Sizing Up Reporting Season

While U.S. elections have dramatically taken center stage, "it's getting late, early" for corporate reporting season and important equity implications emerge from what's been a solid overall slate of results.

Investors should walk away with four takeaways which have implications for equities moving forward:

1. Bigger beats are back

2. Earnings quality is better than meets the eye

3. Trendy trades are quickly shifting

4. Cyclical end-markets show signs of troughing

Calendar Catalysts

For weeks we had noted a few calendar catalysts—FOMC decision days, the U.S. election, and Q3 reporting season— would set the stage for the trajectory of equities, and each of these developments have been met with positive aplomb from investors to this point. Each catalyst has provided valuable but differentiated market intelligence.

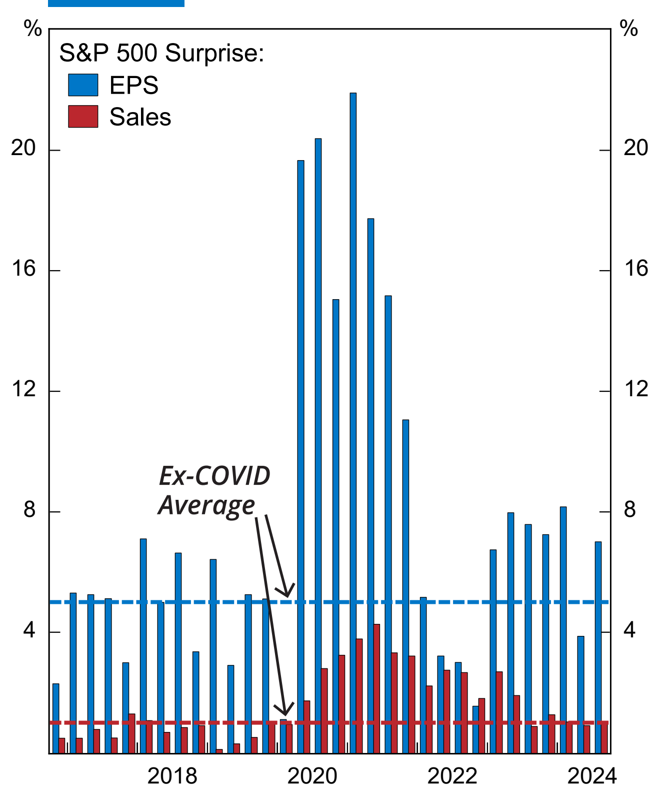
Reporting season is an opportunity to assess how the macro environment is being digested on a more micro level while providing a feedback channel for corporate management, analysts, and investors to emphasize key points of their agenda.

Our framework in sifting through corporate reporting involves evaluating the following:

A) **Results:** provides a snapshot-in-time account of how companies are managing through the business cycle

B) **Management discussion or guidance:** level-sets reasonably achievable performance markers and frames points of desired emphasis

Chart 1 Beats Back Above Average



Note: Horizontal dotted lines denote averages
Source: Bloomberg Finance L.P.

C) Analyst and investor reaction: highlights market drivers, often misaligned with management directives, and infers expectations

In consideration of these parameters third quarter reporting season has been an expression of solid quantifiable results, a positive outlook from corporates, and a trust-but-verify investor stance that signifies some degree of fully priced optimism.

Bigger Beats

Earnings growth matters, but with consensus expectations already baked into equity prices it's the incremental surprise, or the "new news," that moves markets. The S&P 500 is delivering a positive surprise of 7% relative to projected earnings and 1% on a top-line basis. Both figures are an improvement upon last quarter's results which produced the weakest level of surprise since Q4 2022.

It's important to note that companies regularly beat expectations, and we expected nothing less this quarter as companies used a heavy conference schedule in September to temper guidance, however, results have surpassed our expectations. In **Chart 1** we illustrate the trend in actual earnings and sales beats relative to expectations and note that the current pace exceeds average levels when stripping out COVID distortions.

Strong beats are widely distributed across sectors, styles, and market cap which signals underlying fundamental strength as opposed to narrow concentration. Within the S&P 500, every sector outside of Materials has produced better than expected earnings results, while Energy has been the only underwhelming group within the S&P 600 (profitable Small Caps).

Table 1 2024 Q3 Earnings Season Breakdown

2024 Q3 Large Cap	% Reported	Surprise Sales	Surprise EPS	2024 Q3 Small Cap	% Reported	Surprise Sales	Surprise EPS
S&P 500	**86%**	**1.00%**	**7.00%**	**S&P 600**	**90%**	**1.10%**	**9.40%**
Telecomm	96%	1.40%	13.10%	Telecomm	84%	3.80%	17.70%
Discretionary	89%	0.50%	16.70%	Discretionary	76%	0.90%	10.60%
Staples	73%	0.20%	4.00%	Staples	68%	0.60%	4.30%
Energy	98%	1.70%	6.80%	Energy	94%	1.90%	-1.80%
Financials	110%	1.30%	6.70%	Financials	98%	-2.10%	8.30%
Health Care	96%	1.30%	3.30%	Health Care	94%	3.10%	21.90%
Industrials	97%	-0.30%	7.60%	Industrials	83%	0.80%	4.40%
Info. Tech.	63%	1.20%	3.80%	Info. Tech.	85%	2.30%	18.70%
Materials	99%	-0.50%	-3.50%	Materials	94%	1.30%	1.10%
Real Estate	99%	1.90%	1.10%	Real Estate	95%	4.90%	1.70%
Utilities	100%	0.40%	7.40%	Utilities	95%	2.70%	3.90%

Note: Data as of November 10, 2024.

Table 1 breaks down the degree of earnings and sales surprise for Large Cap and Small Cap equities on a sectoral basis for this season.

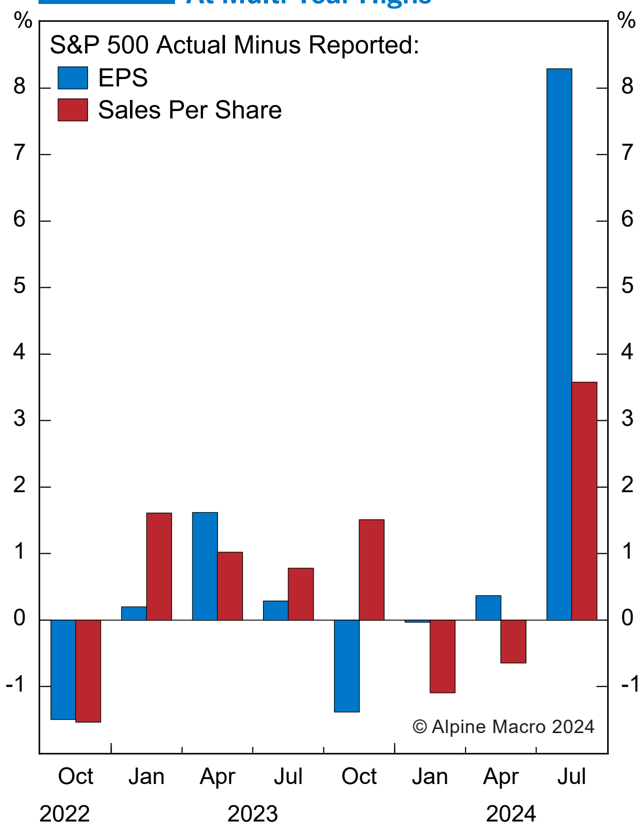
We highlight three core emergent themes for consideration:

1. Earnings are outpacing the macro economy as companies expand margins faster than revenues grow

2. Domestically oriented cyclical segments including Discretionary, Industrials, Financials, and Small Caps are delivering strong results relative to sectors with more exposure to international end-markets (Energy and Materials) and certain defensives (Large Cap Health Care and Staples)

3. Nearly half of the upside surprise is concentrated within Mega Tech (note: NVDA yet to report)

Chart 2 Bottom Up Minus Top Down Spread At Multi-Year Highs



Source: Bloomberg Finance L.P.

More Earnings Than Meets The Eye

Actual corporate earnings are stronger than adjusted top-down calculations otherwise suggest. As Bloomberg calculates, S&P 500 earnings growth is trending closer to 8% on a year-over-year basis. However, a bottom-up aggregation of total profits for all constituents, compared to total share count, indicates a growth rate exceeding 15%. The spread between these measures has reached a multi-year high (**Chart 2**).

The dispersion between various measures is often attributable to differences in divisors, adjustments, or normalizations and can have a material impact on results. However, alternative methods of calculation can provide a cleaner, more dynamic account of what's transpiring at the micro level. It also helps dampen headline equity valuations.

An evaluation of earnings trends at the company level, as opposed to the rolled-up macro level, shows reason for cautious optimism. Results show that the average company is performs well even if the overall index is dragged lower by a cohort of businesses struggling or without a focus on profitability. Solid companies are gaining momentum, largely off the back of operational leverage, while broken business models are getting left behind.

This dynamic is especially acute across more volatile segments such as Small Caps which experience larger turnover of constituency, and

Table 2 Top-Down Measures Understate Solid Fundamentals

2024 Q3	YoY Earnings Growth*	
	Top-Down	Bottom-Up
S&P 500	**7.0%**	**15.3%**
Telecomm	21.3%	33.2%
Discretionary	18.4%	33.9%
Staples	3.6%	6.2%
Energy	-24.1%	-13.8%
Financials	6.4%	12.0%
Health Care	14.6%	16.2%
Industrials	-8.8%	6.4%
Info. Tech.	10.5%	13.2%
Materials	-7.0%	3.7%
Real Estate	1.4%	2.2%
Utilities	13.0%	11.3%

*Bottom-up adjustment limits gains/losses to +/- 100%, removes flips to/from positive & negative earnings. Results represent aggregated cap-weighted earnings growth.

with companies often flipping between profitable and unprofitable.

A trimmed approach to Small Cap results, reducing the significance of +/- outliers, reveals solid weighted-average profit growth of nearly 16% for Q3, otherwise masked by conventional top-down calculations. Trends are similar but to a lesser degree across Large Caps, and it's worth mentioning that earnings are more pronounced in the Growth style.

The bottom line is that headline figures understate strengthening underlying corporate fundamentals which should provide a boost to cyclical segments and provide a slight cushion to extended valuations.

Table 2 details overall and sector earnings growth for the S&P 500 calculated on a top-down basis and from an adjusted bottom-up standpoint.

Trendy Trades Face Scrutiny

Last reporting season marked a distinct point in which investor sentiment pertaining to the effervescent artificial intelligence (A.I.) craze shifted from belief to "trust-but-verify" as it relates to the monetization of investment into adjacent technologies. Corporate management received the message and have recalibrated efforts to communicate the value proposition of their investment into these technologies.

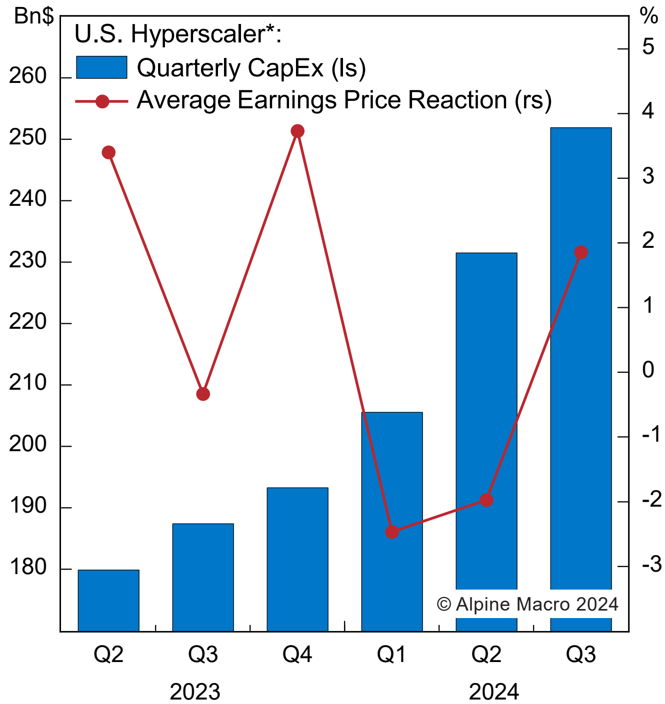
As noted in our August report[1],a dispersion developed in the post-earnings price reaction between A.I. "spenders" and A.I. "sellers," in which companies selling A.I. infrastructure benefited, whereas companies purchasing this infrastructure to repackage or deploy in-house saw declines.

This trend has begun to shift and even reverse in some cases, as companies articulate tangible ways in which their technology buildout can be monetized via revenue growth or efficiencies. Through reporting season, our A.I. "spenders" basket has enjoyed a 1% weighted average price increase following earnings, a bump of nearly 3.3% from last quarter. Caution is still warranted, however, as there's a wide dispersion across members.

Conversely, some of the infrastructure providers, especially within the semiconductor industry, have faltered as solid results have failed to meet an incredibly high bar that's been set. Broadcom (AVGO), which reported Q3 earnings in September, beat on earnings and revenue but still declined -10.4% as investors viewed guidance as underwhelming.

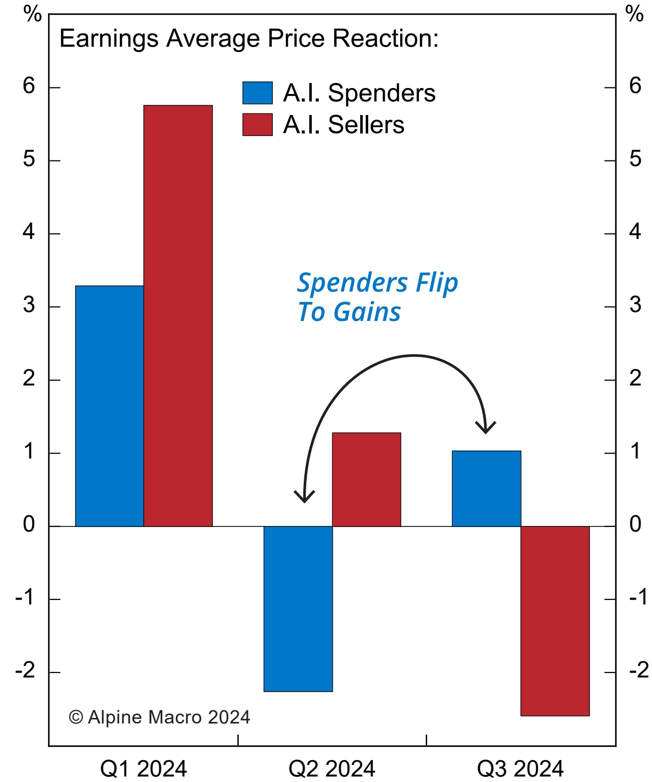
1 Alpine Macro *Equity Strategy* "Macro And Micro Winds Swirling" (August 7th, 2024).

Chart 3 Investors Want Bang For CapEx $$



*Aggregate of IBM, GOOGL, AAPL, MSFT, ORCL, META, AMZN
Source: Bloomberg Finance L.P.

Chart 4 A.I. Buyers Flip Script On Sellers



Source: Bloomberg Finance L.P.

Chart 3 illustrates the rapid rise in hyperscaler CapEx, while **Chart 4** shows how the post-earnings reaction has flipped between A.I. "spenders" and "sellers."

The slight unmooring of another trendy trade is taking place within the pharmaceutical industry as the leading U.S. developer of GLP-1 weight loss drugs surprised with a substantial revenue and earnings miss which led shares careening ~15% in the following days. Its top international competitor also missed its revenue mark and is nearly 25% off from its record high.

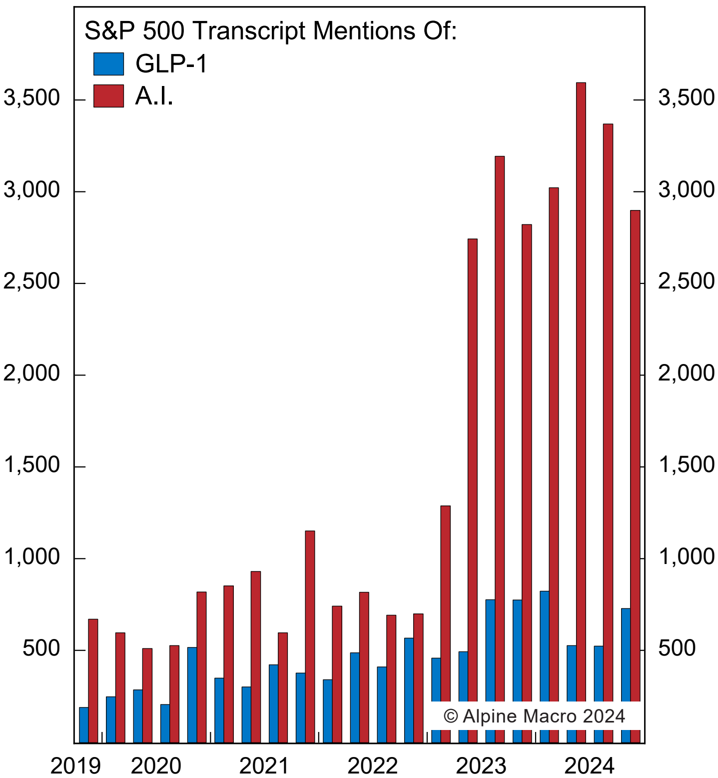
The bottom line is that trendy trade results are high stakes given that: 1) more aggressive "whisper" figures are paramount versus consensus, and 2) companies have accrued premium valuations on expectations of explosive growth. As such, anything less than blowout results with a pristine outlook is vulnerable (**Chart 5**).

The upside to the lagging groups, especially A.I. enablers given our positive outlook, is that a reframing of expectations lower should provide an opportunity to outperform in coming periods.

Potential Trough In Cyclical End-Markets

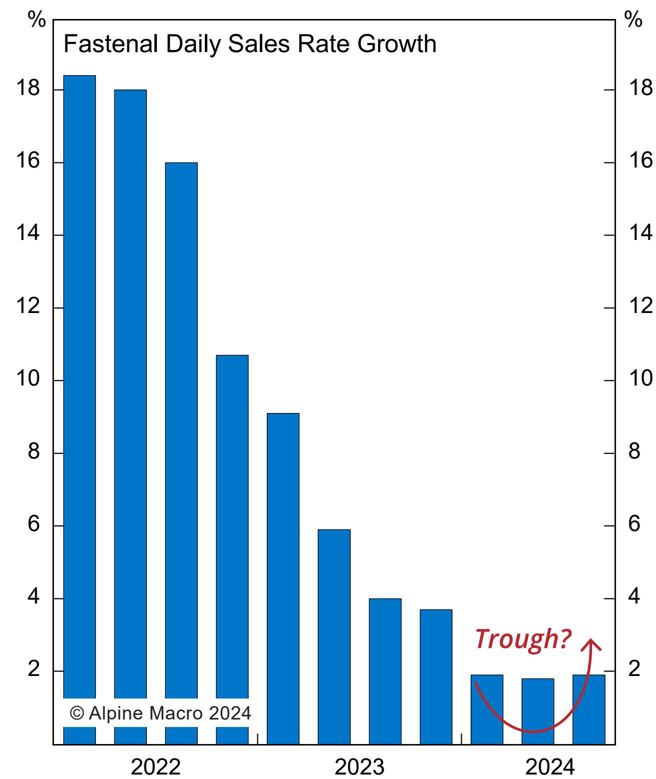
Cyclical end-markets have generally struggled as U.S. manufacturing remains in contraction, while swaths of the global economy such as Europe and China endure significant slowdowns. Therefore, equity segments tethered closely to international revenue streams and industrial activity have stagnated.

Chart 5 A.I. & GLP-1 Interest Reaches Crescendo



Source: Bloomberg Finance L.P.

Chart 6 Potential Trough In Some End Markets



Source: Fastenal Co. Investor Presentation

However, corporate management teams are hinting that the freeze is thawing as they allude to possible troughs in depressed markets such as general construction, transportation, and machinery. These markets have been bogged down by weak unit demand and flat-to-elevated inventory.

Fastenal, a company which sells a wide array of construction and industrial supplies across the world, posted slow sales growth but management noted that: A) the third quarter finished stronger than it began, B) some markets have contracted so much that the hurdle rate is very low, C) overall markets are mixed but this represents improvement over pessimism through past quarters. Other bellwethers concur (**Chart 6**).

It's not all depressed, as anything related to data centers and power is surging, unsurprisingly, and government business appears robust bolstered by lagged release of fiscal stimulus. Caterpillar (CAT) noted that just 27% of the $348bn of spending earmarked from the Infrastructure Investment and Jobs Act (IIJA) had been spent as of August, while Eaton (ETN) announced a 48% increase in mega projects relative to Q2.

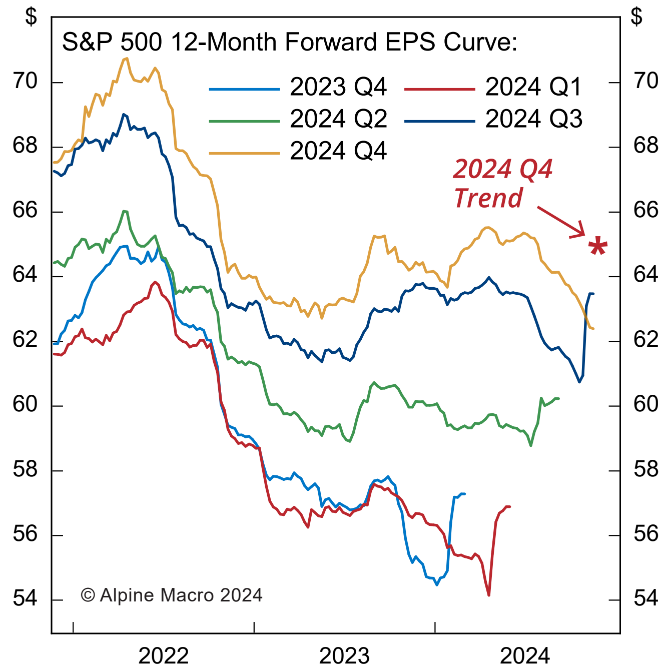
In **Chart 7** we present ETN's consensus growth outlook for various end markets compiled by leading company guidance. Any uptick higher in the ISM Manufacturing Index, which is more probable following U.S. elections, should be viewed as a significant leading indicator for upgrading these expectations.

Chart 7 Select End Market Growth Outlook

Segment	Outlook
Data Centers	DD
Aerospace & Defense	DD
Utilities	HSD
Industrial Facilities	MSD
Commercial	MSD
Residential	LSD
Transportation	LSD
Machinery	LSD

Note: DD= double digit HSD= high single digit MSD= mid single digit LSD= low single digit, Outlook compiled from corporate leader guidance

Chart 8 Earnings Curves Will Inflect Higher



Source: Bloomberg Finance L.P.

What It Means Going Forward

Earnings expectations will be revised upward for next quarter and beyond, in our view, and earnings curves will follow a similar pattern to previous quarters where expectations declined heading into reporting season before results pushed realized EPS higher (Chart 8).

In the last four reporting seasons consensus earnings initially declined before settling an average of 4.3% higher at completion. We have confidence that this dynamic will persist and at current levels would imply Q4 annualized S&P 500 earnings of ~$260, or just 2.7% below the median estimate of Wall Street strategists for CY2025. Given the resilience of the U.S. economy and encouraging trends detailed above, there's a high likelihood that those estimates are too conservative.

Segments with exposure to domestic cyclicality should stand to benefit most from a broadening of profit growth, which aligns with the recovery phase of our investment framework. This would include Small Caps, Banks, pockets of Industrials, and even Real Estate given weak comparables although higher yields pose a risk. Utilities remain well-positioned, slightly misunderstood, and are nearing oversold territory following U.S. elections.

Nick Giorgi
Chief Equity Strategist

Investment Recommendations				
Strategic Recommendations (6 - 12 months)				
Recommendations	**Open Date**	**Performance**		**Active Return**
		Vehicle	**S&P 500**	
Long S&P Industrials	5/29/2024	17.29%	13.68%	3.61%
Long S&P Utilities	6/12/2024	13.07%	10.45%	2.62%
Long S&P 600	6/24/2024	18.64%	9.90%	8.74%
Short S&P Materials	7/24/2024	3.15%	10.32%	7.17%
Long Regional Banks (KRX)	8/21/2024	21.00%	6.52%	14.48%
Long/Short S&P 500 Healthcare Equipment & Supplies/Providers & Services	10/23/2024	2.56%		2.56%

A Unique Mind On The Markets