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OVERSEEING POOR EARNINGS OVERSEAS

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KEY TAKEAWAYS

Corporate earnings, the most important factor in market performance, were poor in developed foreign markets last quarter.

Forecasts for future earnings have been improving in emerging markets and Europe, but have declined dramatically for Japan.

Strength out of the German DAX could be one clue that better times are ahead for Europe.

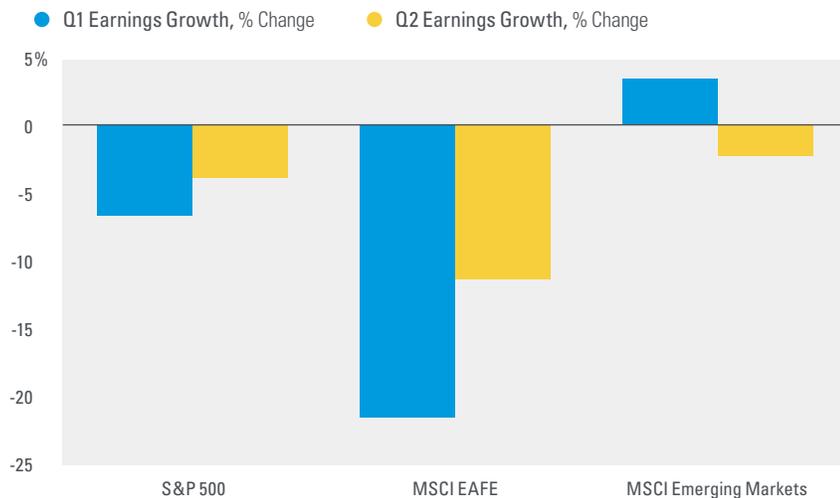
Macroeconomics and geopolitics are interesting to discuss, but earnings are what drive markets.

We tend to forget that truism when dealing with international markets. The recent Brexit vote and discussions on how, and even if, the United Kingdom will eventually leave the European Union have dominated the news, and especially social media. However, the biggest problems facing developed foreign markets are not politics or economics, but the inability of non-U.S.-based companies to grow earnings and revenue. In Europe, earnings are falling faster than revenue, though expectations have been improving for growth in both metrics. The earnings picture in Japan remains very troubled. Overall, we are looking for a turnaround in earnings and earnings expectations before becoming optimistic on developed foreign equities.

AMATEURS VS. PROFESSIONALS

There is an old expression in the military that “amateurs discuss strategy, professionals discuss logistics.” For investors, we can translate that to

1 EARNINGS DECLINE — BETTER, BUT STILL NEGATIVE



Source: LPL Research, FactSet 08/12/16

We use FactSet as it allows us to be consistent in all regions and countries. When look at U.S. data only, we use Thomson Reuters.

All calculations are in local currency.

All indexes are unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

“the macro matters, but ultimately markets move on earnings.” Earnings season is, for the most part, over in the U.S., but we are still in the tail end of earnings for developed international stocks, with 76% of firms reporting as of August 11, 2016. Emerging markets (EM) earnings season is just beginning, with less than half the companies releasing earnings as of this date. We will provide an update on EM earnings in September after more companies have announced results.

Unfortunately, revenue and earnings in developed foreign markets are in reverse [Figure 1]. If the U.S. is experiencing an “earnings recession,” then overseas stocks are in an “earnings depression.” The decline in both revenue and earnings is surprising. Though both Europe and Japan have economies that are sluggish at best, they have managed to avoid recession. There are many possible culprits for such poor corporate performance, most recently, the uncertainty created by late June’s Brexit vote. The true reasons likely run deeper. The two biggest problems in developed markets are demographics and rigid labor markets, which make hiring and firing workers difficult.

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LOOKING THROUGH THE NUMBERS

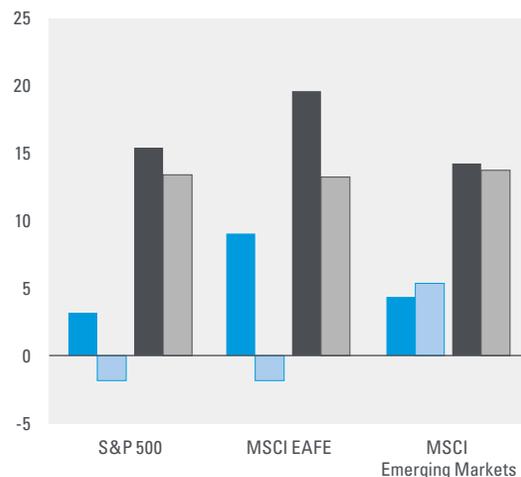
What matters most to financial markets are not historical earnings, but forecasts for future earnings and how these forecasts evolve over time. Wall Street analysts tend to be overly optimistic about future earnings, reducing forecasts as earnings season approaches. There are two data points related to earnings: the release of current earnings and revisions to future earnings. The current earnings reporting season is following the typical pattern, with forecasts coming down since the

beginning of the year [Figure 2]. Two things are striking about this chart. Earnings estimates for emerging market equities in the third quarter of 2016 have *increased* in the past few months, and the outlook for next year’s earnings are essentially unchanged. However, for developed international markets, estimates for both next quarter and next year have fallen — dramatically.

The investment industry has historically considered Europe and Japan together, classified as developed foreign markets and included in the MSCI EAFE Index, which most asset allocators use as a primary asset class. Investors typically use diversified international strategies with EAFE as their benchmark to implement this allocation. However, the two regions have very different economies and market systems and should be evaluated separately. For example, expectations for next year’s earnings growth for Japan were reduced from 19.2% as

2 REGIONAL EARNINGS EXPECTATIONS

- Q3 Estimate, March 31
- 2017 Estimate, March 31
- Q3 Estimate, August 11
- 2017 Estimate, August 11



Source: LPL Research, Thomson Reuters 08/11/16

The earnings expectations set forth in the presentation may not develop as predicted.

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of the end of March 2016, to 9.3% as of August 11, 2016. Much of this decline comes from reduced expectations for automobile and industrial equipment companies, companies that are heavily impacted by the stronger Japanese currency, the yen. Expectations for growth in European earnings for 2017 were reduced from 20.1% to 16.2% over the same period. Most significantly negatively impacted are financial stocks, which are potentially the most directly impacted by Brexit, as well as by negative interest rates. Conversely, expectations for energy companies have been improving with higher oil prices. We use local currency figures, not U.S. dollars when examining earnings. Currency movement matters, as it affects the actual earnings and may be an investment consideration for those outside the country. But the earnings in local currency are what investors in that country will be looking at when making their decisions.

CLOSER LOOK AT GLOBAL RETURNS

Taking a step back from earnings and looking at various country stock market returns shows a mixed backdrop in Europe, while Japan continues to lag. Japanese earnings continue to disappoint, contributing to the Nikkei 225, down 11%, being one of the worst performing stock indexes in 2016. What would come in as one of the bigger surprises of 2016 though is that since the Brexit vote, the British FTSE 100 is up 9.1% to a new 52-week high—making it one of the top performing stock markets in the world [Figure 3]. These returns would have been hard to predict the morning after the vote to leave, with global markets declining sharply. Sparking the surge in the British equities was a huge drop in the British pound, which helps the export-heavy U.K. economy.

3 HOW HAVE VARIOUS COUNTRIES' STOCK MARKETS DONE?

Index	Country	Price	Returns	
			Returns Since Brexit (06/23/16)	YTD
FTSE 100	Britain	6916.02	9.1%	10.8%
Hang Seng	China	22766.91	9.1%	3.9%
DAX	Germany	10713.43	4.4%	-0.3%
Nikkei 225	Japan	16919.92	4.2%	-11.1%
S&P 500	U.S.	2184.05	3.3%	6.9%
ATX	Austria	2284.53	1.9%	-4.7%
AEX	Netherlands	454.09	0.9%	2.8%
CAC 40	France	4500.19	0.8%	-3.0%
EURO STOXX 50	Europe	3044.94	0.2%	-7.4%
FTSE MIB	Italy	16997.83	-5.4%	-20.6%

Source: LPL Research, FactSet 08/12/16

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POSITIVE TECHNICAL DEVELOPMENT?

Germany continues to be one of the most (if not the most) important countries for the overall health of Europe. Some of the recent German economic data have been strong, led by last week's (August 8–12, 2016) second quarter report on gross domestic product (GDP), which showed a better than expected 0.4% gain. As [Figure 4](#) shows, since the Brexit vote, the German DAX has been a leader—a potential sign that the largest economy in Europe could be signaling future strength for Europe in general.

Last, there is a very positive technical development looking at the German DAX, as it recently broke above a bearish trend line going back 16 months. Many times we have seen markets lead economic data by as much as six to nine months, and this recent improving price action out of Germany could be another clue that an improving German economy, and likely European economy, could be coming later this year.

4 THE GERMAN DAX BREAKS OUT



Source: LPL Research, FactSet 08/12/16

The German DAX is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

CONCLUSION

Financial markets were clearly overly optimistic regarding both European and Japanese earnings earlier this year. Earnings have been very disappointing, and near-term estimates have been reduced. But looking to next year, analysts are still positive overall on these markets. The market is already looking to the future, beyond recent earnings weakness, though some uncertainty remains, particularly around Brexit. Should the German DAX continue to lead, it may be a step in the right direction for European markets in general. While reasons for optimism on foreign equities exist, we want to see some of these potential points of improvement come to fruition before we can recommend increasing investment overseas. ■

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.

All investing involves risk including loss of principal.

International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. These risks are often heightened for investments in emerging markets.

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 MSCI EAFE Index is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America: Europe, Australasia, and the Far East.

The MSCI Emerging Markets Index captures large and mid cap representation across 23 emerging markets (EM) countries. With 822 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The DAX (Deutscher Aktienindex (German stock index)) is a blue chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange. Prices are taken from the Xetra trading venue.

The FTSE 250 Index is a capitalization-weighted index consisting of the 101st to the 350th largest companies listed on the London Stock Exchange. The FTSE 100 is a subset, comprised of the 100 largest companies traded on the London Stock Exchange.

The Nikkei Index is short for Japan's Nikkei 225 Stock Average, the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the United States. In fact, it was called the Nikkei Dow Jones Stock Average from 1975 to 1985.

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