Weekly Market Commentary

October 6, 2014

Earnings Preview: Welcomed Opportunity to Focus on the Micro

Burt White
Chief Investment Officer
LPL Financial

Jeffrey Buchbinder, CFA
Market Strategist
LPL Financial

Highlights

Earnings season is here and may counteract the negative headlines with another dose of positive fundamental news.

We expect the third quarter of 2014 could produce another good earnings season, which we believe may positively impact stocks.

While there are some headwinds, Europe in particular, the U.S. economic backdrop is supportive and profit margins should remain high, given the few signs of cost pressures.

The global headlines are certainly not uplifting these days: Russia-Ukraine, Iraq, Syria, Hong Kong, Ebola, etc. All of these challenges are sources of investor anxiety that have led to bouts of selling pressure on the U.S. stock market in recent weeks. The good news is that even with the sell-off in September through early October 2014, the S&P 500 has not experienced a drawdown of more than 4% since spring 2014, thanks to positive underlying fundamentals.

Earnings season is here and may counteract the negative headlines with another dose of positive fundamental news. Four times a year, financial markets focus on what matters most to stocks: earnings. Over the last four years, nearly 90% of S&P 500 returns have come in or around earnings season, as measured by the pre-announcement season — two weeks before Alcoa reports — through the first four weeks of results. (Alcoa marks the unofficial start of earnings season each quarter because the company is typically the first high-profile firm to report after calendar quarter end.) We expect the third quarter of 2014 could produce another good earnings season, which we believe may positively impact stocks.

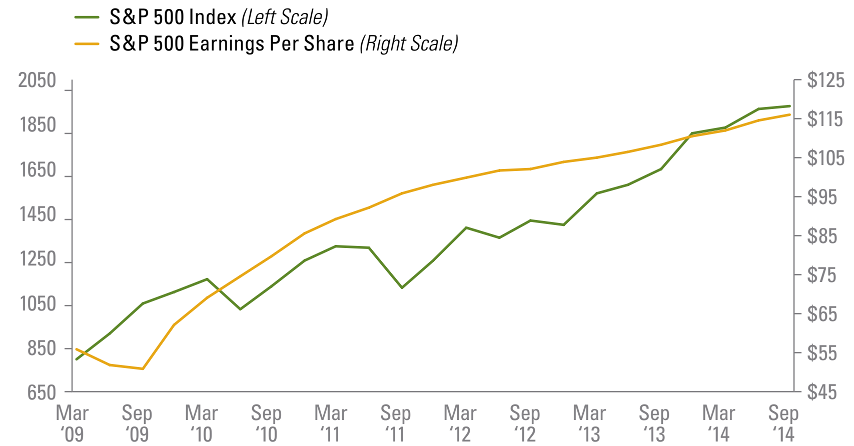
The Old Adage Has Proven True: Earnings Have Driven Stock Prices

Why place so much emphasis on earnings? Because historically, earnings have driven stock prices. This has proven to be the case this year with S&P 500 returns (8%) matching Thomson-tracked consensus forecasts for S&P 500 earnings growth in 2014 (also 8%). Looking further back, stocks and earnings have generally been well aligned during the entire current economic expansion [Figure 1]. Our expectation coming into this year was that earnings and stock prices would reconnect after diverging (in a good way) during 2013, and that has indeed been the case. Last year was all about expanding price-to-earnings ratios (PE) and clarifying policy uncertainty in Washington. In 2014, with policy uncertainty fading and valuations higher, it is all about earnings.

Earnings season is here and may counteract the negative headlines with another dose of positive fundamental news.

LPL Financial

1 Earnings Have Been Aligned with Stock Prices During Economic Expansion



Source: LPL Financial Research, Thomson Reuters, FactSet 10/06/14

The S&P 500 is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

Third Quarter Earnings Season Potentially Another Good One

We expect this earnings season to be another good one for several reasons:

- **U.S. economic growth has picked up.** Revenue growth has historically tracked nominal U.S. gross domestic product (GDP) growth (GDP growth plus inflation). Nominal GDP is tracking toward a 5% annualized growth rate during the third quarter of 2014 and has exceeded 5% in three of the past four quarters (the exception being the weather-depressed first quarter of 2014). The consensus expectation for revenue growth for Q3 2014 is 3.7% year over year, while revenues have exceeded consensus by 0.9% and 1.4% during the past two quarters.

Earnings have beaten targets every quarter since the Great Recession ended on June 30, 2009.

- **Upside earnings surprises are typical.** The Thomson-tracked consensus for S&P 500 year-over-year earnings per share (EPS) growth for the third quarter of 2014 is 6.6%. If companies deliver the same upside as in the second quarter (3.5%), then earnings growth may exceed 10%. This percentage upside is similar to the long-term historical average of 3% (again, according to Thomson). Earnings have beaten targets every quarter since the Great Recession ended on June 30, 2009.
- **Our favorite earnings indicator is still very positive.** The Institute for Supply Management (ISM) Manufacturing Index, which has a strong track record of predicting earnings growth six months ahead, may be signaling continued 5–10% earnings growth. The index has exceeded 56 during the past three reported months (through September 2014) and averaged 56 over the past six months, solidly in expansion territory.
- **Few signs of cost pressures.** Wage growth reported in the latest (September 2014) monthly Employment Situation report from the Bureau of Labor Statistics was 2% year over year. Labor represents the majority

of costs for corporations. The most recent reading on manufacturing unit labor costs for the second quarter of 2014 rose just 0.8% year over year. Another component, raw material costs, is getting cheaper based on the 6.6% drop over the past year for the Bloomberg Commodity Index. (The offset here is the pressure on revenues for energy and materials companies, as discussed below.)

What Might Limit the Upside?

Although these big picture items all suggest corporate America may deliver good earnings results, several factors could limit the upside or result in companies lowering future earnings guidance:

Europe could be a drag for the many multinational corporations that compose the S&P 500 and may lead companies to provide cautious guidance.

- **Sluggish growth in Europe.** With only marginal economic growth near 1% (based on latest GDP data) and marginal inflation (which means less pricing power for businesses operating there), Europe could be a drag for the many multinational corporations that compose the S&P 500 and may lead companies to provide cautious guidance. S&P 500 companies generate an estimated 15–20% of their revenues from Europe, including Russia. During the last week of September 2014, automaker Ford cited weakness in Europe while both Ford and Nike cited a drag from Russia. Conditions in China are better; however, growth there has levelled off and may not help the overall profit growth picture very much.
- **U.S. dollar strength.** The average price of the U.S. dollar was about 0.5% higher during the third quarter of 2014 than it was during the year-ago quarter. A strong dollar negatively impacts foreign profits of U.S.-based companies when those profits are translated back into U.S. dollars. With roughly 40% of S&P 500 profits generated internationally, currency will be a slight drag on third quarter 2014 earnings growth versus the year-ago quarter. The bigger concern is the trajectory of the U.S. dollar, which moved sharply higher during August and September. If U.S. dollar strength continues, this could potentially bring bigger negative currency translation effects in the coming quarters.
- **Commodity price weakness.** Lower costs for raw materials are generally good for company profit margins, but they are not good for the revenues of commodity producers. During the past three months, the Bloomberg Commodity Index plummeted more than 11%, increasing the risk that energy and materials companies miss earnings estimates or lower guidance. These companies are among the most global, with meaningful European and Russian exposure, which carries risk despite recent losses for both sectors.

Conclusion

We welcome the opportunity to focus on the micro amid all of the unsettling macro headlines overseas. We expect another solid earnings season for the third quarter that should have a positive effect on stock prices. While there are some headwinds, Europe in particular, the U.S. economic backdrop is supportive and profit margins should remain high, given the few signs of cost pressures. And that could mean higher earnings and higher stock prices. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

Price-to-earnings ratio is a valuation ratio of a company's current share price compared to its per-share earnings.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

RES 4850 1014
Tracking #1-315113 (Exp. 10/15)