LPL RESEARCH
WEEKLY MARKET COMMENTARY

July 10 2017

SECOND QUARTER 2017 EARNINGS PREVIEW

Q1 A TOUGH ACT TO FOLLOW

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KEY TAKEAWAYS

Another quarter with double-digit, year-over-year earnings growth for the S&P 500 appears likely for the second period, but it won't match the pace of the first quarter.

Annual comparisons are getting tougher with the one-year anniversary of the 2015–2016 earnings recession trough having past.

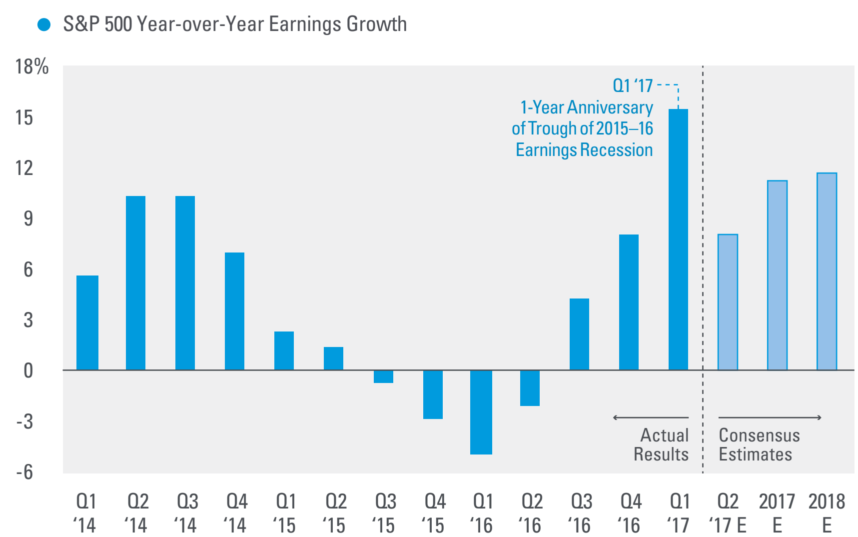
We have several reasons to be optimistic, as was the case last quarter, including generally good macro data and resilient analysts' earnings estimates.

Second quarter earnings growth will be about more than just an energy rebound, with solid contributions expected from technology and financials.

Earnings season is underway this week (July 10–14) and may be another good one, with double-digit S&P 500 Index earnings growth possible. But getting to double digits will be tougher than it was in the first quarter when S&P 500 earnings increased more than 15% year over year.

First quarter earnings season will be a tough act to follow as the year-over-year comparison gets more challenging. The first quarter of 2016 was the trough of the earnings recession, so the first quarter of 2017 had the easiest annual comparison. Growth improved (fell less) in the second quarter of 2016 as corporate America began to emerge from the earnings recession, lifting the base for comparison for the just-completed second quarter. This trend will continue over the rest of 2017 given the earnings growth acceleration achieved during the third and fourth quarters of 2016 [Figure 1].

1 ANNIVERSARY OF EARNINGS RECESSION TROUGH IS BEHIND US, SETTING UP TOUGHER COMPARISONS



Source: LPL Research, FactSet 07/07/17

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

Consensus estimates may not develop as predicted.

CAUSE FOR OPTIMISM

The Thomson-tracked consensus for second quarter earnings growth stands at 8%. Given the typical 3–4% upside to estimates, growth in the 11–12% range is a reasonable expectation. There are several reasons to be confident that results may be in that range if not better:

- **Better second quarter economic growth.** Consensus estimates are calling for a 3.0% increase in gross domestic product (GDP) on an annualized basis for the second quarter, up from the 1.4% pace in the first quarter and providing a solid backdrop for steady revenue and earnings gains (consensus is calling for 4.6% revenue growth in the second quarter). The strong manufacturing and services surveys from the Institute for Supply Management (ISM) during the quarter, especially the June readings (57–58) are supportive. Wage growth has risen at a moderate roughly 2.5% pace based on national income data, helping corporate America protect relatively high profit margins. Meanwhile, data overseas has generally reflected improving economic conditions, albeit gradually, in Europe, Japan, and the emerging market economies, a positive for U.S. multinationals.

  We see the increased frequency of economic data missing consensus expectations in recent months as more of a sign of overly optimistic forecasts than of new incremental weakness in economic conditions.

- **Resilient estimates.** Earnings estimates have held up relatively well in recent months. For the second quarter, the current 8% growth rate is just 2% below the estimate as of April 1, 2017, compared with the typical 3–4% decline. Based on FactSet analysis, this below-average decline is the best in three years. Estimates for the second half of 2017 fell by less than 1% during the second quarter, an encouraging result even though these estimates may still come down a bit more, as they typically do.

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.

  A key question for the outlook is whether any pro-growth policies will be implemented in time to help before year-end. We are skeptical at this point, although we could see a several percentage point boost to S&P 500 profits in 2018, if not more, should tax rates be lowered. One of our goals this earnings season, in addition to gauging the level of corporate optimism, is to try to assess how much, if any, policy boost is embedded in analysts' expectations (we believe it to be minimal at this point).

- **Pre-announcements.** The ratio of companies pre-announcing negative second quarter 2017 results relative to those pre-announcing positive results (1.9) is better than that of the year-ago quarter (2.3), the last quarter (2.4), and the 20-year average (2.7), suggesting a high percentage of companies could exceed estimates again. An impressive 75% of companies exceeded consensus estimates in the first quarter, leading to a 5% overall upside surprise.

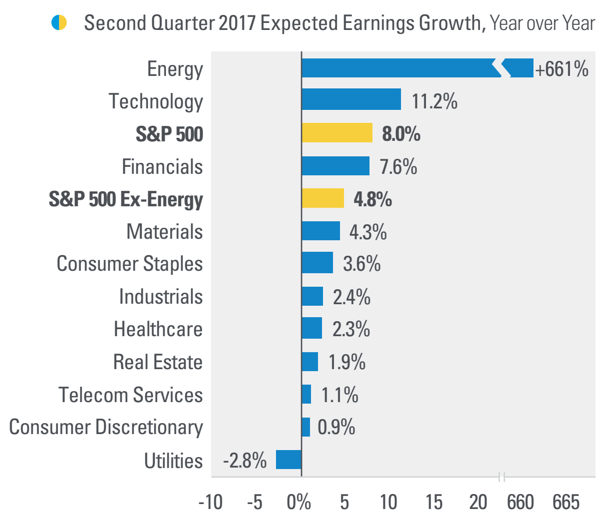
Companies do face several headwinds, including a stronger U.S. dollar (up 4% year over year based on average prices in the second quarter 2017 versus 2016), lower inflation which translates into less pricing power and consequently lower revenues for many industries, and a flatter yield curve, which impacts financials as the gap between lenders' cost of funds and lending rates narrows.

Even though oil prices were up on average in the quarter year over year, the price slid from late May through late June and ended the quarter about $4 per barrel below where it started, introducing some risk to the energy sector outlook (while providing a small "tax cut" to energy consumers). We expect corporate America to fight through these headwinds just fine overall but acknowledge further risk to energy sector estimates—which have fallen in recent months—for the remainder of the year.

MORE THAN JUST ENERGY

Energy should be the biggest contributor to overall earnings growth in the second quarter, as it was in the first, even after lowered estimates. Oil rose about 5% on average, year over year in the second quarter (a far cry from the 54% increase in the first quarter). But other sectors will make a meaningful contribution, most notably technology and financials.

2 ENERGY REBOUND WILL HELP BUT SO WILL FINANCIALS AND TECHNOLOGY



Source: LPL Research, Thomson Reuters consensus estimates 07/06/17

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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.

The energy sector's expected 2.6% contribution to the consensus 8% earnings growth estimate for the S&P 500 is significant (as is the more than 600% potential increase in the sector's earnings off of depressed year-ago levels). However, the expected contribution from technology to overall earnings growth is a close second at just a hair above 2%. The technology sector's expected 11.2% earnings growth rate appears very likely to exceed all sectors outside of energy. This result could be at least a couple of percentage points higher after all reports are in based on the historical pattern and our positive assessment of the sector. Semiconductor industry earnings gains are expected to drive the biggest share of the increase in technology sector earnings.

Despite the drag on lenders' net interest margins from a flattening yield curve observed during the quarter and generally sluggish loan growth recently, the financials sector is expected to produce about 8% growth in earnings in the second quarter [Figure 2], which corresponds to a 1.1% contribution to the overall 8% consensus S&P 500 earnings growth figure.

CONCLUSION

We believe another quarter of double-digit earnings growth for the S&P 500 in the second quarter is possible, given generally solid overall economic data, the strong rebound in energy sector profits, and solid financial and technology sector earnings gains. Earnings estimates have been resilient and the ratio of positive to negative pre-announcements is as positive as it has been in three years. And, despite several headwinds, including the tougher annual comparison, lower inflation, U.S. dollar gains, the recent flattening in the yield curve, and the drop in oil prices, we believe corporate America will deliver more good news this quarter.

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.

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.

Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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.

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