LPL RESEARCH
WEEKLY MARKET COMMENTARY

KEY TAKEAWAYS

Based on the Corporate Beige Book Barometer, companies remained generally upbeat during the second quarter earnings season.

The number of mentions of the Trump administration in earnings conference calls has dropped substantially over the past two quarters.

The positive tone from management teams appears to support a positive outlook for continued earnings gains.

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CORPORATE BEIGE BOOK: UPBEAT AS EXPECTED

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The LPL Research Corporate Beige Book Barometer — our measure of corporate sentiment that reflects an analysis of earnings conference call transcripts — shows that companies remained generally upbeat during the second quarter earnings season. This is hardly a surprising outcome, given actual earnings results were very good and estimates of future earnings held up relatively well as companies provided forward-looking guidance.

Earnings call transcripts analyzed took place starting in mid-July extending through the third week of August.

POSITIVE SENTIMENT CONFIRMS EARNINGS STRENGTH

Corporate sentiment remained very optimistic during the second quarter based on our tally of positive and negative words in earnings conference call transcripts. Although we observed a drop in overall directional language (the total of strong and weak words), the differential remains positive [Figure 1], while the ratio of positive-to-negative words has been on a steady climb since the end of the Chinese currency crisis in spring 2016 [Figure 2]. Specifically, from the third quarter of 2016 to the second quarter of 2017, the ratio of strong-to-weak words rose steadily from 2.6 to 6.8. The drop in directional language may simply reflect stability in the macro environment.

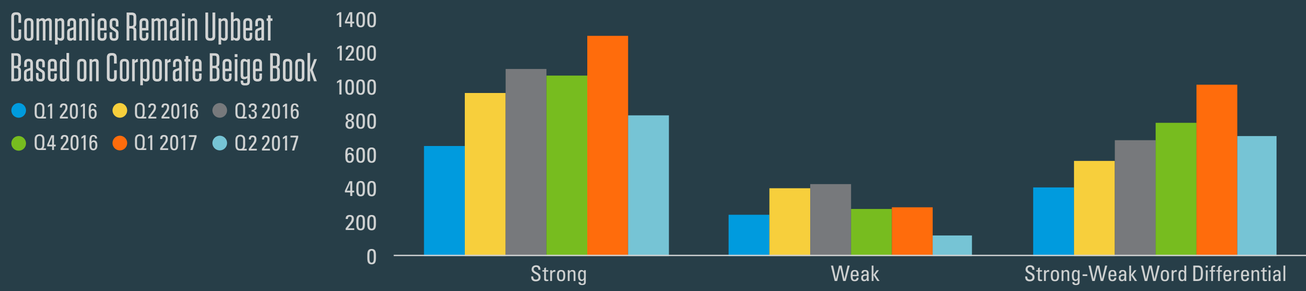
The improvement in management sentiment is encouraging and consistent with the strong earnings season. Corporate profits are growing at a solid, double-digit pace, and we believe the positive tone from management teams supports our outlook for further earnings gains.

SECOND QUARTER 2017 EARNINGS SEASON

Corporate America delivered another outstanding earnings season in the second quarter of 2017, with the second consecutive quarter of double-digit year-over-year earnings growth; a solid 4% upside to forecasts and relatively upbeat guidance from management teams translated into resilient forward estimates. We were particularly impressed with the breadth of earnings gains and atypical upside to revenue forecasts. For more details, click here for our overview of earnings season.

LPL Research Corporate Beige Book

1 Companies Remain Upbeat Based on Corporate Beige Book



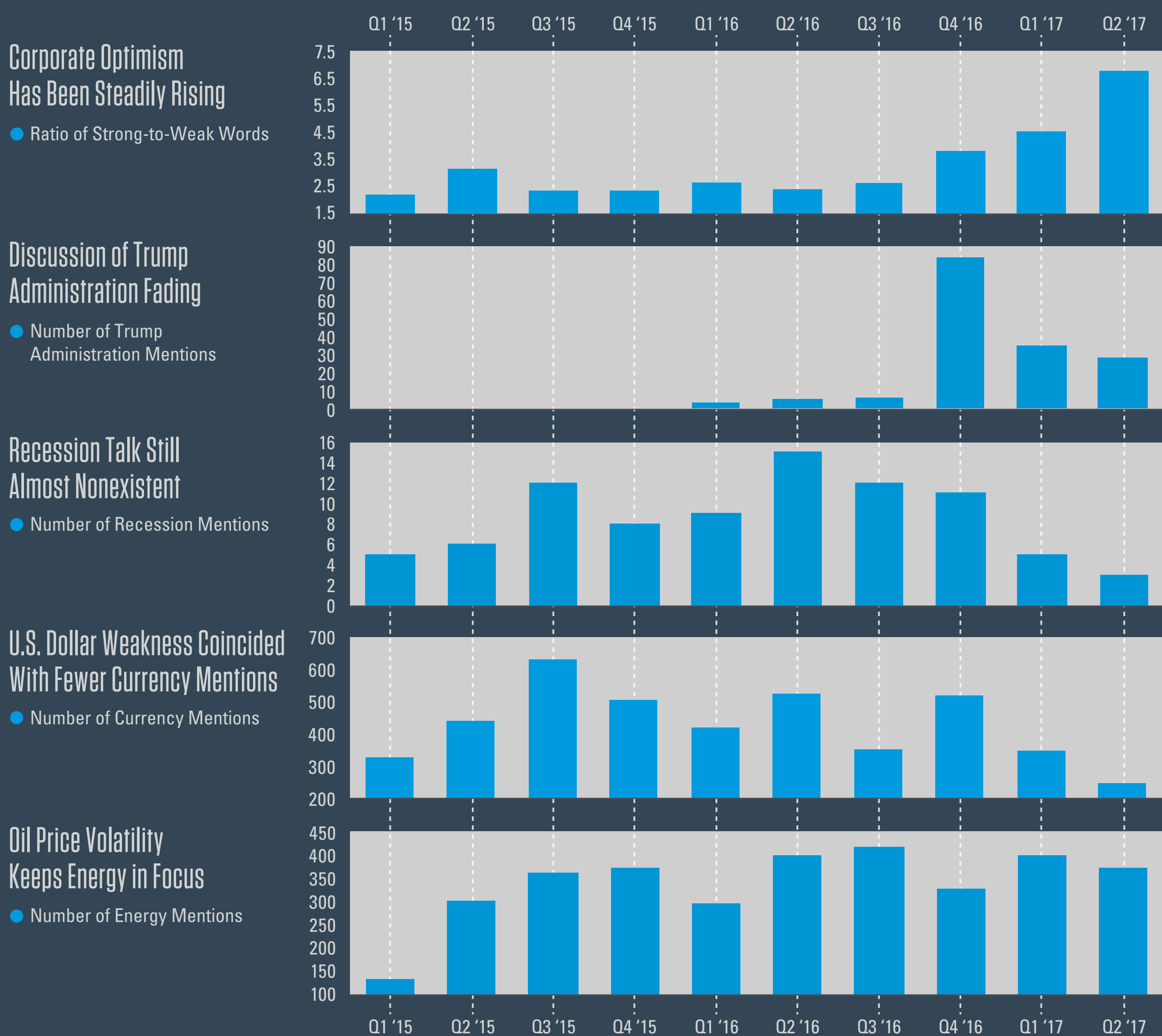
2 Corporate Optimism Has Been Steadily Rising

3 Discussion of Trump Administration Fading

4 Recession Talk Still Almost Nonexistent

5 U.S. Dollar Weakness Coincided With Fewer Currency Mentions

6 Oil Price Volatility Keeps Energy in Focus



Source: LPL Research, Company Reports, Bloomberg 08/25/17

Data represent number of mentions during second quarter 2017 earnings conference calls for companies that have reported as of 08/18/17 as compiled by Bloomberg.

Here are some excerpts from call transcripts supporting the improved economic and business sentiment:

- "We see moderate growth in the global economy. We expect U.S. gross domestic product (GDP) growth of 2.2% in calendar year 2017 and 2.5% in calendar year 2018. Consumer spending is solid, investment and trade are rebounding, and measures of business confidence remain high. —*Transportation*
- "The U.S. economic outlook remains solid, with job and wage growth sustaining consumer confidence and supporting continued economic expansion." —*Building materials*

FOCUS ON THE WHITE HOUSE HAS FADED

The amount of time since the election combined with the lack of fiscal policy initiatives that have been implemented led to a sizable drop in the number of mentions of the Trump administration over the past two quarters [Figure 3].

We can also look at policy-related words such as "tax" or its variants and see the same story. The word "tax" was mentioned over 400 times during fourth quarter 2016 earnings conference calls, compared to less than 100 during the second quarter 2017 reporting season. Over this period, mentions of "infrastructure" (34 to 18), "trade" (91 to 45), and "regulations" (39 to 3) have also fallen substantially.

This analysis suggests that the market's expectations for tax reform and other policy initiatives that the Trump administration and Republican leaders have proposed are low, presenting a potential opportunity for an upside surprise. That thesis is supported by recent underperformance of the so-called "Trump" trades such as small cap stocks (tax reform beneficiaries). A weaker U.S. dollar and gains in Treasuries are also inconsistent with policies promoted by the administration that are expected to tighten up trade rules, stimulate inflation, and push up Treasury yields.

WHAT IS THE CORPORATE BEIGE BOOK?

We use earnings conference call transcripts to gauge overall sentiment of corporate management teams, much like we have done with the Federal Reserve's (Fed) Beige Book to create our Beige Book Barometer (the Fed's Beige Book is a qualitative assessment of the U.S. economy and each of the 12 Fed districts). To create our Corporate Beige Book, we count the number of strong words (or variations of "strong") and the number of weak words (or variations of "weak") and calculate the difference between the two. Examples of strong words include "robust," "solid," and "optimistic"; examples of weak words include "soft," "fragile," and "pessimistic." We can then compare that differential with prior quarters to make comparisons over time. Although not every single call transcript is analyzed, we believe the trends observed provide valuable insights.

Here are some executives' comments on Washington, D.C. policy initiatives:

- "While I still believe that monetary policy is keeping rates artificially low, I also believe that elected officials need to do more on the fiscal policy front, especially through tax reform, to spur faster economic growth." —*Insurer*
- "Certainly, if we can find our way towards putting together an infrastructure bill, that would be very positive." —*Industrial equipment*
- "We continue to be cautiously optimistic that the stage is set for economic expansion. Offsetting that is a general uncertainty with respect to government policy, and economic initiatives, which may be putting a slight damper on corporate outlooks." —*Hotel*

NONEXISTENT TALK OF RECESSION

Corporate executives generally try to stay away from the "R" word (recession) when talking with investors, confirmed by the small number of mentions of the word over the past several years. But the second quarter took that to a new, low level with just three mentions [Figure 4] versus the quarterly average of nine since the first quarter of 2015. This data point, combined with our assessment of leading economic indicators, continues to point to low recession odds over the next year, as discussed in this week's *Weekly Economic Commentary*.

WEAKER DOLLAR LED TO FEWER MENTIONS

The amount of attention on currencies has fallen dramatically over the past two years, reflecting the stability and then weakness in the U.S. dollar. Currency mentions fell more than 20% for the second straight quarter and are at the lowest level since the first quarter of 2015 [Figure 5]. The drop makes sense given the U.S. Dollar Index has been down year over year since July 20, 2017, after approaching 20% year-over-year increases in early 2015. Currency had a marginal negative impact on overall S&P 500 earnings in the second quarter, and based on current exchange rates, could have a positive impact in the third quarter.

Here are several management comments on currency:

- "As a U.S. headquartered global company, currency translation has been a headwind on sales and earnings for more than a year. However, given the U.S. dollar weakening during the second quarter, and assuming those current exchange rates hold, we expect only a modest currency translation affecting our sales and earnings in the third quarter." —*Materials*
- "FX was mostly in line with our expectations, with one point of negative impact on total revenue growth, even with the slightly weaker than expected U.S. dollar." —*Software*

We see the potential for modest gains in the U.S. dollar over the balance of the year depending on the policy path in Washington, D.C., actions of global central banks, and movement in interest rates.

ENERGY STILL GETTING ATTENTION

Oil's rise from the mid-$20s per barrel in February 2016 to the low $50s late last year eased concerns about the negative impact on energy and energy-sensitive companies. Since then, oil prices have pulled back into the upper $40s; and while this is well above levels that had oil producers suffering, the topic continued to get a lot of attention from management teams this earnings season. In fact, oil and its variants (energy, gas, fuel, etc.) surprisingly got more mentions during this quarter than in the first quarter of 2016 [Figure 6], when oil bottomed. Hurricane Harvey's impact is likely to keep energy relevant during the third quarter, though we would expect attention on the topic to fade later this year should oil prices remain range bound.

CONCLUSION

Management sentiment during second quarter earnings season was quite positive which is hardly surprising given actual earnings results were so good and estimates of future earnings held up well. We believe the positive tone from management teams supports our outlook for further solid earnings gains, but will continue to report back as time progresses. ■

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, sector investing 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 USD 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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