Weekly Market Commentary

January 9, 2012

What Investors Should be Watching This Earnings Season

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Highlights

This week is the start of the fourth quarter 2011 earnings reporting season with big, well-known companies like Alcoa and JPMorgan Chase due to report fourth quarter results.

This is the first quarter in over two years that S&P 500 profit growth is not expected to be in the double-digits.

During this earnings season we are paying special attention to revenues and how companies are putting cash to work either by spending or by returning it to shareholders.

U.S. stocks rose last week by 1.7%, as measured by the S&P 500 Index, getting 2012 off to a solid start. A combination of solid and better-than-expected economic data, a quiet week in Europe, and few negative earnings pre-announcements drove the rebound.

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 fourth quarter earnings reports. Four times a year investors focus on the most fundamental driver of investment performance: earnings. While only five S&P 500 companies report fourth quarter results this week, bringing the total to 31, this week is the start of earnings season with big, well-known companies like Alcoa and JPMorgan Chase due to report fourth quarter results.

The consensus of analysts tracked by Thomson Financial expects operating earnings growth of 8% in the fourth quarter of 2011(compared to the fourth quarter of 2010), as profits end the year at new all-time highs. This is the first quarter in over two years profit growth is not expected to be in the double-digits. If the profits of S&P 500 companies match expectations in the fourth quarter, they will have grown about 10% for 2011, in line with our forecast established a year ago.

In 2012, we expect a slower pace of profit growth of about 7%, modestly below the analyst consensus of 10%. In contrast, market participants have priced no growth in profits into stock market valuations with price-to-earnings ratios at levels not seen since the recession of 1990-91, when earnings fell 20%. We believe earnings expectations will continue to be revised modestly lower and market participants are starting to price in a less dire outlook for profits as results are reported and corporate leaders provide guidance on coming quarters.

In recent weeks, stock have been rising even as fourth quarter earnings estimates have been falling. Of the 129 companies that pre-announced fourth quarter earnings guidance in recent weeks, the ratio of negative-to-positive news was 3.3, worse than the average ratio of 2.3 since 1995, and the worst ratio since the 3.4 in the fourth quarter of 2008, during the peak of the financial crisis.

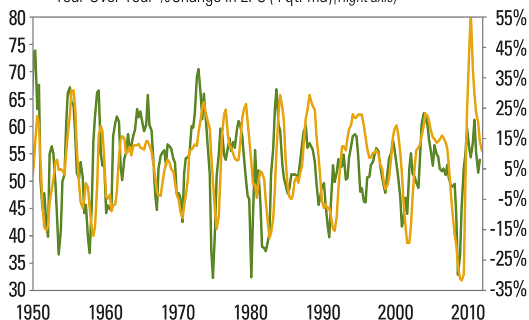
The fourth quarter earnings season runs about four to six weeks starting around two weeks after the close of the quarter. During this earnings season we are paying special attention to revenues and how companies are putting cash to work either by spending or by returning it to shareholders.

- **Revenues and Emerging Markets Drivers**–Revenue growth is driven by global economic activity and is expected by analysts to be around 6%. With profit margins near peaks, profits will more closely track revenues in coming quarters. Economic growth is likely to be below average in the United States over the next year, and Europe is on the edge of recession. About 46% of S&P 500 profits come from foreign markets with just under a third of foreign profits derived from Europe. Fortunately, a meaningful and growing portion of profits come from rapidly growing emerging markets. We will be closely watching the impact of the rapidly changing regional composition of revenue and profits in the S&P 500. It is worth noting that in 2012, emerging market countries will for the first time make up more of global GDP (gross domestic product) than developed markets, according to data from the IMF (International Monetary Fund).
- **How Businesses Are Returning Cash to Shareholders**–The first quarter is when companies most often increase or initiate a dividend. While first quarter bank stress tests need to be completed before the traditionally high-yielding Financials sector can be expected to boost payouts, pressure is building for other companies to increase their dividends as U.S. companies sit on record cash stockpiles and payouts remain at all-time lows. S&P 500 companies paid out about 25% 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 2.1%, above the yield on the 10-year Treasury for one of the few times in history. Announcing share repurchases is another way corporate leaders may put cash to work.
- **How Businesses Are Spending**–While investor attention is often directed on consumer spending as a driver of profits, we will be watching business-spending-driven industries more closely. Business spending and commodity prices are major drivers of S&P 500 profit growth while discretionary consumer spending has a much smaller contribution to the S&P 500. During the fourth quarter, commodity prices generally rose and manufacturing rebounded from the summer weakness, according to the ISM Index (Institute for Supply Management Purchasing Managers Index), supporting modest profit growth for S&P 500 companies [Chart 1] We will be watching to see how effectively this translated into profits for the Information Technology, Industrial, Energy, and Materials companies for clues as to how rapidly their profit growth may slow in 2012.

For S&P 500 companies that have reported fourth quarter earnings so far, 14 of 26 (54%) have exceeded estimates, while 12 have missed estimates. Importantly, 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 fourth quarter of 2011 are shaping up until early February 2012, when about half of the S&P 500 companies will have reported.

1 ISM Suggests Slower S&P 500 Profit Growth

Institute for Supply Management's Purchasing Manager Index and S&P 500 Earnings per Share Growth Rate Year-Over-Year



Source: LPL Financial, Thomson Financial, Bloomberg data 01/07/12

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

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.

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.

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 P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Information Technology: Companies include those that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services; technology hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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