Weekly Market Commentary

October 10, 2011

Earnings Season: What to Watch

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

Highlights

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

Market participants have priced declines in earnings into stock market valuations. Yet, analysts have high, double-digit growth expectations for earnings as profits reach a new record high for the first time since the Great Recession.

During this earnings season we are paying special attention to sales growth, exposure to Europe, and how companies are putting cash to work (or not) and the impact on the outlook for coming quarters.

U.S. stocks rose last week by 2.1%, as measured by the S&P 500 Index, once again rebounding off the low end of the range from about 1100 to 1200 that has constrained the Index for the past couple of months. The rebound was driven by a combination of solid and better-than-expected economic data, few negative earnings pre-announcements, supportive actions by foreign central banks, and talk among European policymakers of injecting capital into Europe's banks to insulate them from a potential Greek default and recession.

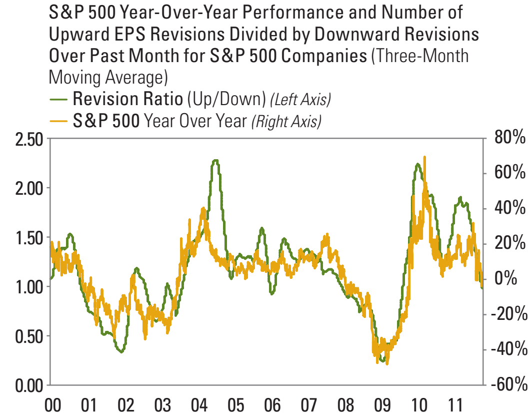
While macroeconomic factors are likely to remain key drivers of the market this week, microeconomics will also garner investors' attention as companies begin to release their third-quarter earnings reports. Four times a year investors focus on the most fundamental driver of investment performance: earnings. As you can see in Chart 1, the performance of the S&P 500 and analysts' revisions to their earnings per share (EPS) estimates are closely linked.

Market participants have priced declines in earnings into stock market valuations, as we detailed in the *Weekly Market Commentary* from September 9 entitled Recession Obsession. Yet, analysts have high expectations for earnings. The consensus of analysts expects double-digit, 13% profit growth (compared to the third quarter of 2010) in the third quarter of 2011, as profits reach a new record high for the first time since the Great Recession, and 15% year-over-year growth for the fourth quarter for S&P 500 companies.

Who is right? The truth is likely to be in the middle as earnings expectations are revised modestly lower and markets price in a less dire outlook for profits as results are reported and guidance on coming quarters is provided by corporate leaders. In recent weeks, third-quarter earnings estimates have been falling. Of the 127 companies that pre-announced third quarter earnings guidance in recent weeks, the ratio of negative-to-positive news was 2.6, worse than the average ratio of 2.3 since 1995. For S&P 500 companies that have reported third-quarter earnings so far, 21 of 29 (72%) have exceeded estimates, while six have missed estimates.

The third-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 sales growth, exposure to Europe,

1 S&P 500 Performance and Earnings Outlook Closely Linked



Source: LPL Financial, Factset 10/07/11

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

and how companies are putting cash to work (or not) and the impact on the outlook for coming quarters.

- **Sales Growth**–We will be putting more emphasis this season on top-line rather than bottom-line growth. Sales growth is expected by analysts to come in around a strong 10%. One headwind companies face is sluggish economic growth around the world, although they were able to post strong growth in the first half of 2011 despite sluggish economic growth. Another headwind is the movement in the value of the dollar. During the third quarter, the dollar was down about 10%, on average, from a year earlier boosting the translation value of foreign-sourced profits. However, entering the fourth quarter the dollar is flat compared to a year ago, eliminating a positive for profits.
- **European Exposure**–Economic growth may likely continue, albeit below average, in the United States over the next year and emerging markets are expected to continue to grow. However, developed foreign economies, particularly in Europe, may enter a recession in the next 12 months. S&P 500 companies' revenues are composed regionally; about 46% of profits come from foreign markets with about 29% of foreign profits derived from Europe. However, that varies widely by sector and industry.
- **Putting Cash to Use**–Pressure is building for higher dividends as U.S. companies sit on record cash stockpiles and payouts remain at all-time lows. S&P 500 companies paid out 26% of earnings in the form of dividends over the past year, down from 30% for much of the 2000s and below the 30-year average of 40%. 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 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 2.2%, above the yield on the 10-year Treasury for one of the few times in history. Also, share repurchases are a way of putting cash to work.

This week, just ten S&P 500 companies are due to report earnings. It is important to keep in mind that 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 third quarter of 2011 are shaping up until just after the end of the month of October, when about half of the S&P 500 companies will have reported.

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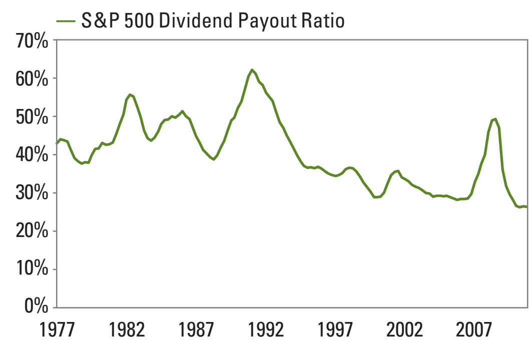
2 S&P 500 Dividend Payout Ratio Lowest in History



Source: LPL Financial, Standard and Poor's, Thomson Financial 10/07/11

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

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 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.

Stock investing may involve risk including loss of principal.