



# Weekly Market Commentary



April 9, 2012

## What Investors Should Watch This Earnings Season

### Jeffrey Kleintop, CFA

Chief Market Strategist  
LPL Financial

#### Highlights

While macroeconomic data and events are likely to remain key drivers of the market this week, microeconomics will also garner investors' attention as companies begin to release first quarter earnings reports.

In each of the past two years, as the last week of April unfolded, the S&P 500 Index peaked and began to decline 16–19% as the back half of the earnings season got underway. We will be watching developments closely to determine if a repeat of that pattern will emerge again this year.

During this earnings season, we are paying special attention to the breadth of earnings growth, earnings guidance on upcoming quarters, and profit margins.

After a strong first quarter, the stock market, measured by the S&P 500 Index, got off to a weak start in the second quarter with a decline of -0.7% last week. Investors focused on the Federal Reserve's (Fed) lack of support for round three of quantitative easing (QE3) in the minutes that were released from the March Fed meeting. As we noted a few weeks ago in our commentary, this is one of the 10 indicators we are watching that might foreshadow another spring slide in the stock market.

While macroeconomic data and events are likely to remain key drivers of the market this week, microeconomics will also garner investors' attention as companies begin to release their first quarter earnings reports. While only a handful of S&P 500 companies report results this week, it is widely considered to be the start of earnings season with big, well-known companies like Alcoa and JPMorgan Chase due to report first quarter results.

Four times a year investors focus on the most fundamental driver of investment performance: earnings. The close connection between earnings and stock market performance can be seen in the fact that the S&P 500 Index and earnings per share have both risen about 80% over the past three years. A slowdown in earnings growth may indicate the same for the stock market.

Stock market momentum has stalled over the past few weeks during the period known as the pre-announcement, or confession, season—so called because business leaders often use this period to offer investors guidance on how the quarter's results are shaping up relative to expectations. This season, of the companies that pre-announced first quarter earnings guidance in recent weeks, the ratio of negative-to-positive news was 3.0, worse than the average ratio of 2.3 since 1995.

The first quarter earnings season runs about four to six weeks, starting around two weeks after the close of the quarter. During this earnings season, we are paying special attention to the breadth of earnings growth, earnings guidance on upcoming quarters, and profit margins.

#### Breadth of Earnings Growth

We believe first quarter earnings are likely to post a mid-single-digit percentage gain from a year ago as earnings growth continues to decelerate.\* The fourth quarter of 2011 marked the first time earnings growth fell into the single digits since the recovery began in 2009. The



slowing growth rate for S&P 500 company earnings reflects not only slower growth among individual companies, but also reflects the shrinking number of companies expected to post growth in earnings for the quarter with about 20% of companies expected to reveal declines.

Just like the recent performance of the stock market, earnings growth is being driven by fewer companies. In fact, just one company, Apple Inc., is expected to account for 1.4 percentage points—or about a third of the growth in earnings for the entire S&P 500. The same single company, Apple Inc., accounted for 15% of the performance of the S&P 500 in the first quarter.

The fewer the number of companies that drive earnings growth (and stock market performance), the more vulnerable the overall market is to disappointments and declines.

## Earnings Guidance and Revisions

The first couple of weeks of the first quarter earnings seasons in April 2010 and April 2011 largely contained good news and drove earnings estimates higher. Earnings estimates for S&P 500 companies for the next year rose a greater-than-average 3–25% during the first couple of weeks of reports. But as the second half of the earnings season got underway in early May 2010 and May 2011, forward earnings guidance disappointed analysts and investors, and the pace of upward revisions declined sharply. This year, we will be watching to see how much earnings expectations rise as the initial reports come in and if they begin to taper off sharply.

The consensus of analysts tracked by Thomson Financial expects earnings growth of 3% in the first quarter of 2012 (compared to the first quarter of 2011). While the bar of expectations may be low for the first quarter of 2012, looking further out on the calendar to the fourth quarter of 2012, year-over-year earnings growth estimates for S&P 500 companies remain high at 16.3%, according to data from Thomson Financial. Earnings guidance may result in substantial downward revisions to earnings growth for coming quarters, undermining support for the stock market.

## Profit Margins

The analyst consensus forecast of 3% earnings growth in the first quarter is the slowest growth rate since the recovery in earnings began in 2009. The weakness stems from the end of profit margin expansion. Analysts expect earnings to track revenue growth of about 4%.

Over much of the past few years, companies were able to post earnings growth rates that were several times the pace of revenue growth as profit margins expanded, granting more profit per dollar of sales. However, the ability to post faster earnings growth than revenue growth has faded; rising costs have contributed to slower earnings gains relative to revenue. In fact, nearly a quarter of S&P 500 companies are expected to report a year-over-year drop in earnings per share despite year-over-year revenue gains in the

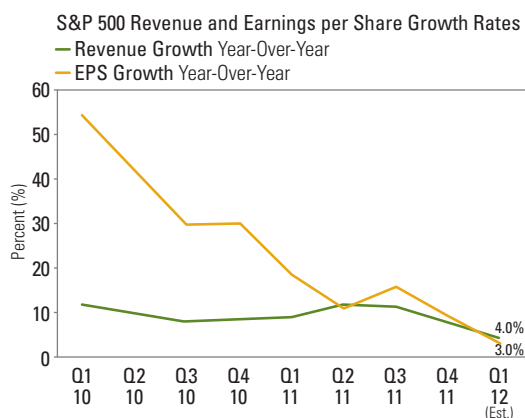
### 1 Spikes in Upward Revisions to Earnings Growth Preceded Stock Market Declines



Source: LPL Financial, FactSet 04/09/12

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

## 2 Slowing Revenue and Earnings Growth



Source: LPL Financial, FactSet 04/09/12

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

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.

first quarter. Three sectors are expected to post earnings declines despite revenue growth. The most dramatic of these is the Materials sector, where 5% revenue growth is expected to accompany a -15% decline in earnings.

In this environment, those areas of the market able to sustain their profit margins are likely to be rewarded by investors. These sectors may include the Information Technology and Industrials sectors. Companies in these sectors are those that appear likely to generate higher-than-average earnings growth rates in the first quarter.

Importantly, the companies that report early in the season are most often not the bellwethers they are commonly thought to be. We may not really know how overall corporate results for the first quarter are shaping up until early May, when about half of the S&P 500 companies will have reported. In each of the past two years, as the last week of April unfolded, the stock market peaked and began to decline 16–19% as the back half of the earnings season got underway. We will be watching developments closely to determine if a repeat of that pattern will emerge again this year. ■

### 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. All indices are unmanaged and cannot be invested into directly.

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.

\* Please see our 2012 Outlook report for a detailed discussion of our earnings growth estimate for 2012.

Stock investing may involve risk including loss of principal.

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.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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.

The company names mentioned herein was for educational purposes only and was not a recommendation to buy or sell that company nor an endorsement for their product or service.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit