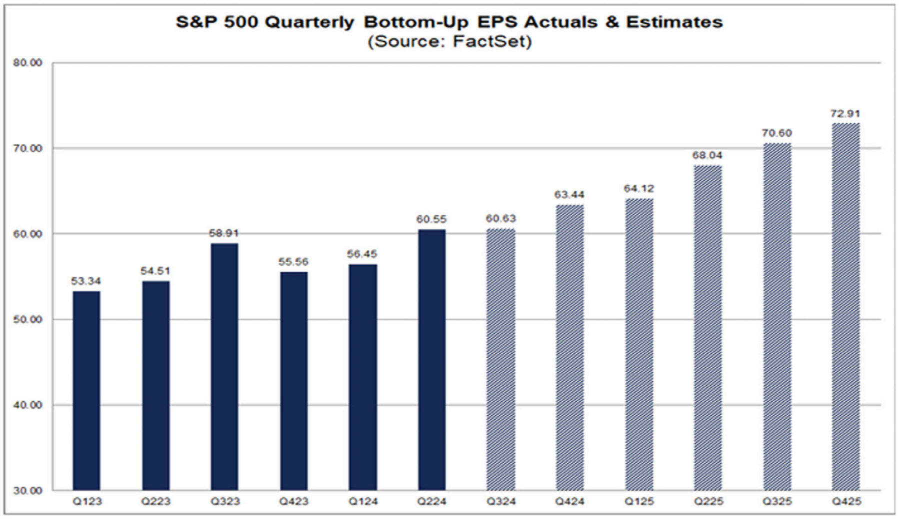
Kensington Market Insights

October 10, 2024

Market Insights is a piece in which Kensington's Portfolio Management team will share interesting and thought-provoking charts that we believe provide insight into markets and the current investment landscape.

Q3 Earnings Season: Navigating Uncertainty Amid Market Opportunities

Q3 earnings season kicks off this week with the S&P 500 expected to deliver a solid 4.2% year-over-year growth rate (chart below). While estimates have come down significantly from an anticipated 7.8% growth rate on June 30, a 4.2% growth rate would mark the 5th consecutive quarter of positive growth for the index and help ease any short-term concerns about a slowing economy.



Source: FactSet as of October 4, 2024

Even more encouraging than the headline number is the expanding breadth of companies within the index contributing to the gains (chart below). Nearly 75% of S&P 500 companies are anticipated to announce a positive change in forward earnings, a stark improvement from 2023, when fewer than 60% of companies reported such growth, as the Information Technology sector primarily propped up markets during much of the year.

About Kensington

Kensington Asset Management specializes in data-driven, quantitative investment solutions spanning across the global investment landscape. Our focus is to help provide investors with confidence through quantitative analytics, by attempting to participate in rising markets, while taking steps to help avoid exposure during times of market decline or volatility. Kensington Asset Management was founded by Bruce P. DeLaurentis, a quantitative pioneer with over 40 years of trading experience through numerous market cycles.

Investment Philosophy

Kensington believes that the best way to generate steady, above average positive returns is to employ an investment methodology that has the potential to recognize and measure consistent and repeating behavioral patterns in the financial markets. With that goal in mind, Kensington has developed clearly defined quantitative decision models that strive to minimize subjectivity in this decision-making process. The overarching goal is to capture sufficient returns in positive market conditions, while protecting capital, with rigorous mitigation during down markets.

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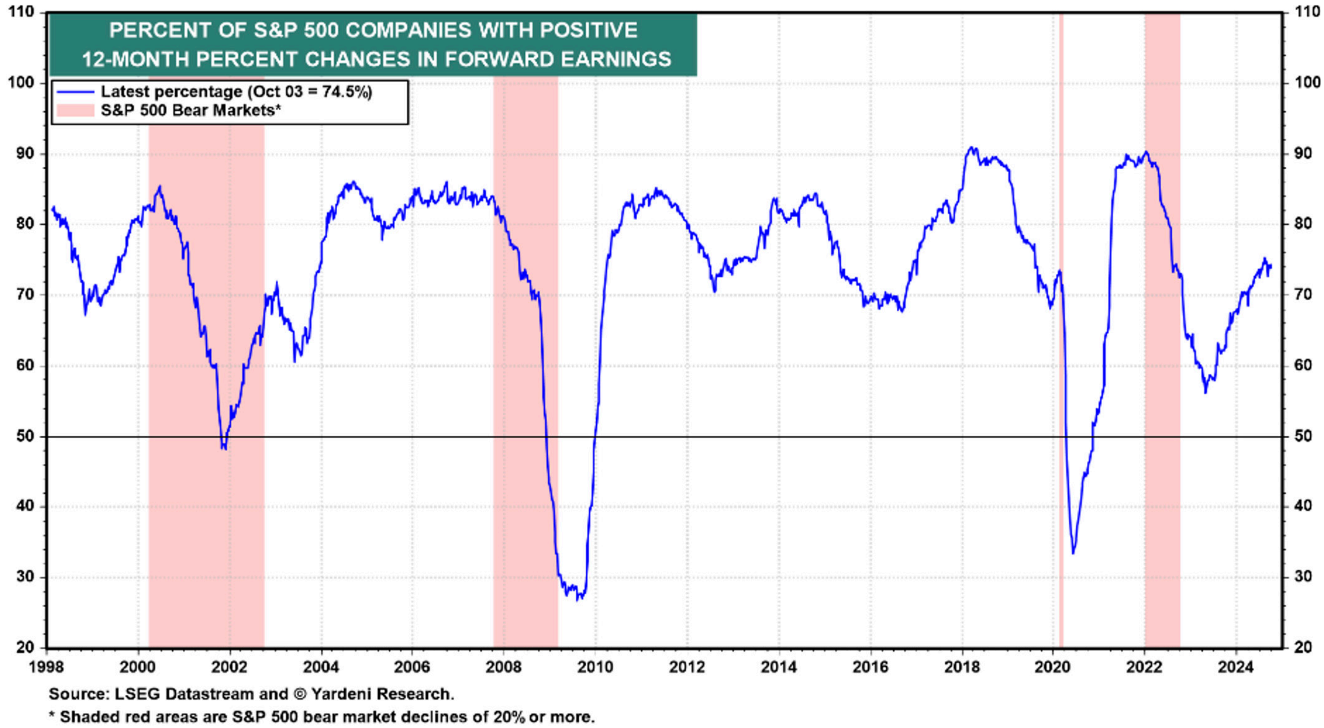
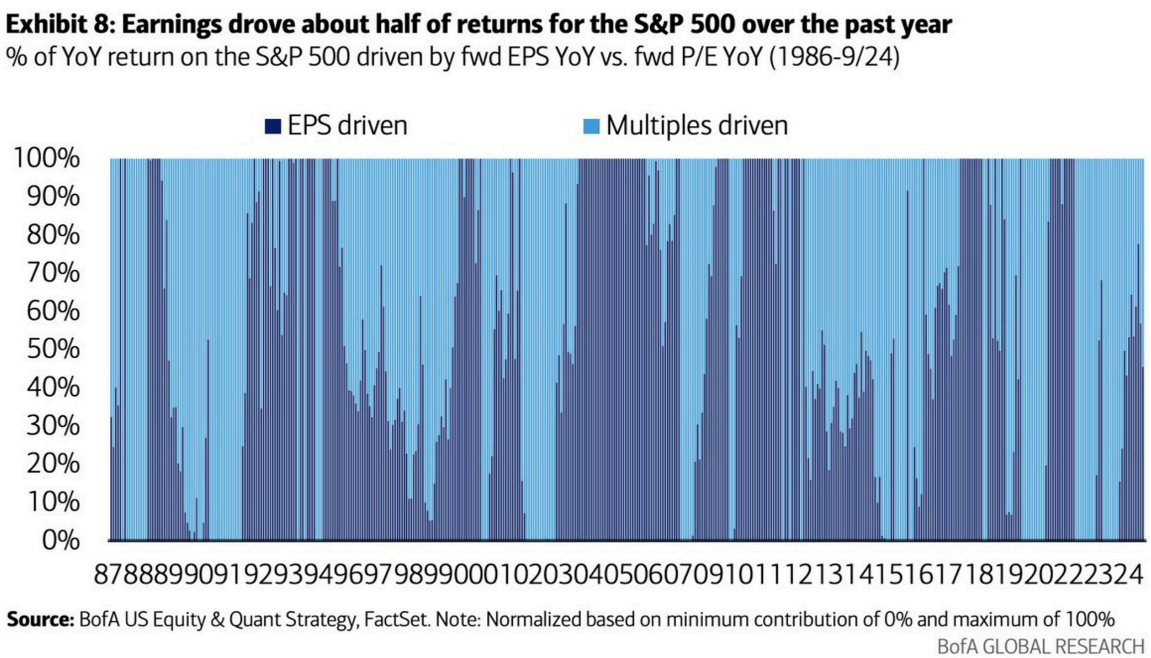
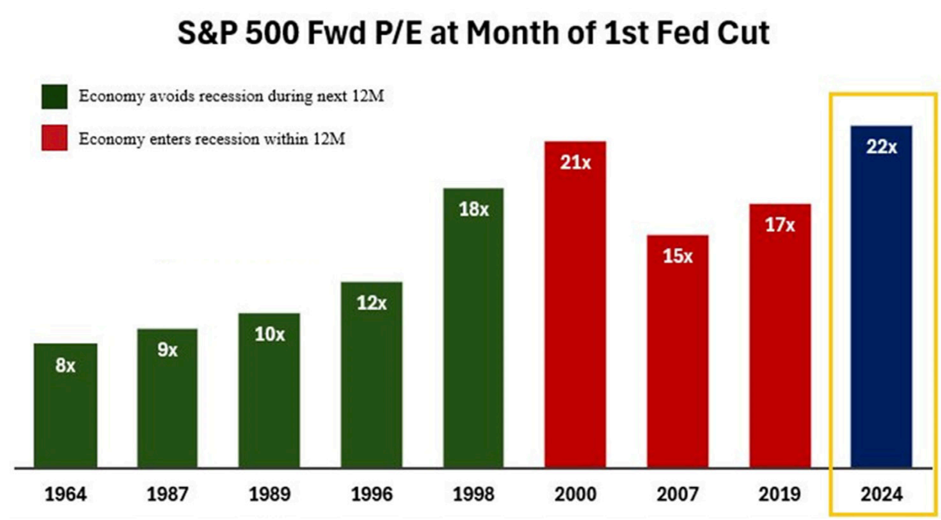


Source: US Bank as of September 6, 2024

Quarterly earnings always play a crucial role in stock market returns, but they may take on even more significance in the months ahead. While 2023 market returns were largely driven by multiple expansion, earnings have accounted for 45% of the S&P 500's 12-month returns as of September (chart below).

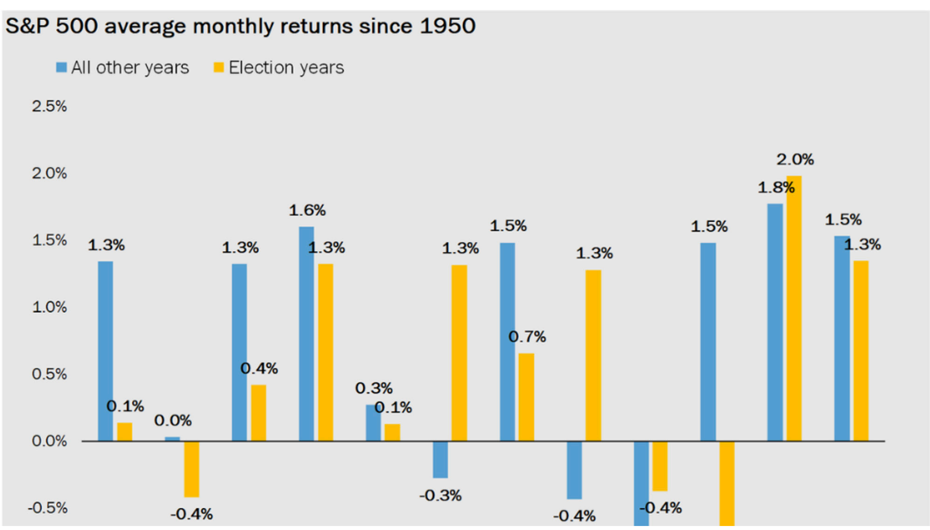


For markets to continue their upward trajectory, that trend will likely need to persist and could be critical in avoiding a recession. As illustrated in the chart below, the S&P 500 Forward P/E at the time of the September rate cut was 22x, the highest multiple seen during an initial rate cut since at least 1964. Although this is a relatively small sample size with only eight previous instances, higher starting multiples have shown some correlation with a recession (highlighted by the red bars). If earnings deliver as expected in the third quarter, it could provide a buffer for market multiples, allowing them to remain steady or even contract without triggering significant drawdowns.

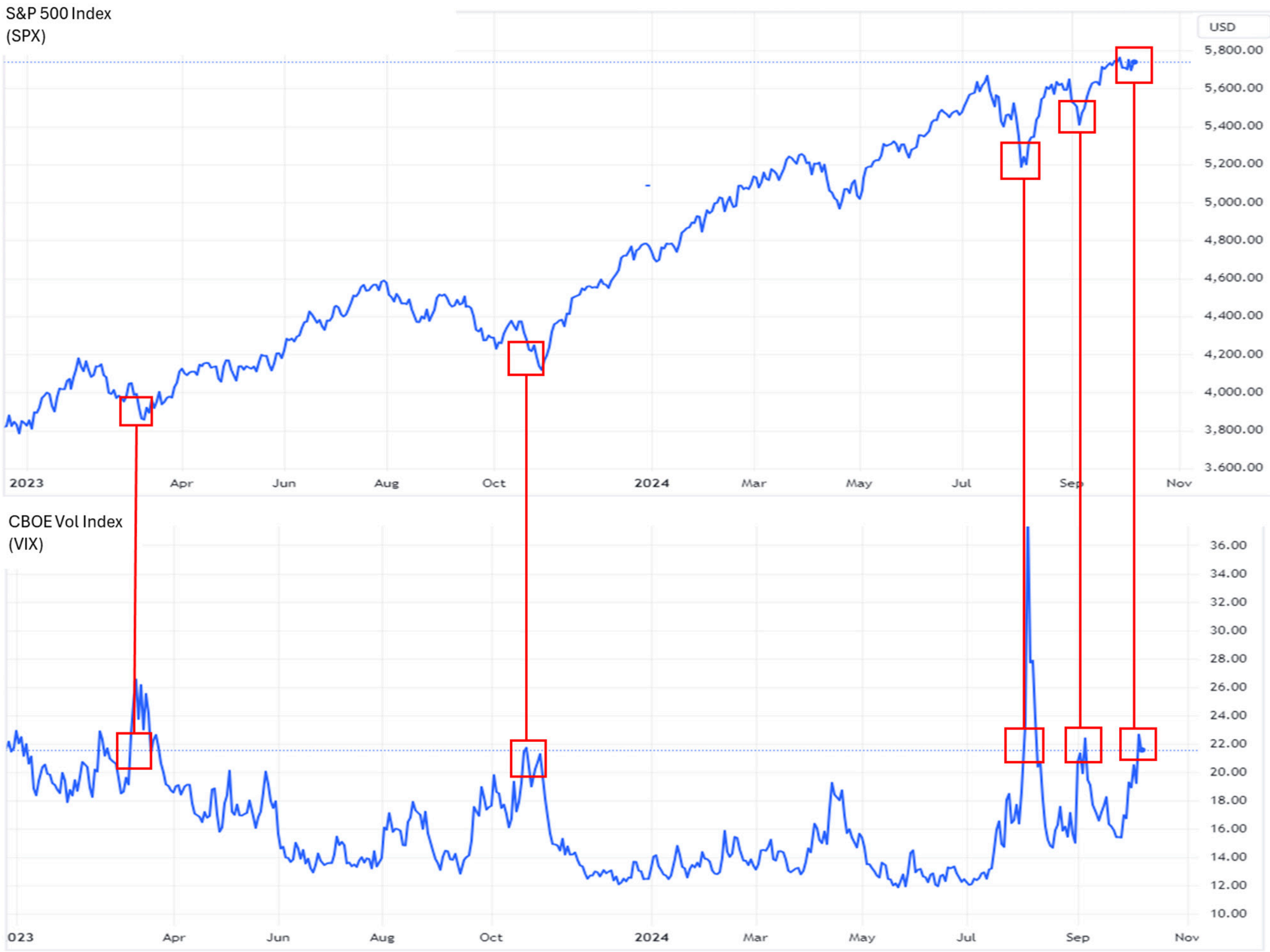


Source: Daily Chartbook

That said, the market is not immune to corrections, especially as we navigate a historically challenging time for equities. While it's often noted that September is the weakest month for equities, in election years, it's October that typically lags the most—a significant divergence from non-election years, where October has historically performed well (see chart).



Source: Callie Cox Media LLC from 1950 to 2024



Source: Callie Cox Media LLC from 1950 to 2024

However, viewed from another angle, these instances have also historically presented excellent opportunities to "buy the dip" as volatility later dissipated. History supports this idea as well. As the election year return chart indicates, while October has been weak in election years, November has historically been the best-performing month for the index—election year or not. What's perhaps most encouraging for election watchers is that, historically, markets tend to rise after the election, regardless of which party wins (chart on next page).

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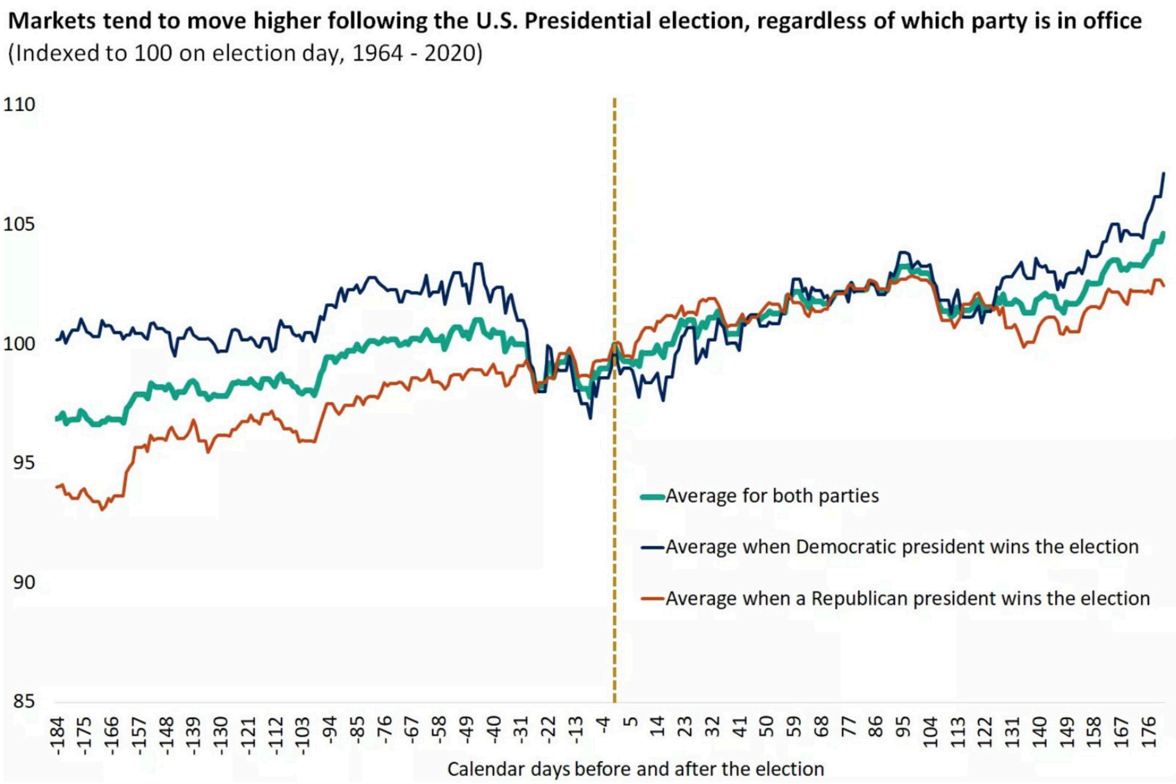

Source: Edward Jones 1964 to 2020

While there are potential headwinds as we head deeper into earnings season, particularly with the historical volatility surrounding October in election years, the outlook for the broader market remains cautiously optimistic. With earnings growth playing an increasingly pivotal role and strong forward earnings guidance expected from a majority of S&P 500 companies, there is potential for resilience in the face of economic uncertainty. Coupled with the historical trend of market gains in post-election Novembers, investors may find strategic opportunities in the midst of near-term volatility. Staying focused on earnings and macro trends will be key as markets navigate this crucial period.

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