

June 6 2016

A LOOK AT THE GAAP GAP

Burt White *Chief Investment Officer, LPL Financial*

Jeffrey Buchbinder, CFA *Market Strategist, LPL Financial*

KEY TAKEAWAYS

This week we take a look at the “GAAP gap,” the gap between reported and operating earnings.

The gap today is largely energy driven, and we see little in earnings data that might indicate a broader market downturn.

Analysis of prior periods with similar gaps reveals these gaps were largely reactions to downturns, not precursors to them.

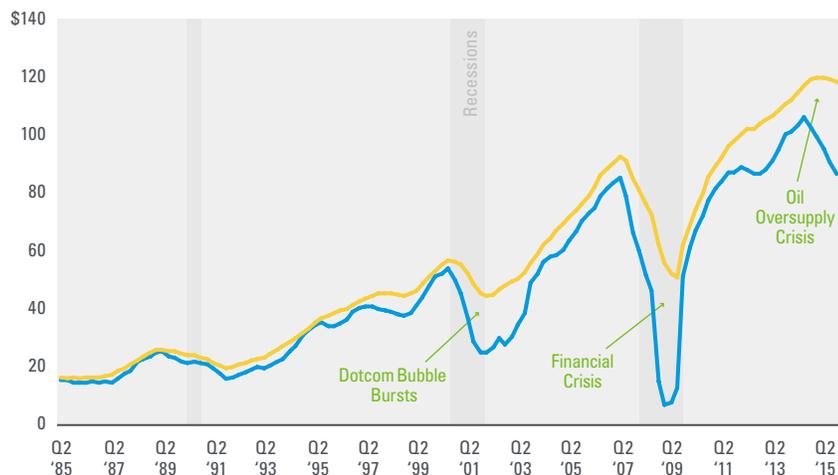
This week we take a look at what we call the “GAAP gap.” Currently, a wide gap exists between reported earnings and operating earnings for S&P 500 companies. We first introduced this topic briefly in our [first quarter 2016 earnings preview commentary](#) after the financial media began to focus on it as a potential bearish indicator. Some have tried to make a cause-effect relationship between this earnings divergence and bear markets, a connection we find extremely weak. Here we dig a little deeper into this issue and make the case that it should not be of much concern to investors.

SHOULD WE WORRY ABOUT THE GAAP GAP?

The large gap between operating earnings and GAAP earnings, shown in [Figure 1](#), has received a lot of attention from the financial media in recent months. Some have expressed the opinion that the size of the gap between these two earnings measures, 26% in the most recent four quarter period, is a signal of bigger earnings troubles ahead. We do not think so.

1 THE “GAAP GAP” WIDENS DURING CRISES

- S&P 500 GAAP EPS
- S&P 500 Operating EPS



Source: LPL Research, FactSet, Thomson Reuters, Standard & Poor's 06/03/16

GAAP = generally accepted accounting principles

EPS = earnings per share

The S&P 500 is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

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.

The biggest reason for the latest gap, which reached 27% in 2015, has been the energy downturn, which led to significant downward adjustments to valuations of oil and gas assets. The drop in energy sector earnings had nothing to do with accounting or earnings quality, and everything to do with the sharp drop in oil prices (largely a supply problem, with some help from the strong U.S. dollar). With crude oil prices near \$50 per barrel and the S&P 500 within 2% of its all-time high, the market has looked past the earnings discrepancy, which is still 19% as of the end of the first quarter of 2016, as we think it should.

HISTORICAL PERSPECTIVE

Similar gaps were observed during the tech crash in the early 2000s and the financial crisis during 2008–09. These periods witnessed sharp asset devaluations (similar to the devaluation of energy properties). During the internet bubble and subsequent accounting crisis (think Enron/Worldcom), the gap between the operating measure and GAAP earnings got as high as 40%. But the widening gap provided little warning. During the first quarter of 2000, near the stock market bubble highs, the gap was just 4%. By the time the gap peaked, the 2001 recession was over and the bear market well underway.

The gap did widen significantly ahead of the October 2002 stock market lows during the Enron/Worldcom crisis. However, we have a hard time interpreting this concentrated accounting fraud situation, which is focused on a small handful of companies, with any warning we might try to find in current earnings data. This period is not very comparable.

The financial crisis, like the tech bubble and today's energy downturn, was also concentrated largely in one sector. The gap reached an extreme level during the fourth quarter of 2008, peaking at more

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 of 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 more difficult.

than 80% in mid-2009 just after the stock market bottomed. But the gap did not meaningfully narrow until the end of 2009, and by then the S&P 500 had already rallied nearly 70% off of its lows. Not a great market timing tool.

Beyond the concentration in one sector, we see little parallel between today's earnings gap and the one during the financial crisis, which had much more to do with the excess leverage and bad loans than earnings quality. Poor earnings quality may have exacerbated the problem later, but the widening earnings gap was a symptom of a long illness.

FALSE SIGNALS

One piece of evidence to suggest that a widening gap between these earnings measures is not a precursor of a market downturn is that the gap widened to above-average levels in 2012, ahead of the powerful 2013 stock market rally when the S&P 500 rose 30%; and 2014 was another double-digit year for the S&P 500.

A jump in the gap in late 1991 was another false signal, as 1992 and 1993 were both solid years for stocks after a nearly 30% gain for the S&P 500 in 1991. We do not have many periods for comparison, but we have enough to be skeptical of the current earnings gap as a signal of major market weakness ahead.

Bottom line, these periods of divergent earnings measures have had clear causes that have been unrelated to the causes of the market downturns. They reflect reactions to downturns, not precursors of them. We continue to expect an earnings rebound in the second half of the year and for the earnings gap to narrow as the energy sector continues to heal.

CONCLUSION

We do not believe market participants should worry about the gap between GAAP earnings and operating earnings. The gap today is largely energy driven and not indicative of a broader earnings quality problem, in our view. Analysis of prior periods with similar gaps reveals these gaps were largely reactions to downturns, not precursors of them. We see little in the earnings data across the broad market that might lead to a broader market downturn.

We would continue to focus on fundamental and market indicators that have historically provided better early warning signs that the economic cycle was nearing its end, such as those we highlight in our [Recession Watch Dashboard](#).

Please see our [“Corporate Beige Book”](#) edition of the *Weekly Market Commentary* and our [“Earnings Recession”](#) Thought Leadership report for more on earnings. Look for much more on this topic in our upcoming *Midyear Outlook* publication. ■

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.

This research material has been prepared by LPL Financial LLC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial LLC is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by Any Government Agency | Not a Bank/Credit Union Deposit

RES 5510 0616 | Tracking #1-503959 (Exp. 06/17)