Weekly Market Commentary

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The Six Trends to Watch This Earnings Season

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Highlights

Four times a year, investors focus on the most fundamental driver of investment performance: earnings. This quarter earnings growth could be the strongest in over a year.

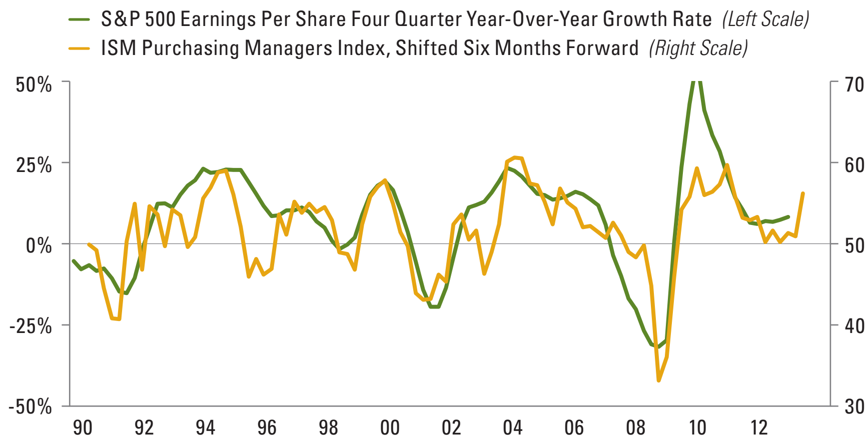
The continued wrangling by lawmakers over the government shutdown and debt ceiling may overshadow earnings reports this week in drama, but not in importance. While Washington drives market volatility, the market trend is determined by earnings growth.

It is hard to draw conclusions from the handful of results in the first week of third quarter earnings reports given very company-specific factors. For example, Alcoa posted solid earnings results and exceeded analyst estimates on productivity gains unlikely to be seen among other metals companies. Yum! Brands Inc. missed estimates due to the impact of the avian flu outbreak on Chinese consumers. And JPMorgan Chase & Co. took a $9.2 billion charge for legal costs.

However, with over 60 companies reporting next week trends will begin to emerge. The six trends we are watching for:

1. Best quarter in over a year – Earnings per share for S&P 500 companies in aggregate are expected to be up about 4%. In recent quarters, companies have reported earnings about 4% above analysts' estimates. If we see a similar outcome this quarter, earnings could be up 7–8% — the strongest growth rate in over a year.
2. The shutdown – We do not expect many companies to cite a negative impact from the government shutdown. Although affecting the economy through different channels, few companies in the second quarter reported being negatively impacted by the sequester. However, the shutdown adds to a combined drag on business from spending cuts, higher taxes, and high gasoline prices, not to mention the overhanging uncertainty of more fiscal cliff battles to come, and the rollout of the Affordable Care Act. On the other hand, confidence and conditions have benefitted from better global growth, a return to all-time highs in the stock market, and the return of the housing market. We will be watching to see how these drivers may have offset each other in the quarter.
3. Improving outlook – We expect more businesses are likely to cite the improving trend in global economic data, which should help boost confidence in future earnings growth. Most notably, the widely followed Institute for Supply Management (ISM) Purchasing Managers Index has a solid track record forecasting earnings growth in coming quarters [Figure 1]. This indicator suggests a rebound from the relatively flat performance by earnings and revenues in recent quarters.

1 Reliable Earnings Indicator Pointing Higher



Source: LPL Financial, Bloomberg, Thomson Financial 10/11/13

Past performance is no guarantee of future results.

All indices are unmanaged and cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Index performance is not indicative of any particular investment.

4. Stronger overseas demand – Sluggish global growth is contributing to slow sales. About 40% of S&P 500 corporate profits are derived from global sources. It is not only the United States that had a PMI that was above 50 and rising in the third quarter—so did Europe, China, and Japan for the first time since early 2009/late 2010. After Europe acted as a drag on overseas sales for the prior six quarters of recession, the economic improvement seen in the third quarter in Europe may result in better international revenue. From industrial production in Germany to machinery orders in Japan and vehicles sales in China, demand is firming around the world. An offset again this quarter is the value of the dollar relative to the Japanese yen, which rose roughly 20% over the past year, acting as a drag on foreign-derived profits when translated back into dollars and reported. This may have had some effect on reported results from companies in the health care, industrial, and technology sectors—where S&P 500 companies' sales to Japan are concentrated.
5. Dividend increases – In addition to the ongoing boom in buybacks, dividends are on the rise. S&P 500 dividends have surged 15% over the past year and are now 26% above their 2008 peak. As investors seek yield in a rising rate environment, businesses are increasingly returning their strong cash flow to shareholders. While the third quarter is historically not the biggest of the year for dividend increases (that honor goes to the first quarter), we still expect to get quite a few of them.
6. Rising interest rates – While interest expense is only a small percentage of costs on average for S&P 500 companies, changes in interest rates can be a significant driver of results in some industries—especially those tied to housing. We will be watching for the impact on bank lending and refinancing activity along with demand for homebuilders.

Four times a year, investors focus on the most fundamental driver of investment performance: earnings. Unfortunately, like the economy, earnings growth has been sluggish. We hope the third quarter of 2013 begins to mark an acceleration from the string of modest earnings per share growth rates reported in recent quarters as global momentum improves. ■

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 Institute for Supply Management (ISM) index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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