

Credit, Profit Woes May Hit Stocks Even if Fed Acts Fast

By PETER A. MCKAY
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Just a month ago, the stock market was up 12% for the year, even as corporate-earnings growth and the economy were slowing. Investors, as they generally do, were looking ahead, in this case to an expected rebound in the second half.

Most of the stock market's gains have been wiped out amid the turmoil of the debt markets and the unwinding of leveraged bets made by several big hedge funds. What is more worrisome is that the second quarter, which produced reasonable but below-average growth, could prove to be the year's high point.

Looking ahead, hopes for the rest of the year increasingly depend on a cut in short-term interest rates by the Federal Reserve, which has already moved to ease the rates that banks use to borrow. That is exactly what investors were hoping for early in the year, but worries about inflation kept the Fed from acting.

But even if the Fed acts, many investors are worried it won't be enough to offset what many expect to be uninspiring profit and economic growth for the third and fourth quarters, caused by the fallout from the subprime-mortgage problem.

"I have a hard time seeing how the Dow [Jones Industrial Average] will get back to 14000," the record the blue-chip indicator set in mid-July, says Michael Farr, president of money-management firm Farr, Miller & Washington.

The Dow is now 6.6% off its peak after last week's turbulence. For the week, the Dow was down 160.46 points, or 1.2%, to 13079.08, up 4.9% on the year. Mr. Farr added: "There are still some good individual companies to be in, but I think the overall market will struggle through year end."

In particular, analysts say the credit shakeout will likely weigh on the second-half profits of financial stocks -- which account for roughly one-third of earnings for companies in the large-capitalization Standard & Poor's 500-stock index. Banks could be hurt by big write-offs for trading losses and a slowdown in underwriting. Combined with slowing profit growth for energy and commodity stocks, which had been big drivers of the market's profit growth, earnings could be steady, but tepid, in the mid- to upper-single digits for the rest of the year.

One key question Mr. Farr and other investing professionals are concerned about is whether U.S. consumers will maintain their spending, which drives the profits of companies in an array of sectors. That has been a question all year, but now investors have the added worry of the credit crunch limiting borrowing, and therefore spending, by business.

Also, if the dollar falls further through year's end, it could hurt U.S. consumers, who would effectively have to pay more for imported goods. Those same consumers have already faced declining wealth because of falling home prices and higher fuel costs spurred by an 18% jump in oil prices so far this year.

Mike Thompson, research director at data firm Thomson Financial, which tracks Wall Street earnings expectations, says he expects a slight slowdown, but nothing to trigger panic in the broader stock market.

According to Thomson data, Wall Street analysts' expectation is that aggregate earnings for companies in the S&P 500 will grow 6.1% for the third quarter. Once all the reports are in hand, Mr. Thompson estimates that growth will probably be about 7%, in line with the 8.1% profit growth the index registered for the largely ignored second quarter.

Such single-digit growth rates are well below the booming quarterly profit increases of more than 10% that companies enjoyed for more than three years straight. Mr. Thompson estimates that quarterly profit growth might not return to double digits until sometime next year, contrary to earlier hopes for such a boom in the fourth quarter. But he adds that the recent growth under 10% has still been solid in historic terms.

"When you run down the list of things facing the market, profits are looking OK," says Mr. Thompson. "Growth is still not what it was, but we can still get there eventually."

Despite Friday's rally, the stock market finished lower last week, unable to recoup all the losses driven by credit jitters. The technology-focused Nasdaq Composite Index fell 1.6%, or 39.86 points, to 2505.03, up 3.7% on the year.

Other yardsticks fell near the break-even point for 2007. The broad S&P 500 is now up just less than 2% on the year after falling 0.5%, or 7.7 points, to 1445.94 last week. The small-stock Russell 2000 fell 0.3% for the week, or 2.75 points, to 786.03, off 0.2% for the year.

Craig Hodges, president and co-portfolio manager at Hodges Capital Management in Dallas, says he has continued to buy railroad stocks, oil drillers and other companies as a bet on steady if unspectacular economic growth.

But his confidence has its limits. For example, Mr. Hodges says he is still generally wary of financial stocks, which have been battered by the mortgage shakeout. The Dow Jones U.S. Financial Services index is off nearly 12% since mid-July.

Despite that pullback, Mr. Hodges, who believes the credit markets could remain volatile for more than a month to come, still isn't ready to jump in.

"This is not the time to be bargain-hunting," he says.

Write to Peter A. McKay at peter.mckay@wsj.com