Volatile Markets Continue as We Approach an All-Important Earnings Season

U.S. equity indexes continue to experience heightened volatility. This has been the case for much of September and should come as no surprise given the season and all that investors have on their plate. We have been watching the S&P 500 closely as a proxy for the broad equity market. Seven trading days ago it sliced through its 50-day moving average and ultimately held late last week at the 320 level. The drop from new highs was more than 10% and coincided with the exact level where we started the year. Since then we have seen buyers step in and push the index right back to its 50-day moving average. This is a logical place for resistance to kick in and selling to resume. This level also represents a move back up to the downward sloping trend line established when we fell from the September 2 highs.

It is noteworthy that the bounce over the past two days has occurred on decreasing volume. All these factors cause me to be skeptical of the case that the selling is over. I hope I am wrong and we can close the week back above the 50-day average, but my guess is we still need to test the 200-day moving average at 310 (SPY) before we have enough real support to move higher. Time will tell.

Earnings ultimately drive price, so it is worth discussing where we are on that front. Since the end of the second quarter, we have seen that most companies' ability to generate profits has been severely impacted by the economic shutdown brought on by COVID. To put it simply, earnings growth has stopped and threatened to turn negative year-over-year. It is the expected growth in earnings that causes investors to pay a premium for stock. If earnings don't rise, then investors don't buy. This reality between earnings growth and price underpins the general disconnect between Wall Street and everyday companies. A rally to all-time highs just doesn't make much sense given this lens. To justify prices above the February highs, investors would have to expect earnings growth above what we were seeing then. Back then, we were seeing year-over-year growth expectations approaching 10%. So, if earnings growth is flat, why would prices today move above those levels? Great question. The answer is, they won't unless growth expectations warrant it.

Some good news is that the earnings freefall appears to have bottomed. The *expectation* is that growth began to resume in the third quarter. We are going to see if that expectation is correct as third quarter earnings are underway in just a few days. In all my time doing this, I don't know that I have ever seen an earnings season as important for the overall health of the market, psychologically and otherwise. The first quarter earnings season of 2009 was huge and kick started the bull market that lasted a decade. The difference here is that in 2009 we were at the bottom with no way to go but up. Today we are at a top and have a long way to fall.

Last week's market commentary can be found here.

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