LPL FINANCIAL RESEARCH

Weekly Market Commentary

November 16, 2009

Third Quarter Earnings Review

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Highlights

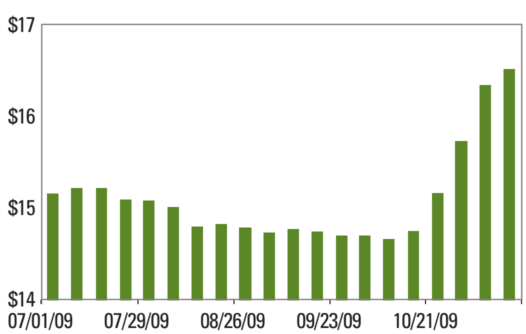
- The third quarter earnings season delivered revenue growth, a record-breaking percentage of companies beating estimates, a rise in the outlook for fourth quarter earnings, and a narrowing in the range of 2010 estimates.
- The aggressive cost cutting in corporate America has led to a profit-driven economic recovery. As earnings rebound, businesses are looking to reinvest in growth. We expect that this renewed pace of business spending will lead to job growth by early next year, helping to sustain the recovery.

At around 1100, the S&P 500 index is in line with its high of the year. Signs that the recovery in the economy and earnings are sustainable are encouraging investors to drive stocks higher. The key sign of sustainability is job growth, and the key to job growth is profit growth.

In our Third Quarter Earnings Preview published on October 5, we stated that we were looking for four trends during the upcoming earnings-reporting season: revenue growth, a record-breaking percentage of companies beating estimates, a rise in the outlook for fourth quarter earnings, and a narrowing in the range of 2010 estimates. With nearly all of the results in for the third quarter, we are pleased to see the season delivered on all four trends.

1. We expected to see better top-line growth in the third quarter compared to the second quarter. While down about 10% from a year ago, revenues did rise sequentially from the second quarter. 58% of companies reported sales above analyst expectations.
2. We believed analysts' estimates for the quarter were too low given the improvement in our Current Conditions Index relative to the falling estimates for earnings during the quarter. Therefore, we hoped to see most companies exceed expectations in the third quarter by another record-breaking margin similar to the second quarter when over 72% of companies exceeded the average consensus estimate. As it turns out, an astounding 80% of companies exceeded estimates in the third quarter — a record that may stand for a long time. The consensus S&P 500 earnings per share expectation for the third quarter went from $14.65 at the start of the reporting season, to $16.51 after most companies had reported. The strongest results relative to expectations were in the Information Technology, Consumer Discretionary, and Materials sectors. In aggregate, S&P 500 companies posted about a 25% annualized increase in earnings from the second to the third quarter.
3. We hoped to see the analyst expectation rise for the fourth quarter. The consensus estimate for fourth quarter earnings was $16.27 before the reporting season got underway — it is now $16.96.
4. We were less concerned about estimates for 2010 moving up; we instead hoped to see increased confidence in the 25% consensus gain. We measure this by a narrowing of the range between the analysts' high and low estimates for 2010. While still wide by historical standards, the range did narrow by about $2 per share as the low-end moved up by $2.50, and the high-end rose by $0.50. The consensus earnings per

1 Q3 Earnings Ended Up Much Better Than Analysts Expected
Analyst Consensus for Third Quarter S&P 500 Earnings per Share



Source: LPL Financial, Factset Research Systems share estimate for 2010 is about $76–$77. Earnings are expected to be strongest in the first half of 2010, an easy comparisons to early 2009, with the first quarter expected to post a growth rate of 38%.

The rebound in corporate earnings is very important to the economic recovery. Conditions for consumers are poor as evidenced by surveys, job losses, and weak income growth. However, corporate profits have accelerated at a record-breaking pace since the fourth quarter of 2008. While consumers face a heavy debt burden, businesses generally have good balance sheets with low debt and high cash balances. Profits have been boosted by cost cutting on everything including employment, advertising, capital spending, travel, and inventories. The aggressive cost cutting in corporate America has led to a profit-driven economic recovery. As earnings rebound, businesses are looking to reinvest in growth. We expect this renewed pace of business spending to lead to job growth by early next year, helping to sustain the recovery in the economy and markets into early 2010.

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RES 1860 1109
Tracking #593410 (Exp. 11/10)