LPL RESEARCH
WEEKLY MARKET COMMENTARY

January 9 2017

FOURTH QUARTER 2016 EARNINGS PREVIEW: LOOKS LIKE ANOTHER GOOD ONE

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KEY TAKEAWAYS

The fourth quarter 2016 earnings season begins this week, and we expect it to be another good one.

Energy prices rebounded in the fourth quarter, positioning the energy sector to potentially deliver its first earnings growth since the third quarter of 2014.

Financials is poised to be a sector standout, with rising interest rates, stock market gains, and healthy credit markets all helping to buoy the sector's profit picture.

Fourth quarter 2016 earnings season gets underway this week (January 9–13), and it looks like it will be another good one. With Alcoa no longer the unofficial kick off of the earnings season, we will consider Friday the start of the season when several big banks with the potential to move the market will report. Here we preview fourth quarter earnings season, which we expect to be another good one, marking the return of earnings growth to the energy sector.

OVERVIEW

Thomson-tracked consensus estimates for the fourth quarter of 2016 are calling for a 6.1% year-over-year increase in S&P 500 earnings. That means based on the typical upside companies generate, near 4%, double-digit earnings growth may be within the realm of possibility. We have several reasons to be optimistic:

- **Resilient estimates.** Earnings estimates held up very well during the last three months of 2016. Since October 1, 2016, fourth quarter 2016 earnings estimates for the S&P 500 have fallen 2.2%, about half the five-year average of minus 4.3% and 3% better than the 10-year average of minus 5.3%. Fourth quarter estimates for the two biggest S&P sectors, technology and financials, have actually risen since October 1 and over the past month providing encouraging signs. The S&P 500's 7% jump since Election Day increases the odds that estimates prove conservative, as stocks do tend to signal earnings moves.
- **Improved pre-announcement ratio.** The ratio of companies pre-announcing negative fourth quarter 2016 results relative to those pre-announcing positive results, at 2.0, is better than the year-ago quarter (2.9), last quarter (2.3), and the 20-year average (2.7). This ratio suggests a high proportion of companies will exceed estimates, potentially higher than in recent quarters. A solid 71% of S&P 500 companies beat estimates in the third quarter of 2016 with a 4.8% upside surprise.

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.

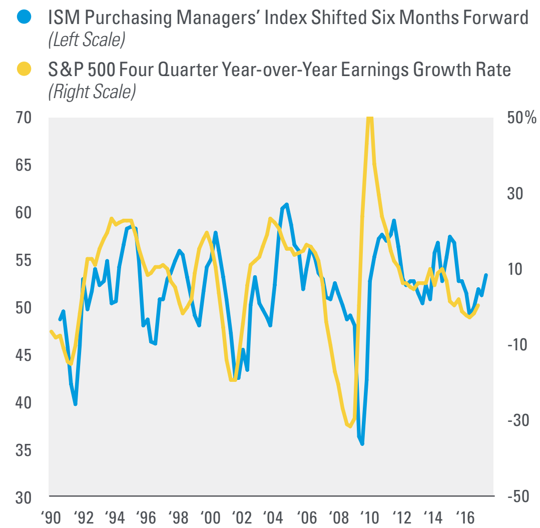
- **Good manufacturing data.** Although the U.S. economy, based on gross domestic product (GDP), is approximately two-thirds consumer spending driven, the composition of the S&P 500 is quite different. We estimate that more than 60% of the S&P 500 is manufacturing driven, making manufacturing data that much more important. As a result, we believe the recent uptick in the Institute of Supply Management (ISM) Manufacturing Index bodes well for earnings this quarter and next [Figure 1].
- **Energy rebound.** Oil prices rose 11% during the fourth quarter, putting the quarter's average price 17% above the average for the year-ago quarter [Figure 2]. That has the energy sector poised to deliver its first earnings growth since the third quarter of 2014 (Thomson-tracked consensus calling for +2.1%). Energy will be a big swing factor from the third quarter of 2016 when the sector's earnings fell 67% year over year. And perhaps the best news of all? We don't have to deal with "ex-energy" earnings calculations anymore!

  Looking ahead, should West Texas Intermediate (WTI) crude oil prices stay at January 6, 2017, levels near $53/barrel through March 31, the average price would be 60% above the first quarter 2016 level.

On the flip side, a strong U.S. dollar may limit the upside to forecasts. The average U.S. dollar level for the fourth quarter of 2016 was 2.1% above the year-ago quarter's level, and 4.2% above the third quarter 2016 level, suggesting currency may be a modest drag on earnings in the fourth quarter of 2016.

U.S. election-related policy uncertainty may also cap gains. Even though corporate, consumer, and investor sentiment have all been on the rise since the election, the first six weeks of the quarter were clouded by political uncertainty. The policy outlook remains unsettled even after the election, suggesting that some spending and investment decisions may have been put off into 2017.

1 RECENT UPTICK IN ISM MANUFACTURING INDEX BODES WELL FOR EARNINGS

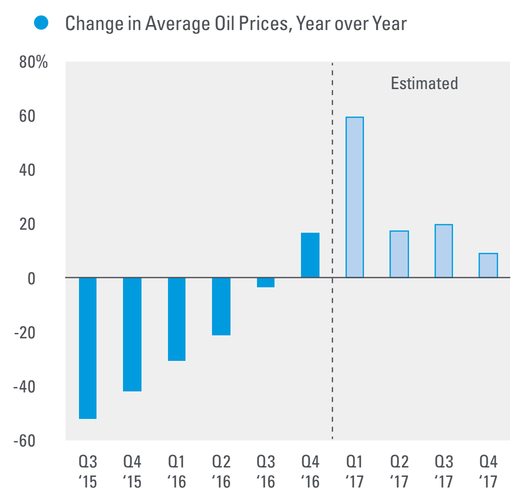


Source: LPL Research, Thomson Reuters, and FactSet consensus estimates 01/06/17

Indices are unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

The U.S. Institute for Supply Managers (ISM) manufacturing index is an economic indicator derived from monthly surveys of private sector companies, and is intended to show the economic health of the U.S. manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change.

2 OIL PRICES ROSE SOLIDLY IN THE FOURTH QUARTER



Source: LPL Research, FactSet 01/06/17

Performance is historical and no guarantee of future results.

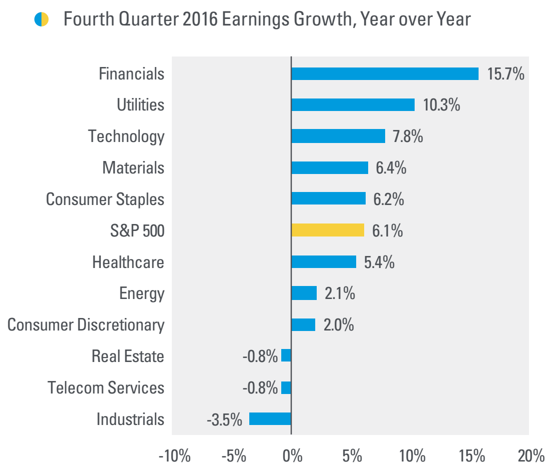
Oil price change estimates are not intended to be forecasts, but rather changes based on the assumption that oil prices remain at January 6, 2017, levels through 2017.

Wage gains may lead to some modest profit margin compression in the quarter for non-energy sectors (higher oil prices will overwhelm wage growth for oil producers). Friday's jobs report (January 6) showed a 2.9% increase in wages, the biggest increase since April 2009, based on average hourly earnings. The offset to that profit margin pressure is consumers have more money in their pockets to spend, which we think may have contributed to a healthy increase in holiday sales this year.

SECTOR STANDOUTS

The biggest story of the season, besides energy's turnaround, will likely be financials, with Thomson-tracked consensus estimates calling for a market-leading 15.7% year-over-year increase. Both the outlook and earnings estimates for financials have improved in recent months. Rising interest rates, stock market gains, and healthier credit markets

3 BROAD-BASED EARNINGS GAINS EXPECTED, LED BY FINANCIALS



Source: LPL Research, Thomson Reuters consensus estimates 01/06/17

The S&P 500 is an unmanaged index which cannot be invested into directly.

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

Earnings growth expectations may not develop as predicted.

(in part due to energy sector stability) all help buoy the sector's profit picture, while more help could be on the way later this year in the form of deregulation. We also expect a strong season for technology, buoyed by the recent increase in the sector's estimates and generally favorable demand trends across the sector.

Eight of eleven sectors are forecast to produce earnings growth in the fourth quarter, with only modest declines expected for real estate, telecom, and industrials [Figure 3]. Should all sectors produce an upside surprise near the long-term average, all 11 S&P sectors would produce positive earnings growth for the quarter.

The one sector that could stand in the way of a perfect 11 for 11 is industrials. Capital spending has been lackluster and the energy downturn has led to earnings weakness for the past several quarters. Although estimates have been revised lower in recent months, industrials may get a boost from higher energy prices, which gives the sector a chance at the 3.5% upside surprise required to post an annual earnings increase.

POLICY OUTLOOK

Actual results and forward guidance are always important to markets. But with so much on the policy agenda following the election, we will keep one eye on Washington and the potential earnings impact of policy changes.

The big one is a lower corporate tax rate, potentially down to 20% from 35% currently. Although there will almost surely be revenue generating offsets, the impact from a lower rate could be 5–6% in S&P 500 earnings, if not more. We won't have details for several months and actual legislation, which may include infrastructure spending in it, may not be enacted until the fourth quarter of 2017 and go into effect on January 1, 2018. This is an important item to watch.

Tax reform is also likely to include a discounted rate for multi-nationals to repatriate overseas cash (currently taxed at the full corporate rate of 35%). As such, a significant amount of cash (estimated near $2.4 trillion) is trapped overseas because companies do not want to pay the tax to bring it back to the U.S. Should this proposal be enacted, we could see a significant jump in share buybacks (Goldman Sachs estimates a 30% increase) that would take share counts down and therefore earnings per share up, potentially by 1–2%. A repatriation tax holiday in 2004 at a rate of 5.25% saw a similar result.

The concept of a border adjustment tax policy where imports are taxed more heavily than exports in order to encourage U.S. production has received a lot of media attention in recent weeks. We see the odds of a proposal like this getting through Congress as fairly low, but a moderate version of it could be put in as a nod to President-elect Donald Trump's pledge to bring back overseas jobs. The proposal would be a revenue generator for the U.S. government, and would reduce overall S&P 500 earnings.

CONCLUSION

There are several reasons to expect good results from corporate America this earnings season when compared with expectations, including solid manufacturing data, resilient earnings estimates, and the rebound in energy profits. Investors will have one eye on these results and another on the potential earnings impact of policy developments over the coming weeks and months. ■

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 U.S. Institute for Supply Managers (ISM) Purchasing Managers' Index (PMI) is an economic indicator derived from monthly surveys of private sector companies, and is intended to show the economic health of the U.S. manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change.

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.

DEFINITIONS

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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