Weekly Market Commentary

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Second Quarter Earnings Season Update

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Amid the barrage of nearly constant economic and market data, nothing is more important to assess the health of corporate America than the quarterly check-in that we affectionately call earnings season. As earnings season approaches its halfway mark, it's a good time to take a look at what we've learned so far.

LPL FINANCIAL RESEARCH'S EARNINGS SEASON DASHBOARD

Start of Earnings Season Supports Our Positive Second Half Outlook for Stocks

Revenue Growth

3.5%

2014's revenue growth pace of 3.5% is more than double the 1.5% advance in 2013

% of Companies Beating Revenue Estimates: 63%

EPS Growth

6.5%

Earnings continue their 2014 trend of over 6% growth, led by the technology sector

% of Companies Beating Earnings Estimates: 69%

As we near the halfway mark of the second quarter earnings season, corporate profits appear to be hitting their stride, and sales growth is revving higher. As we noted in our recently published *Mid-Year Outlook 2014: The Investor's Almanac Field Notes*, earnings are critical to our forecast for further gains in the stock market in the second half of the year. Based on the second quarter results we have seen thus far, and the 6% growth achieved in a weather-weakened first quarter, S&P 500 profits appear well on their way toward achieving the 5–10% growth rate we forecast in our *Outlook 2014*.

Source: Thomson Reuters, LPL Financial Research 07/25/2014.

Note: Revenue and earning growth statistics are a blend of actual results and Thomson Reuters consensus forecasts for companies that have not yet reported. Trailing earnings cover the four quarters ending Q2 2014 and include estimates for Q2 2014, while forward earnings cover the four quarters beginning Q3 2014.

Past performance is not indicative of future results.

\# of S&P 500 Companies Reported: 229

With market valuations creeping higher, the fuel to propel further gains from stocks will likely come from accelerating earnings and revenue growth. Coming off the heels of only modest gains in 2013, this year has seen a much brighter profit and sales environment. The results validate improved economic conditions across the globe and a potential turning point for U.S. companies, as an improved sales cycle might be the driver for stronger business spending and investment in the second half of 2014. The early themes for the second quarter earnings season are:

- **Encouraging revenue picture.** Tracking to a year-over-year gain of 3.5%, the revenue picture is corroborating the better economic data observed in the United States during the past several months after the severe winter weather depressed economic activity during the first quarter. Revenue growth, which averaged just 1.5% during 2013, improved to 2.6% during the first quarter and is on track for 3.5% growth in Q2 2014, according to Thomson Reuters data. A solid 63% of S&P 500 companies that have reported revenue results have exceeded consensus forecasts, well above the average of the prior four quarters of 55%. The emergence of top-line growth is crucial, as it could be the catalyst to motivate corporate CEOs to open up their capex (capital expenditures) wallets and start a wave of business spending that has yet to emerge in force during this business cycle [Figure 1].

Operating profit margin is a key measure of how effective a company is at controlling the costs and expenses associated with its normal business operations.

As noted in our *Outlook 2014: The Investor's Almanac*, the stock market may produce a total return in the low double digits (10–15%). This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10% and a rise in the price-to-earnings ratio (PE) of about half a point from just under 16 to 16.5, leaving more room to grow. The PE gain is due to increased confidence in improved growth allowing the ratio to slowly move toward the higher levels that marked the end of every bull market since World War II (WWII).

1 Company Profit Margins Remain at Record Levels

Source: LPL Financial Research, FactSet 07/25/14

Operating Profit Margin = Net Operating Income/Sales

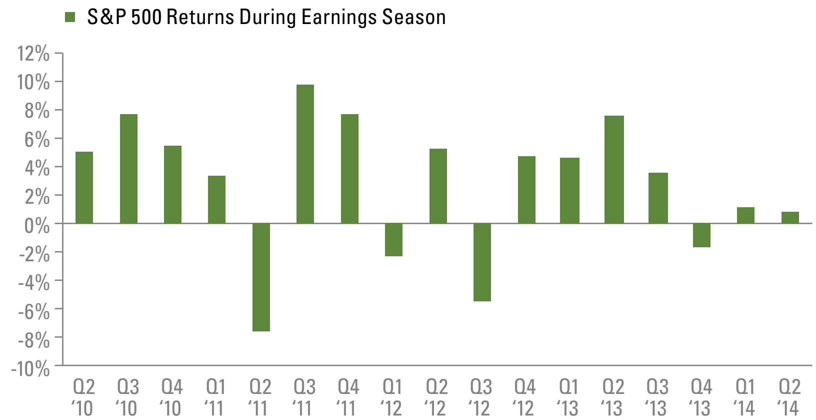
Past performance is no guarantee of future results.

- **Profit margins remain at record highs, despite some cost pressures in pockets.** Upward pressure on input costs, coupled with only modest economic growth, has led to some disappointing results from several consumer staples companies, including Coca-Cola, Kimberly-Clark, and General Mills. But S&P 500 profit margins overall remain at record highs and have shown no sign of compression, enabling earnings to continue to outgrow revenues. We forecast this trend will continue during the second half of 2014, given our expectations of high single-digit earnings growth, as noted in the *Mid-Year Outlook 2014: Investor's Almanac Field Notes*, and the current consensus forecast for S&P 500 revenue growth of a healthy 3–4%.

- **More upbeat guidance.** Historically, earnings season brings about cautious guidance that usually drops the next four quarters earnings estimates for the average company rather significantly. However, this earnings season has seen relatively rosy outlooks from management teams that have led analysts to collectively lower forward estimates by just 0.8% — far better than the historical average of a 3% reduction, according to FactSet data. Companies raising guidance have included such big names as United Technology, PepsiCo, Boeing, and Intel.
- **Overseas markets are not hurting.** Demand in emerging markets, including China, has generally been steady and helped drive growth for several key companies including Apple, Nike, and YUM! Brands. We also have not seen companies use weakness in Europe as an excuse, as was commonplace in 2013. In fact Nike, Accenture, and VF Corp. (owner of North Face, Timberland, Vans, and Wrangler brands) have cited strong performance in Europe. Caterpillar is a notable exception, having experienced some weakness, primarily in China.
- **The technology sector is hitting its stride.** The technology sector is on pace to produce the fastest earnings growth of the 10 equity sectors at 13%, according to the latest data from Thomson Reuters. Maybe more impressively, the sector has produced among the biggest upside surprises to earnings and revenues thus far. The technology sector, which is one of our favorites, is benefiting from recent improvement in business demand that could be the early stages of a capital expenditure rebound.
- **It's been an uphill battle for financials.** After a challenging first quarter, financials performance again reflects a tough interest rate and regulatory environment. Several of the big banks, including Wells Fargo, saw downward pressure on net interest margins (the difference between the banks' borrowing rates and the rates at which banks lend) as market interest rates have continued to fall. Higher interest rates are likely needed for better bank performance, although estimates for the sector are holding up relatively well with only a marginal decline, with most companies in the sector having already reported.
- **Sneaky good numbers from health care.** Health care has been in the news recently due to another challenge to the Affordable Care Act (ACA) in the courts. Although last week's court ruling challenging the legality of premium subsidies in federally run health insurance exchanges introduces some longer-term uncertainty, health care is one of the early winners this earnings season, driven predominately by biotech.
- **Sweet spot is working but may have room to run.** Stocks are higher during 13 of the past 17 six-week earnings periods with an average gain of 2.9% (and a median gain of 4%). Since the start of 2010, 90% of the S&P 500's gains have come during this six-week "earnings sweet spot" period (two weeks before Alcoa reports through four weeks after). So far during the second quarter earnings season period, the S&P 500 is up just 0.8% (as of July 25, 2014), suggesting more potential upside should this pattern hold [Figure 2].
- **As good as earnings have been, the second half of 2014 could be even better.** The Institute for Supply Management (ISM) Purchasing Managers'

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

2 Earnings Have Been the Catalyst for Stock Market Gains



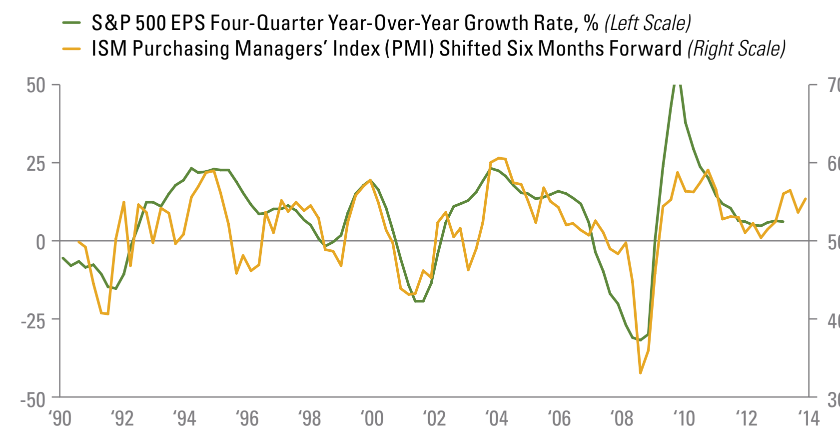
Source: LPL Financial Research, FactSet 07/25/14

We define earnings period as starting two weeks prior to Alcoa's report through the first four weeks of actual earnings reports from the S&P 500.

Past performance is no guarantee of future results.

Index, our favorite leading indicator of corporate profits, has rebounded from the weak 51.2 reading in January 2014 and, with the latest June 2014 reading of 55.3, points to improved earnings potential in the quarters ahead. Readings in comparable indicators overseas in Europe and China point to expansion and earnings gains in those regions as well [Figure 3].

3 Earnings Indicator Pointing to Improving Growth Prospects



Source: LPL Financial Research, Haver Analytics 07/25/14

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Be sure to track the status of earnings by using LPL Financial Research's Earnings Season Dashboard, which is updated every Monday throughout each earnings season at lplresearch.com

Through July 25, 2014, the S&P 500 Index has advanced just north of 6%, almost identical to the level of earnings growth this year. This showcases the power and importance of earnings to the future prospects for stock market gains. In addition, for those fearing an increasingly overvalued market, valuations need not expand at all and stocks could continue to post solid gains if sustained strong earnings growth continues to materialize. ■

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 reference 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.

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 stock representing all major industries.

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