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Earnings Disappoint But Economic Growth On Track

Third-quarter earnings have been slightly below lowered expectations on average. The S&P 500's blended Q3 2012 earnings growth rate is -1.2% (with 245 companies reporting so far, according to FactSet Research Systems), which will end an 11-quarter streak of earnings growth if it remains negative. Revenue growth has also disappointed, with about 36% of reporting companies failing to meet sales expectations. We think weak sales and earnings are related to slower business investment spending evidenced in third-quarter GDP (see Weekly Chart). We think businesses are holding back investment due to uncertainty over the US fiscal cliff and the European financial crisis. If these issues are resolved favorably over the next few months, as we expect, earnings could reaccelerate in 2013.

We think much of the softness in company sales and earnings is related to the slower investment spending evidenced in US third-quarter GDP. Gross domestic private investment was still positive but continued to shrink, contributing just 0.2 percentage points to GDP, down substantially from well over one percentage point last year.

Despite this fading earnings momentum and the likelihood that its cause (political uncertainty) continues into the fourth quarter, analyst consensus estimates are forecasting low-teens growth for the fourth quarter and into 2013. These figures seem overly optimistic to us; we are expecting only single-digit earnings growth at best. Although this would require analysts to lower their estimates, stocks' best performance has historically come when earnings growth is slightly negative to mid-single digits. Thus, we do not expect decelerating earnings growth to end the cyclical bull market; instead, we expect the S&P 500's QE-fueled 38% annualized trend from June through September to fall to a more moderate and sustainable pace.

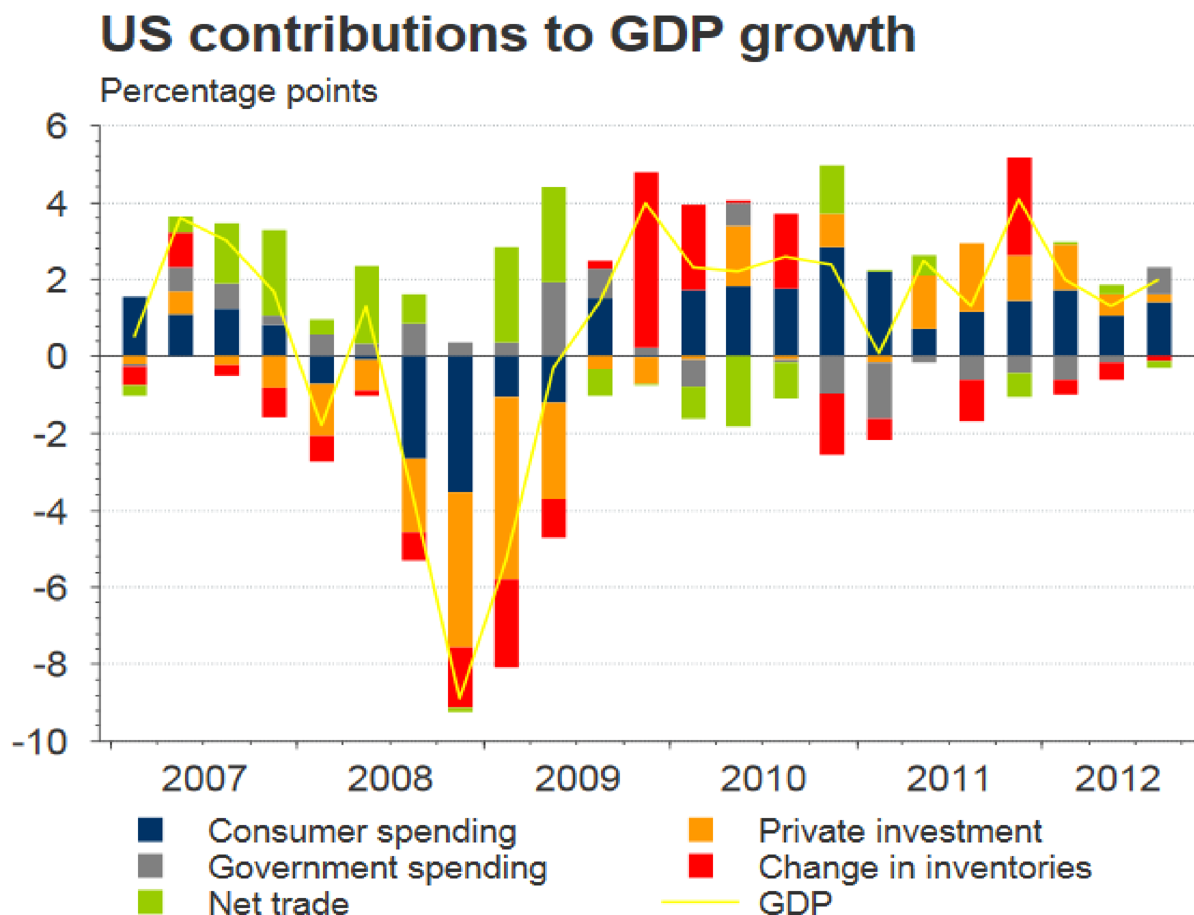
With investor focus shifting from central bank monetary stimulus* to earnings and economic fundamentals, the S&P 500 is down 3.4% from its Oct 17th high, but remains at technical and valuation support levels consistent with a 'normal' pullback in a cyclical bull market. Our 'shallow' retracement level of 1428 was breached last week while support at 1400 has held; a short-term positive. We see 1370 as the low end of a typical pullback to just below the 200-day moving average and a potential bottom during earnings season and the elections. *(*The Bank of Japan's meeting Tuesday could prove significant: investors are anticipating a substantial increase in the bank's balance sheet in order to reach its 1% inflation target [which it has been unable to achieve] and weaken the yen.)*

The US' third-quarter GDP growth accelerated to 2% annualized from 1.3% in the second quarter, slightly exceeding consensus expectations, led by consumer and government spending. Notably, government spending has contributed positively to economic growth for the first time in two years, mainly because of increased defense spending and a pause, if not the end, of state and local government cutbacks. We do not expect government spending to positively contribute to GDP growth next year. In RiverFront's base-case scenario, to which we assign a 50% probability, government spending would subtract about one percentage point of growth (as most of the fiscal cliff is averted or postponed but the first steps toward deficit reduction are taken) leading to around 1% 'new normal' growth in 2013. In our optimistic scenario — prompted by effective policy response from all three major economic blocs (US, Europe, and China) — trade and investment would rebound, producing 2% US economic growth. We currently attach a 30% probability to this scenario. In our pessimistic scenario, a 20% probability, domestic and global policy inaction would lead to a global recession and a 2% decline in US GDP.

Given our weighted-average view of the odds, we think the S&P 500 is likely to track single-digit earnings growth next year, with possible multiple expansion if our optimistic scenario's growth rate occurs. Hence, we think 10% upside for the S&P 500 towards 1540 is achievable in the first half next year (18 times 2014 second-quarter trend earnings of $85.69) with further upside to new all time highs if our optimistic scenario unfolds. On the downside, a global recession could bring the S&P 500

below 1200 (based on 14 times 12-month forward trend earnings). If our probability estimates on the three economic scenarios are correct, equity markets offer a compelling risk-reward, particularly in contrast to record low yielding investment grade bonds. We believe that high quality bonds have limited upside in any non-deflationary scenario, and that such a scenario is unlikely with virtually every central bank lowering rates and/or expanding their balance sheets. Meanwhile, in our more likely baseline to optimistic scenario, rising Treasury yields mathematically guarantee significant investor losses. For example, a one percentage point increase in 10-year Treasury yields would incur a -6.6% total return from current levels. Thus, we continue to prefer relatively 'riskier' assets like stocks.

THE WEEKLY CHART: HOUSEHOLDS & GOVERNMENT DROVE THIRD-QUARTER GDP GROWTH; BUSINESS INVESTMENT AND TRADE DETRACTED



Consumer spending accounted for 1.4 percentage points of the 2% third-quarter US GDP growth (blue bars in our Weekly Chart). Household consumption focused mainly on goods (e.g., cars, home furnishings, and clothing) and contributed one percentage point to GDP. The rest of household consumption was service expenditures — contributing 0.4 percentage points — with health care and financial services actually contracting. Government (grey bars) was the next largest contributor at 0.7 percentage points of third-quarter growth, coming mostly from defense expenditures, with state and local government notably no longer subtracting from growth. Gross domestic private investment (orange bars) was still positive but continued to shrink, contributing just 0.2 percentage points to GDP, down substantially from well over one percentage point last year. Software and residential investment (new home and apartment construction) were the only bright spots, keeping the private investment category in the positive column. We expect business spending will likely ramp up after the uncertainty surrounding elections and resolution of the 'fiscal cliff' eases, whichever party wins. Inventory changes (red bars) subtracted about 0.1 percentage points, which was less than recent quarters, suggesting that businesses are running lean inventories heading into the holidays. Finally, trade (exports minus imports, green bars) subtracted almost 0.2 percentage points of growth, with the volume and value of US exports falling as Europe (still the US' largest trading partner) contracts.

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