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MARKETS

Growth Is New Mantra for Investors

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Consensus estimates call for a 0.9% fourth-quarter drop in profit from Alcoa. Here, aluminum billets at a plant in South Carolina in 2012. *Bloomberg News*

After shrugging off slowing earnings growth in recent years, stock investors say profits are starting to matter again.

Last year, U.S. stocks powered into record territory despite stalling earnings growth as investors focused more on the Federal Reserve's easy-money policies and signs that the U.S. economy was gaining momentum.

Now, with the Fed beginning to pull back on its easing efforts, and stocks in the S&P 500 trading at their highest levels in six years when compared with expected earnings, some investors say it is becoming harder to brush off sluggish earnings news.

"If the market's going to have another leg up here, it's really going to have to be driven by earnings growth," said Jim McDonald, chief investment strategist at Chicago-based Northern Trust Corp., which manages $846 billion. "Earnings have turned from being a secondary issue to being the primary issue."

Northern Trust is betting that corporate earnings will be strong, with an allocation to stocks at the high end of its historical range, Mr. McDonald said. But if profit growth falls short, Mr. McDonald said the firm is ready to pare its U.S. stockholdings.

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Industrial companies in the S&P 500 are expected to report strong profit growth in the fourth quarter. Consensus estimates have airplane maker Boeing's per-share earnings climbing 7.1%. *Associated Press*

Earnings season unofficially kicks off after the close of trading Thursday, with fourth-quarter results from Alcoa Inc. The aluminum producer is forecast to report a 0.9% quarterly profit decline from the previous year, according to consensus estimates from FactSet.

S&P 500 companies are expected to show a 6.1% rise in fourth-quarter earnings per share from the previous year, according to FactSet. That would be up from a 4% rise in the third quarter and the strongest growth since the final quarter of 2012.

Still, even if earnings come in as expected, 2013 will mark a third year in a row of slowing profit growth. For the full year, corporate earnings per share are expected to rise 5.6%, down from 6% in 2012, according to FactSet.

The combination of slowing profits and the 30% rally in the S&P 500 for 2013 leaves stocks on the pricey side. The S&P 500 is trading at 15.3 times its expected profits for the next 12 months, which is 8.5% above its 10-year average of 14.1, FactSet says. When using the previous year's earnings, rather than forecasts, the S&P is trading at a multiple of 16.5, 12% above the 10-year average of 14.7.

Even Federal Reserve officials have taken notice of rising stock-market valuations. According to the minutes from their December policy-making meeting released Wednesday, several Fed officials cited "the rise in forward price-to-earnings ratios for some small-cap stocks" as among potential risks to financial stability and the economy.

"We need better earnings growth" to back up last year's gains, said Bob Doll, chief equity strategist and senior portfolio manager with Nuveen Investments, which manages roughly $215 billion. Mr. Doll said companies will come through with strong fourth-quarter earnings. He is betting on gains in economically sensitive sectors such as industrials.

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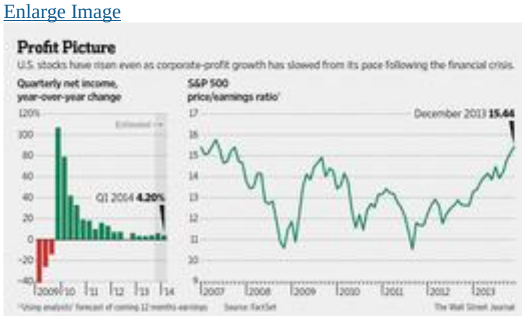

Boeing Inc., a component of the S&P 500 industrial sector, was a top holding in theNuveen Large Cap Growth Fund, which Mr. Doll manages.
Boeing is expected to report per-share profit growth of 7.1% for the fourth quarter, according to FactSet.

Industrial companies in the S&P 500 are expected to report profits rose 14% in the fourth quarter, while materials companies are forecast to report profits climbing 9.1%.

Among sectors seen tied closely to economic growth, only energy is expected to show a decline in profits as a result of falling oil prices.

One concern, investors say, is continued softness in revenue. Fourth-quarter revenue is expected to rise just 0.3%, a slowdown from the 2.9% sales growth the previous quarter.

But many say they are optimistic that sales will increase at a faster pace this year as the economy strengthens. Wall Street is forecasting 4% of per-share sales growth in 2014, up from 1.9% in 2013, according to FactSet. And profits are expected to rise 10% for the year.

"We'll have modest but satisfactory, sustainable improvement in growth," said Margie Patel, senior portfolio manager overseeing roughly $1 billion for Wells Capital Management.

With that outlook, Ms. Patel has been buying economically sensitive stocks. One of her fund's top holdings at the end of November was materials company LyondellBasell Inc., a manufacturer of resins for use in adhesives, sealants and plastics. LyondellBasell is expected to post a 19% rise in profits for the fourth quarter, according to FactSet.

Still, some worry that investors will gloss over soft earnings news and push stock-market valuations to unsustainably high levels as long as the Fed keeps short-term interest rates low.

One warning sign: a high number of companies saying earnings will come in lower than had been forecast. According to Thomson Reuters, there were 108 negative earnings preannouncements for the fourth quarter, compared with 11 positive preannouncements, the highest negative to positive ratio on record.

"There's definitely a disconnect between the news that comes out with companies and their share-price performance," said Michael O'Rourke, chief market strategist at brokerage JonesTrading Institutional Services. "People feel comfortable with the Fed being supportive, and they want to participate rather than risk missing the rally."

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