



Weekly Market Commentary



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The Worst Earnings Season in Years Still Beats Expectations

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Highlights

Earnings have mattered a lot for the U.S. stock market. Over the past three years, earnings are up about 58% and the S&P 500 is up about 55%.

Yet, in recent weeks, stocks have been rising even as earnings estimates have been falling, and fourth quarter earnings growth was the slowest it has been in years. This is largely because investors were even more pessimistic.

Key drivers of earnings can tell us about the durability of earnings growth. During this earnings season we have been paying special attention to revenues and business spending.

Earnings have mattered a lot for the U.S. stock market. Over the past three years, earnings are up about 58% and the S&P 500 is up about 55%. * That one-to-one relationship is no coincidence. Stock market valuations, measured by the price-to-earnings ratio—or what investors are willing to pay per dollar of current earnings—have not changed over the past few years and remain around 13 for the S&P 500, well below the long-term average. The relentless climb in earnings has been what has pulled stocks higher over the past three years, not increasing optimism in the durability of the business cycle.

With such a heavy reliance on earnings growth, are stocks vulnerable to declines with earnings growth now appearing to stall? It would appear so based on the statistics. With 70% of companies having reported, the earnings growth rate for the S&P 500 for the fourth quarter 2011 is about 8%. This is the slowest earnings growth rate since the recovery in earnings began over two years ago.

This 8% growth rate is half of what it was expected to be at the beginning of the fourth quarter. As October of last year got underway, earnings per share were expected to be up 15% from a year earlier. Next quarter (first quarter of 2012) earnings growth is now expected to slide to a gain of just 3% year-over-year, down from expectations for a 10% gain at the start of the fourth quarter of 2011.

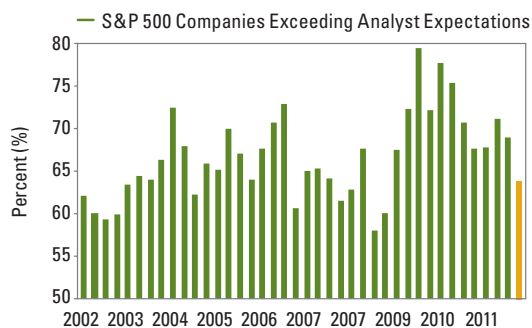
Moreover, just 63.9% of companies that have reported results for the fourth quarter of 2011 have beaten the lowered estimates. This is just below the historical average of 66.7% over the past 10 years and the lowest since the eruption of the financial crisis in the fourth quarter of 2008, as you can see in [Chart 1](#).

Looking ahead to the first quarter results, slightly more companies have lowered than raised earnings guidance along with their fourth quarter reports. Of the companies that issued guidance, 52 in the S&P 500 have issued negative guidance compared to only 20 that have issued positive earnings guidance for Q1 2012. The ratio of negative to positive preannouncements of 2.6 is the weakest showing since the worst of the recession in the first quarter of 2009.

Not as Bad as Was Feared

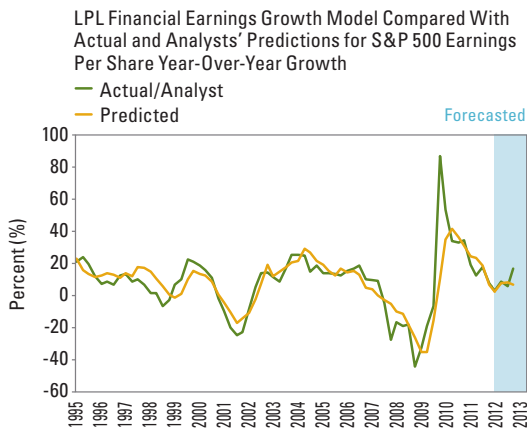
In recent weeks, stocks have been rising even as earnings estimates have been falling and fourth quarter earnings growth was the slowest it has been in years. Fading optimism of analysts and business leaders was offset

1 Fewer Companies Beating Estimates



Source: LPL Financial, Thomson Financial 02/10/12

2 Earnings Set for Slower Growth in 2012



by fading pessimism among individual investors. The explanation is their expectations were much worse.

Investor, analyst and business leaders' expectations for earnings are meeting in the middle. This is a key theme for 2012, as many divergent trends of the past year become more in alignment. Earnings estimates have been coming down to be in line with our estimates. Analysts' expectations for earnings growth for 2012 as a whole were about 13% at the end of last year and now are 8%, very close to our long-held 7% target (as you can see in [Chart 2](#)). At the same time, investors had priced into the stock market a decline in earnings in 2012 (valuations started the year in line with where they were last at the end of 1990, during recession when earnings fell 20% over the following six months) and are now realizing that earnings are instead likely to post modest growth in 2012.

Key drivers of earnings can tell us about the durability of earnings growth. During this earnings season we have been paying special attention to revenues and business spending.

With profit margins near peaks, profits will more closely track revenues in coming quarters. With over 70% of S&P 500 companies having reported, revenue growth for the fourth quarter is tracking toward an 8% increase year-over-year, according to Thomson Financial. As expected, demand from emerging markets was a key driver of revenue growth, enabling companies to offset some anticipated softness in Europe. Companies continue to report solid demand from emerging markets; several examples highlighted this trend with their reports last week:

- McDonald's Corporation announced global comparable sales growth for January 2012 driven largely by growth in emerging markets where sales were up over 7%.
- While Coca-Cola's North American and European volumes grew just 1%, China produced a 10% gain and sales volume in India rose 20%.
- Yum! Brands' same-store sales rose 21% in China, compared with 1% in the U.S.

In addition, strong demand continues to come from business spending-oriented sectors such as Industrials and Information Technology. These sectors have the highest growth rates for the fourth quarter of 2012 averaging about 17%, much better than analysts' estimates. Investor attention is often directed on consumer spending as a driver of profits. However, business-spending-driven sectors are major drivers of S&P 500 profit growth while discretionary consumer spending has a much smaller contribution to the S&P 500. Continued strength in business spending can help drive profit growth in 2012, helping to lift stocks for the year.

Finally, a positive aspect of the earnings season is that dividend growth is making a comeback. The first quarter is when companies most often increase or initiate a dividend. Pressure is building for other companies to increase their dividends as U.S. companies sit on record cash stockpiles and payouts remain at all-time lows. S&P 500 companies paid out about 30% of earnings in the form of dividends in the fourth quarter of 2011 up from



28.7% in the third quarter, down from the average of 30% for much of the 2000s and well below the 30-year average of 40%. We have seen 58 S&P 500 companies increase their dividend so far this year, slightly ahead of last year's pace. Looking at the broader universe of U.S. stocks, which includes smaller companies, the return of the dividend story is more compelling with a 38% increase in the number of companies issuing dividends over the past year with 188 increases in January 2012 compared to 136 in January 2011, according to data from Standard and Poor's.

Company cash and equivalents have soared to record highs even as companies have paid down debt in a dramatic deleveraging over the past few years. A continued return to higher dividend payouts would help attract investors seeking income in an environment of very low bond yields. The S&P 500's dividend yield stands at 2.1%, above the yield on the 10-year Treasury for one of the few times in history. ■

IMPORTANT DISCLOSURES

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*Earnings data are from the fourth quarter of 2008 through the fourth quarter of 2011. S&P 500 data are from the fourth quarter of 2008 through February 10, 2012.

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.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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