Weekly Market Commentary

June 25, 2012

Quarterly "Sweet Spot"

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

This week marks the start of the six-week period that has been the best for the stock market in each quarter of recent years.

With investor expectations low, companies may provide positive surprises as they report their profits.

Three key items we will be watching for this earnings season are: the impact of Europe, rising pension expenses, and falling commodity prices.

This week marks the end of the period leading up to the deadlines for oil-related sanctions on Iran, for the countries in Europe to ratify the permanent bailout fund known as the European Stability Mechanism, and for the Supreme Court to rule on the Affordable Care Act. This week also marks a beginning. It is the start of a six-week period that has been the best for the stock market in each quarter of recent years.

While geopolitical and macroeconomic events have captured much of investors' attention, another factor has been acting quietly behind the scenes and driving U.S. stock market performance in recent years: profits. Over the past four quarters, profits for S&P 500 companies are up about 8%, as is the total return of the S&P 500. Looking back further, over the three years since earnings began to rebound from the recession in the second quarter of 2009, earnings have risen 59%. Similarly, over the past three years, from June 22, 2009 to June 22, 2012, the total return of the S&P 500 has also been 59%. That one-to-one relationship is no coincidence.

Stock market valuations, measured by the price-to-earnings (PE) ratio—or what investors are willing to pay per dollar of current earnings—have not changed over the past few years and remain around 12 for the S&P 500. The climb in earnings has pulled stocks higher over the past three years, not a rise in the PE ratio on increasing optimism in the durability of the business cycle, as is often the case in the first few years of a new economic cycle.

With such a heavy reliance on earnings growth, the stock market has understandably followed a consistent pattern when it comes to the earnings season.

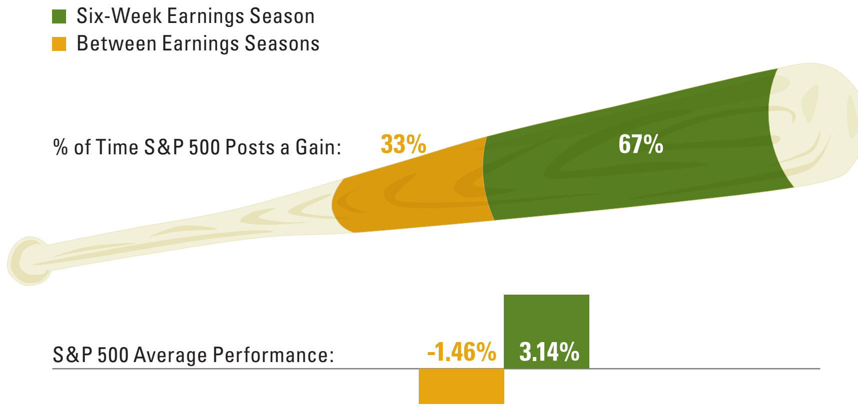
Earnings Season Pattern of Performance

The stock market has again this year followed the pattern of the past two years with a solid gain of roughly 10% during the first quarter, followed by a Spring Slide beginning in April of at least 10%, stemming from a combination of weaker economic growth and concerns over European debt problems. As our Spring Slide indicators predicted, this year has again followed the path of 2010 and 2011.

This year may also continue to follow the pattern of performance around earnings season. In the past nine quarters encompassing all of 2010 through the first quarter of this year, the S&P 500 posted an average gain of 3.14%

during the six-week period beginning in the last week of the quarter (the end of the pre-announcement period) when the results of a little more than half of the S&P 500 companies are reported. During the other weeks of each quarter, the stock market has posted a loss, on average, of -1.46%.

1 Quarterly "Sweet Spot"

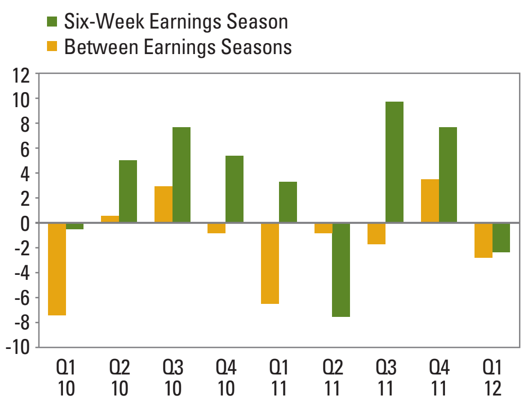


Source: FactSet Research Systems, LPL Financial Data as of 06/22/12

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

This week starts this more favorable "sweet spot" period for the stock market. In all recent quarters but one (second quarter of 2011), the stock market performed better during this six-week period on a relative basis to the declines that took place from the end of one earnings season period until the next one began. However, the period was not always positive for stocks; gains have taken place two-thirds of the time.

2 Earnings Season Better for Stocks



Source: FactSet Research Systems, LPL Financial 06/22/12

Investor Expectations Are Low

The next six weeks may again follow the pattern and offer investors better relative performance for several reasons:

1. **Investors are braced for disappointment.** Companies that have "pre-announced" their second quarter results, in order to offer investors guidance on how the quarter's results are shaping up relative to expectations, have had mostly bad news. Of the 129 companies that pre-announced second quarter earnings guidance in recent weeks, the ratio of negative-to-positive news was 3.5, worse than the average ratio of 2.3 since 1995. This is even worse than the 3.4 in the fourth quarter of 2008, during the peak of the financial crisis. This has left investors expecting more bad news, leaving the potential for stocks to perform better if the news is not as bad as feared.
2. **Expectations are low for earnings growth.** Profits for S&P 500 companies are expected to be up about 6–8% from a year ago. However,

they are expected to be flat compared to a year ago when excluding the Financials sector that is benefitting from a one-time boost due to a record-breaking loss recognition by Bank of America taken a year ago.

3. **Companies are already beating expectations.** Of the 14 companies that have reported actual results for the second quarter, 78% have exceeded analyst estimates, so far. This suggests earnings may come in better than analysts and investors expect.

It may seem like companies are very likely to post poor results given the sluggish U.S. economy and recession in Europe. However, corporate profits are driven more by the solid growth in business spending and manufacturing than the more consumer spending-driven Gross Domestic Product (GDP) that has slowed. Overseas, while Europe is experiencing a recession, solid growth is expected in emerging economies. U.S. companies sell three times as much to the emerging markets than to Europe, supporting revenue growth. While profit growth has slowed, it is unlikely that company profits will post results that are unchanged from a year ago, excluding the one-time gains in the Financials sector.

What to Watch For

Three key items we will be watching for this earnings season are: the impact of Europe, rising pension expenses, and falling commodity prices.

1. We will be gauging the impact of the European recession on profits and guidance for future quarters. Some companies are more exposed to Europe than others. It could be more fear of the unknown than the current impact on profits that causes some corporate leaders to lower their outlooks. While Europe is a convenient "excuse" some companies may use to justify weak results, overall, we expect relatively few Europe-driven earnings disappointments.
2. We will be measuring how much higher pension expense weighs on profits, due to the decline in interest rates hurting both returns and increasing the amount companies must contribute to fund the pension plan. Many companies have addressed this in recent years; however, it remains an ongoing challenge for a number of companies totaling billions of dollars to maintain adequate funding. The highway bill currently in Congress includes an adjustment to how pension contributions are calculated that, if passed, should provide some relief to companies going forward.
3. Commodity prices are major drivers of S&P 500 profit growth. Counter-intuitively, falling commodity prices weigh on corporate profits due to the weaker contributions from sectors such as Energy and Materials not fully offset by the benefit of lower fuel costs and improved disposable income from consumers. During the second quarter, commodity prices fell sharply. The moves in prices tend to impact profits with a bit of a lag. We will be watching to see how this translated into profits for Energy and Materials companies during the quarter and for clues as to how their profit growth may slow later in 2012.

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 quarter are shaping up until early August, as the six-week period of performance draws to a close and about half of the S&P 500 companies will have reported.

RES 3746 0612
Tracking #1-078836 (Exp. 06/13)