McMurtry Investment Report – March 2024

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Can Corporate Earnings keep the Equity Market in an Uptrend?

The quarterly earnings report is closely scanned over by equity analysts. We all know how the share prices of companies just reporting can be extremely volatile.

Companies reporting an earnings surprise by beating consensus estimates often see their share price rise sharply. However, we also see the reverse when companies report a quarterly earnings number that is worse than the consensus number.

However, it is important to closely examine all parts of the quarterly report. The comparison of current earnings to both consensus estimates and to the year ago levels are important in determining how a company is doing.

GAAP vs, Non- GAAP and IFRS vs. ADJIUSTED EPS

Secondly, it is important to focus on recurring earnings before extraordinary items. These earnings are called Non- GAAP in the US and adjusted in Canada. I have seen many instances over the last few weeks where investors only focused on GAAP or IFRS earnings and took the share price down sharply after their earnings report announcement. Once they found that there were several non recurring losses that accounted for the bulk of the poor earnings report, the share prices began to rebound accordingly.

CASH FLOW is more important than EPS

I have always believed that operating cash flow is more important than earnings. The Income Statement distorts earnings as a result of non cash items like depreciation and amortization. However, tracking projected cash flow numbers are difficult to obtain unless you subscribe to a database like Ycharts that provides these stats. However, all the cash flow numbers are reported in the company's Cash Flow Statement in their quarterly reports.

EPS Revisions

Most discount brokers provide you with the consensus EPS revisions over the last 30 days, 120 days and over last 4 quarters. This is very important to pay attention to these stats as they represent the latest EPS projections from the buy side analysts.

Equity Market Valuation

As of the end of February of this year, the S&P 500 index was trading at 23.27 times TTM earnings and 21.17 times projected earnings for 2024.

As of the same date, the TSX Composite index was trading at 18.99 times TTM earnings and 15.05 times 2024 projected earnings.

As I have mentioned several times, our domestic equity market is significantly cheaper than the US one. This can be partly explained by the structural differences between our two economies with the US being more consumer focused while the Canadian economy is much more cyclical and commodity focused.

Taking into account the probability of an upcoming recession is diminishing, this sharp divergence in equity valuations merits my decision to continue overweighting our domestic equity market over the US one.

As of the end of February, cyclicals composed 40.6% of the S&P 500 index, while Canada's cyclicals representation was 79.10%.

QUARTERLY EARNINGS SCORECARD % Change Y/Y

Quarter	*S&P 500 Y/Y % Ch Operating EPS*	*TSX Composite Y/Y % CH IBES EPS*	
December 2023	*4.00*	*-2.90*	
September 2023	*3.77*	*-2.60*	
June 2023	*17.00*	*-11.60*	
March 2023	*6.44*	*-9.30*	
December 2022	*-11.21*	*5.90*	

Although it is difficult to see any real trend in quarterly earnings, it is still obvious that earnings appear to be bottoming. Consensus estimates in the US are calling for a growth rate of 11% in EPS this year, with the same approximate year over year gains in Canada.

We need to be grateful in Canada to be so close to the US and to be benefitting from their strong domestic economy. It is a very different situation in Australia that is being penalized by China's weak growth.

Conclusion

The stock market moves up and down based on many factors including Central Bank Policy. It also is very closely tied to the growth rate of corporate earnings. This is one of the principal reasons why the large cap US tech and communications stocks performed so well last year. Their earnings growth is superior to the rest of the market and is the reason for their strong investment returns.

As long as the earnings growth rates continue to rebound, it will be hard to see a major equity market meltdown. However, equity market meltdowns based on overvaluation do happen from time to time. We experienced this type of market meltdown in 1987. It only lasted for a short period and was not the precursor to an economic recession.

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