LPL RESEARCH

WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

Much like first quarter earnings results and management guidance, our measure of corporate sentiment based on earnings conference call transcripts was better than we expected.

We saw a sharp increase in strong and positive words over the prior quarter, with no change in weak and negative words.

There was virtually no talk of recession, and far less attention was paid toward potential policy changes out of Washington, D.C.

We believe the positive tone from management teams supports a favorable outlook for further earnings gains in the quarters ahead.

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CORPORATE BEIGE BOOK: IT KEEPS GETTING BETTER

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After a very strong first quarter earnings season, we expected to see management sentiment also improve. And similar to how earnings results and the guidance from management were better than we expected, so was our measure of corporate sentiment based on earnings conference call transcripts, which we call our Corporate Beige Book. We saw a sharp increase in the strong and positive words over the prior quarter, with no change in the weak and negative words. There was virtually no talk of recession — as expected — and far less attention was paid toward potential policy changes out of Washington, D.C.

Analysis of earnings conference call transcripts from calls that took place starting in mid-April extending into the third week of May.

POSITIVE SENTIMENT CONFIRMS EARNINGS STRENGTH

Corporate sentiment continued its steady improvement during the first quarter based on our count of positive and negative words from earnings call transcripts. Not only did the total overall use of strong and positive words (e.g., "strong", "robust", "solid", "good", "improving") increase quarter over quarter (from 1,069 to 1,303), but the number of weak and negative words (e.g., "weak", "soft", "difficult", "challenging") remained essentially unchanged. The end result was a big increase in the differential between strong and weak as well as the ratio.

Specifically, the differential between strong and weak words in our analysis rose 29% to 1,016 in the first quarter, after a 15% increase in the prior quarter, leading

FIRST QUARTER 2017 EARNINGS SEASON

First quarter earnings season was excellent by almost any measure. Results beat expectations by more than usual (5% versus the typical 2-3%). The overall growth rate, at over 15% year over year, was very strong, even without the big boost from energy. Guidance was mostly positive, supporting slight increases in estimates for the balance of 2017. The bar has been raised and comparisons with 2016 get tougher from here, but the earnings picture has clearly improved dramatically over the past several months. Even if fiscal policy does not provide any help this year, we see mid- to high-single-digit earnings gains as achievable. Please see our May 15, 2017 *Weekly Market Commentary* for an earnings season overview.

to accelerating strength in what we refer to as our Corporate Beige Book Barometer [Figure 1]. The continued steady improvement in sentiment in recent quarters is also evident in the ratio of positive-to-negative words, which jumped from 3.8 to over 4.5 [Figure 2].

The improvement in management sentiment is encouraging and consistent with the strong earnings numbers we have seen over the past six weeks. Corporate profits are on the rise—despite the recent softer economic data—and we believe the positive tone from management teams supports a solid outlook for further earnings growth in the quarters ahead.

Here are some excerpts from call transcripts supporting the improved sentiment, specifically regarding the economic outlook in the U.S. and overseas:

- "The U.S. economic outlook has improved over the last few months and the growth is expected to move higher for the remainder of the year."—Transport
- "We're seeing actual hard data; where clients are talking to us about expansions, making loan requests for expansions, which, frankly, at a rate we haven't seen in eight years."—Bank
- "We are encouraged by signs of momentum in the global economy. We've seen really good strength here in the U.S. We've seen recovery in Europe. Even in China we saw good economic growth in the first quarter."—Industrial conglomerate

WHAT IS THE CORPORATE BEIGE BOOK?

We use earnings conference call transcripts to gauge overall sentiment of corporate management teams, much like we have done with the Federal Reserve's (Fed) Beige Book to create our Beige Book Barometer. (The Fed's Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts.) To create our Corporate Beige Book, we count the number of strong words (or variations of "strong") and the number of weak words (or variations of "weak") and calculate the difference between the two. (Examples of strong words include "robust," "solid," and "optimistic;" examples of weak words include "soft," "fragile," and "pessimistic.") We can then compare that differential with prior quarters to make comparisons over time. Although not every single call transcript is analyzed, we believe the trends observed provide valuable insights.

POLICY TALK HAS FADED POST-ELECTION

It was no surprise that during fourth quarter earnings season, election and policy talk surged. But the slowdown in policy talk during the first quarter earnings season was more dramatic than perhaps we and others had anticipated. We used the word "tax" or its variants as a determinant of how much policy-related discussion took place and on that measure we went back down to near pre-election levels. After the word showed up over 400 times in the fourth quarter, it made just 174 appearances in the first [Figure 3]. We can also see how little focus there was on other policy initiatives based on the drop in mentions of "border adjustment tax" (from 26 to 4), "regulation" (39 to 16), and "trade" (91 to 35).

Interestingly, one policy word that received as much attention in the first quarter as it did during the fourth was "infrastructure" (36 mentions in each). Anticipation in May of President Trump's infrastructure proposal likely had something to do with that, while corporate tax reform has been on hiatus as Senate Republicans continue to work on healthcare reform.

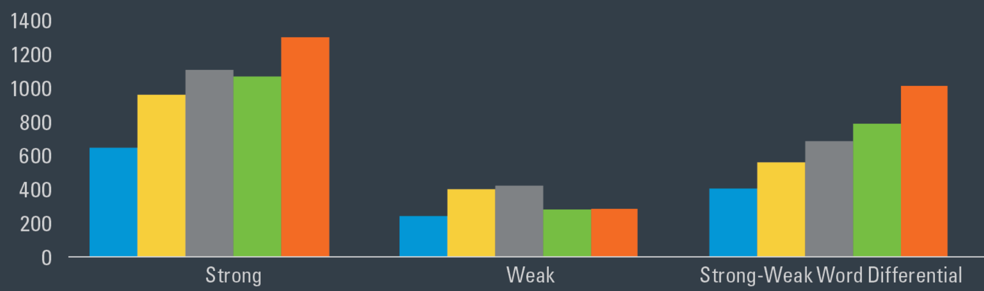
Here are some executives' comments on policy initiatives:

- "There's clearly a return to a lighter touch, pro-growth regulatory philosophy, and that's not only in our industry but it's across all industries right

Corporate Beige Book

1 Steady Climb for Corporate Sentiment

● Q1 2016 ● Q2 2016 ● Q3 2016
● Q4 2016 ● Q1 2017



2 Jump in Strong/Weak Word Ratio Matches Strong Q1 Earnings

● Ratio of strong to weak words

3 Policy Talk Faded Post-Election

● Number of tax mentions

4 Almost No Recession Talk As Expected

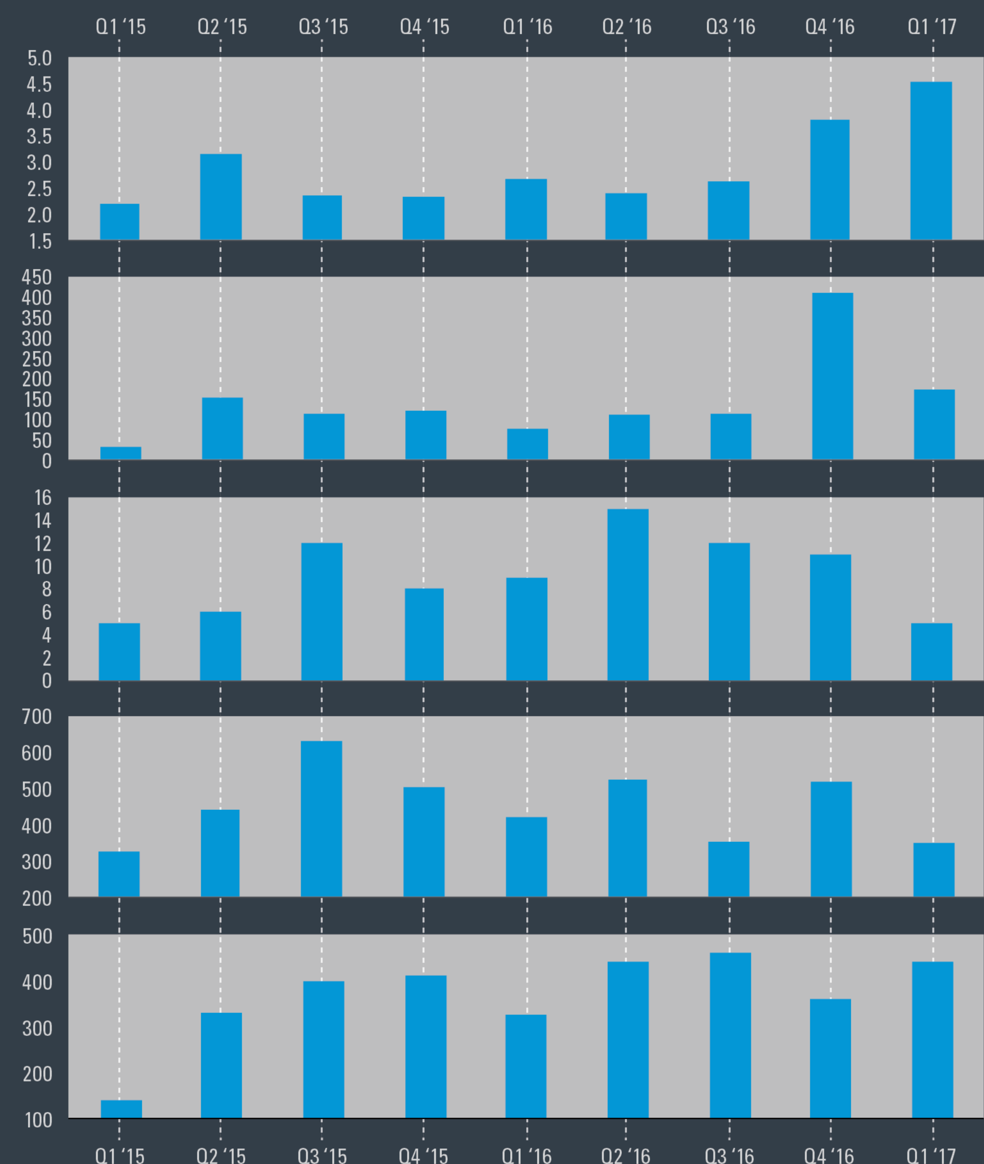
● Number of recession mentions

5 Stable-to-Weaker Dollar Means Less Focus on Currency

● Number of currency mentions

6 Energy Remains in Focus

● Number of energy mentions



Source: LPL Research, Bloomberg 05/25/17
Data represent number of mentions during first quarter 2017 earnings conference calls for companies that have reported as of 05/17/17.

now, and we think this is incredibly positive for our country and it could catalyze the economic growth all of us have been looking for." — Telecom provider

- "Economists have included additional growth in their forecasts from the administration's efforts to modernize trade agreements, reform tax policy, and upgrade infrastructure. We support efforts that boost trade, remove unnecessary regulations, and stimulate real GDP expansion." — Transport
- "Animal spirits were obviously awakened by the policy direction of the new administration, policy direction that I personally endorse when it comes to regulation of businesses." — Insurer

TALK OF U.S. RECESSION NONEXISTENT

Corporate executives generally try to stay away from the "R" word (recession) when talking with investors, confirmed by the small number of mentions over the past two-plus years. But the first quarter took that to a level not seen in a while with just five mentions of the word recession during the quarter [Figure 4] versus the average over the prior eight quarters of 10. We think these data points, along with our assessment of leading economic indicators, continue to point to low recession odds in 2017.

DOLLAR STABILITY REFLECTED IN FEWER MENTIONS

The amount of attention on currency has been dramatically reduced from its early 2016 peak, reflecting the stability in the U.S. dollar. In fact, the dollar has essentially not gone anywhere in two years. During the quarter, currency mentions fell almost 30% to the lowest level since the first quarter of 2015 [Figure 5]. The drop makes sense given the year-over-year change in the dollar had approached 20% in early 2015, compared with modest 1-2% annual increases in the past couple of quarters. With the latest weakness in the dollar, currency may only have negligible impact on overall S&P 500 earnings in the current (second) quarter.

We expect a largely range-bound U.S. dollar for the rest of the year, with the potential for modest gains depending on the policy path in Washington, D.C.

Here are two management comments on currencies:

- "Fortunately, the dollar and the euro were relatively stable last quarter and this headwind has not become stiffer." — Payment processor
- "As they anniversary the onset of the strong dollar impact, their comps have grown relatively easy." — Retailer

ENERGY REMAINS IN FOCUS DESPITE LATEST DIP

Oil's rise from the February 2016 lows in the mid-$20s into the $50s eased concerns about the negative impact of low prices on energy and energy-sensitive companies. Higher energy prices and related improvement in business conditions for energy companies was reflected in the drop in the number of mentions the topic received on conference calls from the third quarter of 2016 to the fourth [Figure 6]. More recently, the pullback in oil prices from the mid-$50s to the low-$50s has increased discussions of how stable or falling energy and gasoline prices are actually starting to help some companies. Overall, energy remains a fairly hot topic.

Here are some examples of companies commenting on energy prices:

- "The national average price of gasoline was $2.48 in March, and although up from last year remains relatively low compared to gas prices in 2010 through 2014. As a result, we expect to see further increases in miles driven and ultimately additional parts purchases in 2017." — Auto parts

- "It's possible that too much supply comes back online in North America, which would drive some additional volatility in oil prices when it comes to commodity prices. While the demand and supply seem to be in better balance, there still is some persistently high inventories for several commodities, which could put some pressure on commodity prices." — Mining equipment
- "We continued to see headwinds on crude oil shipments which were down 87% to about 2,000 carloads in the quarter due to the lower crude oil prices and available pipeline capacity." — Railroad

CONCLUSION

Our Corporate Beige Book suggests that corporate executives have become more confident in the macroeconomic outlook in recent months. We expected management sentiment to improve and support the strong first quarter earnings numbers, and it did not disappoint based on our Corporate Beige Book. Corporate profits are on the rise, and we believe the positive tone from management teams supports a positive outlook for further growth in the quarters ahead. ■

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 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.

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