Defensive sector positioning in the current earnings season

December 2022

Research Signals

The 2022 market downturn has been characterized by several bouts of active dip buying, including in recent months as investors applauded suggestions that the US Federal Reserve may ease off its aggressive rate hiking cycle. However, additional increases are expected, albeit at lower increments, and the potential for an economic recession still looms. Moreover, in the third quarter of 2022, S&P 500 index constituents saw a 5.7% decrease from the prior quarter in the number of firms that beat S&P Capital IQ earnings estimates, according to S&P Global Market Intelligence. Thus, we study attributes of defensive versus growth sectors given the potential impact of already implemented and future rate hikes on companies' bottom lines.

- The November S&P Global Investment Manager Index™ survey of institutional investors identified energy and health care as the most favored sectors, while technology and consumer discretionary were among the least favored, as risk appetites worsened and earnings expectations have lowered
- 44% of companies achieving a positive earnings surprise in the current quarter were also associated with an annual decrease in shares outstanding, compared with just 28% in the third quarter of 2021, with a more pronounced increase in the consumer discretionary sector relative to other sectors
- Technology and consumer discretionary stocks have seen a notable increase in negative earnings surprises in the current quarter compared with the prior year, while energy's count decreased over the same period and health care dropped off more recently

Defensive market sentiment

Throughout the equity market downturn in 2022, several countertrend rallies developed as investors searched for signs of a Fed pivot from its aggressive pace of interest rate hikes. Indeed, in Figure 1 we highlight eight notable rebounds through November 16, 2022, averaging 8.2%, with the largest return of 13.6% occurring from mid-July through mid-August. Yet, the frequency and magnitude of such countertrend rallies is not unusual in a bear market. Coming off the dotcom bubble (see Figure A1 in the Appendix), we note seven significant market

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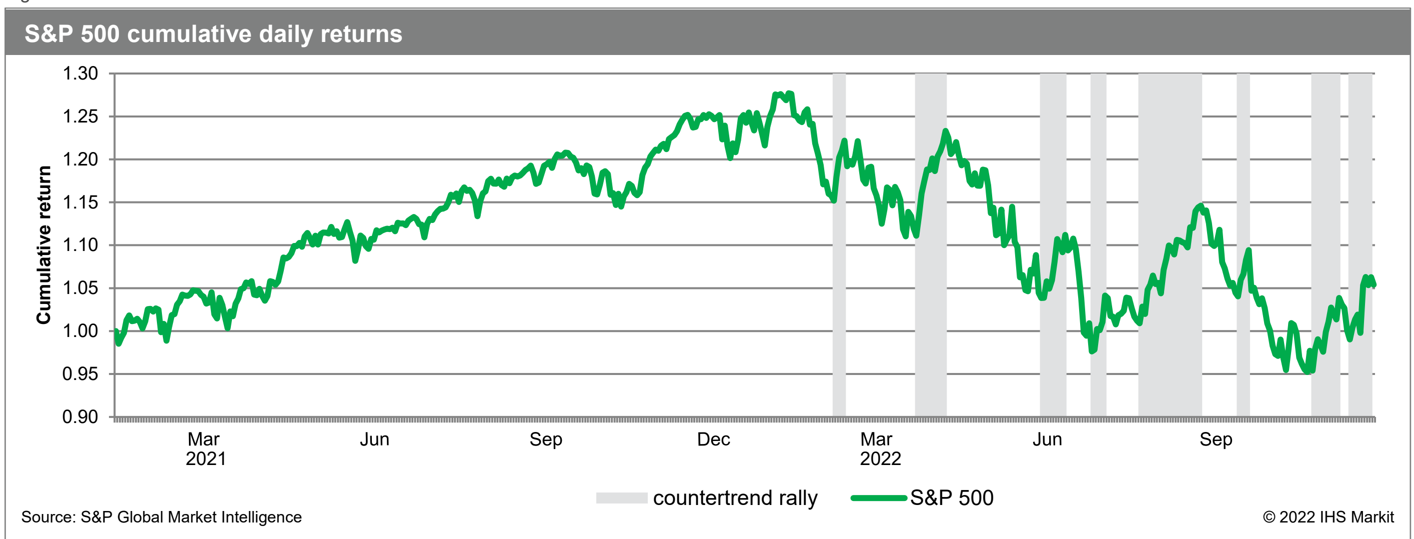
rebounds as stocks trended down, and another six occurred during the Great Financial Crisis (see Figure A2 in the Appendix), averaging 14.9% (max: 21.1%) and 12.7% (max: 24.2%), respectively.

One major distinction with the prior events, though, is that the Fed was easing rates (see Figure A3 in the Appendix), while the current bear market has had to withstand a Fed that is still in a tightening phase that is expected to last at least through early 2023, according to S&P global economists' recent Weekly Economic Commentary report. A more hawkish central bank has certainly weighed on institutional investor sentiment. In fact, the November 2022 S&P Global Investment Manager Index™ (IMI) report identified that risk appetite among US equity institutional investors deteriorated once again in November, driven by concerns over central bank policies and the macroeconomic environment (based on data collected between the 2nd and 7th of November 2022 from a panel of just under 300 institutional investors employed by firms which collectively represent approximately $3.5 trillion assets under management).

Figure 1



We also note from the recent IMI survey that more defensive sectors including energy and health care remain the most favored sectors, while the growth-oriented technology sector saw the biggest negative change in sentiment, sitting just above consumer discretionary which continues to reside among sectors with the weakest degree of sentiment. Looking at monthly cumulative sector returns (Figure 2), we find that energy has strongly outperformed in 2022 and health care has kept pace with the market, while technology and consumer discretionary have lagged. Likewise, energy and health care outperformed during the two previous bear markets (see Figures A4 and A5 in the Appendix).

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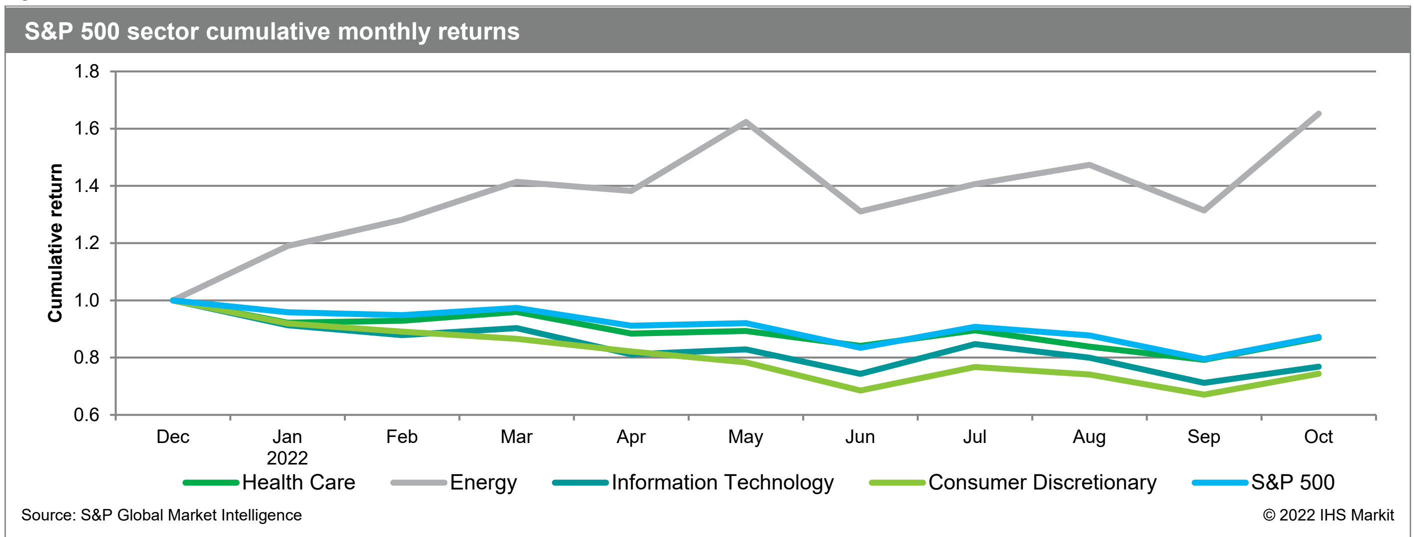
Figure 2

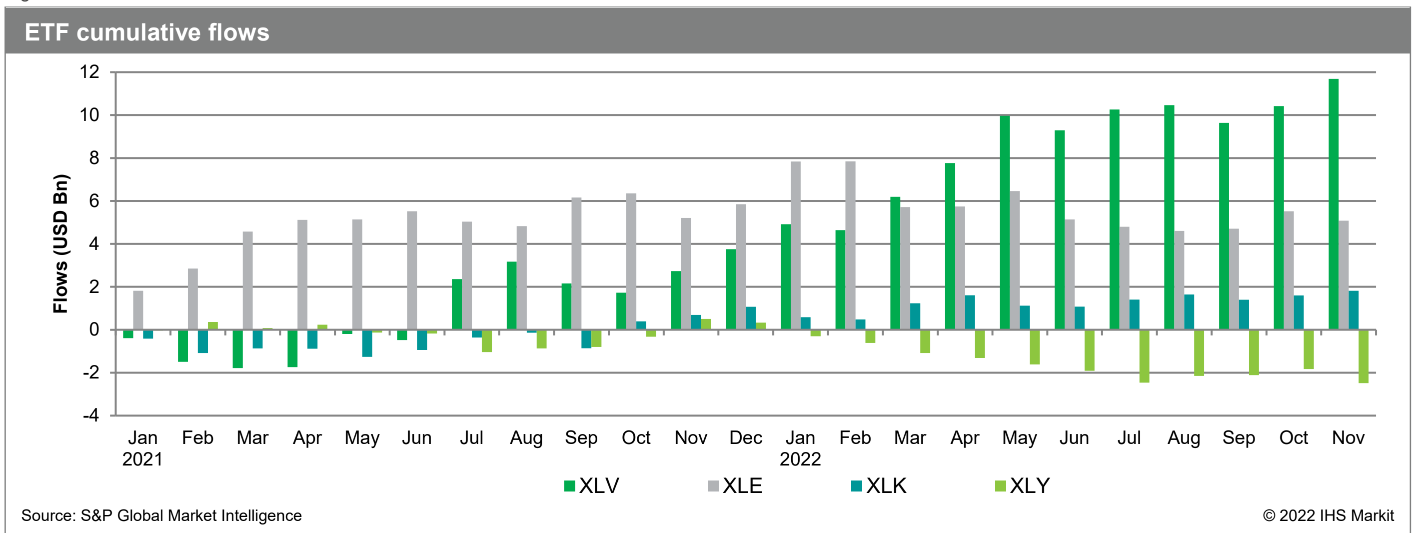


From a retail investor perspective, we also report on cumulative flows (Figure 3) into the following SPDR sector ETFS:

- SPDR Healthcare Select Sector ETF (XLV)
- Energy Select Sector SPDR ETF (XLE)
- Technology Select Sector SPDR ETF (XLK)
- SPDR Consumer Discretionary Select Sector ETF (XLY)

In 2022, cumulative inflows in the healthcare sector increased three-fold, reaching $11.7 billion by the end of November. Energy sector flows lost some momentum after the February 2022 peak, but stabilized in the second half of the year, while technology sector flows picked up some steam in March 2022 before also leveling off in the second half of the year. Conversely, consumer discretionary cumulative flows remained in negative territory throughout 2022.

Figure 3



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Surprising earnings results

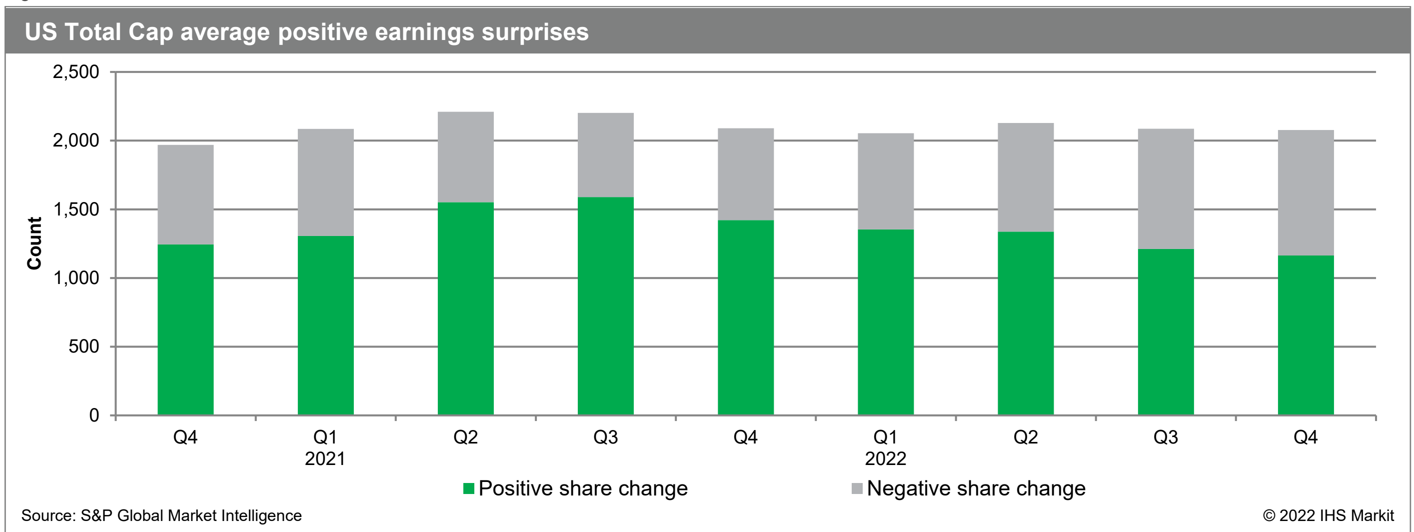
Given this defensive posturing among institutional investors, does the current earnings outlook justify recent dip buying? Following the latest Q3 earnings season, approximately half of IMI survey respondents in November have lowered or will be lowering their earnings expectations for the next quarter. Furthermore, when asked about the risks to shareholder returns, investors overwhelmingly cited a potential earnings recession. This aligns with additional outlook from S&P Global economists that a recession in coming quarters is more likely than not, despite resiliency in consumer spending and the capital goods sector.

Furthermore, according to a recent Wall Street Journal article, with 97% of S&P 500 constituents' third quarter earnings reported, year-over-year profit growth stands at roughly 2%, the slowest rate since the third quarter of 2020 amid the Covid-19 pandemic. Analysts have also sharply downgraded current quarter earnings estimates, implying a contraction in profit growth of around 2%, the first annualized quarterly decline since 2020, compared with roughly 9% profit growth estimated for the same period at the end of June.

With this in mind, we use the Research Signals Stock Screener utility to dig deeper into recent earnings reports. The analysis is based on daily values of our Real Earnings Surprise factor which is constructed as the difference between actual earnings per share and consensus forecasts prior to the announcement date, scaled by price at the end of the quarter. The universe is the US Total Cap constituents, comprising approximately 3,000 of the largest capitalization names.

In Figure 4 we present the average from our daily count of the number of companies that reported a Real Earnings Surprise greater than zero during the calendar quarter. Of that total, we separate companies by their directional annual change in shares outstanding using Percent Change in Shares Outstanding factor values greater than or less than zero. The results show a slight downward trend since mid-2021 in the overall number of positive surprises. What is more, the percent of companies achieving a positive surprise along with a decrease in the shares outstanding increased from a low of 28% in the third quarter of 2021 to 44% in the current quarter, painting the earnings beats with a less impressive brush.

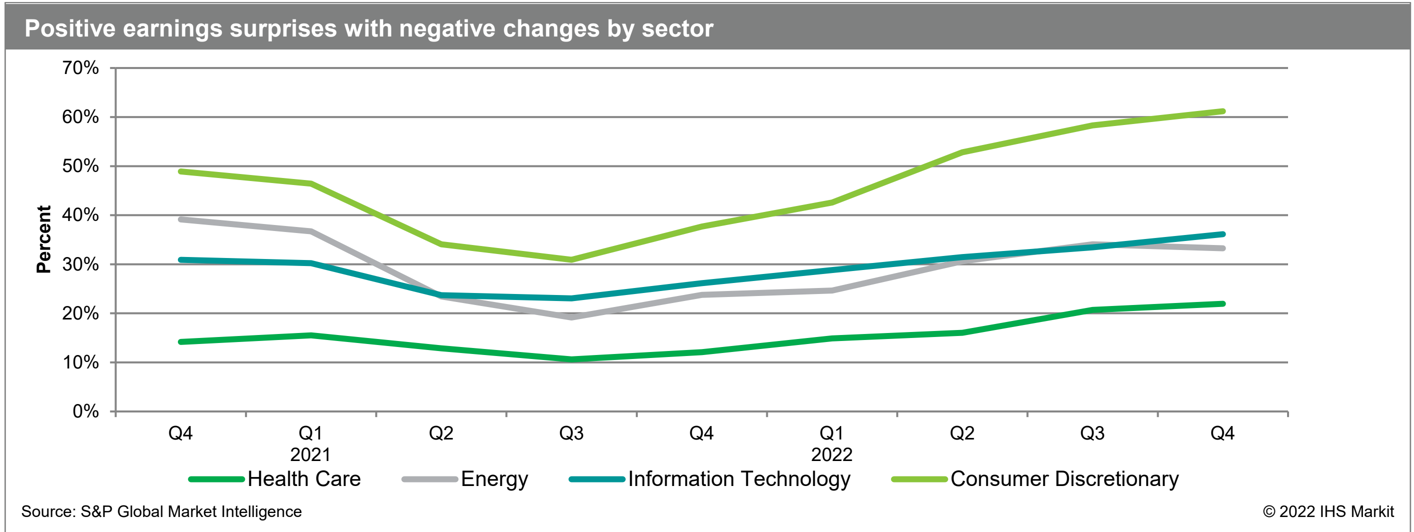
Figure 4



To provide more granularity, we drill down to the same set of defensive and growth-oriented sectors reported on above and report the percent of positive surprises that occurred with a drop in shares outstanding relative to the total number of surprises by sector (Figure 5). While all sectors saw an increase in representation, health care

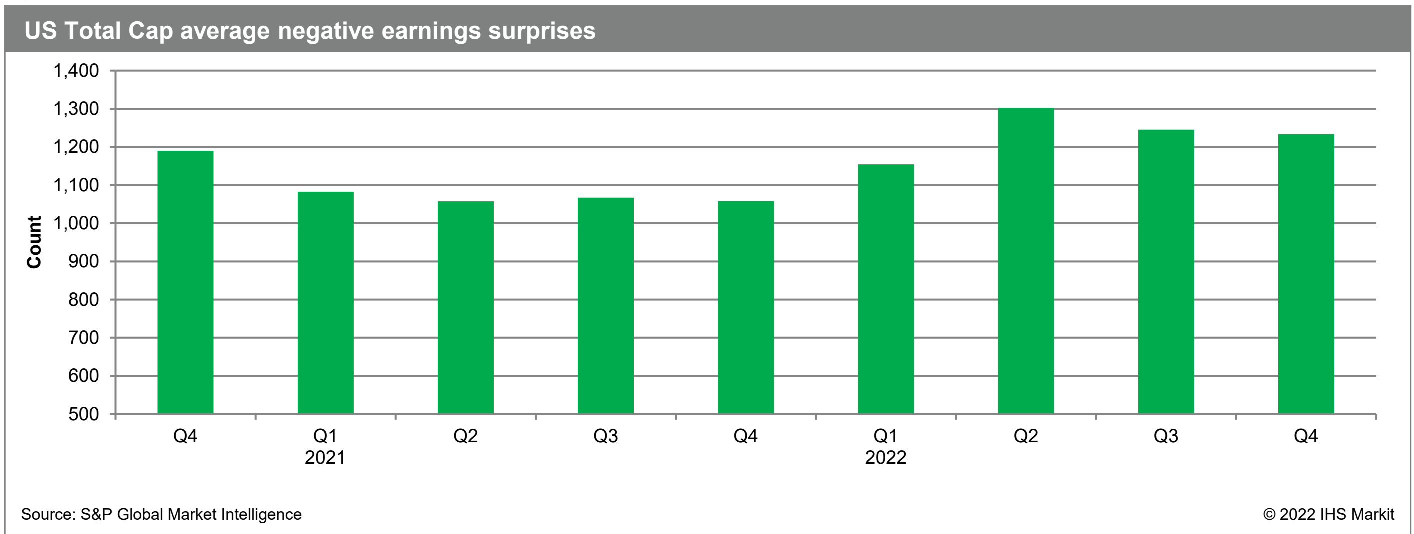
maintained the lowest percentage of firms under this scenario. The energy and technology series followed a similar trend, while the consumer discretionary series exceeded the other sectors throughout the analysis period, with an increasing spread since the third quarter 2021 bottom.

Figure 5



Next, we look at the number of companies that have reported negative surprises (Figure 6). This is perhaps a more valuable statistic to focus on compared with positive surprises, as companies are expected to guide down estimates leading into earnings announcements in order to beat expectations. In this case, we find that 2022 has seen an elevated number of companies reporting negative surprises compared with the prior year, with a 15.7% increase from the 2021 average.

Figure 6



Lastly, we break out negative earnings surprises again by the same sectors reported on above (Figure 7). Note that we report the health care sector on the secondary axis to allow for finer detail to be discerned among the remaining sectors.

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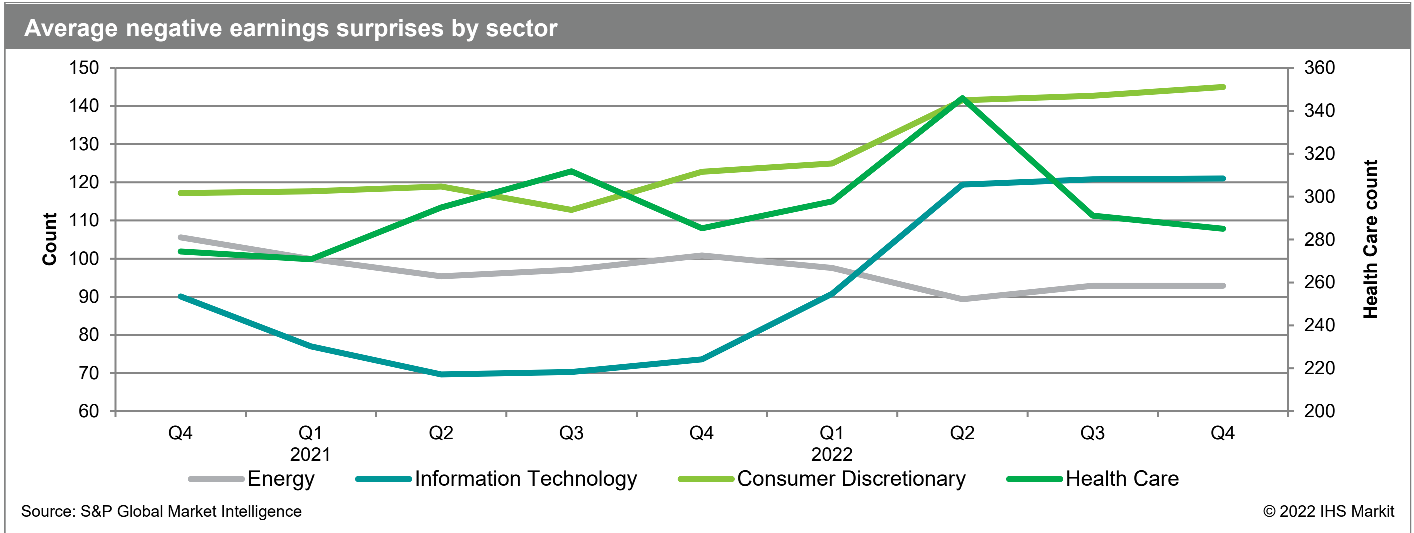
Energy has seen a lower number of companies reporting negative surprises in recent quarters compared with the prior year. Following its peak in the second quarter of this year, the number of health care stocks reporting a negative surprise has dropped off by 18%. On the other hand, technology and consumer discretionary had marked increases of 73% and 27%, respectively, in negative surprises from the third quarter of 2021 through the current quarter.

Figure 7



In summary, recent countertrend rallies have been anchored on investors' hopes of a Fed pivot and the current market downtrend having reached a bottom. However, the question remains whether already elevated interest rates and potential future increases may send the economy into a recession. In the November IMI survey, institutional investors overwhelmingly cited a potential earnings recession as a risk to shareholder returns and further identified energy and health care as the most favored sectors, while technology and consumer discretionary were among the least favored. A deeper dive into recent earnings announcements reveals a large increase from the prior year in the number of negative earnings surprises reported by the technology and consumer discretionary sectors, while energy's count decreased over the same period and health care dropped off more recently. Of those firms that beat expectations, the consumer discretionary sector had a more pronounced percent of positive surprises that occurred with a drop in shares outstanding relative to the total number of surprises, whereas health care tracked at about one-third this level over the past two years, and about half that of the technology and energy sectors.

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Appendix

Figure A1

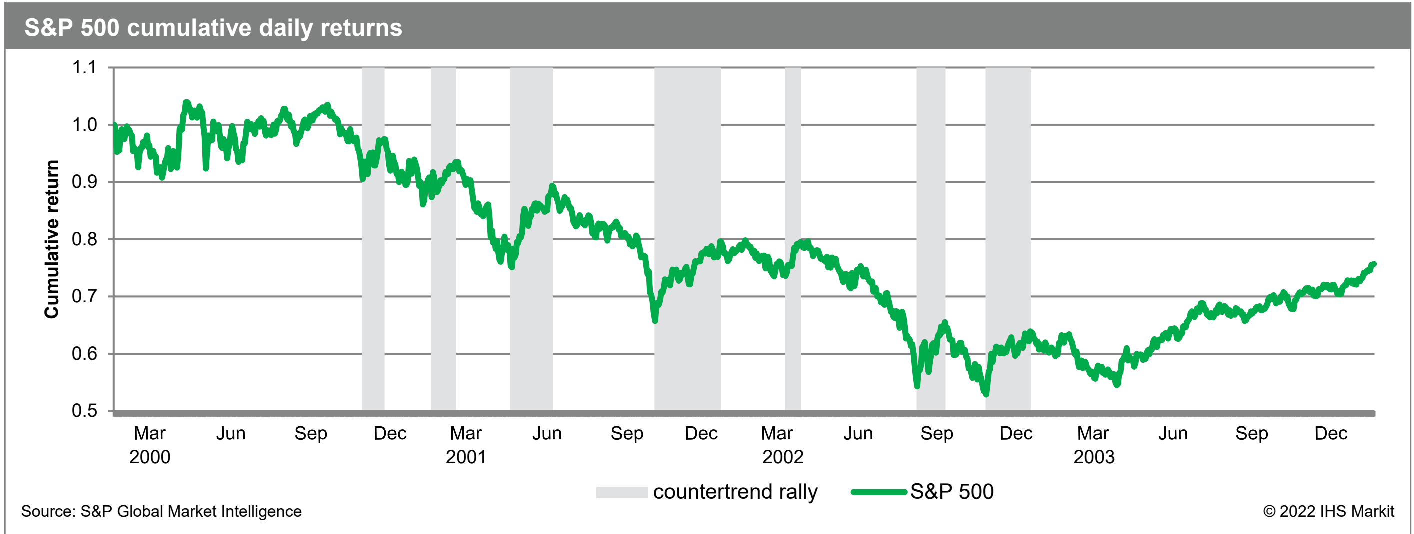

Figure A2

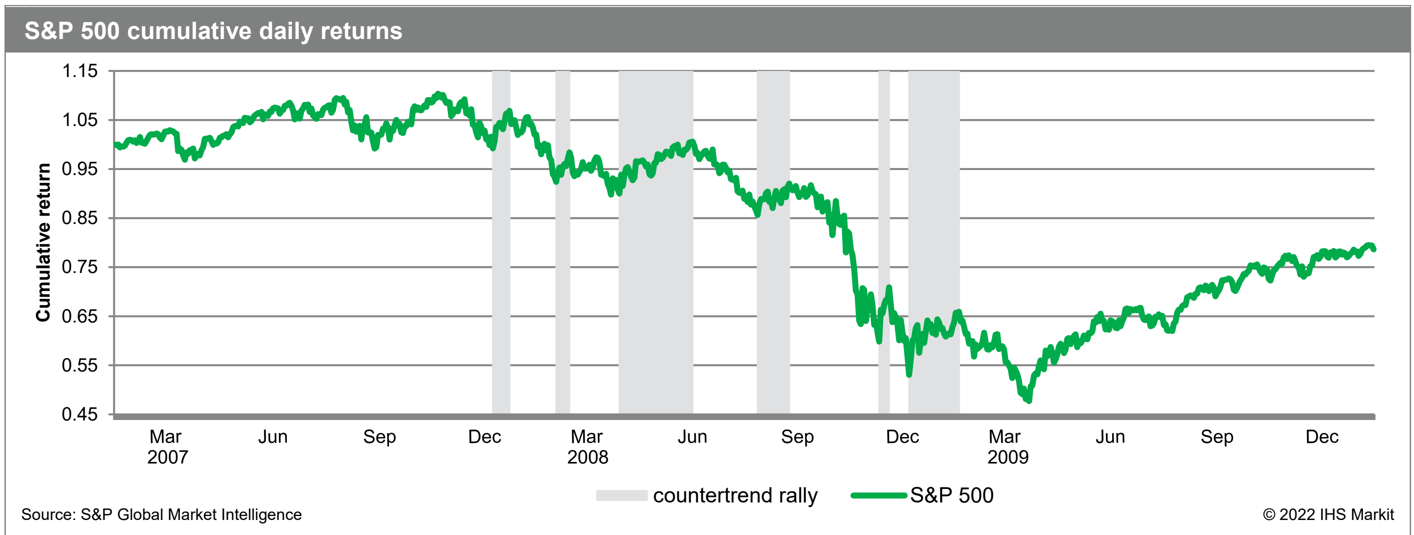

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Figure A3

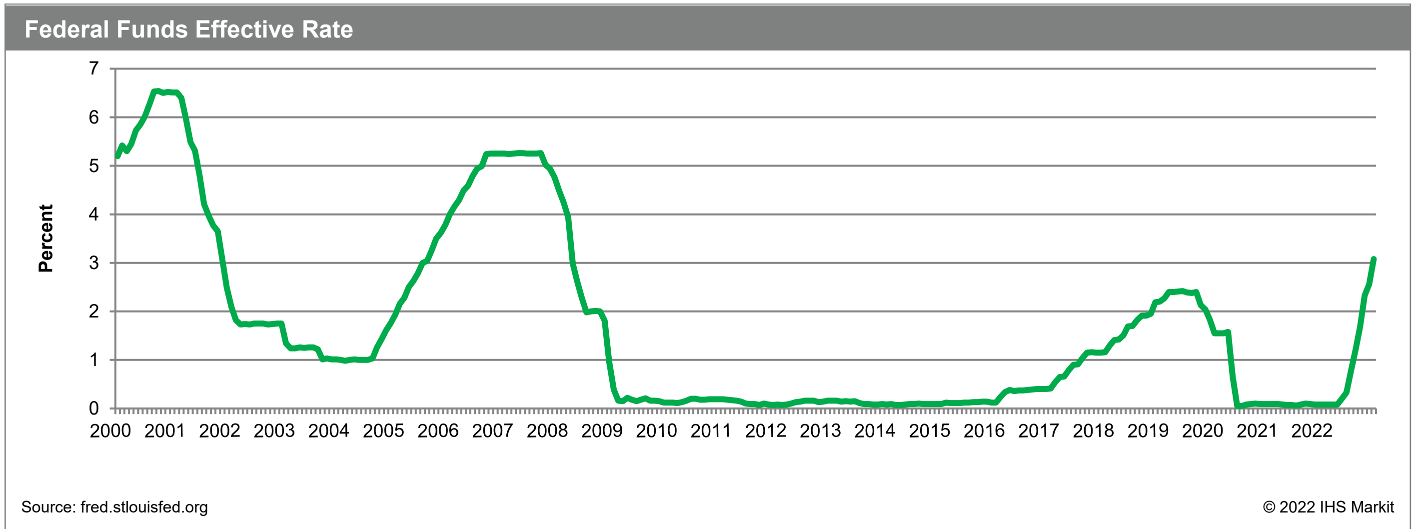


Figure A4

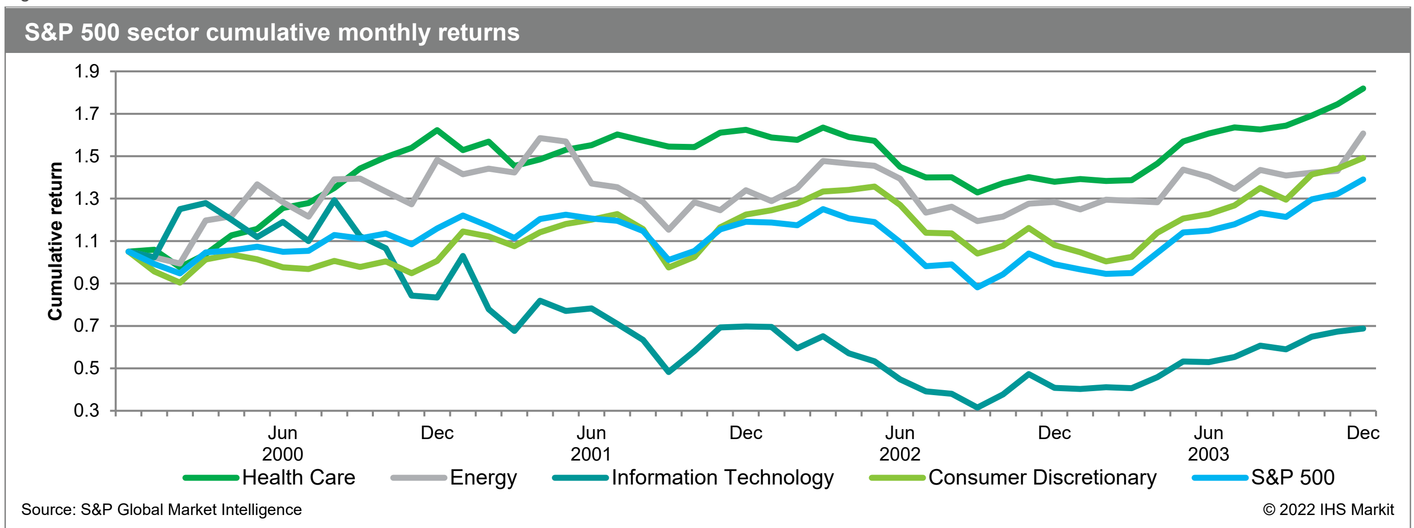
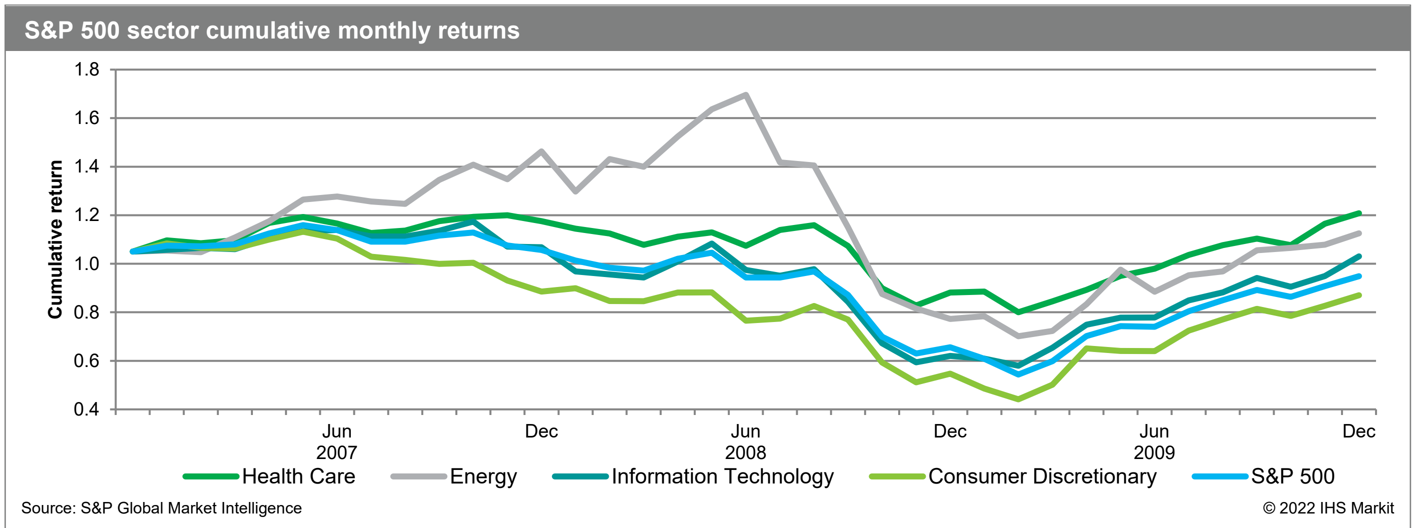


Figure A5



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