WEEKLY MARKET COMMENTARY

A Candid Look into the Current State of the Markets

April 2016

Making a positive impact on as many lives as I can.

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KEY TAKEAWAYS

- The earnings trajectory may be at a trough as pressure from oil weakness and U.S. dollar strength begins to abate.
- But that also means management teams' popular excuses for explaining shortfalls won't work anymore.
- We continue to believe consensus estimates for mid-single-digit earnings growth in the second half of 2016 are achievable.

Q1 2016 EARNINGS PREVIEW: NO MORE EXCUSES

First quarter earnings results will not be very exciting, but the earnings trajectory may be at a trough. We would love to say that this earnings season, which begins on April 11, 2016 (unofficially), will bring better results than recent quarters, but that appears very unlikely. In fact, consensus estimates are calling for a 7% year-over-year decline in S&P 500 earnings for the quarter, the worst decline since the Great Recession and the third straight quarterly decline based on Thomson data (based on FactSet data, it's the fourth). By most definitions, corporate America is in the midst of an earnings recession. Hardly something for investors to get excited about.

But on a brighter note, this quarter may mark an inflection point regarding the trajectory of earnings because the pressure on earnings from oil weakness and U.S. dollar strength is starting to abate. But that also means management teams' popular excuses for explaining shortfalls won't work anymore.

CONSIDER THE SOURCE

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

NO MORE EXCUSES

In 2015, the combination of oil weakness and U.S. dollar strength wiped away high-single-digit S&P 500 earnings growth. Oil fell from over $100 per barrel in 2014 to as low as $26 in February 2016; while the U.S. dollar's gains, which erode profits earned overseas, reached 20% during the second quarter of 2015. These two factors provided excuses for management teams whose results came up short.
But these drags have already begun to abate and are poised to potentially stage powerful reversals. The reversal has begun quicker for the dollar [Figure 1]. After annual increases between 12% and 20% during each of the four quarters of 2015, which delivered estimated 3-6% hits to S&P 500 earnings, the U.S. Dollar Index gained just 2% during the first quarter of 2016. If the dollar stays flat between now and year-end, 2-3% year-over-year declines will be an earnings tailwind during the remaining three quarters of the year.

1 U.S. DOLLAR EARNINGS DRAG ABATING

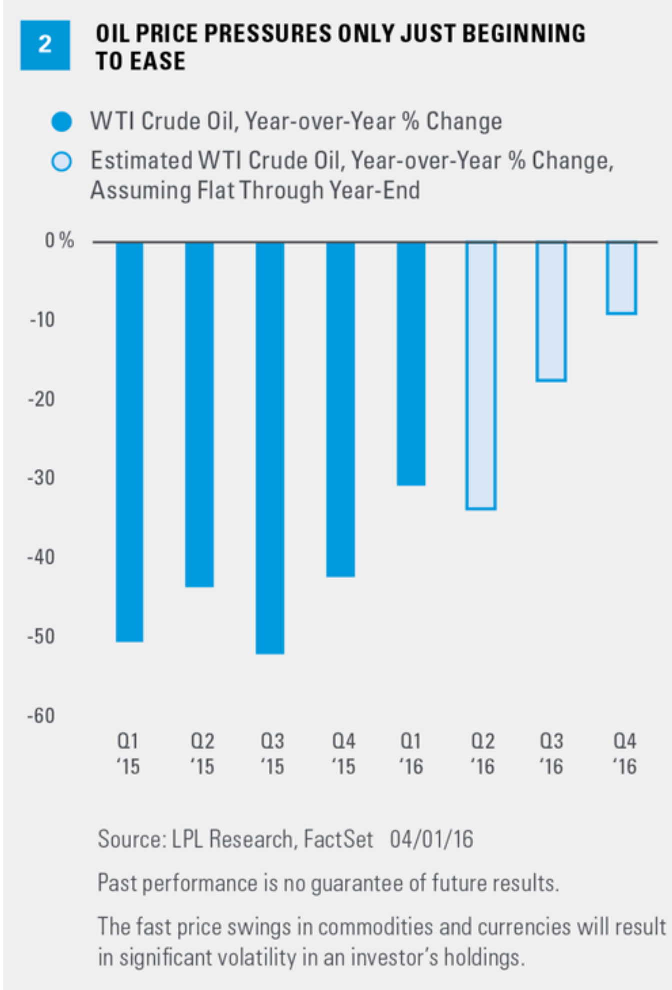
Source: LPL Research, FactSet 04/01/16

The U.S. Dollar Index (DXY) indicates the general international value of the U.S. dollar. The DXY Index does this by averaging the exchange rates between the U.S. dollar and six major world currencies.

Past performance is no guarantee of future results.

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

The oil reversal should take longer to play out, but the annualized declines have started to moderate and could reverse during the second half of the year if oil prices move reasonably higher from current levels. Figure 2 shows that if oil prices remain at current levels the rest of the year, year-over-year declines in average oil prices would continue through 2016. However, should oil prices return to the mid- to high $40s as we expect, oil may potentially begin to experience annual gains during the third quarter of this year. Consensus estimates are already reflecting energy's return to year-over-year earnings gains in the fourth quarter of 2016, and oil prices are currently up about 40% off of their February 2016 lows, so the wait for better earnings news from the sector may not be too far off.



Corporate America has already lost its ability to use currency as an excuse, while the oil excuse is beginning to lose credibility. Hopefully, less reliance on these excuses will enable markets to get more useful, and better, information about business conditions.

WHAT WE'RE WATCHING

Whether earnings declines potentially trough this quarter, should these two drags continue to fade, is the key question for us this earnings season. Given how far 2016 estimates have fallen (down 5.6% year to date), they may at least hold steady as companies report results (a rise is seen as unlikely). Remember, many of these management teams delivered their 2016 expectations to investors in late January and early February 2016 when recession fears peaked, stocks and oil bottomed, and the U.S. dollar was near recent highs. Conditions are better now, suggesting the tone of guidance may be more positive.

Some other things we will be watching this earnings season:

- **Profit margins.** Wage pressures have increased gradually and have started to impact profit margins. We will be watching for signs of further pressures that could lead to margin compression. To date, corporate America has done a terrific job maintaining high profit margins.
- **Capital allocation decisions.** We would like to see companies deploy more capital to invest in future growth, which investors may view as a positive signal for the future. We are fine with companies returning capital to shareholders, but we would like to hear that companies are making capital spending a bigger priority.
- **Emerging markets demand.** China, which has been seeing some improvement in economic conditions, is always worth watching. But U.S. companies may continue to be impacted by weakness in the commodity-producing regions and geopolitical hotspots overseas such as Brazil, Russia, and South Africa.

We believe energy, financials, and healthcare are the key sectors to watch. For energy, we would like to see evidence of further U.S. production cuts beyond the 8% drop already experienced. The quarter may prove difficult again for financials given lower interest rates and financial market volatility. Healthcare results should be strong again, but scrutiny over high drug prices may persist.

QUICK THOUGHTS ON DIVERGENT PROFIT MEASURES

The large gap between operating earnings and GAAP earnings has been receiving a lot of attention from the financial media, and becoming a concern among some investors that it may signal even more earnings troubles ahead. The biggest reason for that gap has been the energy downturn, which has led to significant downward adjustments of oil and gas reserves valuations. The impacts of the energy downturn are well known and the associated risks were seemingly more than priced in when oil prices bottomed earlier this year. The gap between earnings measures was the effect, not the cause, and does not suggest increased earnings quality concerns are warranted, in our opinion.

Other similar periods that saw significant divergences in these earnings measures included the bursting of the internet bubble and the financial crisis, when acquisitions, intellectual property, and financial assets were significantly devalued. During these periods, the gap between the operating measure and GAAP earnings has ranged as high as 30% depending on the data source used for the operating earnings calculation.

OPERATING VS. GAAP EARNINGS

Operating earnings represent earnings from recurring operations. Isolating earnings from recurring operations (essentially a company's core business) facilitates better forecasting and provides valuable information to assess the long-term value of a company or group companies. The more transparency, the better, so knowing of all factors impacting earnings is desirable.

GAAP earnings are based on generally accepted accounting principles (GAAP), a corporate profit measure that follows widely accepted accounting rules and includes all items, regardless of how those profits (or losses) were generated. For example, GAAP earnings include asset write-downs and one-time charges such as restructurings, divestitures, and acquisitions. These factors are important for investors to consider, but they can make forecasting and valuation analysis more difficult.

CONCLUSION

Earnings results will not be exciting, but the quarter may mark a trough in the earnings trajectory as the drags from oil and the dollar begin to abate. We continue to believe mid-single-digit earnings growth in the second half of 2016 is achievable, consistent with consensus estimates, and we hope to get more support for that view over the next four to six weeks--and fewer excuses.

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.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

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.

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Weekly Economic Commentary | Week of April 4, 2016

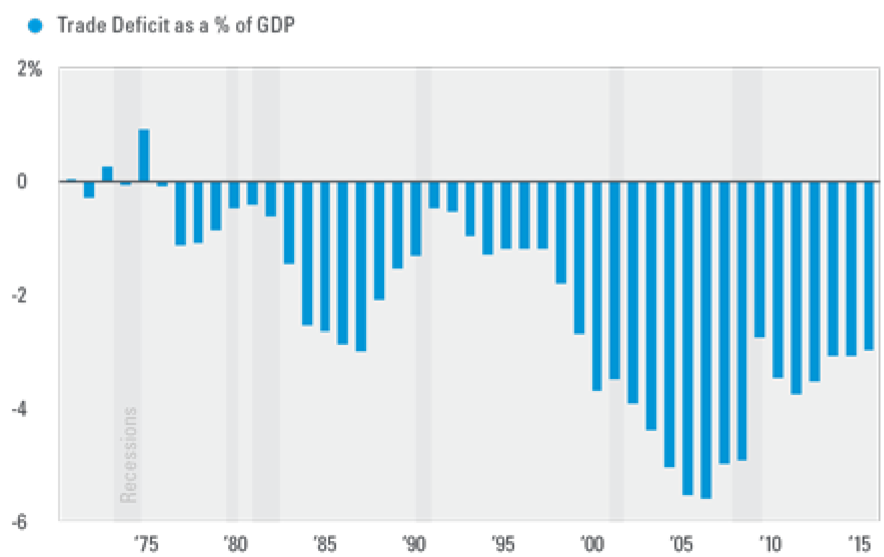
CHECKING IN ON TRADE

KEY TAKEAWAYS

- The U.S. trade deficit has been a drag on overall GDP growth.
- However, the U.S. continues to steadily grow in its role as an exporter of services.
- In addition, the goods the U.S. does export are generally of higher value.

The U.S. has run a trade deficit (importing more goods and services from other countries than it exports) since the mid-1970s, which acts as a drag on overall gross domestic product (GDP) growth [Figure 1]. Although the trade deficit narrows during recessions, when imports typically fall faster than exports, the trade gap has increased over time, and currently stands at around 3.0% of GDP. Along with the massive budget deficit, the trade deficit is one of the major economic challenges facing the U.S. and has fostered the oft-repeated conventional wisdom that "we don't make anything in the U.S. anymore." What's missing from this assessment, however, is the role of the U.S. as a net exporter of services and the increasing value of "good old American know-how." Here we focus on the details of what we import and export, and the impacts on the U.S. economy.

1 EXPORTS CONTINUE TO ACT AS A DRAG ON OVERALL GDP



Source: LPL Research, Haver Analytics 04/04/16

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

INSIDE LOOK AT U.S. TRADE DEFICIT

The trade deficit is computed by adding up the value of all goods and services made in the U.S. and shipped to other countries (which adds to GDP), and subtracting the value of all goods and services from abroad purchased in the U.S. (which is subtracted from GDP). Our large deficit on the goods side ($775 billion in 2015*) more than offsets the trade surplus we have on the services side of the ledger ($246 billion in 2015) [Figure 2]. Combined, our goods and services trade deficit was $530 billion in 2015, or 3% of GDP.

**2 GOODS VS. SERVICES:
IMPORTS, EXPORTS, AND THE DEFICIT/SURPLUS**

	Imports	Exports	Net
Goods	$2.3 Trillion	$1.5 Trillion	-$775 Billion
Services	$502 Billion	$748 Billion	+$246 Billion

Source: LPL Research, U.S. Bureau of Economic Analysis, Haver Analytics 04/04/16

Annual 2015 data shown above.

*Import and export data on both goods and services is available monthly, but for ease of comparison we will limit our discussion to the annual data for 2015.

The composition of the deficit on the goods side (what we import) contributes to the notion that "we don't make anything in the U.S. anymore," while the "hidden" surplus on the service side gets little attention. The United States Bureau of the Census will release the February 2016 data on U.S. imports and exports this week (Tuesday, April 5, 2016), and our trade deficit is likely to get some attention from pundits and politicians, especially during the already contentious election season.

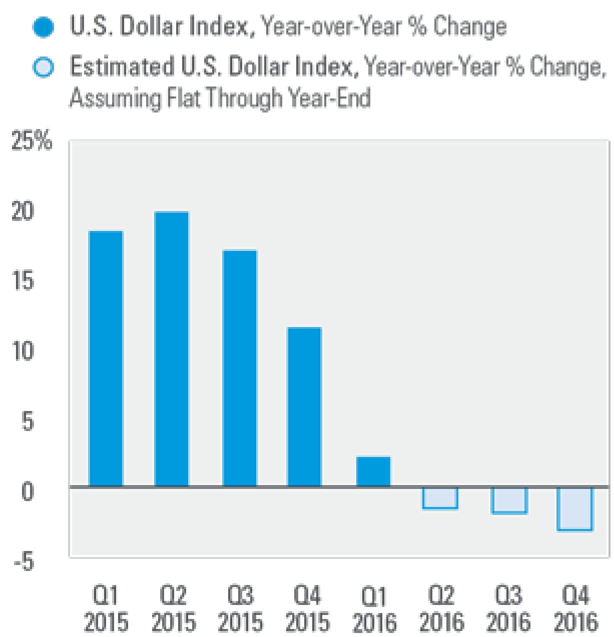
CONSUMER ITEMS DOMINATE U.S. GOODS IMPORTS

In 2015, the U.S. exported $1.5 trillion worth of goods and imported $2.3 trillion, leading to the $775 billion trade deficit on the goods side. The list of our top 10 imported items on the goods side is full of consumer and consumer-related items, such as vehicles ($348 billion), energy ($170 billion), computers and electronic equipment ($120 billion), pharmaceuticals ($108 billion), apparel ($94 billion), furniture ($34 billion), and the somewhat deceiving "miscellaneous manufactured goods" category. This category of imported goods-which includes household items like jewelry, sporting goods, toys and games, office supplies, etc.-is found in the grocery stores and big box discount stores we shop in every day. We imported $115 billion of these goods in 2015 and exported just $45 billion, increasing the trade deficit by $69 billion. Although this category is not the main driver of our overall trade deficit, it is certainly one of the most visible manifestations of it, and contributes to the overall perception that goods aren't being produced in the U.S. anymore.

WHERE DOES THE U.S. DOLLAR FIT IN?

The U.S. dollar soared 18% versus the currencies of its major trading partners since we last wrote an in-depth report on the U.S. exports sector in the summer of 2014. The relentless rise in the U.S. dollar through the end of 2015 from mid-2014 began to reverse in the first quarter of 2016, leaving the dollar just 3% higher versus the currencies of its major trading partners over the past year. (For more on this shift in the dollar, see the *Weekly Economic Commentary*, "From Headwind to Tailwind?") This reversal aligns with our expectation that the dollar may begin to stabilize as central bank policies and their outcomes become clearer, as noted in our *Outlook 2016: Embrace the Routine* publication. A stabilizing dollar should help to boost exports, removing a key headwind for the manufacturing sector and profits of U.S. corporations.

3 AS THE U.S. DOLLAR STABILIZES, IT SHOULD HELP TO BOOST EXPORTS



Source: LPL Research, FactSet 04/01/16

Estimates are based on consensus estimates as calculated by Thomson Reuters.

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GOOD OLD AMERICAN KNOW-HOW DOMINATES OUR SERVICE EXPORTS

What is not as visible to most Americans (and to most pundits and media outlets) is that the U.S. is a net exporter of services, and that our service exports are growing rapidly, as consumers and businesses around the world demand America's intellectual property, expertise, and culture. In 2015, the U.S. exported $748 billion of services, and imported just $502 billion, for a trade surplus on the services side of $246 billion. Although this is not enough to offset the $775 billion deficit on the goods side, our trade advantage in services is noteworthy. At $748 billion dollars, service exports were at an all-time high in 2015, and have nearly tripled in the past 10 years. This figure towers above our imports in the "miscellaneous manufactured goods" category noted above, and yet it gets very little attention. The U.S. runs large and persistent trade surpluses in many key service areas including education, intellectual property, travel, insurance, consulting, legal, telecommunications, and financial services-all of which are part of what we like to call "good old American know-how." In a future edition of the Weekly Economic Commentary, we'll explore the U.S. advantage in good old American know-how in further detail, and what it means for the economy and for certain segments of the labor market.

In general, the charge that "we don't make anything in the U.S. anymore" isn't true; but because many of the items we see and use every day around the house, in the car, or at the office are not made here, it's easy to draw that conclusion. To say it another way, we see the items we import (and in many cases, previously made here) but don't regularly see the things that we export; this is either because they are intangible (consulting services, for example) or do not show up in the stores we regularly shop in. When was the last time you saw a giant jet engine or an MRI machine in your local store? Adding to the misperception is that those items we import most tend to be very labor intensive, but generally not very expensive, while those we export are higher valued added. Over time, the U.S. economy-along with most other developed market economies-has made a transition away from producing low value added, commodities goods toward the production and export of high value added goods (MRI machines and jet engines) and services (legal, consulting, education, intellectual property such as software, etc.). Although this shift has occurred over the past 40 to 50 years, the labor market dislocations of the Great Recession have amplified the impact to many workers in the goods-producing sector.

The economic forecasts set forth in the presentation may not develop as predicted.