LPL RESEARCH
WEEKLY MARKET COMMENTARY

January 14 2019

FOURTH QUARTER EARNINGS PREVIEW: FROM GREAT TO GOOD

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KEY TAKEAWAYS

S&P 500 earnings growth will slow in the fourth quarter but is still expected to be strong.

U.S. economic growth, tax cuts, higher oil prices, and corporate stock buybacks are among the positive drivers.

However, earnings may be capped by trade tensions, slower economic growth abroad, and a rising U.S. dollar.

Fourth quarter earnings reporting begins this week. Over the next five days (January 14–18), 35 companies in the S&P 500 Index will report quarterly results, highlighted by several big banks. Here we preview fourth quarter earnings, discuss several key drivers, and share some thoughts on the outlook for 2019. We expect a mid-to-high-teens increase in earnings for the quarter, driven primarily by the solid economic backdrop.

THE NUMBERS

Consensus estimates from Thomson Reuters are for a 14.5% year-over-year increase in S&P 500 earnings for the quarter, which is slower than the 25% pace of the past three quarters, but still quite strong [Figure 1]. Should results come in ahead of expectations, as we anticipate, it would mark the 39th consecutive quarter that earnings have exceeded estimates. We believe the reduction in fourth quarter estimates has lowered the bar enough that corporate America will clear it, as it typically does. Although several high-profile companies, including

1 STRONG BUT SLOWER EARNINGS GROWTH ON TAP FOR Q4

Source: LPL Research, Thomson Reuters 01/11/19

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Apple, have warned about weaker results, overall preannouncements have been consistent with recent trends. Profit margin trends remain positive [Figure 2].

THE DRIVERS

We see several positive drivers for earnings this quarter:

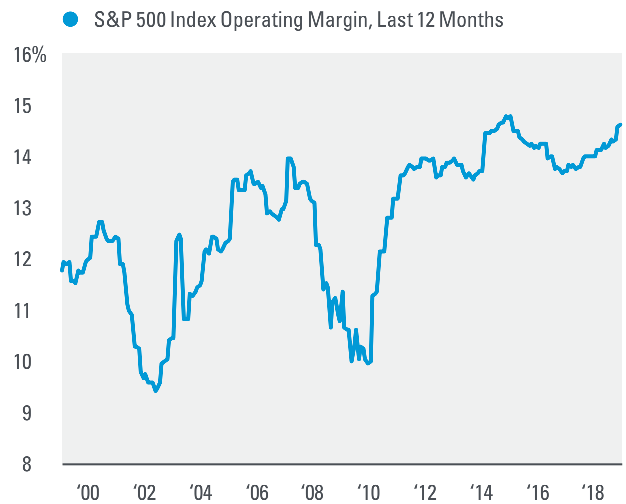
U.S. economic growth. U.S. economic activity should support further, though slower, earnings growth in the fourth quarter. U.S. gross domestic product (GDP) rose more than 3% year over year in the quarter, and 5% including inflation, based on Bloomberg consensus forecasts. Manufacturing activity, which is important because it is tied to earnings, remains quite healthy—the Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI) remains firmly in expansion territory at 54.1, despite a large drop in December (over 50 is considered expansionary). Consumer spending is on a solid trajectory, supported by steady job growth and rising wages. Impact: Positive

Tax cuts. S&P 500 profits will get another strong (perhaps 7–8%) boost from corporate tax cuts in the fourth quarter. Consumer spending may also get a boost from individual tax cuts. Impact: Positive

Higher oil prices. Though oil fell sharply late last year into the low $40s, West Texas Intermediate (WTI) crude still averaged $59–60 per barrel during the fourth quarter, 8% above the year-ago average. Those gains along with firming natural gas prices in November and December will help energy sector earnings grow 60% year over year, based on Thomson Reuters estimates. Impact: Slight Positive

Share buybacks. Stock buybacks (companies repurchasing their own shares) are expected to boost S&P 500 earnings per share by about 2% by reducing the number of shares in the earnings-per-share calculation. Low interest rates and repatriation of overseas profits at lower tax rates help. Impact: Positive

2 OPERATING MARGINS ON THE UPSWING



Source: LPL Research, FactSet 01/11/19

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At the same time, several factors may cap the fourth quarter earnings gain:

Trade tensions, slower growth in China. Clearly, tariffs are impacting corporate profits. The uncertainty has weighed on business confidence, dampening "animal spirits," while economic growth in China was already slowing. Apple's revenue warning brought this risk to the forefront of investors' minds earlier this month. Impact: Negative

Slower growth in Europe. Europe's growth outlook has weakened considerably over the past nine months, which may hurt demand for U.S. goods and services sold abroad. Consensus forecasts for GDP growth in 2018 and 2019 have been reduced by about one half of a percentage point during that time (source: Bloomberg). Impact: Negative

Currency. The U.S. dollar rose 3% during the fourth quarter of 2018 compared with the year-ago quarter, presenting a slight drag on overseas earnings for U.S. multinationals. Impact: Slight Negative

THE OUTLOOK

After the big tax reform boost at the start of 2018, which propelled S&P 500 earnings to a stellar 20%-plus increase for the year, earnings growth will slow in 2019. Still, we expect support from the following:

- **Solid U.S. economic growth.** Our forecast is calling for U.S. GDP growth of 2.5-2.75% in 2019, supported by consumer spending, business investment, and government spending.
- **Fiscal stimulus.** Even though the tax reform boost will be smaller, tax cuts and increased government spending still add incremental economic growth in 2019 relative to 2018. Manufacturing activity will likely remain healthy amid existing policy incentives.
- **Slightly higher and manageable inflation.** Some inflation is good for corporations by providing pricing power.
- **More buybacks.** Corporate balance sheets remain quite healthy and borrowing costs are low, supporting another year of robust share buyback activity.

Primary risks include: 1) tariffs and trade, which add risk to the economic picture in the U.S. and China; 2) a more pronounced slowdown in Europe; 3) higher wages, which could weigh on companies' profit margins; and 4) a possible surging U.S. dollar.

CONCLUSION

We believe a mid-to-high-teens increase in earnings for the fourth quarter is achievable, supported by a solid U.S. economic backdrop, tax cuts, strong energy sector profit gains, and share buybacks. Recent cuts to estimates likely already factor in the drags from tariffs and slower overseas growth during the quarter.

Looking ahead, we believe a mid-to-high single digit increase in S&P 500 earnings in 2019 is achievable, based on slower but still solid U.S. economic growth and fiscal policy support, alongside manageable inflation and continuing share buybacks. Though earnings growth is slowing, our forecast is near long-term averages. While the peak earnings growth *rate* for this bull market may be behind us (it almost certainly came in the third quarter of 2018), growth peaks have historically been followed by several years of economic growth and stock market gains.

We believe the earnings outlook is strong enough to support solid potential gains for stocks over the coming year. We forecast a year-end fair value range for the S&P 500 of 3000, as cited in our *Outlook 2019* publication, representing a solid double-digit return for 2019. That target is derived from a price-to-earnings multiple of 17.5 and our 2019 S&P 500 earnings forecast of $172.50 per share. ■

IMPORTANT DISCLOSURES

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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.