LPL RESEARCH

WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

The new tax law, solid economic growth globally, robust manufacturing activity, and a weak U.S. dollar set up another potentially strong earnings season.

Key areas to watch this quarter include companies' uses of tax law proceeds, reaction to trade tensions, and possible wage pressures.

Though difficult to predict, results may help stocks stabilize by shifting investor attention away from trade headlines and toward strong company fundamentals.

April 9 2018

FIRST QUARTER EARNINGS PREVIEW

WHAT TO WATCH

John Lynch *Chief Investment Strategist, LPL Financial*
Jeffrey Buchbinder, CFA *Equity Strategist, LPL Financial*

First quarter earnings season, which kicks off April 12–13, sets up to show solid growth, buoyed by tax reform. The S&P 500 Index has grown earnings at a double-digit clip in three out of the past four quarters, a trend that is poised to continue for the first quarter. The index could also extend its streak of 35-straight quarters of exceeding earnings expectations. In this week's commentary, we preview what we expect may be a very strong earnings season and highlight some key dynamics we will be watching.

ANOTHER STRONG EARNINGS SEASON ON TAP

We expect a year-over-year increase in earnings for the S&P 500 in the 20% range for the quarter, based on consensus estimates and the average upside to estimates historically, a nice acceleration from the fourth quarter [Figure 1]. Reasons for optimism include:

- **Continued solid U.S. and overseas economic growth.** Revenue and gross domestic product (GDP) are correlated, which bodes well for S&P 500 revenue

1 **ALREADY STRONG EARNINGS GROWTH EXPECTED TO ACCELERATE IN Q1**

Source: LPL Research, Thomson Reuters 04/05/18

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.

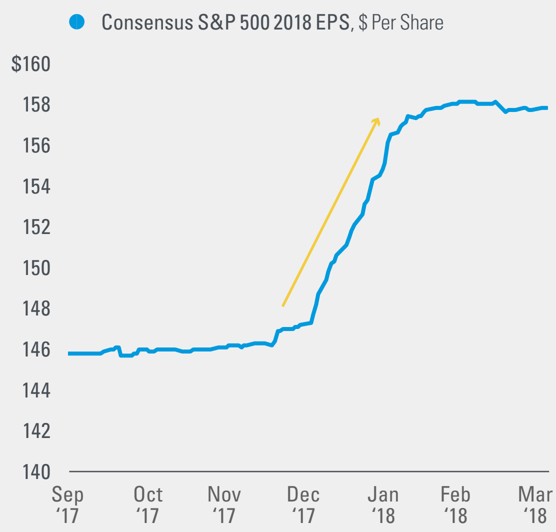
which is expected to increase over 7%. U.S. economic growth, according to Bloomberg consensus, is expected to increase 2.8% year over year for the first quarter, which is a good pace for this environment. Growth remains generally solid around the world, although economic growth has slowed some in Europe and Japan.

- **New tax law.** Earnings estimates for the first quarter have increased by about 6% so far this year, due almost entirely to the Tax Cuts and Jobs Act [Figure 2]. The increase was the biggest ever (according to data from Ned Davis Research) and is about 10% better than the average quarterly change of a 3–4% decline. The reduction in the corporate tax rate is the biggest factor; however, individual tax cuts, incentives to encourage capital investment, and repatriation of overseas cash could have driven some of the increase as well (and may offer the potential for a future boost).

The increase in estimates, the favorable pre-announcement trend, and ongoing benefits of the tax law all point to solid results.

- **Robust manufacturing activity.** The U.S. manufacturing sector is closely linked to earnings, so the signal from the booming Institute for Supply Management (ISM) Manufacturing Index survey is noteworthy. At an average near 60 during the first quarter, this reading indicates manufacturing is as strong as it has been since before the 2008–2009 financial crisis.
- **Weak U.S. dollar.** During the first quarter, the average U.S. Dollar Index level was more than 10% below the year-ago quarter [Figure 3]. Dollar weakness props up overseas earnings for U.S.-based multinationals and could present a strong tailwind for first quarter earnings—potentially in the 2–3% range.

2 **NEW TAX LAW HAS DRIVEN EARNINGS ESTIMATES SHARPLY HIGHER**



Source: LPL Research, FactSet 04/05/18

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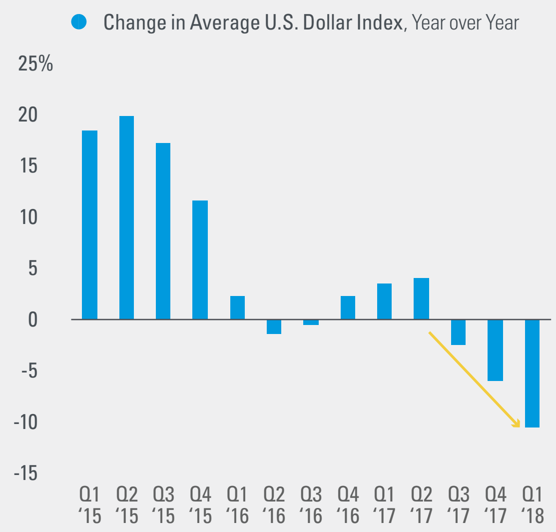
EPS—Earnings Per Share

3 **WEAK DOLLAR MAY BOOST Q1 EPS**



Source: LPL Research, FactSet 04/06/18

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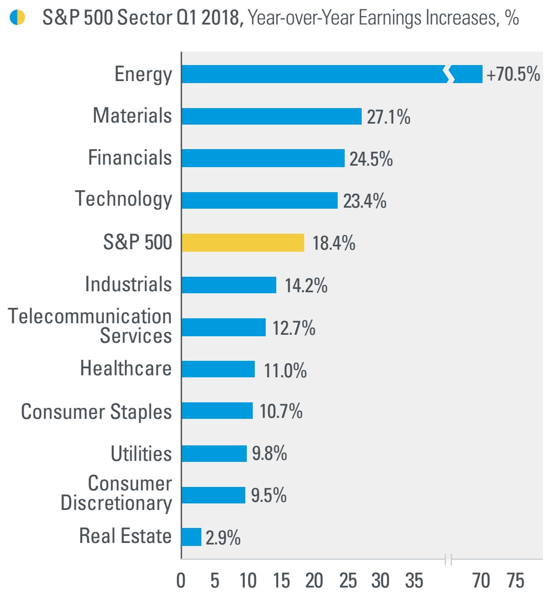
EPS—Earnings Per Share

4

ENERGY, FINANCIALS, AND TECHNOLOGY WERE BIG EARNINGS DRIVERS IN Q1



Source: LPL Research, FactSet 04/06/18

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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.

CONSIDER THE SOURCE

Different sources such as Bloomberg, FactSet, and Standard & Poor's have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

Roughly one third of S&P 500 companies' revenue is earned outside of the United States, which makes currency fluctuations (and U.S. trade policy) a big deal for corporate profitability.

Earnings gains are expected to be particularly strong in the energy, financials, and technology sectors, though we believe growth will be broad-based. Based on consensus estimates, we could see positive earnings growth in all 11 sectors [Figure 4].

WHAT TO WATCH

While forecasts suggest a strong increase in earnings and revenue this reporting season, beyond that, here are several storylines we will be following closely as results come in and management teams provide their outlooks:

- **Uses of tax law proceeds.** A key piece of our economic forecast in 2018 is improving capital investment from companies. During earnings season, we will be listening for companies announcing commitments for capital investment, which can boost productivity. Though other uses of cash can be positives (share repurchases, dividends, debt repayment, acquisitions, employee bonuses), we would like to see a pickup in productivity-enhancing capital investment. That said, individual tax cuts, employee bonuses, and dividend increases should help support consumer spending.
- **Trade policy reaction.** We will be looking for management commentary on trade policy, which is a bigger deal for corporate profits than it is for GDP. Tariffs, should they be implemented, would increase input costs by 25% for certain products. Corporate America is lobbying hard for the Trump administration to pull back some of its proposals that are particularly costly for U.S. companies. This situation should be closely watched in the coming weeks due to the potential implications on companies' costs.

- **Wage pressures.** The biggest component of companies' cost structures is paying employees. Should companies see narrowing profit margins because of higher wages, or provide guidance for higher wage costs in the coming quarters, we would start to get concerned about earnings growth deceleration. Part of our thesis for earnings this year is that profit margins could prove resilient. Our below-consensus S&P 500 earnings forecast in the mid-teens allows for a bit more pressure on margins than consensus currently anticipates.*

EARNINGS PEAK?

The near 20% earnings growth rate expected for the quarter may be as good as it gets for the rest of the current business cycle (without knowing how much longer the cycle will last). Consensus estimates indicate several more quarters near that pace, but it will be difficult for companies to maintain that at this relatively late stage of the economic cycle. As 2018 progresses, market participants may start to look toward slower growth rates in 2019 when the annual bump from the new tax law will have passed and growth comparisons get more difficult. We will be looking for evidence in the upcoming earnings reports that growth may decelerate, though markets may not focus on that for another quarter or two.

CONCLUSION

We expect first quarter earnings season to potentially deliver impressive growth and beat expectations. Though more difficult to predict, results may help stocks stabilize by shifting investor attention away from trade headlines and toward strong company fundamentals. Looking ahead, we maintain our 2018 S&P 500 earnings forecast of $152.50, representing growth in the mid-teens; this estimate may prove conservative given the substantial impact of the new tax law. We expect strong earnings growth to drive a double-digit return for the S&P 500 in 2018, though as we have seen recently, those gains may come with higher volatility.* ■

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research's S&P 500 Index total return forecast of 8–10% (including dividends), is supported by a largely stable price-to-earnings ratio (PE) of 19 and LPL Research's earnings growth forecast of 8–10%. Earnings gains are supported by LPL Research's expectations of better economic growth, with potential added benefit from lower corporate tax rates.

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.

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) 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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