Weekly Market Commentary

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First Quarter Earnings Insights

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Highlights

The dollar amount of first quarter 2013 earnings per share for the S&P 500 companies is expected to be lower than in each of the past three quarters and only 1% higher than a year ago.

With the price-to-earnings ratio rising above its long-term average, investors are getting more confident about future earnings growth.

Four times a year, investors focus on the most fundamental driver of investment performance: earnings. Unfortunately, like the economy, earnings growth remains sluggish. The first quarter of 2013 is likely to mark the fourth quarter in a row of low to mid-single-digit earnings per share growth. The dollar amount of earnings per share for the S&P 500 companies is expected to be lower than in each of the past three quarters and only 1% higher than a year ago, according to the Wall Street analysts' consensus complied by Thomson/Reuters.

The sluggish growth rate for S&P 500 company earnings reflects not only slower growth among individual companies sales with revenues also expected to be up only 1% from a year ago, but also reflects the shrinking number of companies expected to post any growth in earnings at all, with four of the 10 sectors expected to reveal declines.

1 Wall Street Expects a Big Rebound in Profit Growth

Source: LPL Financial. Bloomberg data 04/15/13

The S&P 500 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.

Manufacturing Profits

The Institute for Supply Management (ISM) is one of the best leading indicators for the economy and markets. The ISM is a group that represents purchasing managers at U.S. corporations. The ISM surveys these purchasing managers each month and publishes the results in the form of an index. Although manufacturing businesses make up only about 40% of S&P 500 company earnings, demand for manufactured goods has been a timely barometer of business activity of all types.

Currently at about 51, the ISM suggests a sluggish environment for profit growth [Figure 1]. The level of the ISM index indicates that earnings growth may be slightly positive this quarter, but unless it picks up meaningfully—which seems unlikely given a soft U.S. consumer and the broadening recession in Europe among other challenges—profit growth is likely to be only half as strong as the consensus expects in coming quarters.

Looking Ahead

So far, 29 companies of the S&P 500 have reported earnings. This week, 74 companies are scheduled to report, with about half of the 500 companies due to report by the end of April. While investors are very focused on what the profits were for the past quarter, it is what they may turn out to be over the next several quarters that will likely have the most impact on the markets.

Much like last year at this time, estimates for earnings growth in the third and fourth quarter are in the double-digits. In contrast to those lofty expectations, last year earnings growth in the second half ended up averaging just 3%. Again this year, the estimates for the coming quarters are likely to come down as earnings remain bound by the sluggish economic growth driving revenues. Analysts' 10% third quarter 2013 and 13% fourth quarter 2013 year-over-year earnings growth expectations are out of sync with their much lower 3% revenue growth forecast for the second half. Given weak productivity growth and already wide profit margins, it is unlikely companies can produce double-digit earnings growth on low single-digit revenue growth later this year.

However, we may not see major downward revisions to earnings estimates in the coming weeks as first quarter reports come in. Despite being way too high last year, earnings growth expectations only came down about 1 percentage point during the first quarter earnings reporting season of last year. The likelihood of more gradual downward revisions to growth expectations is one of the reasons why we still believe another sharp 10–20% decline in the market—similar to those seen in the spring of each of the past three years—is unlikely. See our March 25 *Weekly Market Commentary: 10 Indicators of a Spring Slide in the Stock Market* for more insights on our view of the conditions needed for a major market decline.

What We Are Watching

Earnings may come in better or worse than expected for the quarter, depending primarily on factors that are hard to predict.

U.S. consumers have benefitted from a return to all-time highs in the stock market and the return to a strong housing market — these factors combined to result in strong consumer spending growth in the mid-2000s. On the other hand, the combined drags of higher taxes, high gasoline prices, sluggish job and income growth, and the overhang of more fiscal cliff battles to come may have weighed on spending. We will be watching to see how these drivers may have offset each other in the first quarter, especially relative to the high expectations for the consumer discretionary sector.

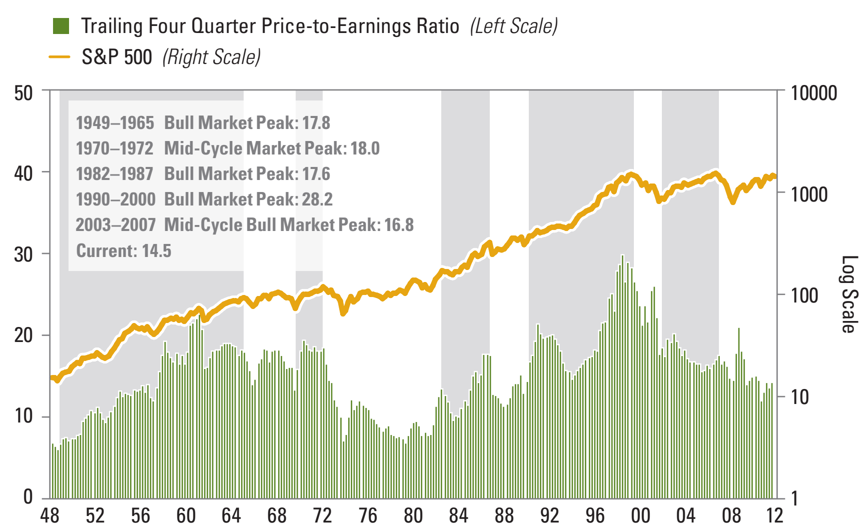
About 40% of S&P 500 corporate profits are derived from global sources. Asian economies experienced improving growth in the first quarter of 2013, while Europe's recession lingered. The extent to which these factors offset each other across different sectors will be worth noting since the trend may continue for much of this year.

Valuing Earnings

Investors are displaying the greatest confidence in continued earnings growth they have had in the past few years. This can be seen in the stock market rally lifting the price-to-earnings ratio, or what investors are willing to pay today per dollar of earnings over the past four quarters, to 15.3. This is now just above the long-term (since 1927) average of 15.1. The higher the price-to-earnings ratio, the brighter the implied outlook for future earnings growth.

While the rise in the price-to-earnings ratio to the long-term average suggests stocks can no longer be considered cheap, they are not expensive. Since WWII, every bull market has peaked with a price-to-earnings ratio of 17–18, with the exception of the late 1990s/early 2000 bull market that peaked at a much higher 28 [Figure 2]. From a valuation perspective, this

2 Bull Market Unlikely To Be Over Yet at Price-to-Earnings Ratio of 15



Source: LPL Financial, S&P 500 04/15/13

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suggests the S&P 500 could rise another 13% to 1800 without the benefit of any earnings growth before the stock market could be considered expensive and at significant risk of a bear market.

All that said, we would not be surprised at a modest stock market pullback of 5–10% as the earnings season offers us a reminder that although a fiscal crisis in the United States and Europe may have been averted in the first quarter, it did come with a cost in the form of growth.

The Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services, and education services.

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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.

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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