



# Weekly Market Commentary

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## Earnings Season Preview

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#### Highlights

The rebound in sentiment may have had to do, in part, with the second quarter earnings season due to kick off this week.

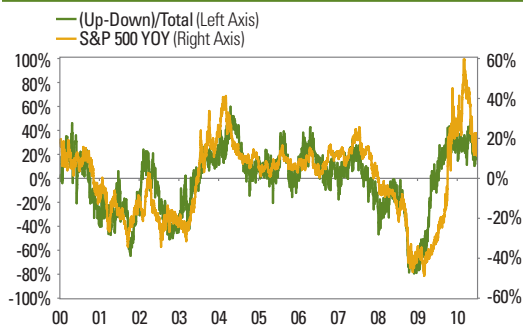
While the S&P 500 has lost 11% since the peak of the stock market on April 23rd, the analyst consensus earnings expectations for S&P 500 companies over the next 12 months have been rising for every sector of the stock market.

A silver lining of a soft labor market is that profit margins are widening, magnifying the impact of revenue growth during the quarter.

The commitment to growth evident in the strong pace of spending by businesses during the quarter suggests that corporate leaders may reflect this improving outlook when they report their performance for the quarter and also in their guidance for future quarters.

#### 1 S&P 500 Performance and Earnings Outlook Closely Linked

*S&P 500 Year-Over-Year Performance and Number of Companies with Upward EPS Revisions Less Companies with Downward Revisions Divided by the Total Revisions Over the Past Three Months for S&P 500 Companies*



Source: LPL Financial, Factset Research Systems 7/9/10

*The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.*

Last week resulted in the biggest weekly gain for the stock market, measured by the S&P 500, in about a year. The rebound completely erased the prior week's 5% decline. Commodities also rose. Increased risk appetite by investors was also evident in the bond market. Economically sensitive High-Yield Bonds rallied while the safe haven demand for Treasuries diminished. Last week marked the first decline for Treasuries in a month, pushing 10-year yields up the most since April, finishing above the important 3% level.

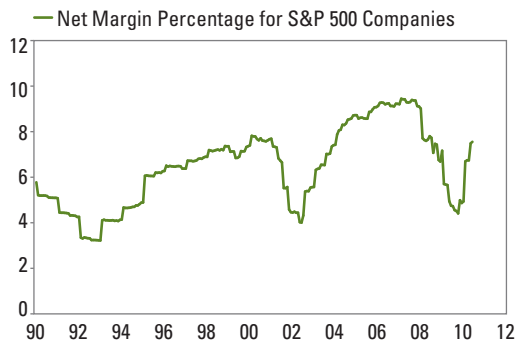
Why the sudden turnaround in sentiment on the outlook? While we cited a number of reasons for a rebound in our commentary last week, one catalyst we have been pointing to has finally arrived. The rebound in sentiment may have had to do, in part, with the second quarter earnings season due to kick off this week. The commitment to growth evident in the strong pace of spending by businesses during the quarter, and the rising private-sector employment numbers, suggest corporate leaders may reflect this improving outlook when they report their performance for the quarter and also in their guidance for future quarters.

Four times a year investors focus on the most fundamental driver of investment performance: earnings. The performance of the S&P 500 and analysts' revisions to their Earnings Per Share (EPS) estimates are closely linked [Chart 1]. A year ago investors were more hesitant than analysts to raise their outlook early in the recovery; however, they quickly caught up in the second half of 2009 as stocks soared. Then, earlier this year the stock market continued to soar even as analysts moderated their pace of upward earnings revisions. Back in April, as we entered the first quarter earnings season, we believed the stock market was due for a pullback as earnings were likely to be good, but not good enough to avoid disappointing lofty investor expectations. The recent stock market pullback has realigned analyst and investor expectations. This has set the stock market up for an advance if companies exceed analyst estimates and prompt a more favorable outlook.

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## 2 Net Margin on the Rise



Source: LPL Financial, Factset Research Systems 7/9/10

The five most important second quarter profit drivers include:

1. Revenues rose during the quarter and over the past year. Sales are likely to be up about 10% over the second quarter of 2009 when the U.S. recession was drawing to a close.
2. Exceptional cost control is driving powerful gross margin expansion, magnifying the impact of top-line revenue growth on the bottom-line. On average, labor costs make up about 70% of the cost of producing goods and services in the United States. With labor being the dominant portion of corporate costs, changes in labor costs have a big impact on profits. The labor cost per unit of output has been falling at an unprecedented 4-5% pace, according to the Bureau of Labor Statistics. At the same time selling prices, measured by consumer price inflation, have been rising about 1-2% year-over-year during the quarter. The combination of rising selling prices and falling input costs have allowed profit margins to expand powerfully, though still leaving more room to rise in coming quarters
3. Rising operating income (Earnings Before Interest and Taxes, or EBIT) margins may also continue to magnify the impact of revenue growth as fixed costs are spread over more units of output raising the profit contribution of each additional unit. The proportion of factory and plant utilization rose from the lowest level in the 40-year history of the measure, tracked by the Federal Reserve, of about 68% a year ago to over 74% during the second quarter, likely on its way to a typical range of 80-85% during an economic expansion.
4. Also, reduced interest and tax expenses are contributing to companies' bottom lines. Businesses have reduced and refinanced a tremendous amount of debt over the past year. In addition, they have a huge amount of tax loss carry forwards made available to them by tax law changes that they are using to minimize taxes. This has helped to contribute to wider net margins, which reflect the sum of all of the profit margin drivers [Chart 2].
5. As companies implement share buyback programs, reducing their outstanding shares, EPS gets a boost since earnings are divided among fewer outstanding shares. While this effect had little impact during the second quarter, it may be more significant over the coming year.

On the negative side, the small boost to profits in recent quarters from translating profits earned in foreign currencies into a weaker dollar have now faded. Despite the loss of this small boost to growth, these combined drivers will continue to expand profit margins (although at a slower pace) over the next year even with slower revenue growth in the second half of the year and into 2011. We are maintaining an outlook for double-digit year-over-year earnings per share growth in the second half of 2010.

The second quarter earnings season gets underway this week and companies are expected to report an overall gain of 27% relative to the second quarter of 2009; however, the companies that report early in the season are most often not the bellwethers they are commonly thought to be. We will not really know how results are shaping up until the end of the month when about half of the S&P 500 companies will have reported.



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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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

EPS: The portion of a company's profit allocated to each outstanding share of common stock. Earnings per share 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.

Consumer Price Inflation is the retail price increase as measured by a consumer price index (CPI).

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