



Insigneo Weekly Dispatch

Earnings Season Half Time Report: Observations and Potential Considerations



By Mauricio Viaud

PM and Senior Investment Strategist
Insigneo

Earnings Season Half Time Report: Observations and Potential Considerations

Executive Summary:

- Expectations are playing an important role this earnings season.
- The “great rotation” trade appears to continue.
- Investors should not overlook mid cap stocks.

So far, two thirds of the companies in the S&P 500 have reported earnings. With this in mind, we have been frequently getting the question: What trends are you seeing out there this season? One word comes to mind that seems to be particularly prevalent this time: Expectations

The equity market can sometimes be like a biased schoolteacher, punishing a student who always gets A’s for getting a B, while rewarding another student who always gets D’s for getting a C. In Behavioral Finance this type of behavior is known as “Recency Bias” where investors tether themselves to recent events and expect them to re-occur in the future. Whether it is in the classroom or in the financial world, this behavior revolves around expectations. Good performance, be it from a student or a company, is expected to continue, while bad performance is expected to remain, well, bad. Truth be told, this does not seem fair. But fair or not, this is how the market behaves, a behavior which has been evident this earnings season.

When it comes to the market, expectations are subjective by nature. They are based on assumptions, and my assumptions of what earnings should be for a company could vary differently from other analysts on Wall Street. Given their subjective nature, it would be logical to think that the range of expectations would be widespread. However, the concentration of expectations that we have seen this earnings season has been astounding. By this I do not mean that everyone on the Street expected all companies to post strong earnings or all to post weak earnings. What I mean is that expectations were lopsided, where they were very high for companies in the Technology and Communication Services sectors, but low for most other sectors. In fact, coming into this earnings season, Wall Street expected the Technology sector to post earnings growth of 15.2% and Communications Services to experience growth to the tune of 13.5%. At the same time, the Street expected the rest of the sectors in the S&P 500 to see earnings growth contract by 0.2%, in aggregate. In essence, Wall Street expected more of the same, Tech and AI related companies to lead the charge in earnings growth, while the rest of the market lagged. However, this has not been the case so far. Many students that normally get A's are getting B's and the market has been unforgiving with them, while the D students have been getting C's, and the market has been understanding.

Examples of these abound. On the one hand, we have Technology giants Microsoft, Meta and Apple. Microsoft posted strong earnings growth numbers, seeing sales from its Azure cloud business rise over 30% for the current period. However, this number was not high enough for Wall Street's lofty

expectations based on AI demand growth, sending the stock 7% lower, its biggest drop in two years. Meta also posted relatively strong numbers; however, CEO Mark Zuckerberg's comments which included the need for the company to ramp up investments on AI sent the stock 5% lower. At the same time, Apple's mid-single digit growth outlook underwhelmed Wall Street, also sending its stock lower. The bright spot this week was Amazon, which beat growth expectations in its ecommerce, advertising, and AWS cloud services business lines, sending its shares higher. The A student that got another A was not punished, while those that got B's were.

On the other hand, we have companies in other sectors, such as Industrials, which had not fared well in previous quarters. After two years of disappointing investors, UPS finally showed signs this quarter that it could be turning the corner regarding revenue and profit growth, sending the stock 10% higher for the day. Boeing reported the continuation of a high degree of cash flow burn in 2025, yet the stock ended up slightly higher for the day, as the news was not as bad as Wall Street expected. In the Consumer Discretionary sector, Starbucks pulled its revenue and earnings guidance for the year ahead to allow its new CEO to start with a clean slate of expectations. Removing forward guidance is a move that would normally send a stock tumbling; however, Starbucks ended the day slightly higher, as Wall Street gave it a pass, hoping for a new beginning for the company after a string of disappointments earlier in the year. This dynamic was also evident within the automotive industry, particularly with Tesla. After the underwhelming reveal of its long-awaited robotaxi earlier in the

month, expectations were relatively low heading into the quarter. However, the company reported an earnings beat that was mostly led by lower cost of goods sold, coupled with an upbeat growth outlook that arguably lacked details, yet the stock closed the day 20% higher.

So, what does this mean for the markets? In short, we could be seeing the underpinnings behind the “great rotation” trade that has been evident in the market over the past few months. This “great rotation” constitutes the movement of funds out of sectors that have led the market, into those that have lagged. In the current environment, we are seeing investors rotate out of the Technology and Communications sectors and into sectors like Industrials and Healthcare that have underperformed. We believe that we are at the end of a market cycle which was only prolonged, not averted, by the advent of Artificial Intelligence. The sector rotation that we are seeing under the surface of the market is consistent with this view. Not only are we seeing a rotation at the sector level, but also at the market capitalization level, where assets are rotating out of large-cap, particularly mega-cap stocks, and into their small and mid-cap peers. This dynamic is evident even within the S&P 500 itself. Over the past two years the market-cap weighted S&P 500, dominated by mega-cap stocks, outperformed its equal-weighted counterpart by more than 20%. However, this gap has narrowed over the past year, with the equal-weighted S&P 500 now only 5% behind its market-cap weighted twin. This dynamic is also consistent with the end of a cycle, and one that we have pointed out in previous pieces.

So, what can equity investors do going forward? For one, we believe that the rotation should continue, so reducing over concentrated positions in mega-cap Technology and Communications and diversifying into other sectors such as Industrials, Healthcare, and Utilities could make sense. Additionally, reducing large, concentrated positions in the mega-cap space and increasing exposure to mid-cap companies could also make sense. Seeing the end of the current market cycle and anticipating the beginning of a new one, investors have jumped from mega and large stocks directly into small cap stocks, as this group is the first to benefit from the emergence of a new cycle. Granted, the valuation discount between large and small cap stocks has been wide over the past four years, as the large cap tilted S&P 500 has outperformed most other indices. That discount currently stands close to 30%. However, let us consider that only approximately 50% of the companies in the S&P 600 Small Cap Index are profitable, and many have high levels of debt. This is why they tend to outperform at the beginning of a new cycle, after the Fed has meaningfully reduced rates and these companies can get cheaper access to capital to fund growth. But what if the pace of rate cuts by the Fed is slower than expected? As of the time of this writing, the market was pricing in less than two 25 basis point cuts for the rest of the year, less than previously expected. Additionally, what if interest rates bottom out at a higher level than expected? Let us consider that over the past decade, the market got used to a near 0% rate environment; however, the neutral rate is now expected to be closer to the 3.5% range.

In a rush to jump from large cap directly into small cap stocks, it appears that many investors may have overlooked mid cap stocks. While stocks in this capitalization range tend to require more debt than large cap stocks, they also tend to have better balance sheets and financial positions than their small cap peers. That being said, approximately one quarter of mid cap stocks rely on variable rate debt, so they would still benefit from a reduction in interest rates, as compared to large cap companies that do not require much leverage. However, mid-cap companies are less reliant on debt than small cap companies, so they would likely also be less negatively impacted if the pace of rate reductions is slower than expected.

From a valuation perspective, mid cap stocks tend to trade at a discount to large caps, but at a premium to small caps. This makes sense, they trade in the middle of the range. However, the valuation gap between small and mid-cap stocks has recently narrowed to just over 2%, as investors have bid up small cap stocks.

Tony Pasquariello, Partner and Global Head of Hedge Funds at Goldman Sachs recently referred to mid-cap stocks as an “unpolished gem”. We would agree with Mr. Pasquariello’s assessment. By building an allocation to mid-cap stocks, investors could, in essence be getting the best of both worlds, more sensitivity to lower interest rates than large caps, with potentially lower risk than small caps, all at more reasonable valuations when compared to the other two segments of the market. We are not saying that investors should completely sell out of large cap stocks and avoid small caps. We are just urging investors not to overlook mid-cap stocks.



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