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It’s Still All About Earnings

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Amid all the noise and chaos of the stock market these days, the fundamentals ultimately apply -- earnings determine share price movements.

That's the good news.

But the bad news is that the severity of profit declines witnessed thus far in the third-quarter reporting season have splashed yet more cold water upon shell-shocked investors. The profit reports are even worse than expected, and might deteriorate further in the fourth quarter.

"Stocks are reacting to poor third-quarter earnings and tepid fourth-quarter guidances," said Gerry Sparrow, president of Sparrow Capital Management in St. Louis. "Most investors appear to have shifted away from worries about the credit squeeze and liquidity crisis and are focusing more on corporate earnings and talk of a global recession."

Although the market has been ensnared in a very bad environment for at least a year, we are still seeing many stocks continuing to decline after posting disappointing earnings, added Sparrow.

"This would suggest that many investors had not discounted the weak profit climate enough," he said. "In an efficient market, markets can ably discount bad news, but the news has been even worse than what was expected."

Poor earnings and upsetting forecasts represent yet another negative manifestation of the global credit crunch. But at least they are the right type of measures for investors to be examining, rather than reacting emotionally to a daily deluge of distracting, and often irrelevant, news items, such as talk of government stimulus packages and possible mortgage-owner bailouts.

"Investors are clinging to the slightest piece of bad or good news; this is an endemic problem in the market," said Christopher Cordaro, chief investment officer at RegentAtlantic Capital in Chatham, N.J.

"Markets have been extremely volatile because people are very fearful. Any distraction gets the market herded off in one direction or another. Investors have not been looking at underlying market fundamentals; instead they're just reacting to short-term news items. I think when this volatility settles down, more investors will be considering long-term fundamentals," he said.

Indeed, most rational investors have been anticipating poor earnings all year. But with the third quarter numbers actually popping up on computer screens and in newspapers, there is now some concrete evidence of how bad things really, and this may have shocked investors.

"It's almost like a confirmation of all the fears and worries investors have held onto all year, and the selling seems to be feeding upon itself," Cordaro said.

Making matters worse, Sparrow noted, is that some companies are reluctant to offer any forecasts at all, citing a lack of earnings visibility.

"It is very difficult in this environment for many companies to have the confidence of forecasting what their revenues and earnings will be even in the next quarter, and we are seeing this across the board in virtually all sectors," he said.

"We saw something similar during the recession of 2001-2002, so it's not entirely unprecedented. In any case, this lack of vision heightens investor anxiety even more."

Silver Lining

Sparrow, who describes the market as "bipolar," thinks this period of extreme fear may actually present a buying opportunity, given that many solid, blue-chip companies have suffered price declines disproportionate to their fundamentals.

"This extreme negative mood has resulted in many stocks trading at prices significantly below their intrinsic values," he said "During these hiccups, we can scoop up companies of all shapes and sizes that we like on a long-term basis."

Indeed, as of Oct. 23, the S&P 500 sported a 12-month forward price-earnings ratio of just 11.2, while the DJIA featured an even more modest figure of 10.

Gary Hager, president of Integrated Wealth Management in Edison, N.J., believes the current volatility has been a significant byproduct of hedge fund liquidations -- and this scenario is likely to continue till the end of the year.

"Investors are reacting, not responding, to headlines, not intrinsic value or fundamentals," he noted. "This is also exacerbated by how thin the markets have become. With the enormous amount of cash on the sidelines, the daily spreads have widened to an unprecedented level. This would explain these extraordinary daily moves and the extreme volatility."

As more people return to the market, the volatility will contract, Hager added. This in turn will encourage others to re-enter.

Indeed, the VIX volatility index is nearly at 70, suggesting that many investors have thrown in the towel and gotten out of the market. This is the type of behavior we tend to see at market bottoms.

"Assuming the market bottoms out, say, in the middle of next year, stock prices will rise in anticipation of improving economic activity and better earnings," Sparrow noted. "This happened with many major stocks earlier in the decade."

Cordaro believes investors might be overly pessimistic. "Many of them are taking the current bad news and projecting them too far into the future -- this is a behavioral bias humans have," he said. "When things are bad, people think they will remain bad for years and years."

Investors should sit tight and consider the long term, Cordaro advises.

"If you look at stock valuations now and assume that earnings will be poor for the next two years, stocks are selling at such cheap prices, they've already been discounted," he said.

Hager largely concurs, saying he believes "the economy has been in a recession since late last year."

"We expect an economic bottom sometime in 2009. But what's important to note is the stock market as an asset class traditionally bottoms out three to six months in front of the economy. As a specific asset class, stocks are on sale. If you start buying after every one says it's safe to go back in the water, you'll most likely miss a significant part of the up move."

Hager is bullish. "But you have to be careful, and selective," he said. "It may take two to three years, but it'll be worth it."

However, Howard Kornblue, senior portfolio manager at Alpha Fiduciary Generational Wealth Management in Scottsdale, Ariz., remains unconvinced that the stock market will rebound soon, even if the economy recovers.

"We now have strong evidence of serious recession," he said. "This is the worst crisis since the Great Depression, this malaise is widespread and deep. People will now be lowering earnings expectations even further, which will pressure stocks even more. I think earnings forecasts still remain too high and that earnings will continue to be depressed for at least the next two to four quarters."

For the moment, Kornblue suggests investors snap up high-quality blue-chip stocks that pay above-average dividend yields. "With dividends you will still get paid even as equity prices continue to decline," he said. "That way you'll be paid to wait until things start to improve."

So this economic downturn, recession, whatever you want to call it, might cut deeply into market cap values, and the only thing that can prop stocks up again are strong earnings. Whether that takes six months or six years is anybody's guess, but the preeminence of sustained profit growth cannot be ignored.