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Mast Report *Making the Important Decisions*

CORPORATE EARNINGS UPDATE

MAY 10, 2017

This report on corporate earnings is based on operating earnings for the Standard & Poor's 500 Index. Earnings on both a per share basis and a dollar basis are used in the analysis. The source for S&P 500 earnings is S&P Dow Jones Indices. This information can be found at its website us.spindices.com. The data on earning in this report are as of May 4th.

Rates of change in S&P 500 earnings differ depending on what series of earnings is used and on the source used. This report uses operating earnings. S&P Dow Jones also provides data on reported earnings for the S&P 500. Reported earnings comply with generally accepted accounting principles (GAAP), whereas operating earnings are not required to do so. This makes reported earnings the better series to use from an accounting perspective. Operating earnings per share for the S&P 500 Index are more highly correlated with the S&P 500 Index itself than are reported earnings per share. In my assessment, operating earnings are the better series to use if one's primary application is stock valuation and estimating future rates of return on the S&P 500 based on market information (prices and yields) and earnings. This is the reason I use operating earnings in reports on corporate earnings and to compute valuation measures and expected rates of return for the S&P 500 Index.

Also, rates of change in earnings per share can differ among sources of earnings for S&P 500. For example, articles on aggregate corporate earnings that appear in the Wall Street Journal usually cite either Thompson Reuters or FactSet as the source. I decided to use S&P Jones Indices as the source for S&P 500 earnings for the seemingly obvious reason, it's their index, and because of the abundance of historical data S&P Dow Jones Indices provides. Also, in some financial media articles, the earnings series used, e.g. reported, operating, or other series, is not specified. So, if you see articles that report rates of change in S&P 500 earnings per share that differ from those in this report, it is likely because it comes from a different source or uses different earnings series, or both. But at least you know what is used in this report and why.

S&P 500 operating earnings per share have been rebounding since the end of the second quarter 2016. Trailing four quarters' earnings at that time were 98.17, and had declined from a prior peak of 114.51 in the third quarter of 2014, a drop of 14.3%. Current estimates as of May 4th indicate that trailing four quarters' earnings per share in the first quarter of 2017 were 111.72, this is an increase of 13.8% from the low in the second quarter of 2016. But as can be seen, trailing four quarters' earnings remained 2.4% below their third quarter 2014 peak.

The major source of the rebound in S&P 500 trailing four quarters' operating earnings since the second quarter of 2016 has been the substantial improvement in operating results for the energy sector. In the second quarter of 2016, the energy sector had recorded an operating loss of $45,527 million over the prior four quarters. In the first quarter of 2017, it is estimated that operating earnings in the energy sector were

$8,051 million over the prior four quarters. The $53,578 improvement in trailing four quarters' operating earnings in the energy accounted for 50.3% of the increase in trailing four quarters' operating earnings for the entire S&P 500 from the second quarter of 2016 to the first quarter of 2017.

In dollar terms, trailing four quarters' operating earnings for the S&P 500 in the first quarter of 2017 were up 12.3% from the second quarter 2016. The slightly larger increase of 13.8% in per share operating earnings for the S&P 500 is accounted for by a reduction in shares outstanding, largely the result of corporate buybacks. Trailing four quarter dollar operating earnings for all other sectors combined rose by 5.8% from the second quarter of 2016 to the first quarter of this year.

Oil prices are widely followed and provide a crude gauge of energy sector profitability. When trailing four quarters' operating earnings were at their recent peak in the third of 2014, the price of oil over prior twelve months averaged $99.30. When trailing four quarters' operating earnings for the S&P 500 were at their recent low in the second quarter of 2016, the average price of oil over the prior twelve months was $41.97. The rebound in S&P 500 operating earnings since the second quarter of 2016, of which the energy sector has accounted for slightly more than half, has been accompanied by an increase in the prior twelve month average price of oil to $47.95, an increase of 14.2% since mid 2016. Energy sector profitability, which is significantly related to and caused by the price of oil, has had and will continue to have a significant impact on S&P 500 earnings.

Sectors other than energy have accounted for the remaining 49.7% of the improvement in trailing four quarters' operating earnings for the S&P 500 since the second quarter of 2016. The major contributors were information technology (15.2%), basic materials (12.8%), and healthcare (11.4%). The sizable contributions from the information technology and health care sectors are significantly due to their large size. The contribution of the basic materials sector is related to levels and changes in broad commodity prices, similar to the impact of oil prices on the energy sector.

Operating earnings per share for the S&P 500 are currently estimated to have increased by 22.8% in the first quarter of 2017 from the first quarter of 2016, with dollar operating earnings up 20.9%. Again, the difference between these rates of change is a reduced number of shares outstanding. Of the change in dollar operating earnings for the S&P 500 in the first quarter of this year from a year ago, 34.1% was accounted for by improving operating profitability in the energy sector. Dollar operating earnings from all other sectors combined are estimated to have increased by 12.2%.

Further increases in S&P 500 operating earnings are forecast for the second quarter of this year, based on analysts' earnings estimates compiled by S&P Dow Jones Indices. S&P 500 operating earnings per share are expected to rise by 22.3% in the second quarter from the second quarter of 2016. Of the increase in dollar operating earnings for the S&P 500 in the second quarter, 30.2% is forecast to have come from the energy sector. Dollar operating earnings for all other sectors combined are forecast to rise by 13.9% in the second quarter from a year earlier.

Analysts' earnings estimates currently call for S&P 500 operating earnings per share for the full year 2017 to increase by 22.1% from 2016 to a level of 129.71. Operating earnings per share for the S&P 500 rose by 5.8% in 2016 from 2015. For 2017, 28.3% of the increase in dollar operating earnings for the S&P 500 is currently forecast to come from the energy sector. Rising operating earnings from the information technology sector are also forecast account for 28.3% of the increase in S&P 500 operating earnings, with health care accounting for 16.4%. Excluding the energy sector, operating earnings for all other sectors combined are forecast to rise by 15.0% in 2017 from 2016.

For continued strong earnings to be realized several things need to occur. Global economic growth has to continue to improve. This includes better growth in the U.S. following a slow start to the year in the first quarter. Annualized growth in real GDP in the U.S. for the second quarter of 3.6% is currently estimated by the Federal Reserve Bank of Atlanta's GDP Now analysis. Oil and commodity prices cannot drop significantly over the remainder of this year, as this would seriously dampen energy sector earnings. China poses the greatest risk to both global growth and oil and commodity prices. Senior officials in China, led by President Xi Jinping, are increasingly concerned about debt levels in China and substantial increases in lending for more speculative purposes. Much, if not most of the recent decline in oil and commodities' prices stems from efforts to dampen growth in debt and lending in the Chinese economy. A material deleveraging in China poses the most significant risk to the global economy at present.

The third thing that has to occur for S&P 500 operating earnings to achieve the strong forecast increases over the remainder of this year is earnings from the big three sectors in terms of dollar operating earnings - information technology, financials, and health care. If current operating earnings for 2017 are realized, information technology will have accounted for 22.0% of the increase in total operating earnings for the S&P 500, followed by financials, 18.6%, and health care, 15.3%. At its recent peak in 2010, the energy sector accounted for 12.5% of total S&P 500 earnings, and the average price of oil in 2010 was $79.44.

Large gains in operating earnings for the S&P 500 will significantly depend on the following. Oil prices will need to get back to and stay above at least $55. The Federal Reserve will need to gradually increase its target for the federal funds rate and long-term Treasury bond yields will also have to rise to keep the yield curve very positively sloped. This is key to the profitability of banks and many other financial companies. And finally, the big technology companies will have to deliver solid increases in earnings.

Strongly growing corporate earnings, along with sustained increases in dividends in the 5%-6% range for the S&P 500, are a necessary requisite for further gains in stock prices. Expected long-term real rates of return for the S&P 500 Index, 4.03% as of May 9th, remain well below historical norms. In addition to rebounding earnings and sustained growth in dividends, the major reason why stock prices have continued to move higher has been the absence of significant return competition from low risk assets, notable long-term Treasury bond yields. The yield on the 30-year Treasury bond has moved up from 2.84% on April 18th to 3.04% on May 9th. Over this period the expected long-term rate of inflation has increased by only a single basis point to 2.06%. The real long-term Treasury yield (long TIPS yield) has increased from 0.85% on April 18th to 1.04% at present. As a result, the expected long-term equity risk premium has narrowed from 3.27% in April 18 to 2.99%. The expected long-term equity risk premium has not been below 3% for any sustained period since the end of 2007. While one can always expect heightened investor euphoria to drive stock prices higher, from a fundamental standpoint earnings and dividends are a necessity for higher stock prices with the expected equity risk premium at 3% and the long TIPS yield edging higher.

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