LPL RESEARCH

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EARNINGS UPDATE: END OF A LONG DROUGHT

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KEY TAKEAWAYS

The earnings recession was not quite as long as the Cubs' World Series drought, but we — like Cubs fans — are glad the drought is over.

Corporate America ended its earnings drought in style, with S&P 500 earnings tracking to a 4% year-over-year increase for Q3 2016, well above prior estimates.

Perhaps even more important than the solid results relative to expectations in Q3 is that the prospects for a continued rebound in the fourth quarter and into 2017 remain intact.

Third quarter earnings results mark the end of a long earnings drought. It was not quite as long as the Cubs' World Series drought (107 years), but we — like Cubs fans — are glad it's over. Like the Cubs, corporate America has ended its drought in style. In the third quarter of 2016, S&P 500 earnings are tracking to a 4% year-over-year increase, well above prior estimates and marking the end of the year-long earnings recession. This week we share our thoughts on the end of the earnings recession and discuss prospects for earnings acceleration in the coming quarters.

For those of you looking for election-related content, we would refer you to our October 24, 2016 *Weekly Market Commentary, "Election Playbook."* Also, look for an election recap from us here next week when, hopefully, we will know all of the results.

THE WAIT IS OVER

After four quarters of year-over-year earnings declines (or five, depending on the data source) from early-to-mid 2015 through mid 2016, the wait for earnings growth is over [Figure 1]. The third quarter also marked the return of revenue growth, which had been absent since the fourth quarter of 2014. There has been a lot to like in the results, in addition to the return of earnings gains:

- **Trough is in.** The results further confirm that Q1 2016 represented a trough in earnings, and the Q4 2015 was the trough for revenue.
- **Strong upside.** The S&P 500, with roughly 5% upside, is on track to potentially produce the biggest upside surprise in any quarter in more than five years (Q1 2011).
- **Robust profit margins.** S&P 500 profit margins are near record highs, and would eclipse record high levels if the energy sector is excluded.

CONSIDER THE SOURCE

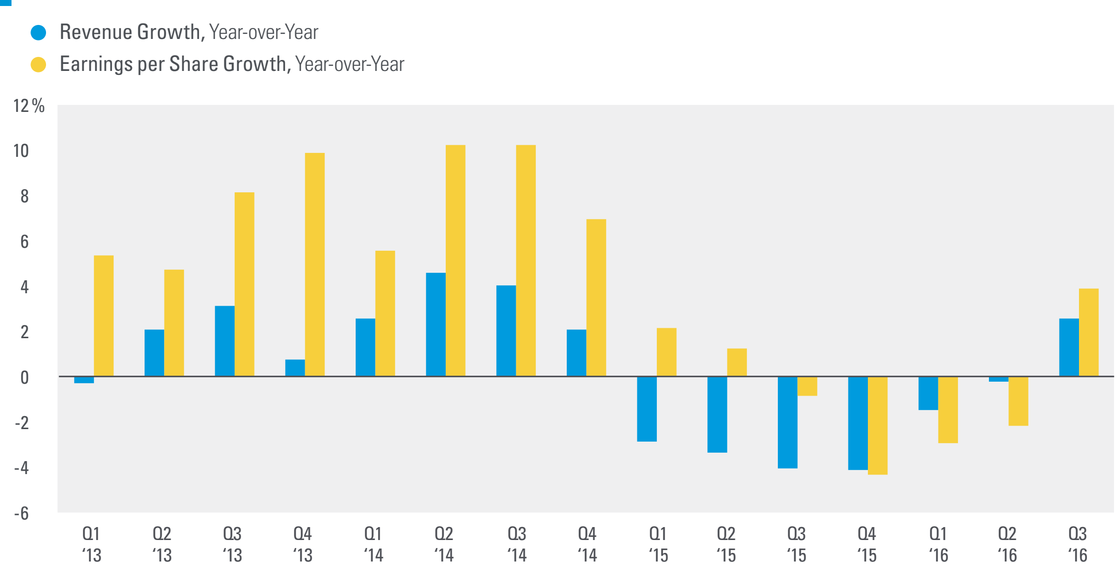
Different sources such as FactSet, Bloomberg, Standard & Poor's and others have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings. We favor Thomson Reuters and FactSet for their long track records and wide following.

- **Stable pre-announcements.** Pre-announcements have been less negative than the historical average. The ratio of negative-to-positive pre-announcements for Q4 2016, at 2.1, is better than the long-term average (2.7), Q3 2016 (2.3), and the year-ago quarter (2.5).
- **Resilient earnings estimates.** Revisions to earnings estimates for Q4 2016 are down by the smallest margin (1.2%) during any earnings season since Q2 2014.
- **Strong results for financials.** The financial sector produced a stellar 6.9% upside surprise, while estimates for Q4 2016 have increased by 1.7% since earnings season began [Figures 2, 3]. Higher interest rates and healthy capital markets activity have been supportive.
- **Strong results for technology.** The technology sector produced a solid 6% upside surprise, and estimates for Q4 2016 have increased by 0.9% since earnings season began [Figures 2, 3]. The sector benefited from strength in internet advertising, cloud computing, and semiconductors.

At the same time, there have also been some disappointments:

- **Industrials estimate reductions.** Since earnings season began, the industrials sector has seen a nearly 5% reduction in Q4 2016 estimates [Figure 3] as oil sensitivity and still lackluster global growth remain headwinds.
- **Commodity headwinds still weighing on materials.** Ongoing challenges in the commodity markets are evident in the 14% reduction in earnings estimates for the materials sector (again since the start of the Q3 2016 earnings season, Figure 3).
- **Drug pricing controversy hurts healthcare.** Healthcare, embroiled in the drug pricing

1 Q3 BRINGS BOTH EARNINGS AND REVENUE RECESSIONS TO AN END



Source: LPL Research, Thomson Reuters, FactSet 11/04/16

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.

Performance is historical and no guarantee of future results.

controversy, has seen far less upside than in prior quarters. The sector has uncharacteristically seen its Q4 2016 estimates reduced by more than the S&P 500 (-1.9% vs. -1.7%) as the pricing environment has tightened.

- **Slowdown in consumer discretionary earnings.** Consumer discretionary earnings growth has slowed significantly over the past several quarters, while the sector has produced less upside than the S&P 500 [Figure 2] with a bigger-than-average downward revision to Q4 2016 estimates since earnings season began [Figure 3].

We see more positives than negatives and characterize this earnings season as a success overall.

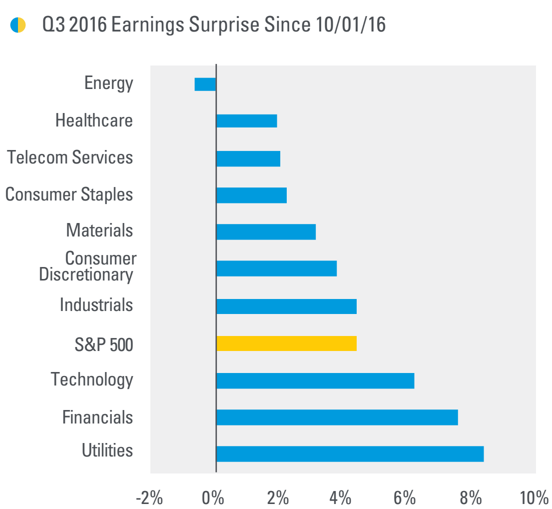
CORPORATE BEIGE BOOK

Later this month we will update our Corporate Beige Book barometer, an analysis of the topics covered in companies' earnings conference calls.

EARNINGS REBOUND INTACT

Perhaps even more important than the solid results relative to expectations in the third quarter of 2016 is that the prospects for a continued rebound in the fourth quarter and into 2017 remain intact. The resilience of forward estimates — the next three

2 FINANCIALS AND TECHNOLOGY HAVE PRODUCED STRONG Q3 UPSIDE SURPRISES

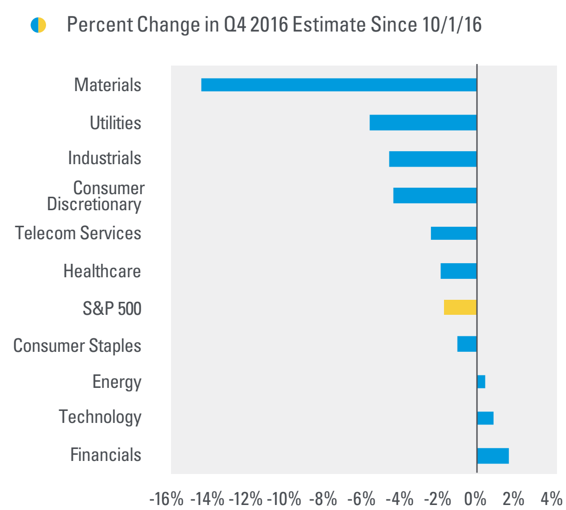


Source: LPL Research, Thomson Reuters 11/04/16

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

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

3 Q4 ESTIMATES FOR FINANCIALS AND TECHNOLOGY HAVE RISEN DURING EARNINGS SEASON



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quarters have fallen by a relatively modest 1.7%, 1.2%, and 1.1%, respectively during earnings season—is one indication that earnings are poised to ramp up, although most analysts and strategists, ourselves included, think that consensus estimates calling for double-digit earnings increases in the first half of 2017 are still too high. A stable and better-than-average series of pre-announcements is also positive.

Some other encouraging signs:

- **Better U.S. economic growth.** In the third quarter of 2016 the economy experienced a pickup in gross domestic product (GDP), the best quarterly growth in two years, an improvement in the Institute for Supply Management's (ISM) manufacturing survey, and accelerating industrial production. We believe these data points indicate economic momentum is starting to pick up and bode well for earnings prospects over the next several quarters.
- **Oil has stabilized.** Despite oil's recent return to the mid-40s on skepticism surrounding OPEC's ability to agree to production quotas, the market has continued to progress toward balancing supply and demand. Given that energy continues to drag on earnings, continued improvement in the sector will be a key component of a sustained earnings rebound.
- **Cost efficiency.** Companies continue to do an excellent job controlling costs, which played a key role in driving earnings growth ahead of revenue growth during the third quarter. Earnings growth in the quarter could end up outpacing revenue growth by close to 2% after all results are in, a reversal of expectations when earnings season began.

Looking ahead, there are several risks to earnings, including, first and foremost, the election. The uncertainty has already started to impact confidence and spending among consumers and businesses. Potentially more protectionist trade policy could impair overseas earnings. High drug prices are a target for both candidates. But as we wrote in our "Election Playbook," corporate America has operated under many different political regimes and business cycles over many decades, and through it all, S&P 500 companies have grown profits by an average of 8% annually.

Other risks to earnings include Brexit (the U.K. is positioned to begin the process of exiting the European Union this spring), a potential negative surprise out of China, and, although not our expectation, a surge in the U.S. dollar.

CONCLUSION

A long earnings growth drought appears to be coming to an end. Though well short of the Cubs 107-year championship drought, and perhaps lacking the excitement of a deciding seventh game in extra innings, the earnings recession ended in style—with a strong earnings surprise and generally positive outlooks from company managements. Softness in some key sectors bears watching, and the election certainly has the potential to throw a wrench into things, but we'll put the third quarter in the win column. For those who are wondering which sports franchise now has the longest championship drought, you just saw them play the Cubs. It's the now 68-year championship drought for the Cleveland Indians (the Detroit Lions are next at 58 years). So for those long-suffering fans, go get 'em next year! ■

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.

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 USD Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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