Weekly Market Commentary

July 15, 2013

What We Are Watching for This Earnings Season

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

The first quarter of 2013 is likely to mark another quarter of low to mid-single digit earnings per share growth.

We will be watching for key trends that may impact future quarters: fiscal drag, slower global growth, wider profit margins, rising buybacks, and higher interest rates.

Four times a year, investors focus on the most fundamental driver of investment performance: earnings. Unfortunately, like the economy, earnings growth remains sluggish. The second quarter of 2013 is likely to mark another quarter of low to mid-single-digit earnings per share growth.

So far, about 30 of the 500 companies in the S&P 500 Index have reported their earnings for the second quarter of 2013. This week the ball really gets rolling with about 80 companies scheduled to report, with about half of the 500 companies due to report by the end of this month. The trend has not been kind, with estimates for profit growth continuing to fall for the second quarter over the past year. Second quarter earnings per share (EPS) for the S&P 500 were expected to increase 10% on October 1, 2012 +8% on January 1, 2013 +6% on April 1, 2013 and +3% on July 1, 2013. Overall, the consensus of Wall Street analysts now expects the growth rate for EPS to come in at about 2.4%. Given the usual 2–3% amount by which companies historically tend to exceed the estimates at the time of reporting, we can expect another quarter of mid-single-digit earnings growth.

What We Are Watching

While investors are very focused on what the profits were for the past quarter, it is what they may turn out to be over the next several quarters that will likely have the most impact on the markets. We will be watching for key trends that may impact future quarters: fiscal drag, slower global growth, wider profit margins, rising buybacks, and rising interest rates.

Fiscal Drag – The government spending cuts known as the sequester may have trimmed a sizeable two percentage points off of gross domestic product (GDP) in the second quarter of 2013. The implementation of the sequester late in the first quarter may result in the government spending cuts having some impact on results in the second quarter—on top of the combined drags of higher taxes, high gasoline prices, sluggish job and income growth, not to mention the overhang of more fiscal cliff battles to come and the roll out of the Affordable Care Act. On the other hand, U.S. consumers have benefitted from a return to all-time highs in the stock market and the return to a strong housing market. We will be watching to see how these drivers may have offset each other in the second quarter. We expect the drag to ease considerably in the second half from what the impact may have been in the second quarter.

The extent to which sluggish global economic growth impacted results will be worth noting, since the trend may continue in the second half.

Slower Global Growth – Sluggish global growth is contributing to slow the pace of sales. About 40% of S&P 500 corporate profits are derived from global sources. On a year-over-year basis, Europe's economy shrank, and growth from larger emerging market economies, China and India, slowed. Also, the value of the dollar relative to that of our major trading partners rose a modest 2% from the second quarter of last year. That can act as a drag on foreign-derived profits when they are translated back into dollars and reported. In particular, the dollar surged against the yen by 23%. This may have had some effect on reported results from companies in the health care, industrial, and technology sectors—where S&P 500 companies' sales to Japan are concentrated. The pace of depreciation has slowed, but the overall year-over-year impact may linger in the third quarter. The extent to which sluggish global economic growth impacted results will be worth noting, since the trend may continue in the second half.

Wider Profit Margins – While revenues are likely to remain close to flat, we will be watching for signs that profit margins may rise to all-time highs in the second half. Estimates for earnings growth in the third and fourth quarters average about 10%. These estimates are likely to decline, as they did last year when second half EPS growth proved to be only about 3%. Analysts' year-over-year earnings growth expectations are out of sync with their much lower revenue growth forecasts for the second half. Given weak productivity growth and already wide profit margins, it is unlikely profit margins can further expand enough beyond all-time highs to produce double-digit earnings growth on low single-digit revenue growth later this year. However, some margin expansion is likely. About 70% of the cost of production for S&P 500 companies is tied to labor. Both wages and benefits costs are rising at a very tame 1–2%. In addition, raw materials costs have generally been falling. We expect these trends to continue in the second half.

1 S&P 500 Profit Margins Near All-Time Highs

Source: LPL Financial, FactSet Research Systems 07/15/13

The S&P 500 is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

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.

Corporations themselves were the biggest buyers of stocks in the first half of 2013.

We will be watching for the impact on bank loan profits and refinancing activity along with demand at homebuilders.

Rising Buybacks – One way companies can drive EPS growth is to shrink the number of outstanding shares. We will be watching for new share buyback authorizations and reports of enacted buyback programs. Corporations themselves were the biggest buyers of stocks in the first half of 2013. The second quarter marked a strong surge in share buyback activity, according to data tracked by Trim-Tabs. With this trend likely to continue in the second half, we will continue to account for the impact of buyback activity on EPS growth.

Rising Interest Rates – For some companies, the rise in interest rates can improve pension funding significantly by lowering the liability. We will be listening for comments about pensions this earnings season by the industrial companies. For most S&P 500 companies, interest expense is only a small percentage of costs. However, changes in interest rates can be a significant driver of results in some industries, especially those tied to housing. Interest rates increased from the second quarter a year ago, from averaging 1.8% in 2012 to 1.97% in 2013. We will be watching for the impact on bank loan profits and refinancing activity along with demand at homebuilders.

We may not see major downward revisions to earnings estimates for the second half of the year in the coming weeks as second quarter reports come in. Instead, given the balance of the above trends, gradual downward revisions to growth expectations are likely to continue. Stocks may reflect greater volatility and increasing sector dispersion of returns as market participants focus on these trends. ■

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.

Investing in specialty market and sectors carry additional risks such as economic, political or regulatory developments that may affect many or all issuers in that sector.

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

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

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.

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.

Health Care Sector: Companies are in two main industry groups—Health care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations. Companies primarily involved in the research, development, production, and marketing of pharmaceuticals and biotechnology products.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

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.

This research material has been prepared by LPL Financial.

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

LPL Financial

Member FINRA/SIPC

RES 4246 0713
Tracking #1-183493 (Exp. 07/14)