LPL RESEARCH
WEEKLY MARKET COMMENTARY

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CAN EARNINGS HELP?

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KEY TAKEAWAYS

The start of fourth quarter earnings season may help the stock market find its footing.

The twin drags of energy and U.S. dollar strength could again wipe away earnings gains; but ex-energy, we see mid-single-digit gains.

We continue to expect acceleration in earnings growth throughout 2016, but see stock market risks and opportunities as fairly balanced in the near term.

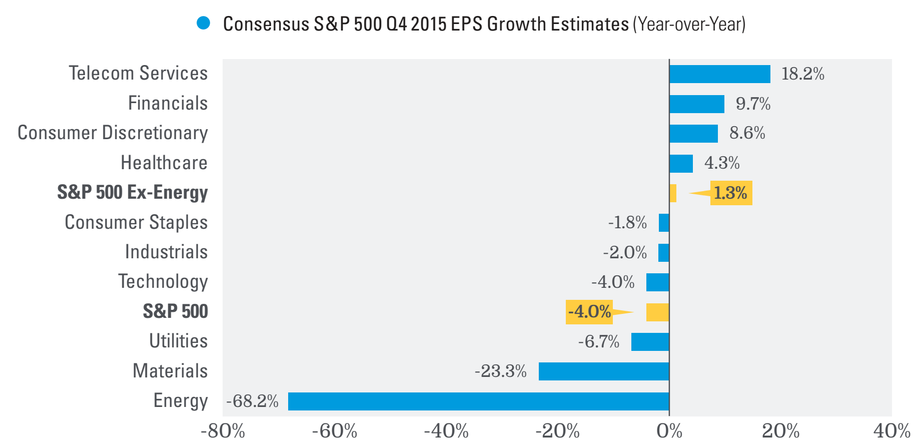
The start of fourth quarter earnings season may help the stock market find its footing. Earnings season starts this week (January 11 – 15) and may be a positive catalyst that turns the market's attention away from China. Amid widespread pessimism, the news out of corporate America may be well received. However, due to the drags from oil and the strong U.S. dollar, the fourth quarter may bring more of the same lackluster headline results seen in recent quarters and, as a result, may not provide much of a boost for stocks.

This earnings season presents an opportunity for corporate America to convince markets that a ramp-up in overall corporate profits may still come in 2016. Evidence that the fourth quarter of 2015 will represent an earnings trough may help halt the stock market's slide. We will also be looking for reassuring commentary on China.

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.

1 FOURTH QUARTER EARNINGS GAINS ABSENT THE ENERGY DRAG MAY REACH MID-SINGLE-DIGITS



Source: LPL Research, Thomson Reuters 1/7/16

Indexes are unmanaged and cannot be invested in directly.

Because of its narrow focus, investing in a single sector, such as energy or manufacturing, will be subject to greater volatility than investing more broadly across many sectors and companies.

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

MORE OF THE SAME

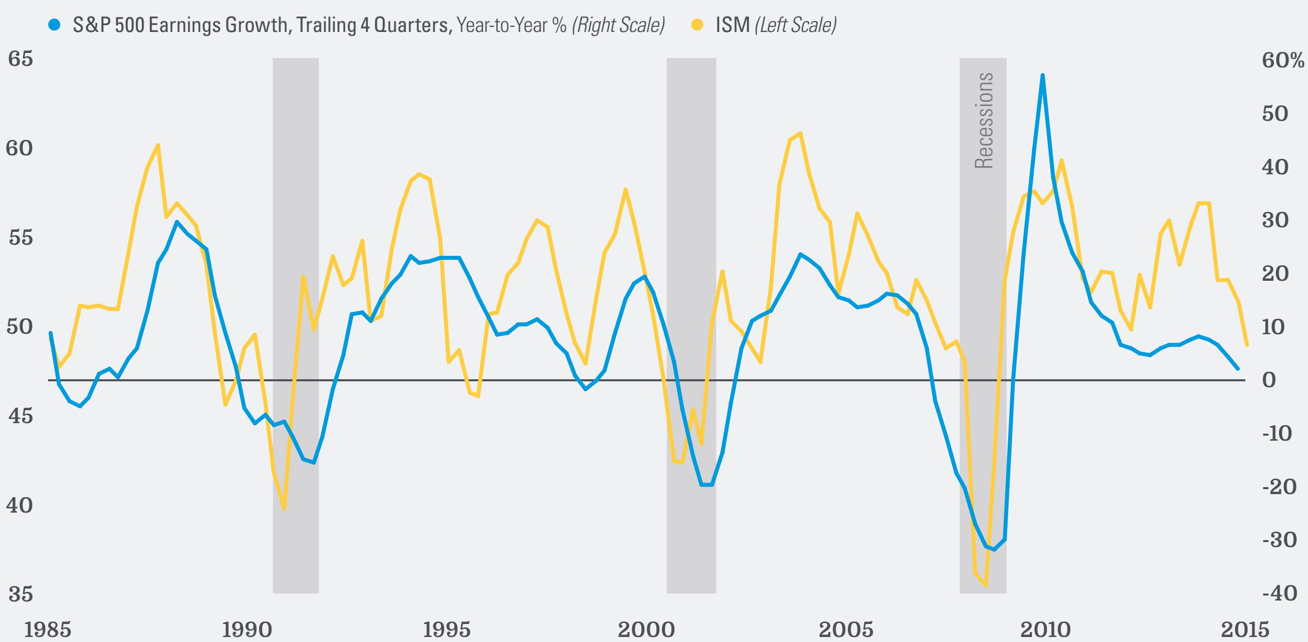
Last quarter we noted that our third quarter earnings preview could have been a copy and paste of the second quarter preview. The story is the same for the fourth quarter, where the drags from energy and a strong dollar could again wipe away earnings gains. Consensus estimates from Thomson Reuters are calling for a 4% year-over-year decline in S&P 500 earnings (other data sources have slightly different numbers). The typical upside surprise means a flat result would be the most likely outcome.

But corporate America's earnings power is better than that. Excluding the energy sector, where a temporary outsized earnings decline is about a 5% drag on overall S&P 500 profits, potential S&P 500 earnings growth goes from flat to up 5% [Figure 1]. Then adjusting for the strong U.S. dollar, we estimate earnings get bumped up by another 2–3%. So, the 1.3% consensus earnings growth rate excluding energy shown in the accompanying chart may end up at 7–8% without the currency drag.

RAMP-UP ON THE WAY?

This earnings season presents an opportunity for corporate America to convince markets that a ramp-up in overall corporate profits may come in 2016. After a fourth quarter 2015 trough, we (and the consensus) expect earnings growth to begin to improve in the first quarter of 2016, despite sluggish global growth and the aforementioned drags.

2 **ECONOMIC GROWTH HISTORICALLY TRANSLATES INTO EARNINGS GROWTH**



Source: LPL Research, Thomson Reuters 1/8/16

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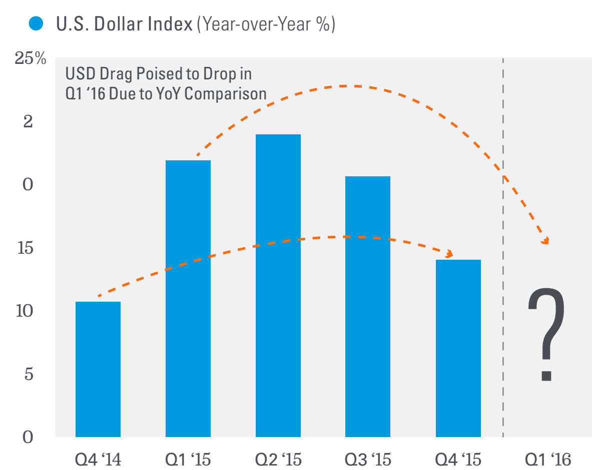
An upward earnings trajectory in 2016 may depend on the following:

- **Improving U.S. economic growth.** We expect overall U.S. gross domestic product (GDP) growth of at least 2.5% this year on the back of larger contributions from manufacturing, business capital investment, and net exports, with continued support from consumer spending. Economic growth has historically translated into earnings growth — and recessions into earnings contractions — suggesting earnings may be poised for a rebound [Figure 2]. We expect a similar reversal in the Institute for Supply Management (ISM) Purchasing Managers' Index (PMI), which has been depressed by the same factors as earnings and illustrates the tie between the U.S. economy and earnings.
- **Stable overseas growth.** With about 40% of S&P 500 company profits generated overseas, and heightened uncertainty about China's growth, economic conditions overseas will be a focus for investors this earnings season. We continue to expect a soft landing in China (less than 5% of S&P 500 profits), which has the capacity for more stimulus. And central bank actions in the Eurozone and Japan may help to boost growth in those countries. Outside of currency, overseas exposure may have only minimal negative impact.
- **Oil stops the bleeding.** As we noted in our *Outlook 2016* publication, we expect oil and the energy sector to engineer turnarounds later this year. The turn may not begin until midyear, or later, as supply takes time to "catch down" to demand; but even flat oil prices in 2016 would result in a much smaller earnings decline in 2016 (consensus is a drop of 12%) than in 2015 (down 56%). We expect to hear of continued challenging business conditions from energy company management teams on earnings calls for at least another two quarters and remain cautious on the energy sector for now.
- **Slower pace of U.S. dollar gains.** As shown in Figure 3, beginning in the first quarter of 2016, the U.S. Dollar Index's annual gains will begin to moderate. The sharp rise in the dollar from the fourth quarter of 2015 to the first quarter of 2016 makes a small year-over-year gain more likely in the first quarter. It is possible the dollar makes another big jump as the Federal Reserve (Fed) tightens and other major central banks move in the opposite direction. But given what we believe is priced into the currency at this point and the lofty levels it has reached, we expect dollar strength to moderate and be a minimal drag on earnings in 2016.
- **Resilient profit margins.** Corporate America has done a terrific job maintaining high profit margins during the economic expansion. We expect companies to largely maintain these solid margins due to still limited wage pressures, cost efficiency, automation, low input costs, low borrowing costs, and falling tax rates. The key risks to margins would be slower than expected revenue growth and unexpectedly strong wage inflation. Margins do tend to revert to the mean as an economic expansion ages so that remains something to watch.

3 U.S. DOLLAR DRAG POISED TO MODERATE BEGINNING IN Q1 2016



Source: LPL Research, FactSet 1/8/16

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We believe consensus estimates, shown in Figure 4, may potentially be achievable for 2016 and note that the energy drag is already beginning to ease. Overall, we expect this pace of earnings growth in 2016, should it occur, to lead stocks to modest gains this year, though with elevated volatility.

MORE HELP?

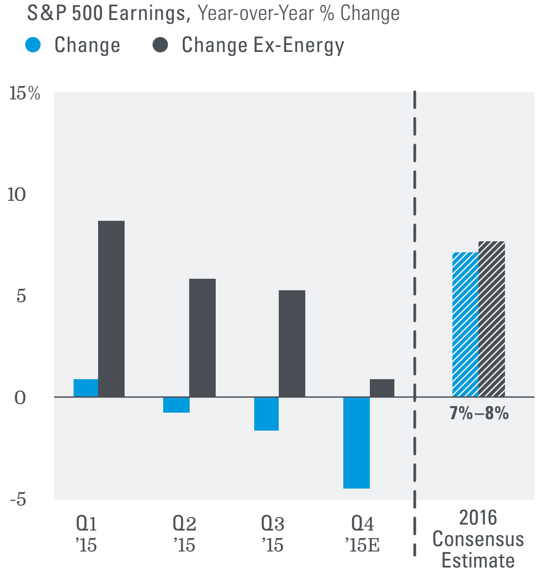
The question everyone is asking this earnings season is: Will corporate America help halt the stock market slide that has seen the worst ever S&P 500 start to a year — down 6% in the first five days? We believe the market shifting attention toward corporate America and away from macro headwinds will help some, but results may not be good enough by themselves to drive much of a rally.

Other potential catalysts for a market turnaround include:

- **U.S. economic data.** Friday's jobs report (January 8) was unable to drive market gains (though perhaps a delayed reaction may come this week). Retail sales, due out this Friday (January 15), could help. Initial data points indicate a good holiday shopping season and this report may provide confirmation.
- **Central banks.** We continue to expect more stimulus actions from the central banks in the Eurozone, Japan, and even China. While some Chinese actions can be counterproductive, as we saw last week with the Chinese government's stock market reforms, for example (topic of today's *Weekly Economic Commentary*), we generally expect monetary policy actions to help U.S. (and perhaps Chinese) stocks stabilize.
- **Memories of October 2015.** The S&P 500 had fallen 12% heading into the third quarter earnings season after suffering its first 10% correction in four years. With expectations low, we may be set up for a similar (though maybe not as strong) rebound this time where companies' in-line results are good enough to push stocks higher. The S&P 500 rallied 8% in October 2015.
- **Negative investor sentiment.** Investors have become extremely pessimistic. Investor surveys suggest investors are as sour on the stock market as they were during 2011–13, a period wrought with crises in the U.S. and Europe. The widespread pessimism may be a positive contrarian signal.

4 CONSENSUS FACTORING IN STRONG EARNINGS RAMP-UP IN 2016

S&P 500 Earnings, Year-over-Year % Change



Source: LPL Research, FactSet 1/1/16

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CONCLUSION

Earnings season may help the stock market find its footing as investors look through negative sentiment and assess the earnings power of the vast majority of corporate America and potential for improvement in 2016. Overall results, however, might not be any better than in recent quarters and may not provide much of a boost for stocks. We continue to forecast modest gains for the S&P 500 in 2016 but in the near term see risks and opportunities as fairly balanced.

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 referenced 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.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

All investing involves risk including loss of principal.

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 Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

Purchasing Managers' Indexes (PMI) are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the 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 two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the U.S.

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.

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