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HURDLING OVERSEAS EARNINGS

WHAT DO THE FORECASTS TELL US?

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KEY TAKEAWAYS

Global equity markets were buoyed by earnings outpacing already strong expectations in the first quarter of 2017.

Expectations generally remain optimistic for the rest of the year, with earnings forecasts either increasing or only modestly decreasing recently.

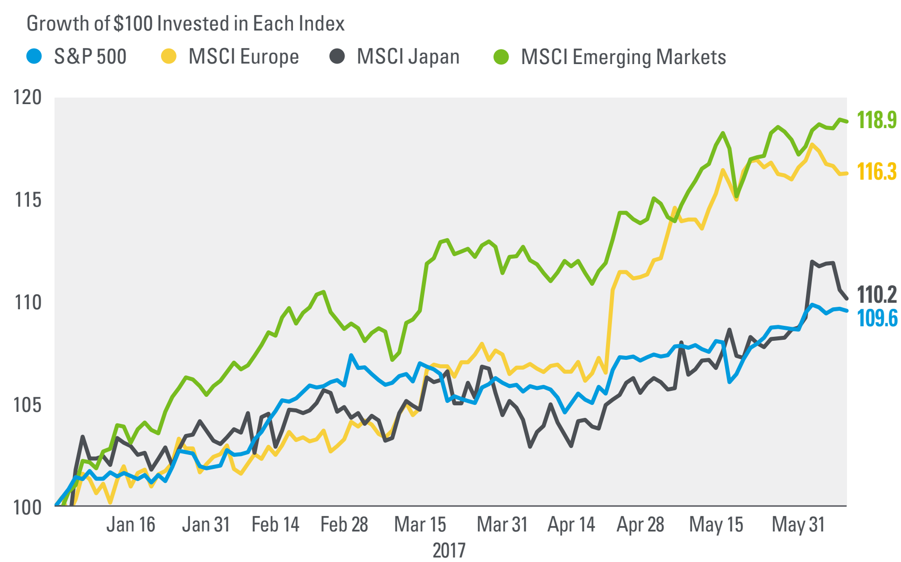
Based on changes to earnings forecasts, analysts seem confident in the global economy and see potential strength in areas like technology and industrials.

Overseas earnings were even better than expected during the first quarter (Q1) of 2017. Global equity analysts were looking for strong earnings growth from overseas companies after years of flat to declining earnings; for the most part, those markets delivered. Stock markets themselves responded, with international markets generally outperforming the S&P 500 Index. Frequently after earnings are released, analysts may reduce future growth expectations, often based on conservative comments from companies as they manage expectations. However, earnings expectations only decreased modestly during this period, and actually increased further for some regions. It is great to see continued optimism on corporate fundamentals, but it could prove challenging for companies to outpace expectations again.

CLEARED THE BAR EASILY

Overall, corporate earnings in Q1 were above what were widely considered aggressive expectations. These strong earnings, combined with economic and other factors, have led to major international indexes outperforming the S&P 500 year to date [Figure 1].

1 INTERNATIONAL MARKETS OUTPACE S&P 500 THIS YEAR



Source: LPL Research, Bloomberg 06/12/17

Data as of 06/09/17

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

But, breaking it down, there were some meaningful differences among regions:

EUROPE

European corporate earnings increased nearly 30% in the 12 months ending March 31, 2017. If that sounds impossible, or at least highly improbable given relatively weak economic growth (GDP growth at 1.9%), it is important to note that energy stocks played a large role in that growth rate. Energy prices were extremely low in Q1 2016 and many companies reported net losses during that period. The normalization of oil prices in Q1 2017 and the return to profitability for many companies boosted total earnings.

JAPAN

Japanese companies typically use the end of Q1 as the end of their fiscal year, which requires companies to fully convert profits and losses back into yen. This is crucial for the Japanese market, where nearly 60% of sales are made overseas. This is one reason that the Japanese stock market is so sensitive to the value of the yen. On the surface, Japanese corporate earnings rose 100% from the previous fiscal year. Though impressive, this is somewhat overstated given the number of companies that actually had negative earnings in the preceding fiscal year. Unlike in most other regions, actual earnings growth, even at 100%, was slightly below expectations. Though some areas, such as technology and real estate, have shown impressive growth, other important areas, most notably banks, continue to struggle with profitability. It should also be noted that Japan does not have much of an energy exploration industry; therefore few, if any, Japanese companies benefit from higher oil prices.

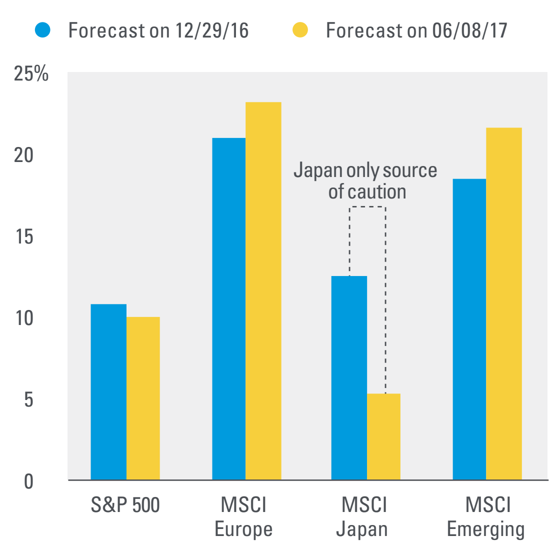
EMERGING MARKETS (EM)

Corporate earnings in EM countries increased 27.7% in the 12 months ending March 31, 2017. What is particularly impressive is that at the beginning of 2017 earnings growth was only expected to be 11.3%. Therefore, actual earnings results for Q1 were, on average, more than twice as strong as expected at the beginning of the quarter. As noted above, improving fortunes in energy markets boosted earnings growth, especially in export-heavy Russia. Yet, we also saw unexpected, strong growth in the technology sector which primarily benefits China, South Korea, and Taiwan.

CAN THEY DO IT AGAIN?

Global stocks have rallied thus far in 2017, in large part due to earnings growth in excess of even high expectations set at the beginning of the year. Can they do it again? Equity analysts have for the most part remained optimistic, and in many cases increased their forecasts for the rest of the year [Figure 2]. Interestingly, 12-month earnings expectations will still be influenced by oil prices, which are still higher than they were one year ago. However, this impact will dissipate over time, and current energy prices, which have declined recently, will play a larger role. Therefore, it is likely that any increase in earnings growth is going to have to be broader than last quarter.

2 ANALYSTS REMAIN BULLISH ON FUTURE EARNINGS GROWTH



Source: LPL Research, FactSet 06/08/17

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EUROPE

Equity analysts have been increasing their earnings forecasts for Europe. In addition to energy, earnings forecasts for financial firms, most notably the major banks, have been rising. As in other regions, analysts are still increasing earnings forecasts for industrial and even materials companies, suggesting an underlying optimism in the global manufacturing economy. Forecasts for technology have been reduced slightly, though technology is generally not as important a sector in Europe as it is in the U.S. and much of Asia. Though the shadow of upcoming Brexit negotiations is looming, underlying economic data for Europe have continued to improve and are not, at this point, dampening the optimism on European earnings. The Brexit process could have a major impact on the value of the British pound, which will likely affect U.K. market earnings; not just on an aggregate level, but also by sector. The majority of U.K. stocks (55%) are held by overseas investors who may be sensitive to further pound weakness, even if it is supportive of U.K. manufacturing exporters.

JAPAN

Earnings forecasts have been increasing for companies in Japan's export-led sectors including industrials and information technology. The yen has been strengthening this year, which does increase the possibility of disappointment. Conversely, expectations for domestically focused companies, such as financials and consumer discretionary companies, have declined this year and are very low, increasing the probability that companies can step over this lowered hurdle. Japan is the only region for which analysts have, in aggregate, materially lowered earnings expectations going forward. However, this may be due to the resetting of Japanese fiscal year and companies issuing more cautious guidance for the coming year.

EM

EM earnings forecasts are lower for the second quarter of 2017, though these forecasts have been increasing recently. Earnings growth is expected to be strongest in the Asian markets, where forecasts are not only high, but have increased consistently since the beginning of the year. Analysts are particularly keen on South Korea, with strong estimates in globally oriented sectors like technology and industrial companies. Expectations are for similar growth for those sectors in Taiwan, while expectations for growth in domestically focused sectors such as consumer stocks and financials are much lower.

CONCLUSION

Earnings power stock prices. That is as true overseas as it is domestically. Recent strong earnings have been a major factor in the relative outperformance of overseas markets to domestic equities. Analysts are still forecasting strength in many areas of the global equity markets, particularly in technology and industrial stocks. Japan is the only region that bucks the trend of increased optimism on earnings. We have been optimistic on EM stocks for over a year, though have remained cautious on developed markets. We are on the lookout for sustainable earnings growth in developed markets, particularly in Europe, to become more positive on these regions. ■

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.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

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.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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 MSCI Emerging Markets Index captures large and mid-cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country."

The MSCI Japan Index is a free float-adjusted, market capitalization-weighted index that is designed to track the equity market performance of Japanese securities listed on Tokyo Stock Exchange, Osaka Stock Exchange, JASDAQ, and Nagoya Stock Exchange.

The MSCI Europe Index is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

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