THE WALL STREET JOURNAL.
WSJ.com

- ABREAST OF THE MARKET
- AUGUST 31, 2009

Can Rally Run Without Revenue?

Investors Wonder Whether Profits Based on Cost Cutting Can Long Endure

By TOM LAURICELLA

As stock investors turn their focus to earnings prospects for the second half and 2010, they are zeroing in on one of the market's biggest challenges: lackluster corporate revenue.

The market barreled ahead this summer and is hovering near its high for the year, fueled in large part by stronger than-expected second-quarter earnings. But a significant driver of the good news was cost cutting. Many companies posted disappointing sales.

In the short-term, earnings prospects may remain favorable for the market. Aggressive expense control and modest inventory restocking could boost third-quarter numbers, while the fourth quarter has easy comparisons against an awful 2008 that will give the appearance of healthy profit increases. But in 2010, the ability of stocks to sustain or extend their advances will have to come from a revival in sales, strategists say. In an uncertain economic environment, that won't be an easy task.

"You can not simply cut costs forever to have sustainable earnings. You need revenues to grow them over time," says Dirk Van Dijk, chief equity strategist at Zacks Investment Research. However, "it's going to be really, really tough" to increase revenue in the current economy, he says.

For now, stock prices suggest many investors are comfortable knowing that at least the decline in profits has been halted.

Heading into September, a notoriously bad month for stocks, the Dow Jones Industrial Average is up 8.75% for the year at 9544.20. That is just off from the best levels seen since early last November. Though trading volume has been light in recent days, the market has been able to hold on to a rally that sent the Dow industrials up 12% since mid-July and up 45.8% from the March 9 low.

According to Goldman Sachs Group Inc., 46% of companies beat Wall Street's earnings expectations by a wide margin, but only 23% significantly bettered revenue forecasts. Sales among companies in the Standard & Poor's 500 stock index fell 16% in the second quarter from a year earlier, following a 14% decline in the first quarter.

David Kostin, an equity strategist at Goldman, points to a decline in a key line item on corporate income statements known as "selling, general and administrative expenses" otherwise known as SG&A. Included in SG&A are salaries and costs of doing business, such as travel or advertising.

SG&A plunged 6.4% in the second quarter from the year-earlier period, Goldman says. In contrast, in the last recession, SG&A fell just 0.2% and in 1991, it dropped 4.1%.

"There's been an unprecedented decline in overhead costs," Mr. Kostin says.

A big part of the challenge for generating an upturn in sales is that consumers, whose spending has driven roughly 70% of economic activity in recent years, are hamstrung by a bleak job market. That was evidenced Friday by a weak reading on consumer confidence from the University of Michigan and government data showing incomes were flat in July.

This environment typically leads to disparate performances between sectors and stocks, according to strategists at Ned Davis Research.

In the initial stage of a recovery from a bear market, the stocks that have fallen the most tend to be the ones that rebound the strongest. "After a bottom, the market shifts to more industry-specific and company-specific factors," says Amy Lubas, senior equity strategist at Ned Davis.

Such differentiation will most benefit those companies that have both cut their costs and have the best prospects for revenue growth, says Goldman's Mr. Kostin.

Among S&P sectors, materials stocks posted the biggest decline in SG&A costs -- down nearly 10% -- followed by information technology. Energy companies, too, have cut costs significantly. In contrast, SG&A costs rose at telecommunications companies and fell only 1% at consumer staples names.

Mr. Kostin says the most likely sources for revenue growth are outside the U.S., where technology, energy and materials companies get the greatest percentage of revenue.

More narrowly, Brazil, Russia, India and China are likely to be the strongest performing economies, and, Mr. Kostin says, the best revenue prospects. Already, a basket of stocks that Goldman identifies as having the greatest business from those so-called BRIC nations has done 29 percentage points better than the S&P 500 this year.

Barry Knapp, equity strategist at Barclays Capital, favors industrials as a play on the cost-cutting binge. "They've been cutting costs for nine years," he says. "That sector looks really well-poised for coming out of the recession."

In addition, technology companies, which have lifted the Nasdaq Composite Index 29% this year, also look good on the cost cutting and revenue metrics, Mr. Knapp says. "But once you get into the consumer discretionary, staples and services areas, it's not quite as good a story," Mr. Knapp says.

Zack's Mr. Van Dijk says that short term there could be good earnings news for retailers. "You have a bunch of retailers who have really cut their inventories way down, and if they do see any pickup at all, their turnover will zoom and that lowers their costs significantly," he says, noting that already it is a group for which analysts have upgraded earnings forecasts.

Still, for retailers aimed at the middle-class, such as Macy's, J.C. Penney and Gap, the good news won't last long.

"They may be good for a trade, but they're a lousy long-term investment," Mr. Van Dijk says. "They just have too many headwinds against them."

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Printed in The Wall Street Journal, page C1