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MARKET REPORT

Profits regaining market influence

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First the good news: Corporate profits were up in the third quarter. Now, the better news: For the first time in several years, profits are starting to matter to investors.

"It was a great quarter, and the fourth quarter is going to be another good one, no matter how you slice it," said Charles Hill, research director at Thomson First Call.

Hill estimates that profits from continuing operations at the Standard & Poor's 500 companies expanded at a rate of nearly 22 percent.

The year-over-year percentage gain is distorted because of results in the technology sector, where Lucent Technologies posted a massive loss in the 2003 third quarter.

But financial-service firms, led by American International Group, Citigroup and J.P. Morgan, pulled profits among major companies sharply higher.

Optimism about an economic recovery has prompted analysts to forecast more good news in the fourth quarter.

For investors, reports and forecasts of increased profits seem like good news. But profits and stock prices don't always march together, especially when stocks are struggling to emerge from a sustained downturn.

Profits at 600 small companies tracked by Standard & Poor's were up about 10 percent in the third quarter, a respectable gain that is half the earnings growth of the large-cap S&P 500 index during the same period.

Yet the S&P 600 index is trading at a record high, while the S&P 500 stands 32 percent below its all-time high.

"Normally in a recovery, in the first year or two the small stocks outperform the large stocks," said Hill.

But investors have been unusually forgiving to small, speculative companies, as they hoped for extraordinary market gains to offset the extraordinary losses of the last three years.

Contrary to conventional investment theory, since the summer of 2000 investors have not been rewarded by correctly predicting upbeat earnings surprises versus earnings disappointments, said Michael Painchaud, research director at Market Profile Theorems.

At the beginning of each quarterly reporting period, his firm constructs two portfolios of stocks--those expected to issue surprisingly good and surprisingly bad quarterly reports.

Generally, the firm has picked correctly, but the results in the stock market made them wonder why they bothered.

For example, in October 2001 the 16 stocks in the negative surprise portfolio beat the 10 stocks in the positive surprise portfolio by 8.8 percent versus 4.1 percent.

Advent Software posted a sharp, unexpected decline in profits in the 2001 third quarter, as Painchaud predicted, but its stock advanced 7.5 percent in October of that year.

Similarly, "we had positive earnings surprises that weren't rewarded."

Since profit expectations are supposed to dictate stock prices, evidence from the last few years suggests investors were betting on something else.

But recently, "we're settling back into rationality," Painchaud said. "Earnings do matter."

The portfolio his firm picked this year on Oct. 1 as likely to report positive earnings surprises beat the portfolio picked as likely disappointments by 4 percentage points in the month of October.

Unfortunately, the outlook for profits beyond the current exuberance for third- and fourth-quarter results is unusually cloudy, said Hill.

Noting the absence of the traditional decline in consumer spending and housing in the last recession, Hill said, "it was a different kind of recession, and it's begetting a different kind of recovery."

For example, no one knows how stocks and financial markets will respond when the effects of the latest tax cuts and government spending spree fade.

"My crystal ball has been fuzzier than ever," Hill said.

Tuesday's action: Stocks closed narrowly mixed in moderate trading, as the third-quarter financial reporting season drew toward a close.

Investors reacted to unexpected quarterly figures from Gillette, which jumped $1.65, to a 16-month closing high, $34.15.

The consumer products company posted a 17.5 percent gain in profits on an 11 percent advance in sales.

On the other hand, traders punished Chicago-based insurance holding company Aon. Shares fell $1.17, to $20.97. The company said profits fell more than Wall Street had forecast, citing losses at an auto financing unit and disappointing profit margins in insurance brokerage.

The Dow Jones industrial average lost 19.63, to 9838.83. The broader Standard & Poor's 500 index slipped 5.77, to 1053.25; the Nasdaq composite index lost 9.74, to 1957.96; the Russell 2000 index of small-company stocks edged up 1.03, to 538.87.

New York Stock Exchange trading volume reached 1.38 billion shares. Winners held a narrow lead over losers among NYSE-listed issues. Nasdaq trading volume totaled 2.02 billion shares, as winners and losers fought to a draw.

Treasury securities advanced, sending interest rates lower, after a report on corporate layoffs showed a large increase in October.

Gold for December delivery rose in New York futures trading, closing up $2.90 an ounce, at $380. Oil prices continued their recent slide, reflecting warm weather.

Crude oil for December delivery dropped 15 cents a barrel, to $28.75, the lowest close since Sept. 29.
