LPL FINANCIAL RESEARCH

Weekly Market Commentary

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Earnings Season Preview

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Highlights

- In the early quarters of a recovery, growth in earnings is not needed to lift the stock market. However, now that we are nearly a year from the market low set in early March of 2009, earnings growth is essential to supporting the stock market.
- We see three primary reasons for profits to come in better than the consensus expectations this quarter including our favorite profit indicator, which suggests year-over-year S&P 500 companies profit growth of about 11% for the fourth quarter, ahead of the 8% ex-financials consensus.
- We believe the downward revisions in earnings over the past four weeks may set the market up for a positive surprise as earnings come in better than expected across most sectors.

The year is off to a good start with stock, bond, and commodities markets posting modest gains. The general improvement in the economic data has been the focus of investors, but over the next few weeks, attention may shift to the fourth quarter earnings results and how well the economic growth translated into profits. The fourth quarter of 2009 was most likely the first quarter that profits rose on a year-over-year basis since the second quarter of 2007.

In the early quarters of a recovery, growth in earnings is not needed to lift the stock market. Instead, the valuation or price-to-earnings (P/E) ratio rises as investors price in the return of earnings growth in the future. Nevertheless, now that we are nearly a year from the market low in early March of 2009, earnings growth is essential to supporting the stock market. This is especially true now that the S&P 500 P/E is back to near normal around 14.5 times 2010 earnings per share of about $77.

Fourth quarter earnings for S&P 500 companies are expected by the consensus of Wall Street analysts to be up about 200% year-over-year, though this is more of a testament to how weak profits were a year ago, in the midst of the financial crisis and record breaking write offs for financial companies, than strength in the latest quarter. If we eliminate the financial sector from the year-over-year comparison, S&P 500 EPS are still expected to be up, but only by 8%. This 8% number is the right number to focus on. We expect numbers to come in modestly ahead of the 8%, or $16.05 per share, consensus estimate.

We see three primary reasons for profits to come in better than the consensus expectations this quarter:

- The combination of the revenue growth plus the increase in operating margins results in a quarter-over-quarter growth rate in profits in the mid single-digits. Yet, the consensus of Wall Street analysts expects a slight decline in profits from the third quarter. Positive GDP growth during the fourth quarter (both in the U.S. and abroad) likely drove S&P 500 revenues by an annualized 5%. Rising factory and resource utilization (which spreads fixed costs over more output lowering cost per unit), combined with low labor costs furthered the trend toward wider operating profit margins in the fourth quarter from the third quarter.
- Despite accelerating sales, Wall Street analysts downwardly revised Q4 earnings estimates during the last four weeks. We believe results will be better than expected, as they were when third quarter results were reported during the fourth quarter.

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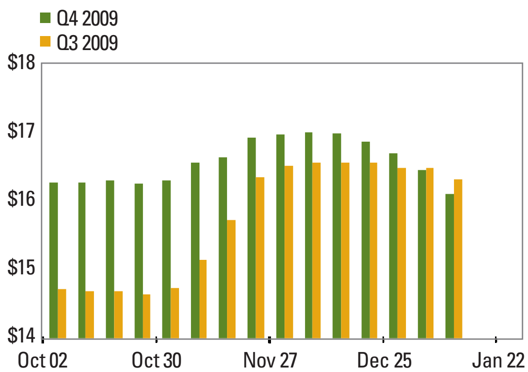
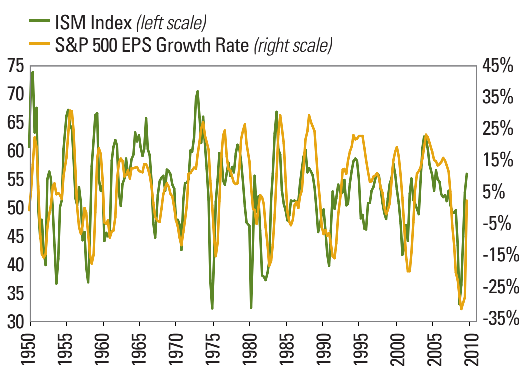
1 Earnings Estimates During the Last Four Weeks



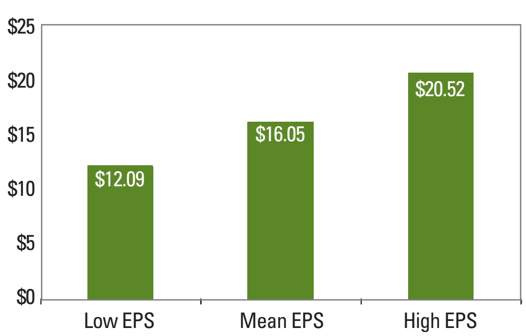
Source: LPL Financial, Factset Research Systems

2 ISM Predicts S&P 500 Profit Growth of about 11% Year-over-Year
Institute for Supply Management's Purchasing Manager Index and S&P 500 Earnings per Share Growth Rate Year-over-Year



Source: LPL Financial, Factset Research Systems, Bloomberg

3 Wide Range of Earnings Estimates
S&P 500 Earnings per Share Estimates Using Lowest, Mean, and Highest Analyst Estimates for Each Company



Source: LPL Financial, Factset Research Systems

- Our favorite profit indicator suggests year-over-year S&P 500 profit growth of about 11% for the fourth quarter [Chart 1], ahead of the 8% ex-financials consensus estimate. The ISM index (the Institute for Supply Management's Purchasing Manager Index) is our favorite indicator of profits. Although this index measures the outlook for just the manufacturing sector, it has proven to be a very good indicator of overall S&P 500 profit growth.

We believe the downward revisions in earnings over the past four weeks may set the market up for a positive surprise as earnings come in better than expected across most sectors. The downward revisions to earnings expectations for the financial sector weighed on the overall total during the past four weeks, while our favorite sectors, Information Technology and Consumer Discretionary, have seen the largest boost to earnings growth during the quarter–both rose by double-digits and are now expected to provide year-over-year gains of over 50%. However, not all sectors will reflect growth in profits from a year ago. Most notably, the Energy and Industrial sectors are expected to post declines with oil prices and export growth down from a year ago.

Analysts' expectations are wide for the quarter. Using the lowest analyst estimate for every company in the S&P 500, the total is about $12.09, while the highest estimate is $20.52. This $8.50 range is similar to the past couple of quarters and reflects a wide range of opinions on the quarter leaving the door open to a greater probability of an upside, just as it was a surprise in earnings.

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.

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

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

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