



Weekly Market Commentary



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Earnings Season Preview

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Highlights

For investors, the key to this reporting season may lie with revenues rather than earnings.

While companies may report solid EPS growth, the outlook for slower revenue growth in 2011 may lead to lower earnings guidance and disappointment as more companies report.

We expect more downward guidance on 2011 from corporations in the coming weeks potentially leading to a pullback in stocks as the earnings season matures.

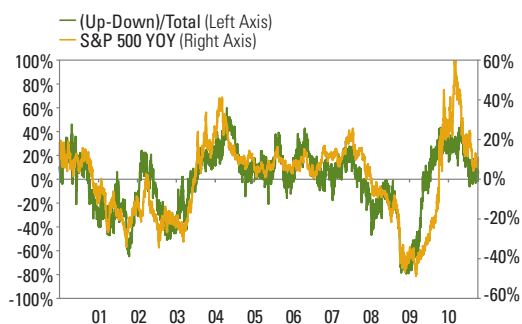
Last week marked the traditional start of the earnings season with eight companies in the S&P 500 reporting, bringing the total number of companies releasing third quarter earnings to 30. This week will add another 15 to that total. With last week's economic data bringing no surprises, investors are likely to focus on the earnings data this week.

Four times a year investors focus on the most fundamental driver of investment performance: earnings. As you can see in [Chart 1], the performance of the S&P 500 and analysts' revisions to their Earnings per Share (EPS) estimates are closely linked. 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. The stock market pullback that began in April realigned analyst and investor expectations.

Third quarter earnings comparisons relative to a year ago, when the economy was just emerging from recession, show strong growth. S&P 500 EPS is expected to be up 24% from the third quarter of 2009. This is a strong gain, but down from last quarter's year-over-year growth rate of 39%. On a sequential basis, the third quarter of the year is typically softer and earnings are expected to be down in the third quarter by about 5% from the second quarter of 2010.

1 S&P 500 Performance and Earnings Outlook Closely Linked

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



Source: LPL Financial, FactSet 10/08/10

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

For investors, the key to this reporting season may lie with revenues rather than earnings. Even if companies meet or even exceed their bottom line EPS estimates, revenue growth could turn out to be disappointing given sluggish economic growth seen in the third quarter. Revenues are likely to be up about 7% over the third quarter of 2009. Analysts have been lowering their earnings estimates modestly during the quarter. In addition, companies have been guiding expectations lower for third quarter earnings at a much more rapid pace than in recent quarters, with a 2-to-1 negative-to-positive ratio of earnings preannouncements. While companies may report solid EPS growth, the outlook for slower revenue growth in 2011 may lead to lower earnings guidance and disappointment as more companies report.

With revenue growth slowing, companies continue to squeeze profits out of lowering costs. On average, labor costs make up about 70% of the cost of producing goods and services in the United States. The labor cost per unit of output has been falling at an unprecedented 4-5% pace, according to the Bureau of Labor Statistics. In addition, as output rises, the cost per unit of this output is falling 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 75% during the third quarter. 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.

One factor that will not be a driver in the third quarter is currency. The small boost to profits in recent quarters from translating profits earned in foreign currencies into a weaker dollar was not a factor in the third quarter. Although the dollar has since resumed its decline, during the third quarter the dollar was at about the same level it averaged during the third quarter of 2009.

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 the end of the month when about half of the S&P 500 companies will have reported. Analysts expect a little more than \$95 in EPS in 2011 for S&P 500 companies, representing about 15% growth. We believe 10% growth is more likely for EPS in 2011 and expect more downward guidance on 2011 from corporations in the coming weeks potentially leading to a pullback in stocks as the earnings season matures with 95 companies reporting earnings next week (October 18-22).

IMPORTANT DISCLOSURES

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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.

Stock investing may involve risk including loss of principal.

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