LPL RESEARCH
WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

The S&P 500 appears likely to produce double-digit year-over-year earnings growth for the first quarter, powered by energy's rebound.

Last year's first quarter marked the trough of the earnings recession as S&P 500 earnings fell 5%, setting up an easy comparison.

We have several reasons to be optimistic, including good macro data and resilient estimates.

April 10 2017

FIRST QUARTER 2017 EARNINGS PREVIEW: DOUBLE DIGITS?

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The S&P 500 is poised for double-digit earnings growth in the first quarter. Earnings season gets underway this week and corporate America is poised to show a strong increase in its bottom line. The S&P 500 appears likely to produce double-digit year-over-year earnings growth for the first quarter, powered by energy's rebound from the oil downturn that battered the sector early last year. Last year's first quarter marked the trough of the earnings recession as S&P 500 earnings fell 5%, setting up an easy comparison for the first quarter of 2017 [Figure 1]. This week we preview the upcoming earnings season.

OVERVIEW

Thomson-tracked consensus estimates for the first quarter are calling for a solid 10.1% year-over-year increase in S&P 500 earnings. With potential for the roughly 3% upside companies typically generate, that makes growth in the 12–14% range a reasonable expectation. Should earnings growth reach that range, it would mark

1 TROUGH OF EARNINGS RECESSION IN Q1 2016 SETS UP EASY COMPARISON IN Q1 2017

Source: LPL Research, FactSet 04/07/17

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the fastest pace since the third quarter of 2011. Revenue is expected to rise 7% from the year-ago quarter. We have several reasons to be optimistic:

- **Good macro data.** Earnings are more manufacturing driven than consumer driven — unlike the overall economy — so the recent strength in the Institute of Supply Management (ISM) Manufacturing Index, which averaged 57 during the first quarter, bodes well for earnings in the first quarter and possibly the second as well. Strong measures of business confidence — including the Conference Board's CEO confidence survey and the Duke University/CFO magazine business outlook survey — provide positive fundamental data points. Data overseas have also been good and mostly better than expected, based on economic surprise indexes, in what is a fairly synchronized global expansion.
- **Oil prices are sharply higher.** Oil prices averaged $51.80/barrel during the first quarter, putting the quarter's average price 54% above the average for the year-ago quarter, when crude oil averaged $33.63. Earnings growth returned to the energy sector during the fourth quarter of 2016, but losses in the first quarter of 2016 make the energy sector's growth contribution significant in the first quarter of 2017; specifically, based on consensus estimates energy could contribute 4% to S&P 500 earnings growth. The potential to approach 10% earnings growth even when excluding the energy sector is encouraging.
- **Resilient estimates.** Earnings estimates have held up well since the start of the year. After a 1.4% drop in consensus S&P 500 estimates for the full year 2017 during January and February (from +12.5% to +11.1%), estimates barely budged from the start of March through the first week of April, slipping just 0.2% to +10.9%. The resilience of estimates reduces the probability of widespread shortfalls. As always we will watch estimates closely during earnings season to gauge corporate optimism and assess earnings growth potential for the rest of the year.

CONSIDER THE SOURCE

Different sources such as FactSet, Bloomberg, Standard & Poor's, and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

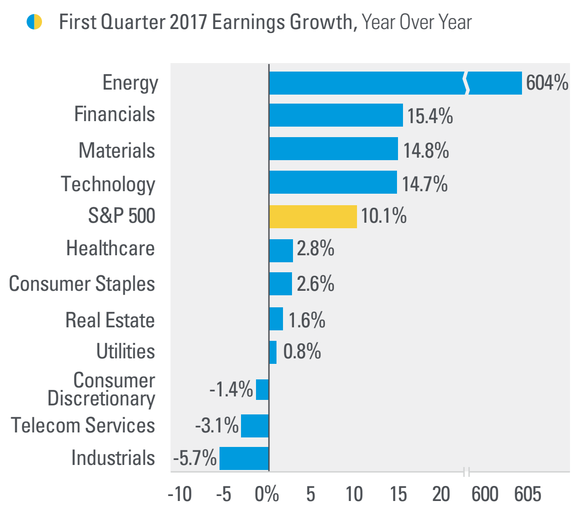
We see little risk that the S&P 500 fails to deliver a year-over-year double-digit gain in first quarter earnings, although the strong U.S. dollar may potentially curb earnings by 1% or so overall and could lead to some trimming of rest of year forecasts. For the first quarter of 2017, the average U.S. dollar level, based on the U.S. Dollar Index, was 3.5% above the year-ago quarter's level. Should the dollar stay at its most recent levels, the Dollar Index would be up 7% year over year during the second quarter.

Though not material for first quarter results, we do see risk that tempered policy hopes may lead to some estimate reductions in late 2017 and throughout 2018. The challenges the Trump administration has faced thus far with healthcare reform and the challenges it may face trying to get tax reform through Congress suggest some analysts and strategists who had factored in optimistic policy views may take the opportunity to reduce their estimates a bit. Most tax reform proposals we have seen would boost S&P 500 earnings by 5–10% if implemented, though we believe the low end of that range is more realistic.

SECTOR STANDOUTS

Energy will be the biggest contributor to overall earnings growth in the quarter if the sector can match or exceed estimates [Figure 2]. But financials and technology, the sectors with the two biggest weights in the S&P 500, are expected to do more than their fair share by potentially producing mid-teens earnings growth year over year. Financials are likely to benefit from the rise in interest rates over the past year, along with healthy capital markets and credit conditions; help from deregulation is probably coming later in the year (something we will surely hear about this week as several big banks report). Technology earnings should get support from strength in semiconductors and software.

2 ENERGY REBOUND THE BIGGEST DRIVER OF FIRST QUARTER EARNINGS GROWTH ESTIMATES



Source: LPL Research, Thomson Reuters consensus estimates 04/07/17

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

POLICY OUTLOOK

With so much focus still on the policy agenda, we will continue to keep one eye on Washington and the potential earnings impact of policy changes. We continue to expect corporate tax reform to get done around the end of the year or early 2018 and to potentially boost earnings by somewhere in the 3–7% range once implemented. A reduction of the corporate tax rate to 25% remains doable, in our view, and would likely be paid for partly by repatriation (a lower tax rate to bring overseas earnings back to the U.S.), which enjoys bipartisan support and support from corporate America.

We will also be watching for corporate commentary on possible infrastructure spending programs and, even though passage is unlikely, the controversial border adjustment tax.

CONCLUSION

Double-digit earnings growth for the S&P 500 in the first quarter is very likely, powered by energy's rebound. An easy comparison to last year's first quarter, which marked the trough of the earnings recession, certainly helps give growth a boost. But based on solid macro data, we believe corporate America will deliver good news outside of the energy sector this quarter and keep us on pace for high-single-digit S&P 500 earnings growth in 2017*, even without a lift from policies in Washington, D.C. ■

*As noted in our *Outlook 2017: Gauging Market Milestones*, we expect mid-single-digit returns for the S&P 500 in 2017 and the continuation of the nearly eight-year-old bull market, consistent with historical mid-to-late economic cycle performance. We expect S&P 500 gains to be driven by: 1) a pickup in U.S. economic growth partly due to fiscal stimulus; 2) mid- to high-single-digit earnings gains; 3) an expansion in bank lending; and 4) a stable price-to-earnings ratio (PE) of 18 – 19. Gains will likely come with increased volatility as the economic cycle ages.

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 referenced is historical and is no guarantee of future results.

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 stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

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.

The U.S. Institute for Supply Managers (ISM) manufacturing index is an economic indicator derived from monthly surveys of private sector companies, and is intended to show the economic health of the U.S. manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change.

The USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beating consensus. The indexes are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of one standard deviation data surprises.

RES 9999 0417 | Tracking #1-598311 (Exp. 04/18)