COVID Brings Uncertainty to Q3 Earnings Season

Do companies really not know how they will perform in the future?

Let's say you own one of the 30 million small businesses in the U.S. You probably manage your cash flow weekly, maybe even monthly, but definitely quarterly, right? You are constantly analyzing different scenarios too:

- What happens if sales drop off by 5 or 10%?
- What happens if sales increase by 5 or 10%?
- What happens if my expenses increase?
- What happens if I have to close for an extended period of time?

All of these questions and more likely rattle through your head every day. And if someone asked you what the next 3 months might bring, you could likely predict where your business will be with stunning accuracy. Right?

Well, shockingly, of all the companies in the S&P 500, 1 in 4 can't (or won't) predict what the next 3 months will bring. Worrisome? For sure. True? Unlikely.

The Uncertainty of Q3 Earnings Season

During every quarterly corporate earnings season, independent research analysts create reports that provide estimates of a company's expected earnings for future quarters and for the next year. All of these analysts' estimates taken together are then considered "consensus" earnings estimates.

Further, many publicly-traded companies also provide their own guidance on expected earnings. They are not required to provide this guidance, however, they just choose to – or choose not to.

Heading into Q3, as happened in Q2, many companies are having difficulty providing an estimate for future earnings due to the uncertainty surrounding the impacts of COVID-19. As a result, they are simply withdrawing guidance altogether. Consider this from research firm FactSet earlier in October:

- Heading into the third quarter earnings season, 147 stated that they were not providing EPS guidance or confirmed a previous withdrawal of EPS guidance for either FY 2020 or FY 2021. Almost all of these companies cited the uncertainty of the future economic impacts of COVID-19 as the reason for not providing or withdrawing guidance.
- At the sector level, the Consumer Discretionary (33) and Industrials (27) sectors had the highest number of companies withdrawing or not providing annual EPS guidance.

What Should You Do?

It is of course disheartening when a company seems to say: "we have no idea how much we might earn this year or this quarter because there is just too

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much uncertainty." That might cause an investor to just want to walk away completely.

But remember this: public companies have to be very careful when giving earnings estimates because there are very strict securities laws governing what they can and cannot say. And just because a company is withdrawing its estimates, that doesn't necessarily mean that everything is bad.

In fact, consider the one sector that intuitively should hold up decently during a pandemic: health care. According to FactSet, the Health Care sector had one of the highest number of companies withdrawing earnings guidance.

That seems counter-intuitive, right? Well, maybe not. Again, it's natural to assume that a company is withdrawing guidance because they just can't estimate how bad earnings might be – but the opposite can be true too.

A Cynic's View: Little Upside

Do you really think that 1 in 4 companies within the S&P 500 don't know how their earnings will play out in the third quarter? Even the mildest of cynics would likely say no.

Here is the main reason for dropping earnings guidance that few people would admit to: There is little upside to providing guidance.

- Imagine that you are CFO and say that your company will earn $1/share next quarter and the final number is 90 cents. Guess what happens? It's reported that you "missed" earnings and your stock is likely to take a short-term tumble. If, on the other hand, your final numbers come in at $1.10/share, you might be accused of either not having a good handle on your company's books or worse: sandbagging.
- Further, short-term guidance promotes short-term investors. The media is going to present which companies "missed" or "exceeded" earnings estimates every single time. And guess what? There are a lot of short-term traders that are going to invest based on these criteria, hoping to make a quick buck trading on earnings announcements. Such short-term investors increase share-price volatility and corporate expenses, which intuitively impact share price negatively.

Finally, Q3 Earnings Season Will be Bad

This could be another reason more companies are pulling guidance. Companies just don't want to admit how bad the Q3 Earnings Season will be.

On October 12th, FactSet reported that the S&P 500 is expected to report a year-over-year decline in earnings of more than 15% for the third quarter.

If your company were going to report a decline in earnings of more than 15%, would you want to let the world know in advance?

Finally, even if every single one of the S&P 500 companies declined to provide quarterly guidance, they are still required by law to file quarterly earnings reports (10Qs) with the Securities and Exchange Commission. And it's not as if Wall Street won't step in and provide their own "guidance" anyway.

Bottom line: investors should always take a company's earnings estimates with a big fat grain of salt anyway. Same is true for Wall Street's consensus estimates.

Investors would likely be better served by reading real 10Qs, instead of reading about predictions about 10Qs.

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