. Even with that forecast, we still view the stock as being overvalued. It's a 1-star stock at a 76% premium to fair value.

Still one of the more overvalued stocks across all of our coverage. Again, it's just one of these situations. The market's just paying it way too high of a valuation for its weight-loss drugs. It's interesting. I spoke to Damien Conover again. He's the head of our analyst team for healthcare. He noted that he actually models in a higher number of prescriptions than what the market even forecasts.

Yet, the stock's still trading higher. So, again, I don't think the market is really pricing in some of the things over the long term. Of course, over the longer term, you do have to price in price declines as more competition comes online. I think maybe within the past month, even Amgen AMGN stock had popped because they were moving forward with one of their weight-loss drugs that just moved into phase 3 trials.

And then lastly, there always is the risk, too, of patients discontinuing this therapy, depending on its tolerability and its cost. It is a very expensive drug. Or if there were to be any long-term safety issues.

Dziubinski: And then your last hot stock to consider selling is a company that's actually a favorite shopping experience for both of our families, Dave. It's Costco COST. Is this a case of liking the company but not liking the stock at current prices?

Sekera: That is exactly correct. I guess in the spirit of full disclosure, we are customers of Costco. We certainly enjoy going there. I probably spend more money coming out of there than I intend to any time we go. And when I look at Costco, it is the third-largest retailer in the US. There's a lot to like about the company.

We rate the company with a wide economic moat based on its cost advantages. They do have a very solid business model, very strong underlying fundamentals, and growth. But according to our analysis, it's just a matter of valuation. I'm not going to go into all the details on this one. We have talked about it several times.

But when I look at our fair value and where it's trading in the marketplace today, it's trading at a forward P/E of 52 times this year's earnings. Let's just put that in context. That's a higher PE ratio than even Nvidia, which I think is trading at like 46 times. To be honest, I just really don't understand how the market really expects Costco to grow into that type of multiple.

So, overall, a 1-star rated stock that trades a 65% premium to our fair value.

Dziubinski: Well, Nvidia and Costco, you don't see those two compared very often. Thanks for your time this morning. Viewers interested in researching any of the stocks that Dave talked about today can visit Morningstar.com for more analysis. We hope you'll join us for the Morning Filter again next Monday at 9 a.m. Eastern, 8 a.m. Central. In the meantime, please like this video and subscribe to Morningstar's channel.

Have a great week!

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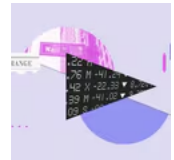

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