Weekly Economic Commentary

January 14, 2013

What Does GDP Say About EPS?

John Canally, CFA
Economist
LPL Financial

Highlights

Per our Base Case scenario provided in our *Outlook 2013* publication, we expect gross domestic product (GDP) will be in the 1.0–1.5% range in 2013.

While the media and market participants may be focused on corporate earnings this week, we will continue to focus on one of the key drivers of earnings, global gross domestic product (GDP) growth.

A continuation of the smooth leadership transition in China, and more aggressive fiscal and monetary policy stimulus, would likely put a floor on Chinese (and global growth) in 2013, providing a lift for earnings prospects for global companies.

Please see the LPL Financial Research Weekly Calendar on page 3

This week (January 14–18), amid the deluge of corporate earnings reports for the fourth quarter of 2012, the World Bank will release its bi-annual Global Economic Prospects report, which forecasts the economic growth trends in the global economy for 2013 and beyond, and gauges the impact of these trends on developing nations. Of course, forecasters of all stripes are continuously revising forecasts of growth trends for economies around the globe, and this week's commentary provides an update on those forecasts, a topic we last wrote about in mid-October 2012.

While the media may pay a great deal of attention to the fourth quarter earnings reports this week, the markets are likely to largely look past the earnings reports and focus more on corporate guidance on earnings and revenue for the new year. In our view, a key driver of earnings and revenue growth is global economic growth, as measured by gross domestic product (GDP). Broadly speaking, earnings growth is driven by "top-line" or revenue growth less the costs incurred earning that revenue, with labor costs accounting for more than two-thirds of costs. A good proxy for global revenue growth is global real-GDP growth plus inflation, or as noted in Figure 1, nominal GDP growth. Thus, the pace of growth in the

1 Nominal Global GDP a Good Proxy for Corporate Revenue Growth

Source: Standard & Poor's, Haver Analytics 01/14/13

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

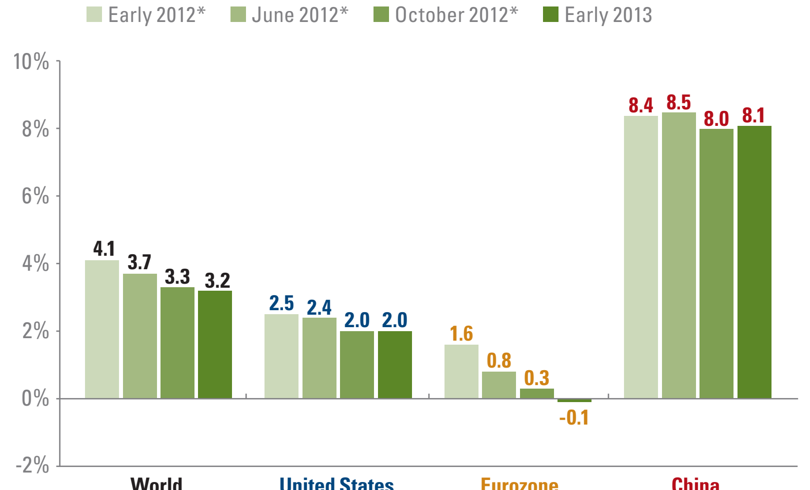
global economy is a key driver of global earnings growth, and ultimately the performance of global equity markets.

Investors will be reminded of the importance of global economic growth in 2013, as China reports its GDP for the fourth quarter of 2012 on Thursday, January 17, 2013. The consensus is looking for a 7.7% year-over-year gain in real GDP in the fourth quarter. If this consensus forecast is realized, China will have avoided the "hard landing" scenario feared by many market participants at the start of 2012. Investors remain concerned about the mix of growth as China continues the long-term transformation from a mainly export and internal infrastructure economy into a more domestic, consumer-oriented economy. The market's forecast for China's economic growth in 2013 stands at 8.1%, up from the October 2012 forecast, but still below the consensus forecast (+8.4%) made a year ago, in early 2012 [Figure 2].

Taking a wider view, the consensus now expects global GDP growth to register 3.2% in 2013, quite similar to the 3.3% forecast made in October 2012, but well below the forecast made a year ago (late 2011/early 2012) for 2013 of 4.1%. The slowdown in China, the lack of a rebound in Europe's economy, and still-tepid growth in the United States accounts for most of the downward revision in global growth forecasts for 2013 over the past year. On balance, global GDP forecasts for 2013 peaked out at around 4.2% in early 2011, held up well until mid-2012, but have been trending down since then.

The Eurozone area has seen its 2013 growth prospects cut the most of all regions over the past year. In late 2011, the consensus was looking for a 1.6% growth rate in GDP in 2013. By mid-2012, the consensus had reduced its forecast for 2013 to just 0.8%, and by October 2012, forecast growth in the Eurozone in 2013 was pegged at just 0.3%. Today, the consensus is forecasting a 0.1% drop in real GDP in the Eurozone this year.

2 Progression of 2013 GDP Forecasts for the World, the United States, the Eurozone, and China



Source: Bloomberg 01/13/13

* Forecasts made in 2012 are for 2013.

Note: For ease of comparison across countries, the GDP figures in the text and the figures are annualized growth rates and adjusted for inflation.

LPL Financial Research Weekly Calendar

2013	U.S. Data	Fed	Global Notables
14 Jan		Williams Lockhart **Bernanke***	
15 Jan	Empire State Mfg. Index (Jan) **Retail Sales (Dec)** PPI (Dec) Business Inventories (Nov)	Rosengren* (Dove) Kocherlakota (Dove) Plosser (Hawk)	Eurozone: Trade Balance (Nov) U.K.: CPI (Dec) **World Bank Releases Global Economic Forecast** Russia: Central Bank Meeting
16 Jan	CPI (Dec) Industrial Production (Dec) Capacity Utilization (Dec) **Homebuilders Sentiment Index (Jan)**	**Beige Book** Kocherlakota Fisher	Brazil: Central Bank Meeting Eurozone: CPI (Dec)
17 Jan	**Housing Starts (Dec)** **Initial Claims (1/12)** Philadelphia Fed (Jan)	Lockhart	**China: GDP (Q4)** **China: Industrial Production (Dec)** Fixed Asset Investment (Dec) Retail Sales (Dec) **Spain: Debt Auction** **France: Debt Auction**
18 Jan	**University of Michigan Consumer Sentiment (1H Jan)**		Mexico: Central Bank Meeting U.K.: Retail Sales (Dec)

Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

We discussed our forecast for U.S. GDP growth this year in our *Outlook 2013* publication. We provided more specifics on the likely drivers of that growth in the *Weekly Economic Commentary: Full Speed Recover?* from January 7, 2013.

Closer to home, as noted in our *Outlook 2013*, failure to address the debt ceiling (and lingering sequestration issue) may lead to a recession in early 2013, while a quick resolution to the looming debt ceiling debate along with a "Grand Bargain" to address the nation's longer term fiscal issues could lift real GDP growth into the 3.0% range for the year. Overall, from an economic standpoint, 2013 may look and feel a lot like 2012.

What Could Change the Downward Trajectory of Global Economic Growth Forecasts?

Although global growth forecasts have stabilized since the fall of 2012, they have not yet picked up. Re-acceleration of growth in the United States is being held up largely due to the ongoing fiscal wrangling. In Europe, the old adage that "it has to stop getting worse before it gets better" comes to mind. The latest reading on Eurozone industrial production (November 2012), a good and timely proxy for the overall economy, showed that industrial activity shrunk 3.7% over the 12 months ending November 2012, and has not yet bottomed out. One of the best leading indicators of economic activity in the Eurozone, the Organization of Economic Cooperation and Development's (OECD) leading index, has not yet turned higher either.

For more details on Europe and its potential to emerge from recession in 2013, see our *Weekly Economic Commentary: Gauging Global Growth* from October 22, 2012.

In order for Europe to emerge from recession in 2013, policymakers in Europe, including the European Union (EU), the European Central Bank (ECB), and governments in Germany, Spain, Italy, Greece, etc., need to hasten the pace of policy actions aimed at stemming the now nearly three-year-old European sovereign debt/banking crisis. The pieces of the puzzle include:

- A tighter banking union;
- A European-wide banking regulator and deposit insurance scheme;
- A well-funded mechanism to provide aid to countries (like Spain) that need additional help paying back debt;
- Tighter fiscal rules; and
- More flexible labor market rules.

While these key elements appear to be on the table, more progress needs to be made on all fronts sooner rather than later. Although policy actions taken by the ECB and governments in Europe over the past year have likely greatly diminished the odds of the worst-case scenario—a breakup of the Eurozone—a recession is still the most likely outcome in Europe in 2013. A modest recovery in Europe (which would help to boost U.S. and Chinese exports and lift global growth) in 2013 may occur if the ECB begins to cut rates again, and if Europe moves faster in resolving the issues at hand. On the other hand, any backsliding by any single government, the ECB, or the Eurozone itself in moving ahead with the progress already made could push the Eurozone deeper into recession in 2013, putting further downward pressure on global growth in 2013.

In China, the once-a-decade leadership transition is now nearly complete, and the Chinese economy now appears to have the wind at its back. After spending most of 2012 fretting that the Chinese economy was headed for a "hard landing" in 2012 and 2013, most market observers now accept that Chinese growth began re-accelerating in late 2012. The series of monetary and fiscal policy moves in late 2011 and 2012, which followed a period of policy tightening in 2010 and 2011, has helped to stabilize growth. A continuation of the smooth leadership transition in China, and more aggressive fiscal and monetary policy stimulus, would likely put a floor on Chinese (and global growth) in 2013, providing a lift for earnings prospects for global companies. On the other hand, if China is reluctant to act more aggressively, or begins to tighten interest rates again, fears of a "hard landing" (5–6% GDP growth in 2013) would likely return. Though unlikely, aggressive stimulus measures similar in size and scope to the measures put into place in 2008 and 2009 would likely see a sharp rebound in China's GDP growth (to close to 10%), which would likely result in a ratcheting up of the market's global GDP growth forecasts for 2013.

On balance, while the media and market participants may be focused on corporate earnings this week, we will continue to focus on one of the key drivers of earnings, global GDP growth. Looking ahead, barring a re-acceleration of global GDP growth, we continue to expect just modest corporate revenue growth in 2013. This supports our view that corporate earnings (as measured by the earnings of companies in the S&P 500 Index) are likely to grow at a low single-digit pace in 2013. ■

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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.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

The Organization of Economic Cooperation and Development (OECD) brings together the governments of countries committed to democracy and the market economy from around the world to support sustainable economic growth, Boost employment, raise living standards, maintain financial stability, assist other countries' economic development, and contribute to growth in world trade.

INDEX DESCRIPTIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Empire State Manufacturing Survey is a monthly survey of manufacturers in New York State conducted by the Federal Reserve Bank of New York.

Producer Price Index is an inflationary indicator published by the U.S. Bureau of Labor Statistics to evaluate wholesale price levels in the economy.

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Weekly Market Commentary

January 14, 2013

Consulting the Crystal Ball

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

We are often asked about market clichés like the "January Effect" or the "Super Bowl indicator" during this time of the year.

When people feel there is a situation that is too complicated, they often fall back on rules of thumb to make decisions. But when enough of us rely on them, it can have real repercussions.

However, on balance, these time-worn axioms support our outlook for a modest gain for stocks in 2013* and may provide some comfort to nervous investors.

It is inevitable that around this time of year, investors ponder what the year may hold in store for the markets. While we present many drivers in our *Outlook 2013* that will combine to define the path of least resistance for the markets to follow in 2013, the interrelationships between economics, fiscal and monetary policy, geopolitics and corporate actions can seem complex. Investors can feel overwhelmed and seek a simple answer.

When people feel there is a situation that is out of their control or that it is too complicated to analyze, they often fall back on rules of thumb to make decisions. But when enough of us rely on them, it can have real repercussions.

We do not place much value on market clichés like the "January Effect" or the "Super Bowl indicator," but we are often asked about them during this time of the year. Jittery investors are looking for more reasons to continue selling stocks, measured by domestic stock mutual fund net outflows tracked by the Investment Company Institute (ICI), despite the gains in recent months and years. Were these indicators to turn negative, selling by nervous market participants might push stocks lower.

However, on balance, these time-worn axioms support our outlook for a modest gain for stocks in 2013.

- **First five days of the year –** This popular piece of market folklore says that the direction of the stock market during the first five days of the year determines whether the market will be up or down for the year. The support for this indicator comes from the fact that of the 40 times the first five days of January have posted a net gain since 1950, 36 were followed by full year gains for the S&P 500—at first glance a 90% accuracy level. How significant is that? Not very. Here are a three things to keep in mind:
    1. The S&P 500 has posted a gain for the year more than 70% of the time, no matter what the first five days have done.
    2. A decline in the first five days has been only about 50% accurate at predicting a down year.
    3. The most recent exception was in 2011, when stocks posted gains in the first five days, as measured by the S&P 500 index, but the index was down just slightly for the year. Other notable exceptions

*LPL Financial Research provided these forecasts based on: a low-single-digit earnings growth rate supported by modest share buybacks combined with 2% dividend yields and little change in valuations for the S&P 500. Please see our *Outlook 2013* for details.

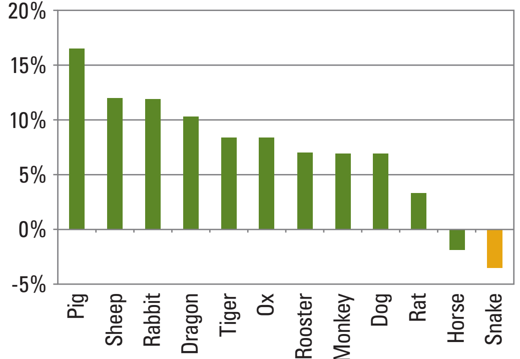
in recent years include: 2007, when stocks were down for the first five days, but posted a modest gain for the year, and 2002, when stocks posted a gain for the first five days only to end up with one of the worst years on record.

That said, the 2.2% gain in this year's first five days may be encouraging for investors looking for an early indicator of how the market will fare throughout the rest of the year.

Time-worn axioms suggest a desire for an easy answer to how to invest in today's interconnected and complex market.

- **January Effect** – As January goes, so goes the year according to this market adage. It is true that January has more consistently indicated the direction of the stock market for the year than any other month, and when January was positive for the S&P 500, the year as a whole ended with a gain 90% of the time since 1950. Again, this sounds impressive, but when January was negative, the year suffered a loss just a little over 50% of the time. Nevertheless, the modest gain so far for the barely half-over month of January may be encouraging to some.
- **December Low indicator** – If the Dow Jones Industrial Average (DJIA) in the first quarter moves below the low set in December, the stock market is likely to suffer for the year. Much like the two indicators above, this appears to work well until you look at how often the market finished the year down when the December low was broken—about half the time. Regardless, the DJIA is 4–5% above the December 2012 low of 12,938, providing some buffer against this indicator, turning some investors more cautious.
- **Super Bowl indicator** – The Super Bowl indicator claims that the DJIA goes up for the year as a whole when the winner comes from the original National Football League, but when an original American Football League or expansion team wins, the DJIA falls. Going into the 1998 Super Bowl when the underdog Denver Broncos defeated the Green Bay Packers, the Super Bowl indicator had been correct in 28 of 31 years. However, since 1998, the Super Bowl indicator has had a poor record; it has only been correct about 50% of the time. The most notable failure was the New York Giants' upset win in 2008 over the New England Patriots, which was supposed to bring about a bull run for stocks—instead the Dow plunged that year as the financial crisis took hold. Last year's replay of the 2008 contest successfully predicted gains for stocks in 2012. This year's matchup on February 3 will likely be widely watched, but not for its forecasting ability.
- **Chinese Lunar New Year** – 2013 is the year of the snake. A look back at average annual stock market returns from 1950 by zodiac sign shows us that the year of the snake has been the worst performing and one of only two zodiac years with negative returns. Unfortunately, this year's animal has not been lucky for investors [Figure 1].

1 Chinese Zodiac Points to Losses in 2013



Source: Bloomberg, LPL Financial 01/14/13

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We put more stock in indicators such as rail freight traffic, mortgage applications, hotel revenue per room, coal prices, business loan demand, bulk cargo shipping vessel costs, and recreational vehicle sales.

Of course, there are many more of these indicators we could mention. But you get the idea. The enduring popularity of these strategies for investment decision making—despite their history of merely coin-flip accuracy when examined closely—is a testament to a desire for an easy answer to how to invest in today's interconnected and complex markets.

For investors looking for simple and tangible indicators of growth in the economy and markets they are better served to look at other offbeat, yet more meaningful, indicators that we put more stock in which include things like: rail freight traffic, mortgage applications, hotel revenue per room, coal prices, business loan demand, bulk cargo shipping vessel costs, and recreational vehicle sales. All of which have been pointing to continued, though sluggish, growth. ■

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INDEX DEFINITIONS:

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.

Dow Jones Industrial Average (DJIA): The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore their component weightings are affected only by changes in the stocks' prices.

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