



Weekly Market Commentary

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Highlights

This has been the weakest earnings cycle in 55 years. Earnings growth needs to improve to support valuations and drive the stock market higher. Fortunately, growth may be set to improve in the coming quarters.

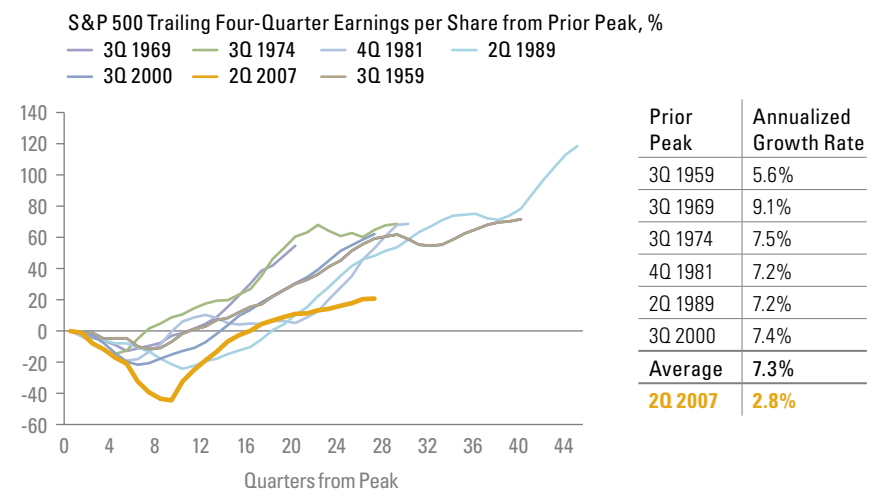
The Weakest Earnings Cycle in 55 Years

This has been the weakest earnings cycle in 55 years. Every earnings cycle over the past 55 years has generated about a 7% annualized earnings per share (EPS) growth rate, when measured from peak to peak or from trough to trough. The best multi-year earnings cycle measured from prior peak to the next peak was an annualized 9.1% and the worst 5.6%, with most clustered tightly around the average of 7.3% [Figure 1]. This is notable given the differing levels of inflation, interest rates, and economic growth that companies had to adapt to in each cycle. However, the current cycle—while not yet over—has been much weaker than the average, generating only a 2.8% annualized growth rate from the prior cycle peak in the second quarter of 2007 through the first quarter of 2014.

Most prior earnings cycles had already climbed 50–70% above their prior peak at this point in the cycle. However, the current cycle has only exceeded the prior peak by about 20%, which can be attributed to two factors:

- First, the trough in earnings was much deeper, magnified by the severity of the recession. Financial companies wrote off many years of gains in just a few quarters.
- Second, the momentum of the earnings recovery over the past few years has been subpar—tracing a much flatter line than in prior cycles.

1 The Weakest Earnings Cycle in 55 Years



Source: LPL Financial Research, Thomson Financial 04/14/14

Past performance is no guarantee of future results.



Earnings growth for the first quarter of 2014 does not seem to be improving, with growth appearing to stall on a year-over-year basis. The Thomson Financial-tracked consensus of Wall Street analysts expects growth to be just 1%.

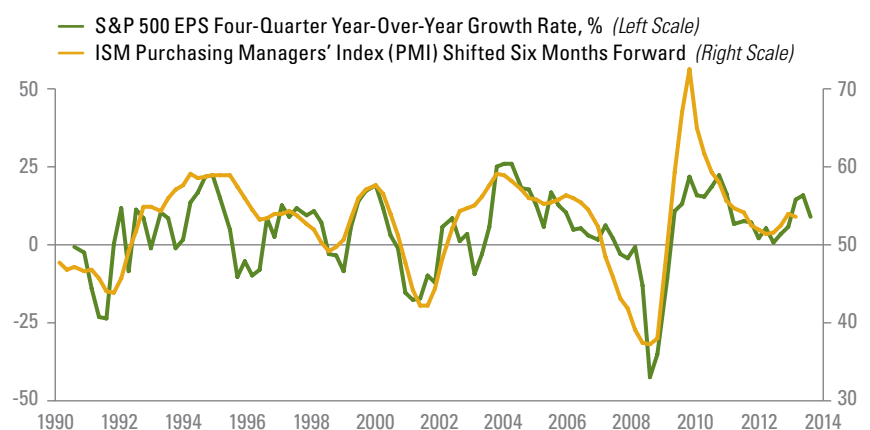
Earnings growth needs to improve to support valuations and drive the U.S. stock market higher. The increase in the price-to-earnings ratio over the past year—with stock prices rising faster than corporate earnings—has been a focus of investors lately. Worries among market participants that this type of growth is unsustainable have led to sharp declines among some “bubbly” stocks in certain industries.

From the prior peak in the earnings cycle, 27 quarters ago (June 30, 2007), S&P 500 earnings per share are up 21%, while the S&P 500 Index is up a similar 21% over the same period, as of 04/11/14.

Earnings growth is critically important to generating and sustaining gains in the stock market over the long term. For example, from the prior peak in the earnings cycle, 27 quarters ago (June 30, 2007), S&P 500 earnings per share are up 21%, while the S&P 500 Index is up a similar 21% over the same period, as of 04/11/14.

Fortunately, growth may be set to improve in the coming quarters. Earnings growth in the first quarter of 2014 was likely dragged down by extreme weather conditions affecting sales, production, and supply chains. This is not a surprise, so rather than counting how many companies cite weather as a factor, or “excuse,” in their earnings discussions, the market may be watching closely for how many businesses cite an improving trend emerging toward the end of the first quarter as weather began to normalize. Typically in any weather-related disruption, 25–35% of the economic activity is lost, but the majority of it is just deferred. The pent-up demand should boost second quarter results. We are already seeing it in rebounding shipping traffic and new orders. Most notably, the widely followed Institute for Supply Management (ISM) Purchasing Managers’ Index has a solid track record forecasting earnings growth in coming quarters [Figure 2]. While the ISM slid in the first quarter—largely tied to the impact of the extreme weather—this indicator points to a 5–10% earnings per share growth rate on a year-over-year basis in the coming quarters as the economy thaws from the first quarter deep freeze.

2 Reliable Earnings Indicator Pointing to 5–10% EPS Growth



Source: LPL Financial Research, Thomson Financial, Bloomberg data 04/14/14

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Positive forward guidance from corporate leaders may boost confidence in future earnings growth and help to lift stocks in the coming weeks.

Positive forward guidance from corporate leaders may boost confidence in future earnings growth and help to lift stocks in the coming weeks. In general, earnings season tends to be a good period for stock market performance. Stocks posted gains during the six-week period that runs from two weeks before to four weeks after Alcoa reports since the bull market began around the start of the second quarter of 2009. In fact, since the end of 2009, 94% of the gain in the index came during those quarterly periods, leaving nothing, on average, but volatility during the other seven weeks of every quarter.

It is hard to draw conclusions from the handful of earnings results for the first quarter reported so far given the impact of very company-specific factors. For example, Alcoa's earnings were hurt by a decline in aluminum prices. However, this week over 10% of the S&P 500 companies report their first quarter results and offer guidance on the second quarter and beyond. These include plenty of bellwethers that reflect broad business trends such as IBM, Coca-Cola, and Union Pacific. By the end of this week, market participants should have a good sense of whether earnings are likely to re-accelerate and support the stock market. ■

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. All indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance 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.

Stock and mutual fund investing involves risk including loss of principal.

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. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

The company names mentioned herein was for educational purposes only and was not a recommendation to buy or sell that company nor an endorsement for their product or service.

INDEX DESCRIPTIONS

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.

This research material has been prepared by LPL Financial.

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