LPL RESEARCH WEEKLY MARKET COMMENTARY

January 20 2020

EARNINGS ARE ALL ABOUT 2020

John Lynch, *Chief Investment Strategist, LPL Financial*
Jeffrey Buchbinder, CFA, *Equity Strategist, LPL Financial*

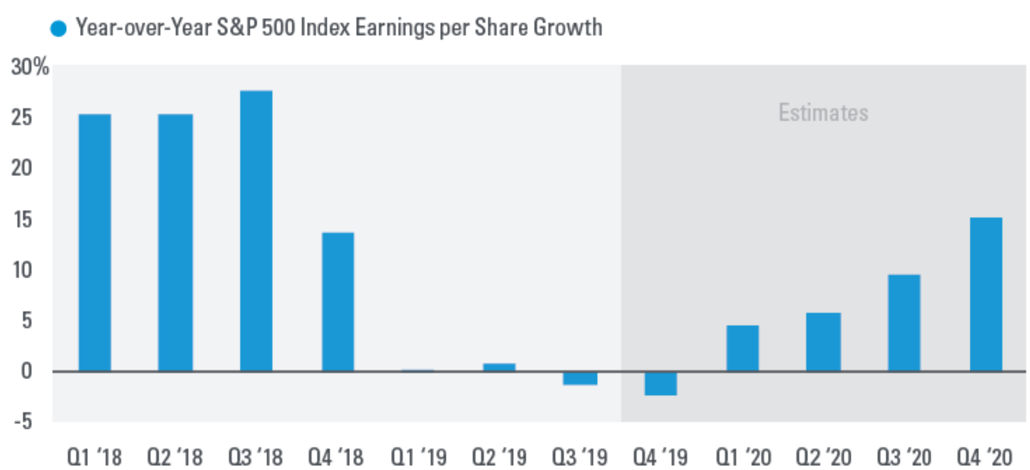
Earnings growth was largely absent in 2019, but we expect it to pick up in 2020. With stock valuations elevated, we think earnings hold the key to pushing stocks higher this year. We preview fourth quarter earnings season and share our thoughts on the outlook for corporate profits in 2020.

OFF TO A GOOD START

Fourth quarter earnings season kicked off last week with 24 S&P 500 Index companies reporting fourth quarter results. The market's reception to the first batch of results was mostly positive, particularly for several of the big banks. The percentage of companies beating consensus estimates (74%) and the average magnitude of positive surprises (4%) compared favorably to recent trends.

We expect a marginal increase in S&P 500 earnings per share (EPS) for the fourth quarter on a year-over-year basis, based on current FactSet consensus estimates for a 2% year-over-year decline and the average historical upside of roughly 3 percentage points **[FIGURE 1]**. The highest-earning companies with the biggest weightings in the S&P 500 earnings calculation are weighing on this growth rate: The median earnings growth rate is expected to be 4–5 percentage points higher, while the energy sector alone is expected to be a 2.3 percentage point drag by itself, based on current estimates.

1 CONSENSUS ESTIMATES CALLING FOR FLAT EARNINGS IN Q4 2019



Source: LPL Research, FactSet 01/14/19

Estimates are based on FactSet consensus. The economic forecasts set forth may not develop as predicted.

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REASONS FOR OPTIMISM

There are several reasons for optimism this reporting season:

- Economic growth has remained steady in the United States.
- Global growth exhibited signs of stabilization, which likely helped the globally diverse large cap companies.
- Wage growth has remained comfortably range-bound and has not been much of a threat to profit margins.
- Progress on the U.S.-China trade deal provided some clarity that buoyed business confidence late last year.
- U.S. dollar strength paused, so currency is unlikely to be a meaningful drag on profits for U.S.-based multinationals as it was in recent quarters.

From a sector perspective, technology has experienced much more positive earnings guidance for the fourth quarter than it has historically, and it could surprise us on the upside. Positive guidance uncharacteristically has outpaced negative guidance 20 to 19, according to FactSet. (Company guidance is more frequently negative.) Financial company profits are expected to benefit from the steepening of the yield curve and more favorable market environment, evident in last week's earnings reports. And energy sector profits may be helped by the latest rise in oil prices.

POSSIBLE CAUSES OF CONCERN

Although we anticipate better-than-expected results overall, some potential causes for concern include:

- Ongoing manufacturing weakness, based on the latest survey data from the Institute for Supply Management
- A weakening Citi economic surprise index suggesting the U.S. economy may not have performed quite as well as expected last quarter
- Weak earnings revisions trends in the consumer discretionary, industrials, and materials sectors.

CAPPING OFF FLAT EARNINGS YEAR IN 2019

We've become accustomed to meager earnings growth, as we noted in our January 15 blog. As shown in **FIGURE 1**, if fourth quarter results are anywhere near current expectations, 2019 may end up as a year without any earnings growth. Tariffs and trade uncertainty clearly weighed on profit growth. As we've seen, however, that didn't stop the S&P 500 from rallying 30% as stocks priced in an improving outlook for 2020. The increase in stock valuations that drove the market's gains last year is very unlikely to repeat in 2020. With the S&P 500 at our year-end fair value estimate already, earnings growth may have to take the lead in powering the bull market forward this year.

2020 IS THE KEY

With a lot of good news priced into stocks at current valuations, we think the key to this reporting season will be whether the optimistic growth outlook reflected in consensus earnings estimates for 2020 remains intact. Many companies will be commenting on 2020 for the first time, so their guidance could potentially impact expectations meaningfully.

Our estimate of $175 per share in S&P 500 EPS for 2020, which is about $3 below FactSet's consensus, represents a 6–7% increase from our $165 forecast for 2019. Based on the latest consensus estimates for 2019, that 2020 growth rate may get pushed up a bit by a smaller denominator. Still, we think $175 is attainable if capital investment picks up after stalling last year and wage growth remains stable.

We could even envision modest upside to our earnings forecast in the event of further progress on trade and the possibility of additional tariff relief late in 2020. The signing of the phase-one trade deal between the United States and China has helped de-escalate tensions. While negotiations on the next phase may be tougher and could even stall out, businesses surely will welcome the additional clarity that de-escalation has provided.

STOCKS LOOK FAIRLY VALUED

Stocks currently are at our year-end fair value target for the S&P 500 of 3,300 on the upper end. Even though the stock market probably pulled forward into 2019 some gains we expected in 2020, we still see potential for earnings growth to send stocks even higher over the balance of 2020.

Elevated valuations, geopolitical risk, and the 2020 election are among the risks that will likely bring some market volatility, but interest rates and inflation are low, and rate changes by the Federal Reserve may be on hold all year. We think this bull market may have more room to run, and as a result, we continue to favor market weight equities in appropriate strategies.

WEEKLY MARKET PERFORMANCE REPORT

Please see our new *Weekly Market Performance* report with insights on major asset classes.

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 professional prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in this material may not develop as predicted.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

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DEFINITIONS

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.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS is an important variable in determining a share's price and serves as an indicator of a company's profitability.

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