LPL RESEARCH

WEEKLY MARKET COMMENTARY

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A TALE OF TWO EARNINGS SEASONS

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KEY TAKEAWAYS

The fourth quarter of 2014 will be a tale of two earnings seasons: the best of times and the worst of times.

Despite a substantial drag from the energy sector, we expect another good earnings season overall.

We expect more winners from cheap oil than losers, although the energy sector faces significant challenges.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets, as well as weather, geopolitical events, and regulatory developments.

The fourth quarter of 2014 will be a tale of two earnings seasons: the best of times and the worst of times. Companies that benefit from lower energy prices should generally report positive results and have mostly optimistic comments about their business outlooks. Conversely, companies within or connected to the energy sector will likely have a difficult time due to the sharp, swift decline in oil prices. Overall, we expect the winners from cheap oil to outnumber the losers, with another good performance by corporate America. Alcoa unofficially kicks off earnings season on January 12, 2015.

Q4 EARNINGS LIKELY TO BE GOOD, DESPITE ENERGY DRAG

Despite a substantial drag from the energy sector, we expect another good earnings season overall for the just completed fourth quarter. Consensus estimates from Thomson Reuters are calling for a 4% year-over-year increase in S&P 500 earnings per share for the quarter, even while absorbing an expected 20% decline in energy sector earnings. We see some potential upside from cheaper energy and other commodity input costs for consumer companies and manufacturers (those without close ties to the energy sector), which may help earnings achieve their average historical upside surprise of about 3%. The biggest cost component for S&P 500 companies, wages, has not yet exerted enough upward pressure on corporate cost structures to raise concerns about profit margins, which continued to expand throughout 2014 and currently remain at record highs.

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Our favorite earnings indicator, the Institute for Supply Management (ISM) Manufacturing Index, has continued to signal mid- to high-single-digit earnings gains for late 2014 and early 2015. Although the index pulled back in December 2014, due partly to reduced energy sector spending plans, it remains solidly in expansion territory at over 55 (50 is the breakpoint between growth and contraction). The three-month average is near the highest levels since the end of the Great Recession.

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The pace of economic growth in the United States also bodes well for earnings. After the weather-depressed contraction during the first quarter of 2014, gross domestic product (GDP) growth exceeded 4% annualized during the second and third quarters and is on track for near 3% growth for the fourth quarter, based on available data as of year-end 2014. This pace of growth should support the low- to mid-single-digit revenue gains necessary to drive forecasted earnings gains, even when factoring in energy sector impacts.

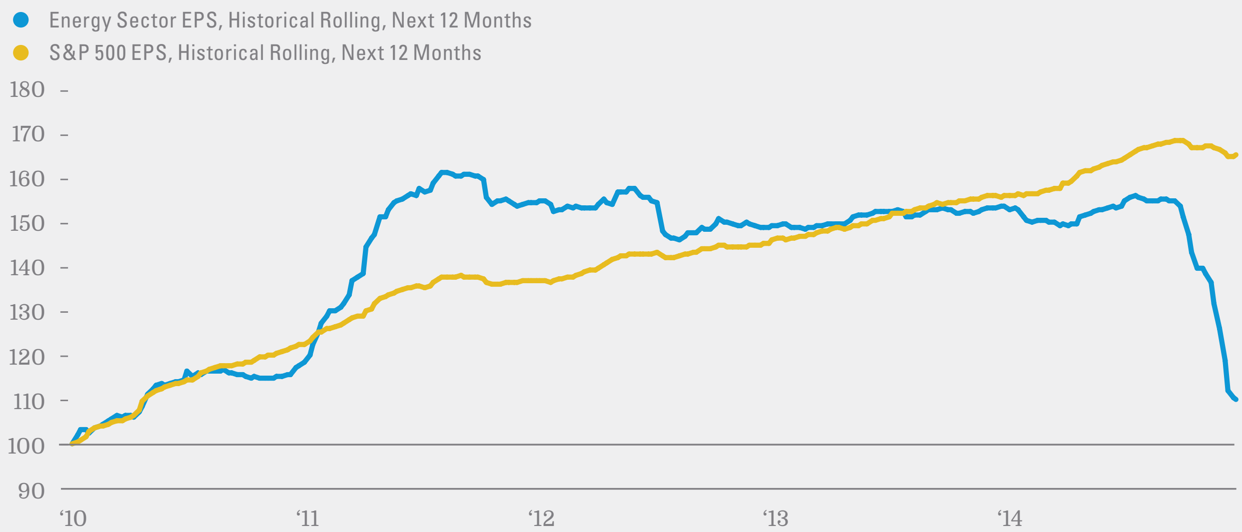
THE "EX-ENERGY" QUARTER

Earnings and other financial statistics are often expressed excluding a particular sector due to one-off irregularities. "Ex-financials" is one example in recent years due to the fall, then rise, of the financial sector in the aftermath of the 2008 financial crisis.

This earnings season, earnings "ex-energy" will likely become a commonly heard phrase because of the sector's expected divergence. Analysts and strategists will likely strip out energy and assess how earnings for the S&P 500 would look if that sector is excluded. The divergent path that the sector's earnings have taken [Figure 1] will likely be the top story during this earnings period (overtaking Europe, which was last quarter's top story, and the strength of the U.S. dollar). Over just the past three months, energy sector earnings estimates for the next four quarters have tumbled 29%, compared with the S&P 500 overall which—despite including energy—has seen estimates fall just 2% during this period.

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.

1 S&P 500 EARNINGS ESTIMATES HAVE HELD UP WELL AS ENERGY ESTIMATES HAVE PLUMMETED



Source: LPL Financial Research, FactSet 01/02/15

Both S&P 500 and energy sector earnings per share (EPS) are indexed to 100.
Each data point shows the estimate for the next 12 months at that point in time.

Indexes are unmanaged and cannot be invested in directly.

S&P 500 earnings have many drivers. But the sharp drop in oil prices (more than 50% from last year's peak in June 2014) will bring energy to the forefront this earnings season. The energy sector is expected see a 20% year-over-year earnings decline in the fourth quarter, based on Thomson Reuters consensus estimates. The only other sector expected to see a decline is materials, also commodity based, and that sector's expected earnings decline is less than 2% [Figure 2]. In fact, energy is such an outlier that removing it lifts S&P 500 earnings by about two percentage points (boosting consensus from 4% to 6%). The industrials sector provides an additional energy-related drag by being the destination for substantial capital investment by energy companies, indicating that removing energy could lead to more than a two-point boost to S&P 500 earnings.

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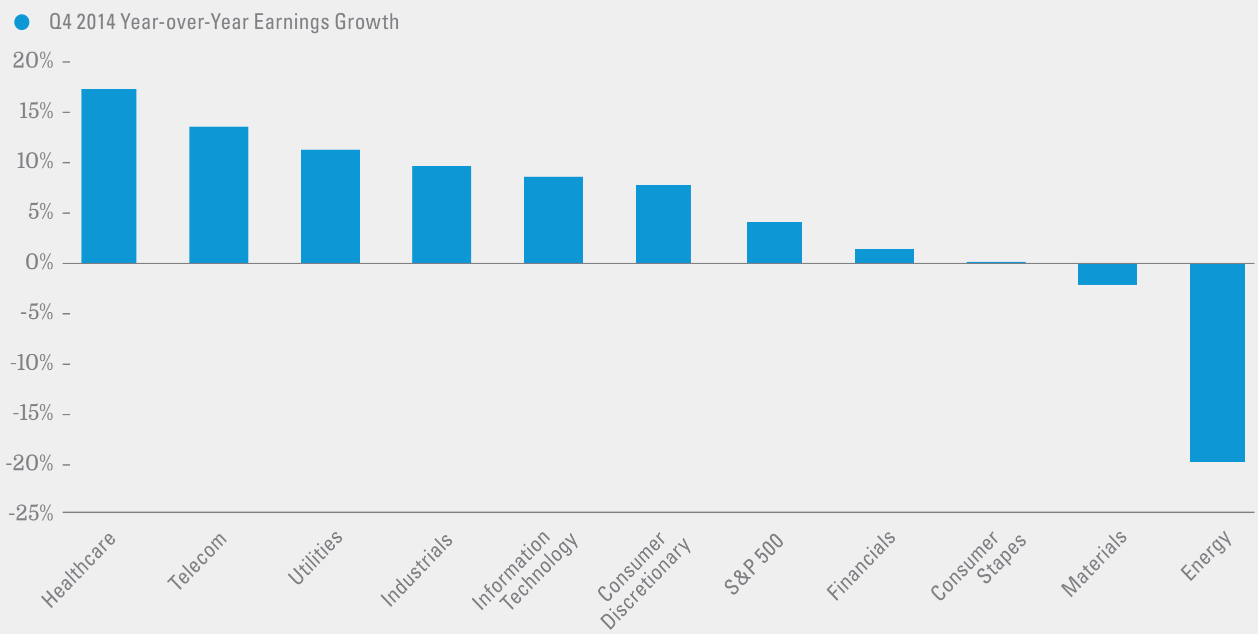
THE UPSIDE TO OIL'S DECLINE

The flip side of lower energy prices hurting energy sector earnings comes from the sectors that have benefitted from lower oil and other commodity prices. The most obvious is the consumer discretionary sector, as lower prices at the gas pump and cheaper home heating bills help boost discretionary income. Manufacturers also benefit from cheaper fuel and raw materials. Airlines and automakers are big beneficiaries as well, although commodity-hedging activities do partially dampen the positive impact.

2 ENERGY EARNINGS EXPECTED TO CONTRACT SUBSTANTIALLY



Source: LPL Financial Research, Thomson Reuters 12/31/14

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OIL IS NOT THE ONLY CHALLENGE

Europe may continue to be a drag for S&P 500 company profits, given the Eurozone is on the brink of another recession (based on latest GDP data) and has very low inflation, which gives businesses operating there less pricing power. S&P 500 companies generate roughly 15% of earnings from the Eurozone. Much less concerning, but still a risk, is exposure to the big oil-producing emerging market (EM) countries, Russia in particular. We estimate exposure to these EM countries, some of which are in or near recession, at only about 1–2% of overall S&P 500 profits. The strength in the U.S. dollar may also be a drag on overall earnings again, as foreign-sourced profits (particularly in Europe) are translated into fewer dollars.

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

The fourth quarter will be a tale of two earnings seasons. For the energy sector, it will no doubt be a very difficult earnings season due to the sharp drop in oil prices. Conversely, companies that benefit from lower energy prices may report solid results and have positive comments about their outlooks amid the favorable economic backdrop in the United States. Overall, we expect more winners from cheap oil than losers, with another good performance by corporate America. ■

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.

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