LPL RESEARCH WEEKLY MARKET COMMENTARY

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CORPORATE AMERICA IMPRESSES

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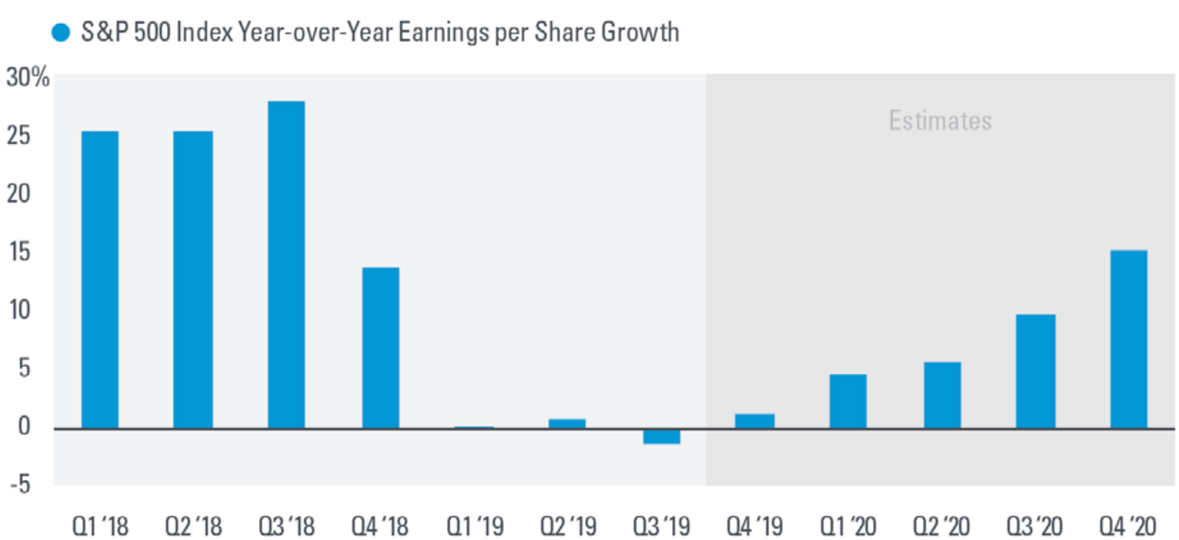
Corporate America impressed us this earnings season. Though S&P 500 Index companies have generated only 1–2% earnings growth compared with the year-ago quarter, we consider this an excellent result given the challenges companies faced in late 2019. The challenges have not let up in 2020, however, with significant disruptions for U.S. companies operating in China due to the coronavirus outbreak.

STRONG RESULTS AMID STIFF HEADWINDS

Companies have done an admirable job growing profits—considering several stiff headwinds that they've faced. Despite slowing global economic growth, weakness in capital investment and manufacturing, a strong U.S. dollar, and a huge drop in energy sector profits, S&P 500 companies impressively ground out better-than-expected overall earnings growth of 1–2 percentage points during the fourth quarter of 2019. That earnings gain may cement Q3 2019 as the trough, which we think should end talk of another earnings recession **[FIGURE 1]**.

1 CORPORATE AMERICA GRINDING OUT SMALL EARNINGS GAIN IN Q4



Source: LPL Research, FactSet 02/19/20

The economic forecasts may not develop as predicted.

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As we noted in our February 19 [LPL Research blog](), we have been impressed with the upside surprises during earnings season when we consider the challenging conditions. A solid 65% of S&P 500 companies have beaten revenue estimates, the highest number since second quarter 2018 and well above the long-term average of 57%. The 3.5% revenue growth rate is not great, but it's a solid 0.9% above prior expectations. The upside surprise for earnings growth is also solid at 4.4%.

SURPRISINGLY RESILIENT GUIDANCE

These earnings numbers appear even better if the embattled energy sector is removed—going from a 1–2% increase to a roughly 4% increase. However, the look ahead may be more important than the look backward, which means the forward guidance that companies provided can be critical.

We assess the collective outlooks of corporate America by following the path of forward earnings estimates during reporting season. Estimates for S&P 500 earnings per share (EPS) in 2020 have fallen by less than one percent since December 31, 2019, and now stand at $176 per share (source: FactSet).

Though these numbers may decrease slightly in the coming days, and the China situation remains fluid, this modest reduction in EPS estimates reflects the resilience of U.S. companies amid significant supply chain disruptions due to business shutdowns, quarantines, and travel restrictions within China. As a comparison, the typical reduction in EPS estimates during the first six weeks of a quarter—the period when most results are reported—has been closer to 2% in previous years. The percentage of companies providing negative guidance on both revenue and earnings for the first quarter has been below average as well, which we believe also reflects resilience.

Signs of a rebound in U.S. manufacturing activity may provide another encouraging signal about the earnings outlook. Historically, an improving Purchasing Managers' Index (PMI) for manufacturing has signaled improving earnings growth. The Institute for Supply Management's (ISM) PMI rebounded in January 2020, returning to expansionary territory (above 50) for the first time since July 2019. This data was prior to the coronavirus (now COVID-19) outbreak, but it has suggested the U.S. economy had some momentum heading into February, which may help dull the impact from the virus.

ASSESSING VIRUS UNCERTAINTY

Assessing the potential earnings impact of the COVID-19 outbreak in China is very difficult at this point in time. Most companies that reported results in late January and early February said it was too early to determine the impact or offered no updates, while some lowered their outlooks. As we continue to hear from more companies with better information, we could see estimates fall further.

That said, our base case is that economic activity in China could ramp back up to pre-crisis levels over the next two to three months. (It's important to note that prediction would mirror the SARS experience in 2002–03, but it is offered with no particular expertise in this area). That scenario could limit further damage to economic output in China, minimize additional impact on U.S. corporate profits, and give us confidence in our $175 per share estimate for S&P 500 EPS in 2020—a 7% increase from 2019.

STOCKS ARE ABOVE FAIR VALUE

The S&P 500 Index has surged past our S&P 500 fair value target of 3,300 for 2020 year-end. We fully acknowledge that while we strive to get every forecast we make as accurate as possible, predicting stock market movements—particularly in the short term—can be more art than science. Additionally, stocks can trade above (or below) fair value for extended periods of time.

That said, we set this S&P 500 target range before we knew the United States and China had reached a trade agreement. Given that development, along with strong fourth quarter earnings results, potential near-term COVID-19 containment, and now higher earnings-based stock valuations, our bias at this point is toward raising our target. (Another option would be to potentially downgrade our equity market view.) The fundamentals of economic growth, inflation, interest rates, and corporate profits point to further potential stock market gains in the months ahead, and we maintain our market weight equities recommendation in appropriate strategies.

We plan to discuss stock valuations here next week, along with our updated perspectives on the stock market outlook for 2020.

WEEKLY MARKET PERFORMANCE REPORT

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

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