# Weekly Market Commentary

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LPL Financial

# Q3 Earnings Season Preview

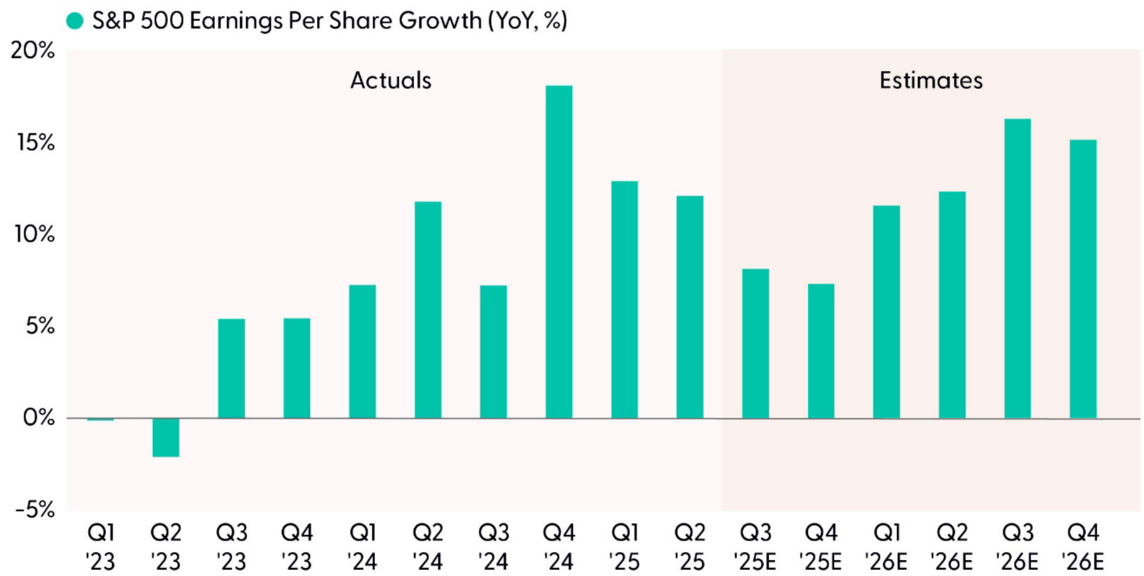
We believe corporate America will follow up an outstanding second quarter earnings season with another good one in the third quarter. Support from a resilient economy, tariff mitigation measures, artificial intelligence (AI) investment, and currency should offset increasing tariff costs. With much of investors' collective attention focused on the duration and economic impact of the government shutdown, and how to assess the outlook for the U.S. economy in the absence of government data, writing about something else this week is a nice diversion.

## Don't Expect Much Suspense This Quarter

Earnings season is usually predictable quarter to quarter in the absence of economic inflection points. We would suggest the second quarter was more of an inflection point than the third as tariffs ramped up in a meaningful way and companies' visibility into tariff costs improved. As of the latest Bloomberg data, the effective tariff rate ended July at 9.7%, up slightly from below 9% at the end of June. We think another three to five points of tariffs will likely be added on to July levels to land at an overall rate between 12% to 14%, but the Supreme Court will determine how quickly we get there. The nation's highest court is expected to rule on the legality of the Trump administration's tariffs imposed under the International Economic Emergency Powers Act (IEEPA) within the next few months.

So, with less suspense around tariffs, steady economic growth that could approach 3% for Q3, the continued surge in artificial intelligence (AI) investment, and a roughly 5% drop in the average level of the U.S. dollar from the prior-year quarter, corporate America has an excellent opportunity to post another low-teens earnings growth rate for the S&P 500. We don't think a 5% upside surprise above the consensus 8% estimate is not too high of a bar, but another 8% upside surprise such as we had last quarter might be a bit too much to ask.

## Tariff-Driven Slowdown Unlikely to Hurt Q3 Earnings Growth Much




Source: LPL Research, FactSet, 10/02/25
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Estimates may not materialize as predicted and are subject to change.

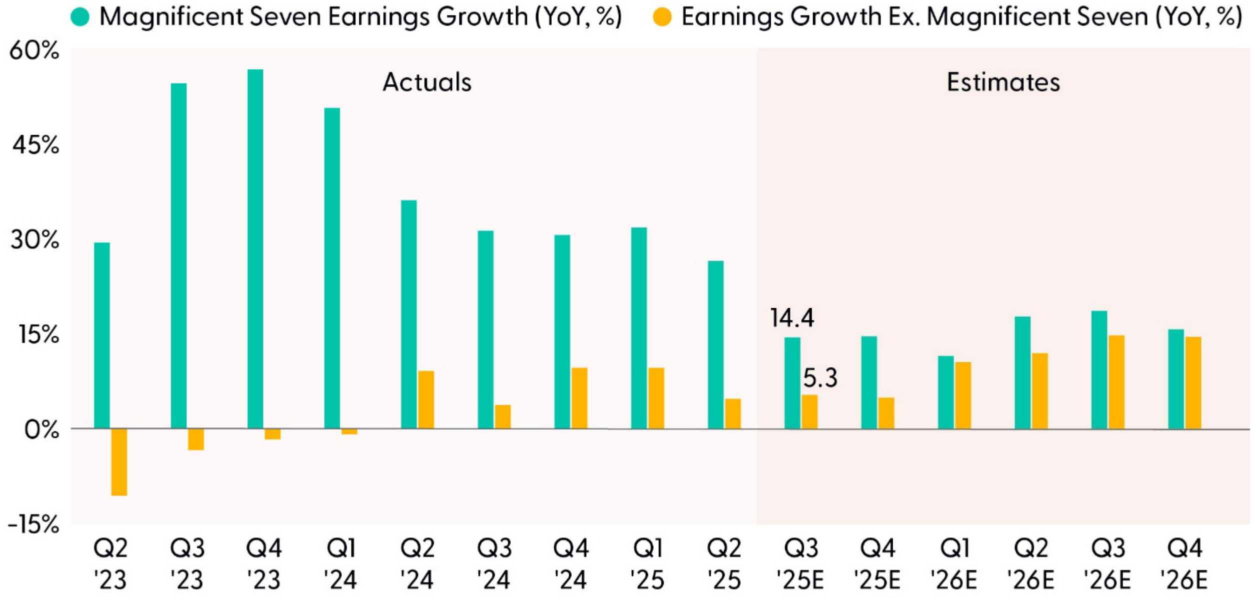
## Artificial Intelligence Capital Investment Remains the Dominant Driver

The Magnificent Seven will again be a significant driver of earnings growth in the third quarter. In fact, 70% of the 8% expected S&P 500 earnings growth reflected in analysts' estimates is coming from the biggest six technology companies (the Magnificent Seven minus Tesla). It's remarkable that companies this big can grow earnings 40–50% — but several hundred billion in capital spending annually will do that!

As shown in the "Magnificent Seven Remains a Powerful Earnings Driver" chart, this group continues to dominate the earnings growth of the rest of the companies in the index. While this trend will likely continue through year-end, it is expected to narrow next year as the S&P 493 (the S&P 500 excluding the Magnificent Seven) plays some catch-up.

This earnings growth gap is still big right now and underpins LPL Research's continued preference for large growth equities over their large value counterparts. But, as the gap narrows in 2026, we would expect this bull market to broaden out. Cyclical value stocks may get some additional support from the fiscal stimulus provided by the One Big Beautiful Bill Act (OBBBA). LPL Research's positive view of financials fits this theme, but industrials are another potential beneficiary.

### Magnificent Seven Remains a Powerful Earnings Driver




Source: LPL Research, Bloomberg, 10/02/25
Disclosures: Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results. Estimates may not materialize as predicted and are subject to change. Magnificent Seven includes Alphabet (GOOG/L), Amazon (AMZN), Apple (AAPL), Meta (META), Microsoft (MSFT), NVIDIA (NVDA), and Tesla (TSLA).

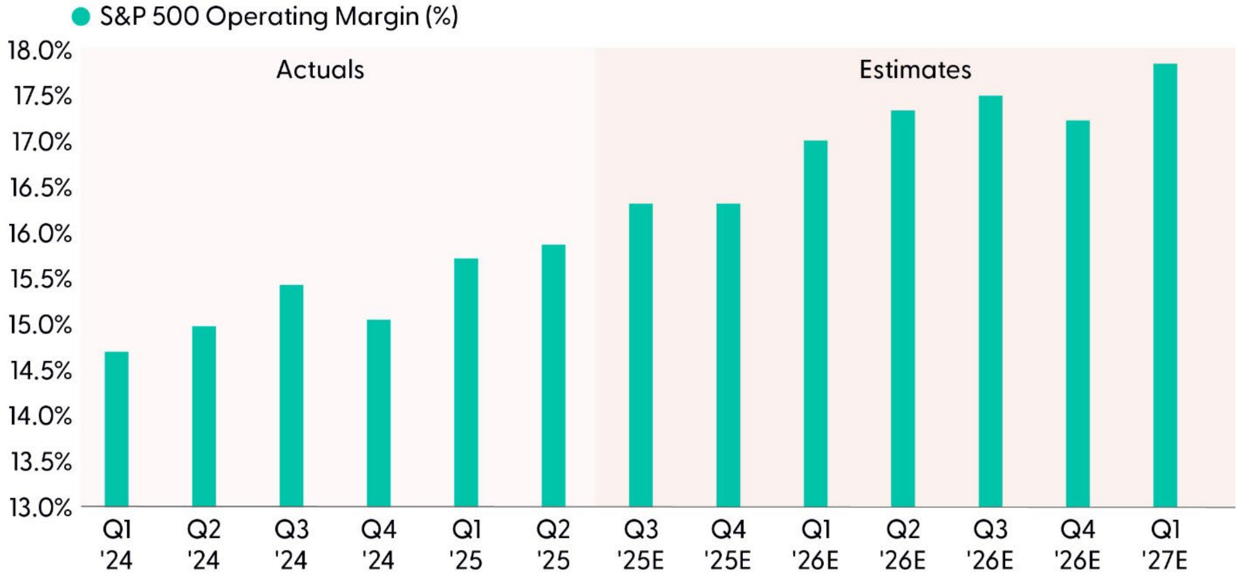
## Margin Outlook: Where Are Tariff Effects?

Tariff effects were expected to show up in second quarter earnings reported in July and August. Well, they certainly showed up for some global industries, such as automakers, industrial equipment makers, and apparel retailers. But at the macro level, the effects have been much less than we, and most analysts, anticipated. There are a lot of reasons for this, including:

- Some tariffs haven't gone into effect yet.
- Some service industries are largely unaffected.
- AI-driven productivity enhancements are starting to show up, supporting profit margins, while most AI companies have moderate tariff exposure.
- Several key companies have struck side deals by committing to investing in the U.S. or furthering other Trump administration objectives. Apple (AAPL), Intel (INTC), Pfizer (PFE), and Taiwan Semiconductor (TSM) are among the biggest names.
- Most imports from Canada and Mexico are subject to lower tariffs under the USMCA trade agreement.
- Tariff costs have been spread out among exporters, importers, and consumers, dampening the hit to profit margins.

More margin pressure is likely coming as more of these tariffs flow through in the next few months. However, based on analysts' earnings estimates, Wall Street sure isn't worried. The "Corporate America Managing Large — But Lesser — Tariff Burden Very Well" chart reflects expectations that margins will continue to expand. Given the recent track record, we won't bet against corporate America expanding margins, though we do not expect quite as much as analysts are currently forecasting.

### Corporate America Managing Large — But Lesser — Tariff Burden Very Well




Source: LPL Research, Bloomberg 10/02/25
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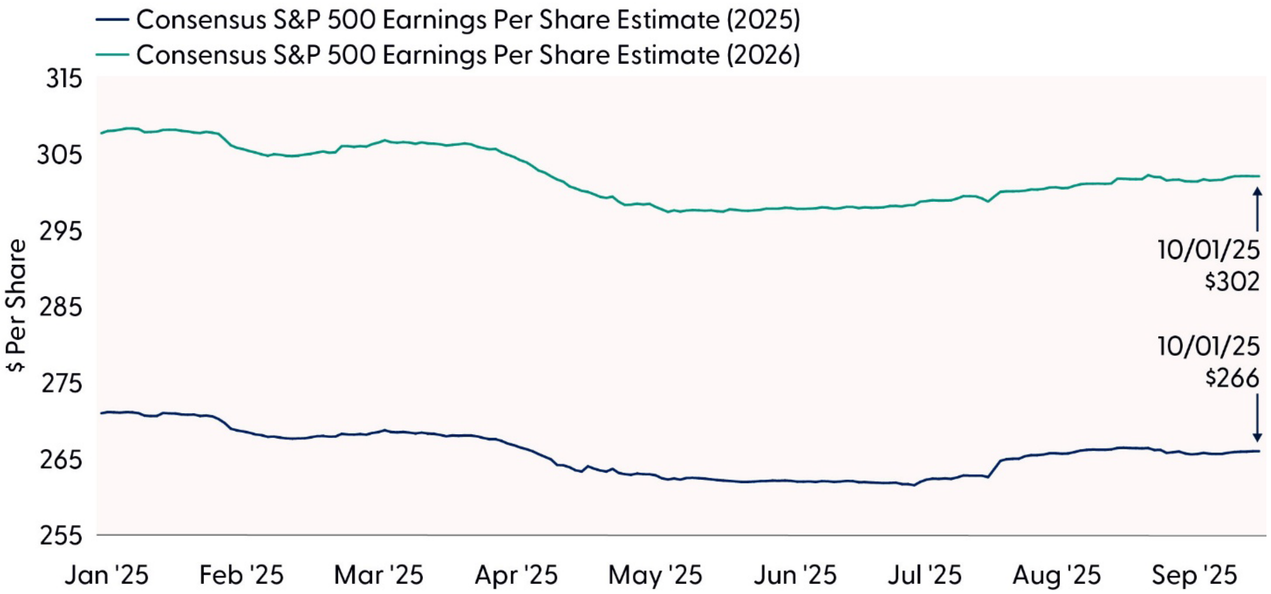
### Reasons For Optimism on Earnings In 2026

We anticipate corporate America to continue to enjoy a solid economic backdrop next year, supporting solid earnings growth. Fiscal stimulus from the OBBBA is expected to jump start growth after a late 2025 slowdown. We expect companies to continue to manage tariffs effectively. The AI investment surge is only going to get bigger next year, driving strong technology sector earnings gains. And another year means companies will have more time to generate productivity gains from AI, supporting margins. Finally, share buybacks are expected to remain at their record pace set this year, depressing the denominator in the earnings per share calculation.

Put all that together and you get a real possibility of a 10% increase in S&P 500 profits in 2025. That puts $290 per share in play for the index next year, compared to the $280–285 range we cited in our second quarter earnings recap commentary. While it's uncomfortable to predict higher price-to-earnings multiples will propel stocks even higher with valuations already elevated, earnings may do the work for us and keep this bull market well supported through 2026.

### Earnings Estimates Have Impressively Risen Lately




Source: LPL Research, Bloomberg, 10/02/25

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### Conclusion

In our view, we believe corporate America should continue to deliver solid earnings growth in the third quarter with few surprises. Given the strong second quarter performance, solid economic backdrop, resilient earnings estimate trends, and the tailwind of AI capital investment, it's very likely earnings will deliver another 5–7% upside to current consensus estimates and grow earnings at a low-teens pace in Q3. It won't be easy given more tariff costs had to be absorbed last quarter compared with Q2, but we won't bet against corporate America. That's been a losing bet for the past several years.

Looking ahead, the combination of AI investment, tech-driven productivity gains, and supportive fiscal policy could potentially enable earnings to grow at a double-digit clip in 2026 and keep this bull market well supported.

### Asset Allocation Insights

LPL's Strategic and Tactical Asset Allocation Committee (STAAC) maintains its tactical neutral stance on equities. Investors may be well served by bracing for occasional bouts of volatility given how much optimism is reflected in stock valuations, lingering tariff and inflation risks. STAAC's regional preferences across the U.S., developed international, and emerging markets (EM) are aligned with benchmarks. The Committee still favors growth over value, large caps over small caps, and the communication services and financials sectors.

Within fixed income, the STAAC holds a neutral weight in core bonds, with a slight preference for mortgage-backed securities (MBS) over investment-grade corporates. The Committee believes the risk-reward for core bond sectors (U.S. Treasury, agency MBS, investment-grade corporates) is more attractive than plus sectors. The Committee does not believe adding duration (interest rate sensitivity) at current levels is attractive and remains neutral relative to benchmarks.

# Important Disclosures

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The Standard & Poor's 500 Index (S&P500) 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 PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet or Bloomberg.

This research material has been prepared by LPL Financial LLC.

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