



# Weekly Market Commentary

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### Highlights

Investors have high expectations for earnings this year. However, having climbed all the way back to near the prior peak, earnings growth is slowing as businesses have stepped up spending on materials, capital, and labor.

For the second quarter of 2011, corporate profits are forecast to have grown by just 8% from a year ago, the smallest gain in two years. We expect downward guidance on earnings in the second half of 2011 from business leaders in the coming weeks as they report their second quarter earnings, potentially leading to downward revisions to 2011 earnings by analysts, and acting as a headwind for stocks as the earnings season matures.

During this earnings season, we are paying special attention to transitory impacts, business spending, and guidance from business leaders on the earnings outlook for coming quarters.

## Earnings Season Preview

U.S. stocks rose last week, giving the S&P 500 its biggest two-week rally in 21 months, extending its climb since June 24, 2011 to 5.9%. That is the biggest two-week increase since October 2009 despite Friday's 0.7% drop following the worst monthly jobs report since September 2010. Why the optimism? In a word: earnings.

The 2011 second quarter earnings reporting season kicks off this week. 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. [\[Chart 1\]](#)

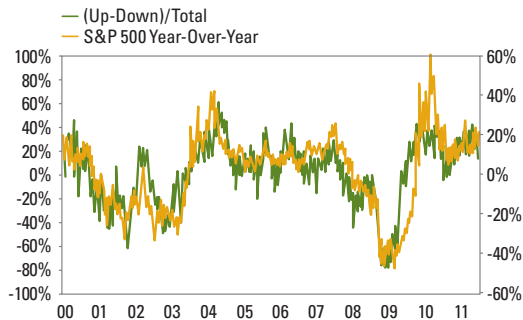
Investors have high expectations for earnings this year. Analysts expect 18% profit growth in the second half of 2011, and a record \$98 in EPS in 2011 for S&P 500 companies, representing about 15% growth for the year and a return to record profits.

Having climbed all the way back to near the prior peak, earnings growth is slowing. We believe EPS growth of closer to 10% is more likely in 2011, well below the 39% EPS gain in 2010. In addition to peaking profit margins, our outlook for 2011 EPS is bound, in part, by continued sluggish revenue growth resulting from sluggish economic growth in the developed markets, including the United States. We expect downward guidance on earnings in the second half of 2011 from business leaders in the coming weeks as they report their second quarter earnings, potentially leading to downward revisions to 2011 earnings by analysts and acting as a headwind for stocks as the earnings season matures.

In recent weeks, second quarter earnings estimates have been falling. Of the 128 companies that pre-announced second quarter earnings guidance in recent weeks, the ratio of negative-to-positive news was 2.55, worse than the average ratio of 2.1. For the S&P 500 companies as a whole, the consensus of analysts' estimates have slid, and now point to average earnings per share of growth of just 8% from one year ago, the smallest gain in two years. Earnings growth is below the 10% growth rate of revenues as the rise in profit margins has stalled as businesses have stepped up spending on materials, capital, and labor.

The second quarter earnings season runs about four to six weeks starting about two weeks after the close of the quarter. During this earnings season we are paying special attention to transitory impacts, business spending, and guidance from business leaders on the EPS outlook for coming quarters.

**1 S&P 500 Performance and Earnings Outlook Are Closely Linked**  
*S&P 500 Year-Over-Year Performance and Number of Upward EPS Revisions to S&P 500 Companies Less Number of Downward Revisions Divided by the Total Revisions Over Past Three Months for S&P 500 Companies*



Source: LPL Financial, Factset Research Systems 06/30/11

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.

- **Transitory Impacts** – The market rebound in the face of falling second quarter estimates (but resilient third and fourth quarter estimates) suggests that market participants believe the second quarter earnings growth rate slowdown is transitory and driven in large part by the supply-chain impact of the Japanese earthquake and tsunami on the world's third largest economy, the violence in North Africa and the Middle East, and the European debt problems, offset partially by currency impacts from a year ago when the dollar was soaring. We will be watching closely to see how much of the slowdown appears to be transitory - and what is not.
- **Business Spending** – While investor attention is often directed on consumer spending as a driver of profits, we will be watching business-spending-driven industries more closely. Business spending and commodity prices are major drivers of S&P 500 profit growth while discretionary consumer spending has a much smaller contribution to the S&P 500. During the second quarter, commodity prices fell slightly and manufacturing growth nearly stalled. We will be watching to see how this translated into profits for the Information Technology, Industrial, Energy, and Materials companies for clues as to how rapidly their profit growth may slow in the second half of 2011.
- **Guidance** – We will be listening closely to conference calls and reading corporate earnings press releases to aid in assessing the likely movement in earnings expectations. Chief Executive Officer (CEO) confidence rose in the first quarter of 2011, to highs not seen since the prior business cycle peak in mid-2007, but it slipped in the second quarter as attention turned to Japan's natural disasters and the violent clashes in North Africa and the Middle East.

It is important to keep in mind that 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 just after the end of the month of July, when about half of the S&P 500 companies will have reported.

#### 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 reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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.

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