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EARNINGS SEASON HIGHLIGHTS AND LOWLIGHTS

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KEY TAKEAWAYS

In this commentary we look at some of the highlights and lowlights of fourth quarter earnings season.

Despite the massive drag from the energy sector and the negative impact of a strong U.S. dollar, fourth quarter 2014 earnings are on track to exceed prior estimates.

We maintain our 5–10% earnings growth forecast for 2015* and believe cheaper energy costs will help us get there.

Despite the massive drag from the energy sector and the negative impact of a strong U.S. dollar, fourth quarter 2014 earnings are on track to exceed the prior Thomson-tracked consensus estimate of 4.2% (as of quarter end on December 31, 2014). In fact, despite a slow start, earnings growth for the quarter (after all 500 companies have reported) should approach 7%, reaching the average historical upside surprise of 3%. As of February 6, 2015, with about two-thirds of S&P 500 companies having reported, S&P 500 earnings were on track for a 6.4% year-over-year increase for the quarter according to Thomson. In this commentary we look at some of the highlights and lowlights of this earnings season as it enters the home stretch.

HIGHLIGHTS

Industrials defying skeptics. The industrials sector had many skeptics coming into this earnings season. The sector is one of the most global and was expected to see among the biggest negative currency impacts, both in terms of translation of foreign profits and pricier U.S. exports (a strong dollar makes imports more expensive for foreign buyers). A significant portion of energy capital spending flows to the sector, so reductions in oil exploration and production investment have negatively impacted the industrials sector. Lackluster economic growth in Europe and slowing growth in China add to the challenges. But strength in North America and expanding profit margins helped offset the drags, and industrials are on pace for 12% earnings growth in the quarter, 2% above prior expectations as of quarter end. Although guidance has led to estimate reductions, as it often does for all sectors, 2015 estimates are still calling for a solid 7% earnings gain compared with 2014. Our industrials sector outlook remains positive.

Technology producing big upside surprise. The technology sector is on pace for a solid 17% year-over-year gain in fourth quarter earnings, nearly double the prior 9% expectation, representing the biggest upside surprise among all 10 equity

*Historically since WWII, the average annual gain on stocks has been 7–9%. Thus, our forecast is in-line with average stock market growth. We forecast a 5–9% gain, including dividends, for U.S. stocks in 2015 as measured by the S&P 500. This gain is derived from earnings per share (EPS) for S&P 500 companies growing 5–10%. Earnings gains are supported by our expectation of improved global economic growth and stable profit margins in 2015.

sectors [Figure 1]. The sector has also posted the highest "beat rate" among all sectors with 88% of S&P 500 companies beating on the bottom line (tied with healthcare). This achievement is particularly impressive given the significant drag from the strong U.S. dollar (like industrials, technology is among the most global sectors). The biggest driver of the upside was Apple, which by itself generated about 2 percentage points of S&P 500 earnings growth after increasing earnings per share by 48%, well above consensus. The technology sector has benefited from revenue and earnings gains across the hardware, software, and semiconductor groups, with tailwinds from trends in mobility, cloud computing, security, and data analytics. Our technology sector view remains positive.

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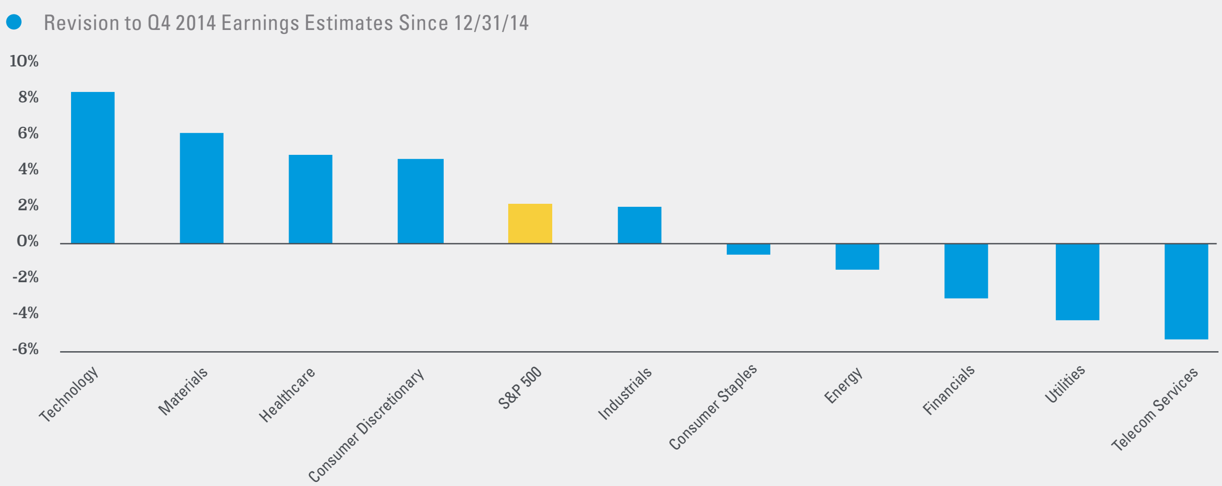
Typical guidance reduction (ex-energy). Historically, bottom-up consensus estimates have fallen by an average of about 3% during earnings season since Thomson began tracking estimates back in the mid-1990s. Analysts tend to be overly optimistic coming into each quarter and year and companies tend to guide conservatively to lower the bar to where they can beat it. This earnings season was unique in that it coincided with plummeting oil prices, leading analysts to reduce energy sector estimates substantially (by about 30% for the first quarter of 2015 to a more than 60% decline). Excluding energy, 2015 estimates for the S&P 500 have been reduced by 2.7%, near the long-term average, despite negative currency impacts.

Profit margins stay elevated. In our *Outlook 2015: In Transit* publication, we noted that as the economic cycle matures, cost pressures may begin to emerge and limit companies' ability to expand profit margins. We are still waiting for that, as the combination of modest wage increases, low input costs (fuel and other raw materials), still low borrowing costs due to low interest rates, and the efficiency of corporate America have combined to prop up operating margins again [Figure 2, page 3]. Moreover, still active share buyback activity continues to prop up earnings per share by reducing share counts by about 3% annually.

1 TECHNOLOGY HAS PRODUCED BIGGEST Q4 2014 UPSIDE EARNINGS SURPRISE



Source: LPL Financial Research, Thomson Reuters 02/06/15

Indexes are unmanaged and cannot be invested in directly.

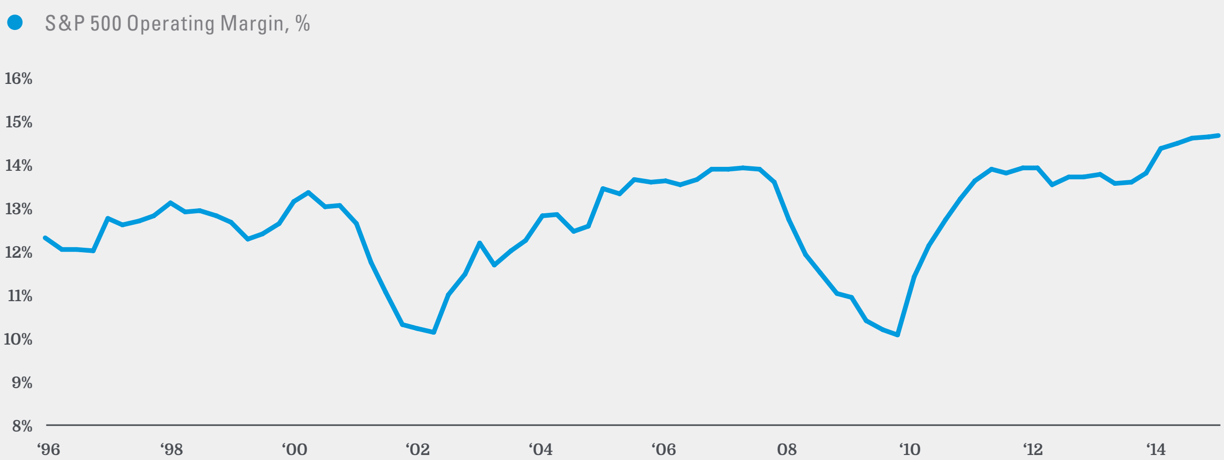
Currency boost for companies overseas. Although Europe's economy is not growing much, the same drag the U.S. multinationals are experiencing from the strong U.S. dollar is a boost to corporate profits for multinationals in Europe (the story is the same for Japan). This impact is beginning to be seen in economic data and earnings reports. Although revenue for the developed foreign benchmark, the MSCI EAFE Index, is expected to be flat (according to FactSet consensus estimates), and financials is the only sector expected to grow earnings materially, weak currencies versus the U.S. dollar are starting to provide a boost and may continue to do so.

LOWLIGHTS

Massive energy earnings decline. Perhaps the biggest story this earnings season—and certainly the lowest lowlight—is the dramatic estimate reductions in the energy sector. Estimates for the sector's fourth quarter earnings growth have fallen from +6.6% as of September 30, 2014, to -19.8% as of December 31, 2014, and -21.2% as of February 5, 2015. The drop in fourth quarter earnings is expected to be so severe that if the sector is excluded, fourth quarter earnings growth would jump from 6.4% to more than 9%, while revenue growth would increase from 1.8% to over 4%, based on Thomson Reuters data. Estimates may bottom soon based on prior severe energy downturns, which is a key factor we are watching to help determine whether to upgrade our energy view (currently neutral but with a positive bias). It is also important to keep in mind that this lowlight is a highlight for consumers in the form of cheaper gas and home heating costs.

Flattening yield curve hurts financials. The basic business model for lenders that make up most of the financials sector is to borrow at short-term interest rates and lend at long-term rates. In the current interest rate environment, with gradually rising short-term rates and very low and falling (until very recently) intermediate and long-term rates, banks' profit potential is curbed. Financials will likely be the only sector besides energy to post an earnings decline in the fourth quarter (consumer staples is right on the line) and will almost certainly miss prior estimates. Our sector view is neutral rather than negative due largely to the potential gains from rising interest rates, which were evident in the sector's market-leading gains on Friday, February 6, 2015.

2 CORPORATE PROFIT MARGINS CONTINUE TO DEFY SKEPTICS



Source: LPL Financial Research, FactSet 02/06/15

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Big drag from strong U.S. dollar. It was not a big surprise that U.S. dollar strength would weigh on fourth quarter earnings. In fact, we noted that in our earnings preview in our January 5, 2015, *Weekly Market Commentary*, "A Tale of Two Earnings Seasons." Recall that because an estimated 35–40% of S&P 500 earnings are derived from overseas in other currencies, a strong dollar means those foreign profits are translated into fewer dollars. While perhaps 2–3% currency translation impacts were expected, a number of multinationals reported larger impacts and saw their shares decline on the news. The intensity of the dollar's ascent made it difficult for companies to hedge effectively, while the benefits of solid U.S. economic growth and low energy prices did not flow through quickly enough to offset currency effects. The good news is these effects should eventually reverse. And despite energy's massive decline, the S&P 500 is producing near double-digit gains excluding currency impacts.

Currency risk arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

CONCLUSION

After a slow start, the fourth quarter 2014 earnings season staged an impressive comeback. On track for near 7% year-over-year earnings growth, despite the negative impact of the significant drop in oil and strong U.S. dollar, we consider this earnings season—with its highlights and lowlights—a good one overall. Although the latest consensus estimates for 2015 are calling for only about 3% earnings growth for the S&P 500, we maintain our 5–10% earnings growth forecast for the year. Our favorite earnings indicator, the Institute for Supply Management (ISM) Manufacturing Index, is still sending a positive signal and lower energy costs should provide a boost throughout 2015. ■

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 MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The Institute for Supply Management (ISM) Index is based on surveys of more than 300 manufacturing firmsy 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.

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