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THIRD QUARTER 2017 EARNINGS PREVIEW

SLOWER BUT STILL SOLID

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KEY TAKEAWAYS

We expect another solid quarter of earnings growth, but a third straight double-digit increase for S&P 500 profits appears unlikely.

Hurricane impacts, tougher comparisons, and a lack of contribution beyond technology and energy present earnings growth headwinds.

Hurricane impacts aside, we have several reasons to be optimistic, including solid manufacturing data, recent U.S. dollar weakness, and resilient estimates.

Third quarter earnings season gets underway this week (October 9–13) and it should be another good one. The S&P 500 Index has exceeded earnings expectations 33 straight quarters and we see no reason why the third quarter won't make it 34. However, as seen in [Figure 1](#), earnings growth should fall short of the stellar results and double-digit pace of the past two quarters. We don't like to lead with the negatives, but some of the reasons earnings growth may slow down this quarter include:

- Hurricane impacts.** The most visible impact of the devastating hurricanes (Harvey and Irma) late in the third quarter can be seen in insurance company earnings estimates. The property casualty industry within the financials sector may have to absorb more than \$100 billion in insured losses during the quarter, which is why financials earnings are expected to fall. Disruptions in other industries in the affected areas (Florida and Texas) such as retail and oil and gas production add to the challenge.

1 SLOWER EARNINGS GROWTH IN Q3, THOUGH ESTIMATES SUGGEST BETTER DAYS AHEAD



Source: LPL Research, Thomson Reuters consensus estimates 10/06/17

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

Consensus estimates may not develop as predicted.

- **Tougher comparisons.** Earnings growth improved significantly from the second quarter of 2016 to the third quarter of 2016 [Figure 1]. In the second quarter of 2016, S&P 500 earnings fell 2.1% year over year, compared to the 4.3% year-over-year increase in the third quarter of 2016. That means the base from which to grow year over year was higher for the third quarter of 2017 than it was for the second quarter of 2017, making earnings growth tougher to come by this earnings season.
- **Sharply lower energy growth.** Energy sector earnings growth is expected to drop from 563% in the second quarter to 135% in the third, even as oil prices rose sharply during the third quarter. Tougher comparisons and hurricane impacts are driving the slowdown, although energy is still expected to be a major contributor to S&P 500 earnings growth in the quarter, along with technology [Figure 2].
- **Little contribution outside of technology and energy.** The expected year-over-year increase in S&P 500 earnings is essentially being driven by energy and technology, with only a minor contribution from healthcare. The lack of breadth of earnings gains, on top of the expected decline in financials earnings, will make anything better than a mid-single-digit overall earnings increase unlikely.

CAUSE FOR OPTIMISM

With the negatives out of the way, let's get to the good news—though mid-single-digit earnings growth is hardly bad. We have several reasons to be optimistic about earnings growth this quarter:

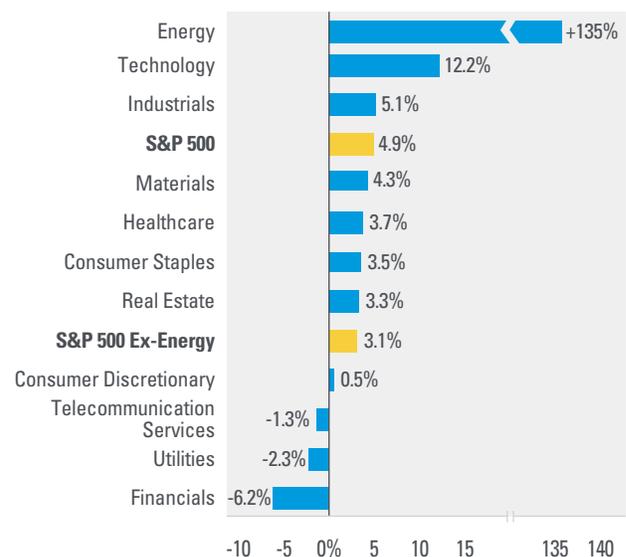
- **Solid manufacturing activity.** Strong manufacturing activity is supportive of corporate profits. The Institute for Supply Management Manufacturing Purchasing Managers Index (PMI) rose 2 percentage points to a solid 60.8 in September, which is the highest since 2004, while the New Orders component of the survey

CONSIDER THE SOURCE

Different sources such as FactSet, Bloomberg, and Standard & Poor's have different calculations than Thomson Reuters for S&P 500 earnings, based on various methodologies and different interpretations of what constitutes operating earnings.

2 ENERGY AND TECHNOLOGY TO DRIVE MOST OF THE EARNINGS GROWTH IN Q3

● Third Quarter 2017 Expected Earnings Growth, Year over Year



Source: LPL Research, Thomson Reuters consensus estimates 10/06/17

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Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

rose 4.3 percentage points to an even stronger 64.6 reading. Meanwhile, favorable economic and manufacturing conditions overseas are supportive of U.S. multinationals—virtually all PMIs globally are above 50.

- **Estimates have held up well considering the impact of hurricanes.** Consensus earnings estimates for the third quarter have held up well considering the reduction in estimates over the last three weeks of September, mostly in financials, due to hurricane-related losses. Estimates for the third quarter have dipped by about 3.7% over the past three months, slightly better than the long-term average reduction of just over 4%. Looking further out, estimates have held steady and point to earnings growth reacceleration, partly reflecting the potential for a corporate tax cut.
- **Pre-announcements.** The ratio of companies pre-announcing negative third quarter 2017 results relative to those pre-announcing positive results, at 1.6, is better than the year-ago quarter (1.9), last quarter (1.8), and the 20-year average (2.7), suggesting a high percentage of companies will exceed estimates again. The second quarter's 73% earnings beat rate led to a 5% upside surprise.

- **U.S. dollar pressures have abated.** The average level of the U.S. Dollar Index during the third quarter of 2017 was 2.4% lower than in the third quarter of 2016, setting up a small tailwind to overseas earnings for U.S. multinationals. This is the first year-over-year decline in the index since the third quarter of 2016 and its biggest annual decline since mid-2014.

CONCLUSION

We expect a solid earnings season in the third quarter, especially considering the circumstances. Markets may have to find a way to unravel the impact of the hurricanes, but we believe that investors will appreciate the underlying earnings strength once all results are in. We see several signs that after the dip in earnings growth in the third quarter, corporate America may be poised for better growth at the end of the year and into 2018.

We believe that the earnings outlook is sufficient to support the stock market at current levels. Although we may see a pickup in volatility in the near term, our early take on 2018 S&P 500 earnings is supportive of gains for stocks next year. Tax reform, or tax cuts, may provide a boost. More to come in our *2018 Outlook* due out in late November. ■

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 referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

All investing involves risk including loss of principal.

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 Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment.

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.

The U.S. Dollar Index measures the performance of the U.S. dollar against a basket of foreign currencies: EUR, JPY, GBP, CAD, CHF and SEK. The U.S. Dollar Index goes up when the dollar gains "strength" compared to other currencies.

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