LPL RESEARCH
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ANOTHER VERY STRONG EARNINGS SEASON EXPECTED

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KEY TAKEAWAYS

Consensus estimates are calling for a 21% year-over-year increase in S&P 500 earnings for the second quarter.

While some companies are being disproportionately affected by tariffs, we do not expect trade tensions to have much impact on overall results.

Though earnings growth may be slowing, we believe the economic expansion has a good amount of runway left.

Second quarter earnings season is underway and may be another good one. Consensus estimates are calling for a 21% year-over-year increase in S&P 500 Index earnings for the quarter, setting up a second straight quarter of 20% or higher growth and marking the eighth straight quarterly increase [Figure 1]. Should results come in ahead of expectations as we expect, our data indicate it would mark the 37th consecutive quarter of earnings exceeding expectations. While tariffs have dominated headlines recently, and some companies are being disproportionately affected, we do not expect trade tensions to have much impact on overall results. The season kicks into high gear this week (July 23–27) with 175 S&P 500 companies reporting.

1 ANOTHER 20% EARNINGS GROWTH QUARTER EXPECTED

Source: LPL Research, FactSet 07/20/18

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KEY EARNINGS DRIVERS

We expect several factors to drive S&P 500 earnings growth over 20% during the second quarter:

- **Corporate and individual tax cuts.** Corporate tax cuts have lifted S&P 500 Index profits by about 7%. Consumer spending may also be getting a boost from individual tax cuts that began to kick in this spring.
- **Strong manufacturing activity.** The Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI) came in at a very strong 60.2 in June and has averaged over 59 so far in 2018, in line with the best readings over the past 30 years. Manufacturing activity has historically correlated well with earnings.
- **Higher oil prices.** The average price of WTI Crude in the second quarter of 2018 was 36% above that of the prior year quarter. Higher gas prices do hit consumers' wallets, but with a lag. Energy production is a much bigger driver of S&P 500 profits than prices at the pump.
- **Lower U.S. dollar.** Although the U.S. dollar rose during the second quarter of 2018, the average price of the U.S. Dollar Index during the quarter was 6% lower than a year ago. As a result, the year-over-year earnings growth figures will get a point or so boost from currency this season because of the overseas profits generated by U.S.-based multinationals.

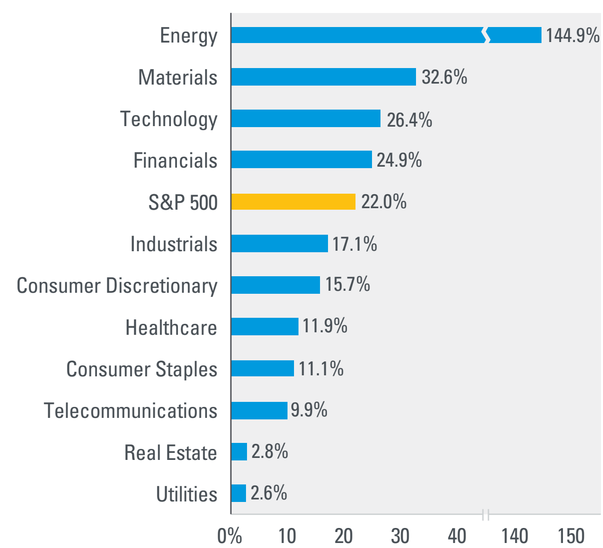
We expect modest upside to current estimates based on historical patterns. Upside in line with the long-term average would put growth in the 24% range. The +0.9% revision to second quarter earnings estimates during the quarter and above-average ratio of positive-to-negative pre-announcements (0.74) are positive signs. A solid 84% of the 87 S&P 500 companies that have reported thus far have exceeded earnings estimates, well above the long-term average.

SECTOR STANDOUTS

At the sector level, the biggest drivers of the strong year-over-year increase are expected to be technology, energy, and financials (in that order). In fact, more than 60% of the earnings growth is expected to come from those three sectors based on consensus estimates. Energy is expected to produce the strongest growth again, bolstered by the sharp rise in oil prices over the past year. Technology and financials are also expected to see strong earnings gains, both driven by lower taxes and strong revenue growth. Internet software & services and semiconductors are expected to see the biggest increases within technology, while financials sector earnings are benefiting from a better trading environment, higher interest rates, and deregulation [Figure 2].

2 BIGGEST Q2 EARNINGS DRIVERS: ENERGY, TECHNOLOGY, AND FINANCIALS

S&P 500 Sector Q2 2018, Year-over-Year Earnings Increases, %



Source: LPL Research, Thomson Reuters 07/20/18

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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.

Industrials will be a key sector to watch this season given its exposure to tariffs and trade tensions. Estimates for the sector's earnings were revised slightly lower during the second quarter, but the sector's earnings growth is still expected to approach 20% for the quarter after all results are in, which would likely place it in the top half of all S&P 500 sectors. The story for materials is the same, where more than 30% earnings growth is expected but tariffs may bite. A leading materials company blamed tariffs for its lowered profit outlook last week.

AS GOOD AS IT GETS?

S&P 500 earnings grew 27% year over year in the first quarter, which could be as good as it gets for the rest of the current business cycle. While it is difficult to be disappointed with a low 20s growth rate coming off of high 20s, the possibility of a growth peak caused some concern among investors last quarter and will likely continue to garner some attention as the second quarter reporting season kicks into full gear this week. As we noted in the *Midyear Outlook 2018* publication, a peak in earnings growth rates has not historically been a sign of impending trouble for stocks or the economy. In fact, about four years have passed, on average, between an S&P 500 earnings growth peak and the next recession, during which stocks have produced solid gains [Figure 3].

A LOOK AHEAD

In our recently released *Midyear Outlook 2018*, we increased our S&P 500 earnings forecast for 2018—from $152.50 per share to $155, an almost 18% year-over-year increase over 2017. The increase was driven primarily by strong first quarter results, but economic data received during the second quarter pointed to an even stronger backdrop for corporate profits than we had anticipated. While our $155 per share forecast is below the consensus estimates of $160, we prefer to be conservative due to the potential for further U.S. dollar strength, wage pressures, and tariff-related costs.

3 EARNINGS GROWTH PEAKS ARE NOT TYPICALLY SOON FOLLOWED BY RECESSIONS

EARNINGS GROWTH PEAKS	NEXT RECESSION START DATE	PEAK TO RECESSION (MONTHS)	S&P 500 GAIN/ LOSS
September 1953	August 1957	**47**	105.2%
September 1959	April 1960	**7**	-2.7%
September 1962	December 1969	**87**	66.7%
December 1968	December 1969	**12**	-9.7%
December 1973	January 1980	**73**	10.7%
December 1976	January 1980	**37**	0.4%
September 1981	July 1990	**106**	208.2%
June 1984	July 1990	**73**	133.8%
June 1988	July 1990	**25**	30.9%
March 1995	March 2001	**72**	147.6%
June 2000	March 2001	**9**	-14.8%
June 2004	December 2007	**42**	29.8%
March 2018?	?	**?**	?
	Average	**49**	**58.9%**
	Median	**45**	**30.4%**

Source: LPL Research, Thomson Reuters, FactSet, National Bureau of Economic Research 07/16/18

CONCLUSION

All indications are that second quarter earnings season will be another good one. The results are likely to spark more questions about whether earnings growth has peaked and what that might mean for the economy and stock market. Though earnings growth may be slowing, we believe the economic expansion has a good amount of runway left, which means more earnings growth should lie ahead.

As always, we will be closely following guidance and future estimates to gauge earnings momentum. Although it's too soon to see widespread tariff impact, we will be watching for management commentary on potential hits to profitability from tariffs and other trade policies.

We continue to forecast year-end fair value for the S&P 500 at 2900–3000, representing a potential low-double-digit return for 2018. We derive that target from a price-to-earnings multiple of 19 and our 2018 S&P 500 earnings forecast of $155 per share. ■

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 Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

The Institute for Supply Management (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.

The U.S. Dollar 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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