STANDARD & POOR'S

What's on the Horizon for the Rest of 2011?

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Midway through 2011, Americans can't be blamed for feeling uncertain about what to expect from investment markets and the economy during the second half of the year. On the one hand is the optimism generated by widespread expectations of impressive growth in this month's second-quarter corporate earnings reports. On the other, numerous domestic and global economic woes continue to linger, casting dark clouds on the prospects of a robust recovery.

S&P's Senior Economist, Beth Ann Bovino, recently wrote, "The U.S. economic recovery is in the midst of a soft patch with key economic indicators weak through mid-June … The concern facing markets is whether the soft patch will lead into something more severe for the economy. We believe that the current soft patch is another bump in the road, though not big enough to derail the recovery, as the economy will likely continue to recover at half-speed."[1]

Eyes on Equities

In the near term, upbeat headlines about earnings are likely to cheer equity investors. According to S&P's Capital IQ, consensus estimates for Q2 earnings project a 15.6% increase in year-over-year operating results for the S&P 500. The greatest advances are expected to come from the Materials (+60.6%), Energy (+38.1%), and Financials (+17.5%) sectors. The weakest showings should come from the Consumer Staples (+9.4%), Health Care (+4.2%), and Utilities (+2.3%) groups. Telecom Services is expected to see a slight earnings decline.[2]

Capital IQ S&P 500 Consensus EPS Estimates

	Year-Over-Year % Changes						
Operating EPS Y/Y % chgs.	**2011 Quarterly Results**				**Annual Results**		
S&P 500 Sector	**Q1A**	**Q2E**	**Q3E**	**Q4E**	**2010A**	**2011E**	**2012E**
Energy	40.1	38.1	54.2	30.4	63.6	40.2	9.1
Materials	53.9	60.6	38.6	26.4	66.1	44.8	13.5
Industrials	32.2	10.8	18.5	14.6	31.1	18.1	18.3
Consumer Discretionary	15.1	10.7	19.6	14.2	4.1	14.8	16.0
Consumer Staples	8.4	9.4	11.1	9.7	9.1	9.7	10.2
Health Care	9.4	4.2	4.8	6.5	37.7	6.2	5.8
Financials	11.6	17.5	14.3	36.5	78.5	19.8	22.5
Information Technology	25.1	11.7	7.9	9.2	59.0	12.8	12.4
Telecommunication Services	(5.0)	(0.1)	16.0	17.9	61.6	6.4	13.8
Utilities	(2.0)	2.3	(1.4)	2.0	(9.4)	(0.1)	0.1
S&P 500	**19.7**	**15.6**	**16.9**	**17.2**	**37.9**	**17.3**	**13.1**

Source: S&P's Capital IQ.

Reasons for this wide range of returns vary greatly with each sector, but factors consistent to all include a 2.9% year-over-year increase in real GDP, the fallout from the supply disruption caused by the natural disaster in Japan, severe weather in the United States, a

13.5% decline in the value of the U.S. dollar, and a 26% rise in commodity costs per the S&P GSCI (formerly known as the Goldman Sachs Commodity Index).[2]

Looking beyond July's headlines, S&P analysts see the S&P 500 reaching 1350 by year-end and 1400 a year from now. They also believe increased macroeconomic uncertainty and tougher EPS comparisons are likely to reduce equity appreciation relative to strong 2009 and 2010 gains, and that dividend yield will thus represent a greater share of U.S. equity total return this year.[3]

Wither the Economy?

The Federal Reserve continues to vow to keep U.S. interest rates low for an "extended period of time." What is more, Chairman Bernanke recently reiterated that no new quantitative easing program, or QE3, is in the works for this year. However, interest rates are already at historic lows, the U.S. economy is continuing to grow, and fears are rising that inflation lurks around the bend. With that in mind, it doesn't take an expert to conclude that U.S. interest rates have only one way to go: up. The questions, then, are: how fast, how much, and will upcoming moves derail the recovery before the year is done?

S&P predicts the Fed will not start increasing interest rates before early 2012, giving the economy more time to heal, but will then continue to do so through 2014, when they reach 4.0%.[4]

Of course, U.S. corporate performance and financial policy alone won't determine the outcome of 2011. For example, Europe's still-unfolding sovereign debt crisis has underscored the potential fragility of the global economic recovery, sending stocks up or down on an almost weekly basis - and calling into question the U.S. government's long-term ability to finance its own debt burden.

Furthermore, the all-important U.S. housing market remains stuck in a deep rut. Although home prices increased in April for the first time in nine months, S&P believes home prices could decline up to an additional 5% below their early 2009 lows this year as sales slowly improve.[5]

So halfway through 2011, is the glass half empty or half full? Only time will tell with certainty.

[1]Source: S&P Equity Research Services, "Second-Half 2011 Investment Outlook: Risks to the Forecast," June 28, 2011.

[2]Source: S&P Equity Research Services, "Second-Quarter EPS Outlook," July 5, 2011.

[3]Source: S&P Equity Research Services, "Finding a Floor," June 29, 2011.

[4]Source: Standard & Poor's Ratings Direct, "It's Only Up From Here," June 29, 2011.

[5]Source: Standard & Poor's Ratings Direct, "The S&P/Case-Shiller Home Price Indices Rose in April, Temporarily Easing Concern Over A Housing Double Dip," June 28, 2011.