LPL RESEARCH
WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

Second quarter earnings season was quite impressive, with S&P 500 Index earnings growing 25% year over year.

A pickup in economic growth, strong manufacturing activity, tax cuts, and a weaker U.S. dollar versus the year-ago quarter were the biggest drivers of strong growth.

Looking ahead, guidance was generally positive despite tariffs and trade policy uncertainty.

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ANOTHER IMPRESSIVE SHOW FROM CORPORATE AMERICA

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

Second quarter earnings season was outstanding by many measures. The numbers were strong even without the boost from the new tax law, while guidance was generally positive despite tariffs and trade policy uncertainty. In this week's commentary, we recap an outstanding second quarter earnings season and highlight three key takeaways.

BY THE NUMBERS

We expected another strong earnings season for the second quarter, and we got it. Growth was again very impressive, with S&P 500 Index earnings growing 25% year over year, nearly matching the 26% growth rate from the quarter before. Even when excluding the impact of the new tax law (estimated at 6–7%), earnings growth came in at 18–19%, which is still outstanding.

A pickup in economic growth, strong manufacturing activity, tax cuts, and a weaker U.S. dollar versus the year-ago quarter were the biggest drivers of strong growth. At the sector level, rising oil prices helped drive a strong rebound in energy sector profits, which was among the biggest contributors to overall earnings gains. However, the technology sector was by far the biggest contributor to S&P 500 earnings growth, accounting for more than 25% of growth (specifically, 6.7 points of growth out of 25% points total came from technology).

Some other highlights:

- S&P 500 earnings have now increased at a double-digit clip five out of the past six quarters.
- Earnings have now exceeded consensus expectations for 37 consecutive quarters, based on Thomson Reuters data.
- The percentage of companies beating earnings estimates, at 80%, is the highest on record going back to 1994, based on Thomson Reuters data (and above last quarter's 78% beat rate).
- The magnitude of the upside surprise on earnings, at 4%, was slightly above the post-1994 average.
- Revenue grew 9.4% year over year, the fastest pace since 2011. Revenue's upside surprise of 1.4% is one of the largest of the current economic expansion and bull market.

- Estimates for the next four quarters rose during reporting season for the second straight quarter, a rare positive development, and particularly impressive late in the business cycle amid trade/tariff concerns.

Last quarter we wrote about the one beef some have with this quarter, and that was the possibility that it may mark a peak in S&P 500 earnings growth. Even if earnings growth slows markedly from the current pace, we still believe the earnings and economic outlooks are good enough to keep this bull market going through 2019 and potentially longer.

KEY TAKEAWAYS

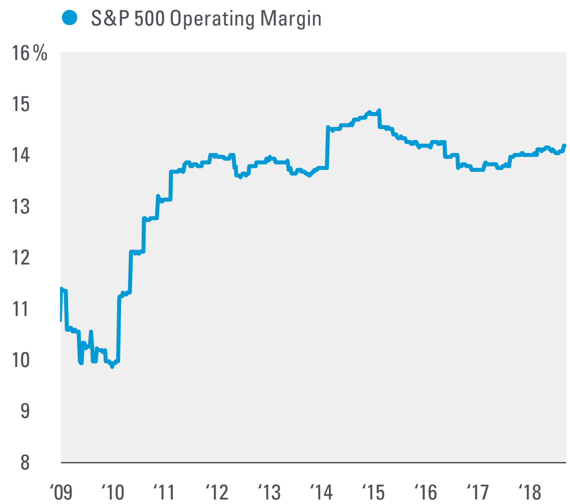
We believe these are the key takeaways that emerged from the strong second quarter earnings season:

- **Trade issues having limited impact (so far).** A fair number of companies highlighted the uncertainty surrounding trade policy during reporting season, particularly industrial companies. However, the overarching message was that the impact has been limited. Companies discussed potential supply chain shifts, the pass-through of higher costs to consumers, and even some "pre-buying" to get products before tariffs were implemented. Goldman Sachs estimates that a 10% tariff on all Chinese imports could reduce 2019 earnings per share for the S&P 500 by about 3%, suggesting this is a meaningful risk, but one that appears unlikely to halt earnings growth next year.
- **Margin expansion opportunities are probably limited [Figure 1].** Building wage pressures get the most attention because labor is the biggest cost component for S&P 500 companies. However, logistics costs, commodity costs, and borrowing costs are also rising, suggesting that profit margins may level off in late 2018. That would leave revenue growth (including passing

CONSIDER THE SOURCE

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.

1 MARGINS MAY STILL HAVE SOME CATCH-UP LEFT BUT EXPANSION OPPORTUNITIES MAY BE LIMITED



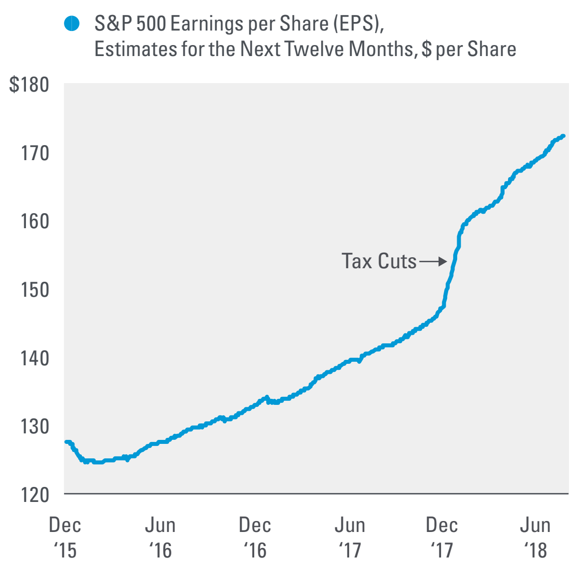
Source: LPL Research, FactSet 08/24/18

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.

tariff-driven cost increases along to customers in the form of higher prices), more share buybacks (high potential), and efficiency improvements (where automation provides opportunities) to drive gains in earnings per share. The recent uptick in capital investment could lift productivity and support margins, and there may still be some profit impairment from the energy sector downturn in 2015–16 to recover, but based on where we are in the business cycle, upside could be limited.

- **Rising estimates reflect generally upbeat guidance** [Figure 2]. During reporting season, S&P 500 earnings per share estimates rose 0.5% (similar to what happened in the first quarter). Historically, estimates fall 2–3% during this period, suggesting guidance has been abnormally positive. Some filtering through of tax cuts is likely at play here, but "organic" drivers of earnings all look good, notably business investment and manufacturing trends. Economic growth looks set to continue at a solid pace into 2019 based on our favorite leading economic indicators, and modestly higher inflation enables some pricing power that can potentially boost future revenue growth. However, 2019 consensus S&P 500 earnings growth estimates of 10% may be a bit too high given the likelihood of a more challenging margin environment.

2 EARNINGS ESTIMATES RISING AMID TRADE AND TARIFF CONCERNS



Source: LPL Research, FactSet 08/24/18

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The economic forecasts may not develop as predicted.

CONCLUSION

Corporate America is deserving of superlatives. Second quarter earnings season was outstanding on a variety of measures, including growth rates, beat rates, and upside surprises on both the top and bottom lines. Results more than support our earnings growth forecasts for 2018, and are particularly impressive given the implementation of tariffs and building wage pressures.

Bolstered by second quarter results, our 2018 S&P 500 earnings forecast of $155 per share, representing growth of 17%, may prove conservative. The impact of tax reform is still cycling through. We expect continued strong earnings growth to drive further upside in the S&P 500 over the balance of 2018.

Even as the S&P 500 nears the low end of our year-end target of 2900 (our range is 2900–3000), we are not recommending investors sell stocks here. We expect the bull market to continue well into 2019 and potentially beyond, despite now being the longest ever. But with little progress on China trade negotiations, midterm elections looming, and the index already up more than 8% year to date, any additional gains may come with higher volatility. We suggest keeping equity allocations near benchmark levels, or possibly a bit lower for more conservative investors. Please discuss your specific situation with a financial advisor. ■

Additional descriptions and disclosures are available in our publication *Midyear Outlook 2018: The Plot Thickens*.

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.

All investing involves risk including loss of principal.

DEFINITIONS

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.

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.

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