



Weekly Market Commentary



June 27, 2011

Pre-Announcement Season

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Highlights

The so-called earnings “pre-announcement season” is upon us.

The current ratio of negative-to-positive pre-announcements is 2.3, above the historical average pre-announcement ratio of 2.1; historically this 2.3 ratio has been followed by a gain of about 2% in the S&P 500 during the ensuing earnings season.

While the above average pre-announcement ratio may be a small positive for the earnings season once it gets underway, the next few weeks may continue to feature negative pre-announcements and modest losses for the stock market.

The so-called earnings “pre-announcement season” is upon us. This is the time when corporate leaders often pre-announce any changes to their earnings expectations ahead of their second quarter earnings reports that begin in mid-July. These pre-announcements will likely be with us for the next few weeks until the actual earnings reporting season begins.

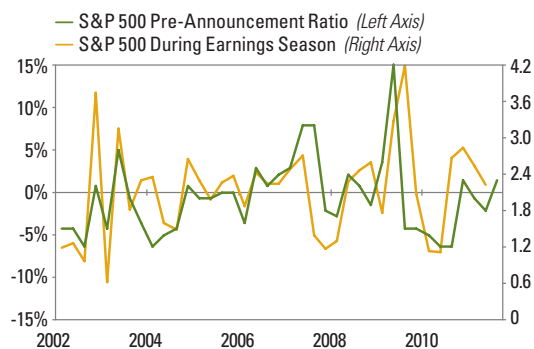
Traditionally, the start of the earnings season is marked by Alcoa reporting their quarterly earnings. This earnings reporting season, Alcoa is scheduled to announce their second quarter results on July 11. During the four weeks that begin at the start of the earnings season, the bulk of S&P 500 companies report their earnings and the stock market reacts accordingly. While this is still about three weeks away, we can get a reasonably good indicator of how stocks may perform during the earnings season by looking at pre-announcements.

As we highlighted in last week’s *Weekly Market Commentary*, we expect more than the average number of negative pre-announcements this quarter. For the past couple of years, the pre-announcement season has been relatively quiet as business conditions improved. However, due to the economic slowdown during the second quarter and supply chain problems extending from the disaster in Japan, the next few weeks may feature more bad news than in recent quarters as companies lower their earnings outlook. Last week, we heard from a wide range of companies lowering their expectations for the quarter. S&P 500 companies lowering their earnings guidance included: Carnival Corp, Conagra Goods, Whirlpool, and Jabil Circuit.

So far, the ratio of negative-to-positive pre-announcements is 2.3, above the historical average pre-announcement ratio of 2.1. An above-average ratio has often lowered the bar on expectations heading into the earnings season as market participants price in a greater probability of company’s missing analysts’ estimates. Over the past 10 years, an above average ratio of 2.3 has been followed by a gain of about 2% in the S&P 500 during the earnings season.

While the above average pre-announcement ratio may be a small positive for the earnings season once it gets underway, the next few weeks may continue to feature negative pre-announcements and modest losses for the stock market. Although the track record indicates a modest gain for stocks during the earnings season, there is a risk that stocks will buck the trend and continue to decline during the earnings season despite the above-average negative pre-announcements.

1 Pre-Announcements Predict Stock Market Performance During Earnings Season



Source: LPL Financial, Bloomberg, Thomson Financial 06/24/11



One reason stocks may continue to suffer once companies begin reporting earnings is that they may, at the same time, lower their earnings guidance on the next couple of quarters. We believe earnings expectations remain too high for the third and fourth quarters, but that does not mean the results will be weak. On the contrary, earnings per share for S&P 500 companies are likely to post solid gains at or above 10%. However, the consensus of analysts' estimates point to an 18% gain in each quarter.

With profit margins near their peak and revenue growth slowing due to below average economic growth in the United States and slower growth abroad, it will be very hard for companies to achieve those 18% gains. Therefore, companies may cut their earnings outlook, prompting analysts to do the same, which may weigh on stock market performance. It is worth noting that market participants have been more cautious than analysts—stock market valuations (at a well below average forward Price-to-Earnings ratio of 12) do not reflect anywhere near the well above average 18% analyst expected earnings per share growth in the coming quarters tempering the impact of any disappointments.

The negative sentiment, low valuations, and solid earnings growth outlook supports our view for a modest pullback to be followed by a rally, rather than a more severe or sustained decline.

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