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GLOBAL SUMMER EARNINGS

SIZZLE OR FIZZLE?

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KEY TAKEAWAYS

Overseas markets generally had strong earnings last quarter, with energy companies providing the biggest boost.

Future expectations are high once again for energy companies, but also for consumer and financial companies.

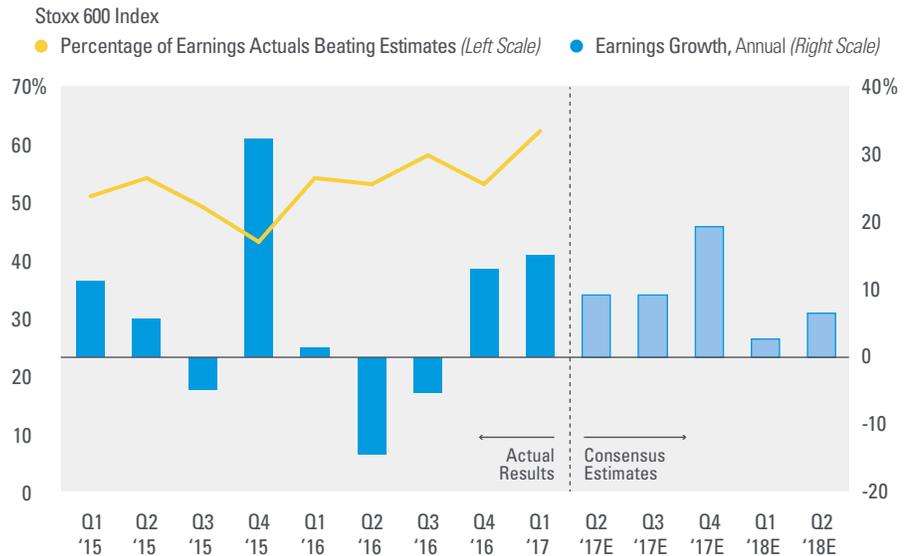
Structural changes may be happening in France that could positively impact the environment for corporate profitability.

Can overseas earnings continue to grow and extend the first-half rally in many international markets? That is the question investors are asking as second quarter 2017 earnings season begins. Since the financial crisis of 2008, U.S. companies and equity markets have generally outperformed their overseas peers. Greater U.S. profitability and corporate efficiency have resulted in stronger earnings growth, and domestic equity markets outperforming overseas ones. That may be starting to change, as earnings growth is improving overseas and international markets are outperforming domestic market indexes.

EARNINGS IN FOCUS

Now that Europe is past the potentially upsetting elections in the Netherlands and France with little volatility, the market will be focusing on earnings. European corporate earnings had been weak until the fourth quarter of 2016, which continued the trend of strong fourth quarters, even in weak years [Figure 1]. Despite a strong

1 EUROPEAN EARNINGS IMPROVE



Source: LPL Research, Thomson Reuters 07/14/17

Data as of 07/14/17

All indexes 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. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted. Consensus estimates may not develop as predicted.

finish in 2016, for the year European corporate earnings had declined -5.4% in U.S. dollar terms. Unlike in other years, earnings started strong in 2017, with annual earnings growth of 15% through the first quarter of 2017. Expectations were high, and 62% of companies outperformed expectations, far better than recent performance. The single largest contributor to growth came from energy companies, which benefited from the rebound in oil prices over the past year. Other sectors also showed strength, with earnings improvements in basic materials, consumer companies, as well as financials.

Expectations for the future remain high for European earnings growth, forecast at 9.1% for the second quarter of 2017. Even excluding the expected boost from energy, analysts are still forecasting 6.1% growth. As with last quarter, consumer companies and financials are also expected to grow. The biggest change is expected in European industrials, which had flat earnings last year and declining earnings in the first quarter of 2017. Investors are hopeful that the strong manufacturing data in Germany and France will translate into better company bottom lines.

Emerging markets (EM) are also expected to continue a trend of strong earnings growth in the second quarter. Consensus market forecasts for the quarter are for earnings growth of 9.1%, the same figure as European estimates. Overall estimates for 2017 are calling for 22.2% growth. Furthermore, as is the case for European companies, estimates for the year had been rising. This has been especially true for important sectors like energy and technology. Within technology there has been an increased focus on Chinese “new technology,” which relates to firms that provide internet connectivity or use the internet to sell goods and services.

SECTOR MATTERS

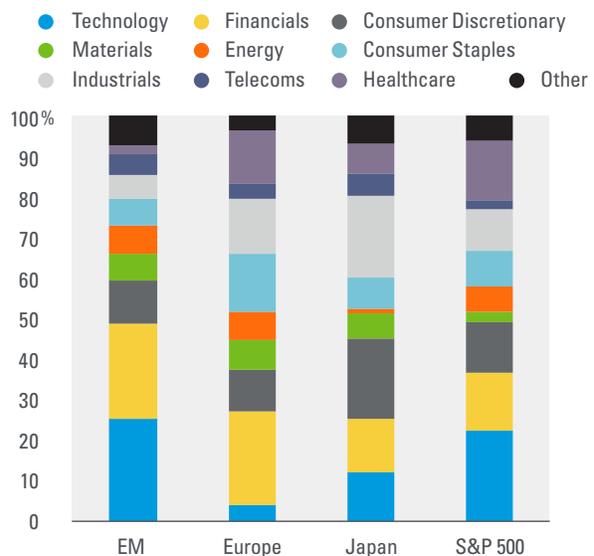
Historically, when examining geographic regions, asset allocators would focus on the relative strength and weakness of the different countries in that region. While we still look at individual countries, increasingly we have been focusing on sector allocations within and across regions. The equity markets have become

more globalized with less focus on country-specific issues. Sectors like energy or materials always had a strong global component; a change in the price of oil, copper, or any other commodity generally impacted all the companies in that industry the same way, regardless of where the company was located.

More recently other sectors, such as financial services, are becoming increasingly globalized. The relative health and performance of an industry like banking used to be dependent primarily on local factors such as interest rates and regulations. But today, these factors are increasingly global. Decisions made by a major central bank may have implications for banks in countries around the world. Technology has changed as well, with emerging and developed market companies both supplying to and competing with each other.

Markets today have different compositions [Figure 2] and therefore respond differently to global economic

2 SECTORS INFLUENCE REGIONAL RETURNS



Source: LPL Research, Bloomberg 07/17/17

Data as of 06/30/17. Indexes: Emerging Markets (EM)—MSCI Emerging Markets Index; Europe—MSCI Europe Index; Japan—MSCI Japan Index.

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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.

factors. For example, technology is an important part of the U.S. and many EM economies and stock markets, but is a relatively minor part of the European market. With the large allocations to the technology and consumer discretionary sectors, in some ways the U.S. market more closely resembles EM.

THE FRENCH TWIST

European companies typically have lower levels of profitability and efficiency when measured by metrics like return on equity. Part of the reason for this is government policies related to taxes and labor regulations. For example, France has a 35-hour work week. While designed to allow for more people to be employed, in practice this becomes cumbersome for employers and ends up being a disincentive to expand hiring. The French retirement age is 62 years old, with a complicated formula for determining pension benefits upon retirement. For most of this century, Germany was the economic leader of Europe, with most other countries being considered second tier. At times this has created tremendous political friction between Germany and some of the other countries, and can be seen as weakening the European Union as a political force.

The French elections this spring resulted in Emmanuel Macron winning the presidency, with the subsequent victory of his En Marche! party in

parliament. Macron has promised significant tax, labor market, and other reforms; so much so that a number of commentators have suggested that Macron might be the French Margaret Thatcher, or even the French Ronald Reagan. By any measure, those would be ambitious comparisons, especially given the strong student and labor movements in France. If he is successful in getting his reform package enacted, the election may mark a sustained turning point in French corporate policy, the performance of French companies, and maybe even how U.S. investors view French stocks.

CONCLUSION

It is highly beneficial for the global economy to see Europe begin to accelerate growth in its economy, as well as in corporate profitability. Should the growth trend continue in 2017, it may impact not only European equity markets positively, but also stocks globally. Certainly the equity markets are expecting both Europe and EM to continue to show strong earnings growth across a number of different sectors. Investors are also looking to see if France can prove to be a more structurally favorable investing environment. If these positive developments continue there will be a broader range of options for global investors. ■

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.

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.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS & DEFINITIONS

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 Stoxx 600 is an index tracking 600 publicly-traded companies based in one of 18 European Union countries. The index includes small cap, medium cap, and large cap companies. The countries represented in the index are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Holland, Iceland, Ireland, Italy, Luxembourg, Norway, Portugal, Spain, Sweden, Switzerland, and the UK.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Europe Index is a free float-adjusted, market capitalization-weighted index that is designed to measure the equity market performance of the developed markets in Europe.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 320 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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