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## U.S. Earnings Update

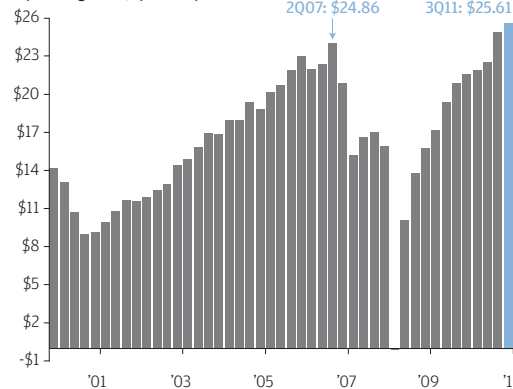
### Record-setting earnings, growth, and surprises

As 3rd quarter earnings season winds down, more than 90% of the S&P 500 market cap has reported, and it appears we're headed for another quarter of record-breaking results. Our estimate for 3rd quarter operating EPS is currently running at \$25.61, exceeding the previous peak of \$24.86 set in 2Q 2011, and up roughly 19% from a year ago.

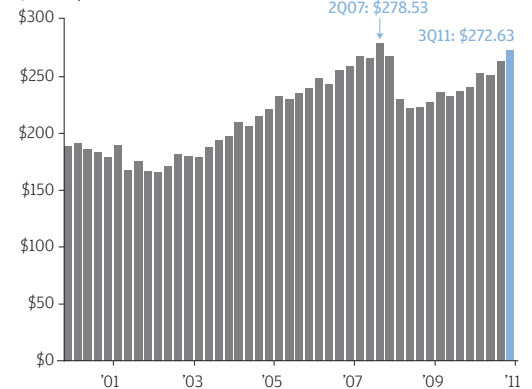
However, perhaps what's even more impressive than the earnings growth is the revenue growth we've observed across all 10 S&P 500 sectors. The index is currently tracking revenue growth of roughly 13% year-over-year, a clear indicator earnings have been boosted by more than cost cutting. To be sure, margins have also widened out, which has helped fuel earnings growth over the past two years, something we'll touch on in more detail in the coming pages.

### EXHIBIT A: S&P 500 Operating EPS and RPS

S&P 500 Earnings Per Share  
Operating basis, quarterly



S&P 500 Revenue Per Share  
Quarterly



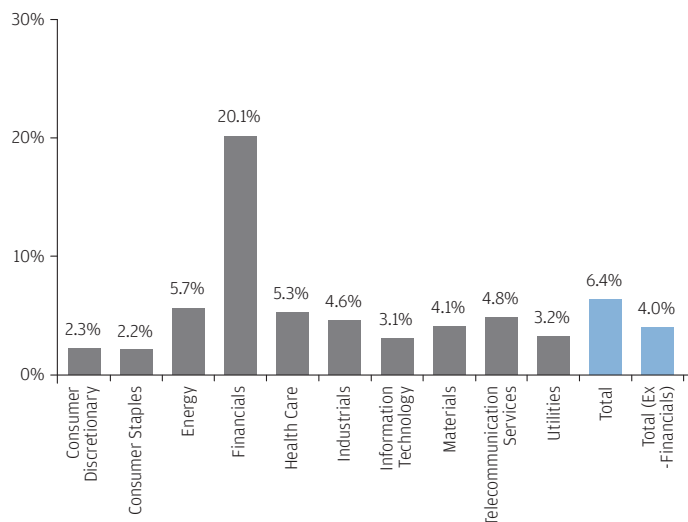
Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management. 3Q11 numbers are JPMAM estimates.

As we focus on the drivers of earnings growth in the 3rd quarter, it's important to understand how the individual sectors have contributed.

Exhibit B highlights the average earnings surprise in each sector relative to analyst estimates; here we can see how each sector has played a role in this quarter's results. Overall, S&P 500 companies surprised analyst estimates on the upside by an average of 6.4%. While the surprises have been somewhat similar across sectors, one outlier in particular jumps out. Financials have, on average, surprised analyst estimates by 20.1%, and were clearly a driving force behind this quarter's results. As such, it's important to dive a bit deeper to understand what really drove earnings.



**EXHIBIT B: Q3 Earnings surprise by sector**



Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

### Understanding financials and the debt valuation adjustment

In February 2007, the Financial Accounting Standards Board (FASB) issued the Statements of Financial Accounting Standards number 159, *The Fair Value Option for Financial Assets and Liabilities* (also known as FAS 159). Once this standard was put in place, each bank was forced to make a decision as to which assets and liabilities were going to be accounted for under the new fair value method, and then make the necessary adjustments each quarter. The idea was that banks would be required to mark-to-market their assets on a quarterly basis; if this forced banks to raise capital as the value of their assets fell, it would, in theory, make the U.S. financial system safer. The standard, however, cuts both ways, as banks would also be required to mark-to-market liabilities. In other words, these adjustments are made to both sides of the balance sheet. In the 3rd quarter of 2011, bank CDS spreads widened out on the back of financial stress building in Europe, which ultimately led to a decrease in bank liabilities (the value of their own bonds fell). As the market value of these liabilities collapsed, banks posted an accounting profit through what's known as a Debt Valuation Adjustment (DVA). A few sell-side analysts we

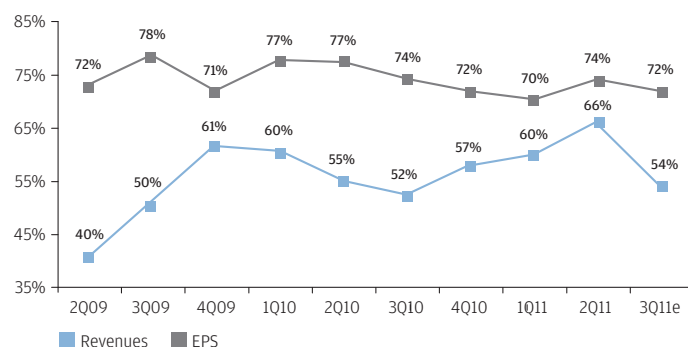
solicited believe this DVA and other similar accounting measures added approximately \$9-14 billion in profit for the five largest banks in the 3rd quarter. However, these accounting profits will naturally unwind themselves as credit markets normalize, and the value of bank liabilities returns to previous levels. Needless to say, once we exclude the noise in these accounting profits, the results in financials weren't quite as impressive. Nevertheless, as referenced in Exhibit B, even excluding financials, S&P 500 operating EPS still surprised analyst estimates by an encouraging average of 4.0%.

### Beating analyst consensus estimates

As we compare the current quarter to previous earnings seasons, the results are largely in line with where we expected them to be. Exhibit C shows the percentage of companies in the S&P 500 beating consensus EPS and revenue estimates over the past ten quarters. Here we note that while the majority of companies have continued to beat EPS estimates, the number of companies beating revenue estimates has fallen this quarter. While a single quarter does not constitute a trend, it does suggest that analysts have gotten better at estimating revenues. The growing gap between revenue beats and EPS beats is an interesting point worth noting, and it stands to reason that if analysts have gotten better at estimating revenues, yet continue to underestimate earnings, they must be underestimating the growth in margins.

**EXHIBIT C: Percent of companies beating revenue and EPS estimates**

S&P 500 companies

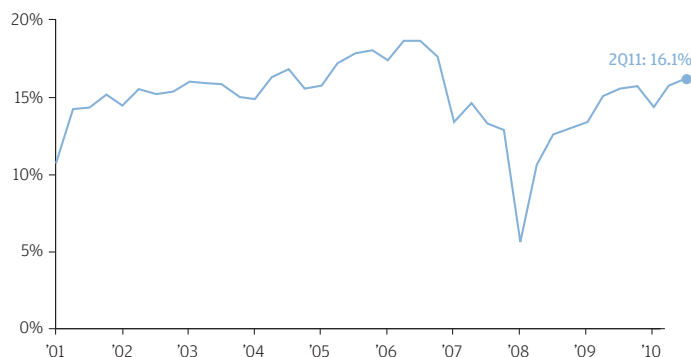


Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

### Profit margins and expenses

A look at margins over the past ten years in Exhibit D illustrates that operating profit margins have rebounded from the financial crisis in 2008, and are close to the prior cyclical peaks. As margins keep rising, analysts continue to underestimate operational leverage, thus causing them to undershoot EPS estimates.

**EXHIBIT D: S&P 500 operating profit margin**

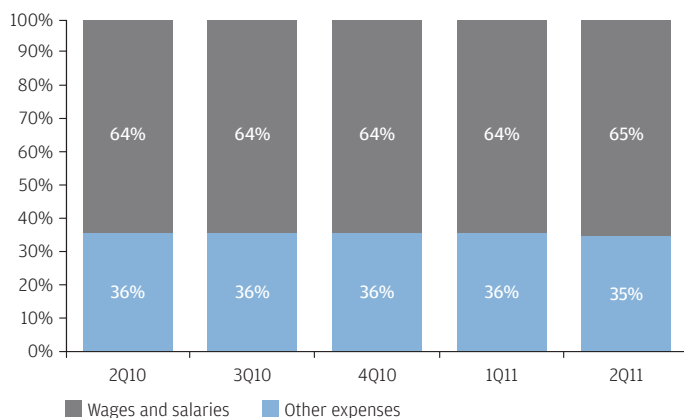


Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

We're often asked by our clients if profit margins may have already peaked. The short answer is that as long as the U.S. avoids another recession, which is currently our base case view, we think margins could continue to inch higher over the upcoming quarters. In order for margins to compress, expenses need to rise at a faster pace than revenues, or said differently – revenues need to fall at a faster pace than companies can cut expenses. A look at Exhibit E highlights a breakdown in corporate expenses from the National Income Product Accounting tables. The chart confirms that the majority of a company's expenses are wages and salaries, currently at around 65% of total expenses. According to the BLS, real average hourly earnings across the U.S. have actually fallen by 1.9% over the past year<sup>1</sup>. Indeed, after adjusting for inflation, a company's biggest expense has actually fallen over the past year. With the unemployment rate at elevated levels and our baseline view that this slack in the labor market will likely persist for some time, it's hard to imagine margins compressing anytime soon.

<sup>1</sup>Bureau of Labor Statistics U.S. Department of Labor: News Release, Real Earnings – September 2011, Wednesday 10/19/2011

**EXHIBIT E: Breakdown of corporate expenses**

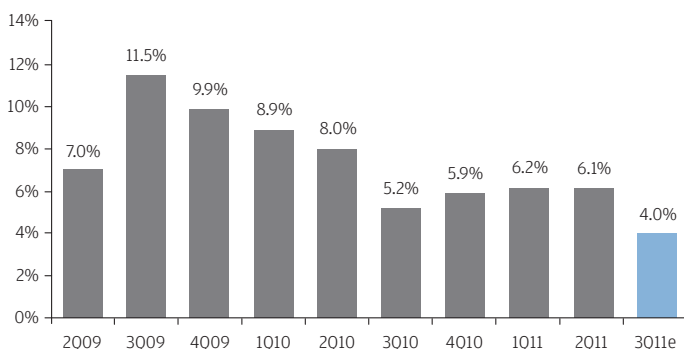


Sources: BEA, J.P. Morgan Asset Management. Total expenses are calculated as the sum of total compensation (including benefits), depreciation, net interest, and taxes.

### EPS and revenue surprises

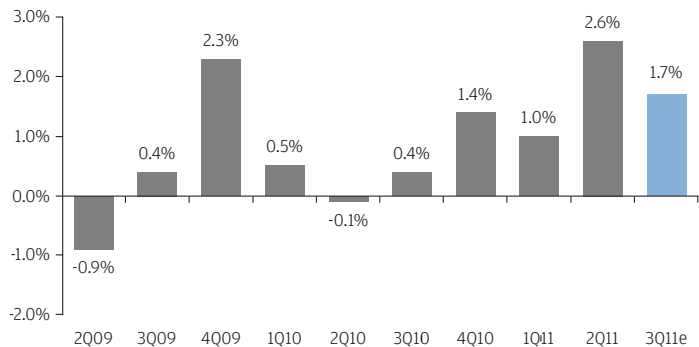
Overall when we compare 3rd quarter earnings to previous results, the impression we're left with is generally positive. We continue to see top-line revenue growth and operating earnings set new records; corporate balance sheets appear healthy, with the private sector continuing to deleverage while accumulating record amounts of cash; and although there was some noise in the financial sector, profitability continues to exceed analyst expectations. Exhibits F and G illustrate the average EPS and revenue surprises we've seen in the S&P 500 ex-financials over the past 10 quarters. While the magnitude of these surprises is tapering off, we take comfort in knowing the U.S. private sector continues to be resilient despite the plethora of macro and political issues we face around the globe.

**EXHIBIT F: Earnings surprise ex-financials**  
S&P 500 companies



Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

**EXHIBIT G: Revenue surprise ex-financials**  
S&P 500 companies



Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

**The accuracy of analyst estimates**

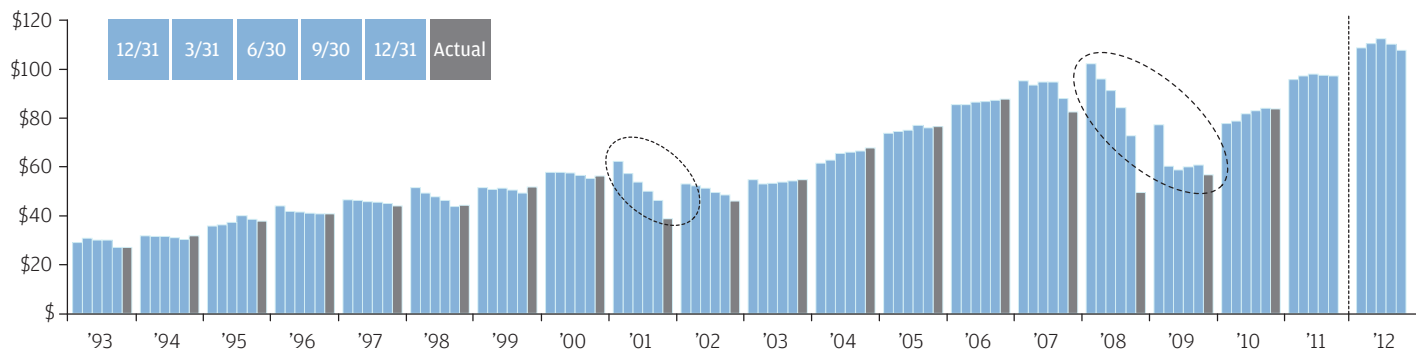
As we near the end of 2011 and begin to think about opportunities in U.S. equities in 2012, it's important to look at both multiples and expected earnings. On one hand, multiples remain well below their long-term averages, suggesting the equity markets are attractively valued; but it's important to note that macro-economic concerns and fear around Europe's sovereign debt crisis may keep multiples depressed for some time. On the other hand, however, even without any meaningful multiple expansion, markets can rally on the back of stronger earnings, as market prices are the product of both variables. One concern we often hear from clients is that analysts aren't very good at forecasting earnings. Exhibit

H illustrates how analyst estimates have tracked actual operating EPS for the S&P 500 over the past 18 years<sup>2</sup>. Each year on the chart highlights annual consensus EPS estimates at the beginning of each quarter and year-end (blue bars), as well as the actual EPS recorded at year-end (grey bars). The data suggests that analysts are typically good at forecasting earnings, with the exception of instances where the U.S. economy enters a recession, as highlighted on the chart. In most years, nevertheless, analyst estimates and their revisions have been directionally accurate.

**The opportunity in 2012**

As we look at the remainder of this year, we believe that 2011 analyst estimates of \$97.24 in operating EPS are appropriate, and actual results are likely to be close. As we look at 2012 estimates in Exhibit H (note the bars in 2012 represent estimates at the beginning of each quarter in 2011 as well as the most recent estimate), it's possible these numbers are still a bit too frothy. Currently, analysts are estimating 2012 operating EPS of \$107.69, which represents approximately 11% year-over-year earnings growth. A point to note is that these numbers have been falling over the past few months and will likely continue to decline as analysts revise their forecasts. While 2012 estimates peaked at approximately \$113, fears of a slowdown in global economic growth have brought estimates lower.

**EXHIBIT H: S&P 500 mean analyst estimates versus actual operating EPS**



Sources: Standard & Poor's, Compustat, FactSet, J.P. Morgan Asset Management.

<sup>2</sup>These consensus estimates are built using mean estimates for each company in the S&P 500 collected by all analysts in FactSet Aggregates and using market cap weightings to create a bottom-up estimate for the entire S&P 500 index.

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Based on our own econometric modeling, barring an unforeseen shock to the global economy, we believe 2012 operating EPS will likely come in around \$104, representing 6-7% year-over-year earnings growth. Given the current run-rate of 3rd quarter EPS at \$25.61, simply annualizing that figure brings us to \$102.44 – giving our forecast some clear upside risk.

Despite the negative headlines and political problems we face around the world, the private sector in the U.S. continues to prove its resilience in the face of uncertainty. While we do share concern over a slowdown in the pace of global economic growth and the outcome of policymaking decisions on both sides of the Atlantic, we continue to find value in the U.S. equity markets on the back of strong fundamentals, suggesting opportunities for investors may lie ahead.

**Appendix**

	Consumer Discretionary	Consumer Staples	Energy	Financials	Health Care	Industrials	Information Technology	Materials	Telecom Services	Utilities	Total	Total (Ex-Financials)
<b>EARNINGS</b>												
Total Reported in Sector	61	34	41	80	47	55	65	31	8	32	454	374
Total Co. in Sector	77	42	42	81	52	60	74	31	8	33	500	419
Reported by % MKT Cap	9.0%	9.4%	12.0%	14.1%	10.4%	9.5%	18.4%	3.5%	2.9%	3.6%	92.8%	91.7%
Earnings Growth YoY%	18.1%	8.8%	59.4%	14.0%	6.7%	17.7%	12.9%	32.5%	17.4%	4.4%	18.5%	19.5%
Positive Earnings Growth	48	25	32	55	41	49	41	26	3	22	342	287
Negative Earnings Growth	10	5	8	25	6	6	21	5	4	10	100	75
% Beat	67%	65%	68%	63%	81%	82%	85%	65%	38%	72%	72%	74%
% Miss	26%	21%	24%	36%	9%	9%	12%	29%	50%	19%	22%	18%
% Hit	7%	15%	7%	1%	11%	9%	3%	6%	13%	9%	7%	8%
Earnings Surprise %	2.3%	2.2%	5.7%	20.1%	5.3%	4.6%	3.1%	4.1%	4.8%	3.2%	6.4%	4.0%
Current quarter EPS Estimate*	\$2.18	\$2.38	\$3.96	\$4.13	\$3.23	\$2.55	\$4.63	\$0.83	\$0.58	\$1.14	\$25.61	

\*S&P 500 estimate is a running estimate of operating earnings using actual earnings of companies that have reported and mean estimate earnings of companies that have not yet reported.

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Revenue Growth YoY%	13.9%	12.2%	33.2%	3.1%	7.3%	9.1%	14.3%	15.4%	6.4%	2.0%	13.2%	14.8%
Positive Revenue Growth	53	28	37	54	44	47	51	30	6	17	367	313
Negative Revenue Growth	8	6	3	24	3	8	13	1	2	14	82	58
% Beat	59%	59%	59%	50%	66%	58%	58%	52%	13%	19%	54%	55%
% Miss	28%	21%	32%	35%	17%	29%	18%	35%	50%	72%	31%	30%
% Hit	13%	21%	10%	13%	17%	13%	23%	13%	38%	6%	15%	16%
Revenue Surprise %	1.5%	2.4%	4.7%	2.0%	1.5%	0.5%	0.5%	2.5%	-0.2%	-4.3%	1.8%	1.7%

**CHANGE IN ESTIMATES\***

<b>2011</b>												
# Up	38	14	23	38	25	27	36	12	2	18	233	
# Down	27	18	18	38	16	23	28	18	6	8	200	
EPS estimate	\$20.13	\$21.24	\$49.86	\$15.40	\$33.66	\$21.08	\$31.33	\$17.31	\$7.23	\$12.77	\$97.24	
<b>2012</b>												
# Up	37	17	13	20	23	21	28	9	2	10	180	
# Down	33	19	27	53	26	36	39	20	6	10	269	
EPS estimate	\$22.80	\$23.09	\$51.49	\$19.03	\$35.35	\$23.85	\$34.81	\$19.21	\$8.02	\$12.51	\$107.69	

\*Represents # of companies where mean estimates for the calendar year listed above have been revised upward or downward, within the last month.

**S&P 500 P/E RATIO AVERAGE (NTMA)**

Today	13.9x	14.2x	10.4x	9.6x	11.2x	12.4x	12.3x	11.7x	15.9x	14.3x	11.9x	
1 Year Avg.	14.4x	13.9x	11.3x	11.4x	11.3x	14.1x	13.4x	13.4x	14.7x	12.6x	12.7x	
5 Year Avg.	16.3x	15.3x	11.2x	11.8x	13.3x	14.3x	16.3x	14.6x	13.8x	13.4x	13.5x	
10 Year Avg.	17.7x	17.2x	13.0x	12.2x	16.3x	16.3x	21.4x	16.1x	15.4x	13.2x	15.3x	

Sources: IBES, Standard & Poor's, FactSet, J.P. Morgan Asset Management

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The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index. Indexes are unmanaged.

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