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ABREAST OF THE MARKET

Oil to Put Chill on U.S. Earnings Season

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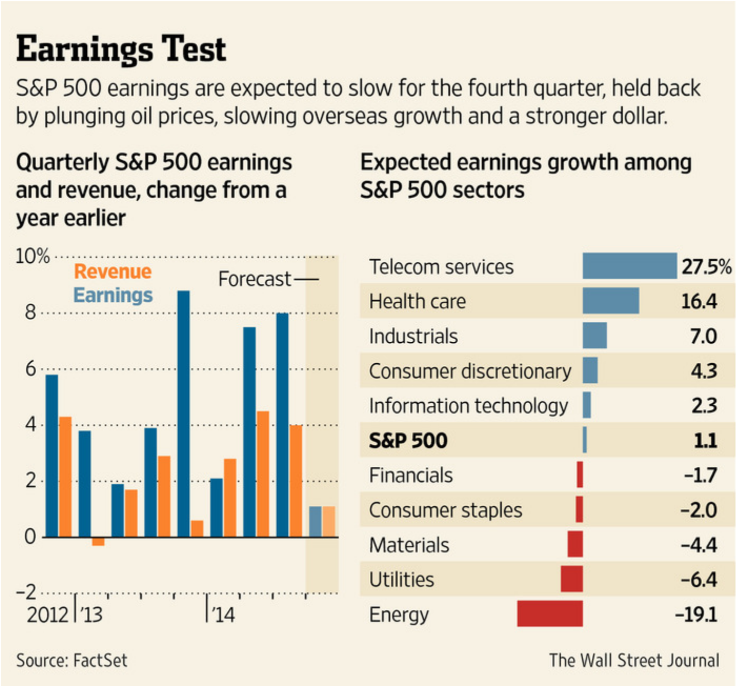
As fourth-quarter earnings season gets under way, investors are bracing for the softest U.S. profit growth in years, pinched by collapsing oil prices and a strong dollar.

That double whammy, coupled with the highest valuations for stocks since the financial crisis, will test the market's ability to prolong its extended bull run and will likely make for continued bumpy trading in the weeks ahead.

Over the past few months, the Dow Jones Industrial Average and S&P 500 have carved out new record highs, while suffering frequent setbacks. Both indexes hit fresh peaks in the final sessions of last year but have since experienced two straight weeks of declines.

Some prominent hedge funds are cutting back their exposure to stocks and reducing their use of borrowed money to amplify their bets, according to fund managers and a confidential memo Morgan Stanley sent to clients last week that was viewed by The Wall Street Journal. The highly-paid traders who were surprised by a stock market rally in 2014 are betting that 2015 will bring the tumult they expected last year.

Still, many investors and stock-market strategists say an improving U.S. economy, as evidenced by Friday's stronger-than-expected jobs report for December, coupled with continued low interest rates means there will be enough momentum to keep the six-year-old bull market running.



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That optimism will be put to the test by the earnings season that kicks off Monday when Alcoa Inc. reports results after the close of stock trading.

Overall, companies in the S&P 500 are expected by Wall Street analysts to report that profits rose 1.1% from a year earlier in the fourth quarter, according to FactSet. That would mark the slowest pace of growth since the third quarter of 2012, when earnings declined 1%. Revenue at S&P 500 companies is forecast by analysts to rise 1.1% from a year earlier in the fourth quarter, its slowest growth in a year.

Excluding the energy sector, which has been hit by the tumble in the price of oil, earnings at companies in the S&P 500 are projected to rise 3.6%, below the 5.2% average growth rate for earnings of all S&P 500 companies over the past eight quarters, according to FactSet.

To a large degree, the weakness in fourth-quarter earnings is well-anticipated. That is because much of the blame goes to energy companies, whose profits are expected to fall 19.1% for the quarter thanks to the plunge in oil prices.

At the same time, a sharp rise in the value of the dollar is expected to reduce the value of revenue earned abroad by several percentage points, as well as cut into the businesses of U.S. exporters whose products have become less competitively priced. Slowing economic growth overseas is also pressuring profits for U.S. multinationals.

"There are a fair amount of headwinds that are beginning to really start to blow hard in the face of corporate America," said Burt White, chief investment officer for broker-dealer LPL Financial. But Mr. White added that the expected earnings gains are "pretty good given the situation."

Mr. White is looking for good news from transportation stocks thanks to falling fuel costs. He is recommending the $2.2 billion iShares Transportation Average exchange-traded fund.

With profit growth slowing and stocks near record highs, share prices have been getting more expensive relative to earnings. Stocks in the S&P 500 are trading at 16 times the coming 12 months' forecast earnings, according to FactSet. That is the highest since June 2007 and well north of the 10-year average of 14.1.

"Valuations are high," said Jim Paulsen, chief investment strategist at Wells Capital Management, which oversees $345 billion. "The market's in a more vulnerable state than it's been at any point in this recovery."

Still, Mr. Paulsen said the bull market that started in 2009 "will likely last several more years and probably rise considerably more before it ultimately peaks."

As is generally the case, stock analysts have slashed profit forecasts in the weeks leading to earnings season. At the start of the fourth quarter, analysts had been expecting an overall profit growth rate of 8.4%.

That lowers the bar on profits, traders and investors said, making it easier for companies to beat forecasts and give their stocks a boost.

While the energy sector is seen as a drag on fourth-quarter profits, many investors say lower oil prices are a positive for the future.

In the longer term, investors say, costs should come down for energy-consuming companies ranging from manufacturers to transportation companies to chemical makers.

And in the short term, lower prices at the gas pump are expected to boost earnings among retailers and other companies whose sales get a lift when consumers have more money to spend.

"What you're going to see is good holiday sales data from the retailers, and with gas prices [falling] even further since then, that benefit is likely to carry into" 2015, said Michael Scanlon, senior investment analyst at John Hancock Asset Management.

Mr. Scanlon said one fund he helps advise, the $1.4 billion John Hancock Balanced fund, has in recent months been reducing holdings of energy stocks and buying consumer discretionary shares.

Sam Peters, who manages the $2.8 billion ClearBridge Value Trust, thinks that a bad quarter for energy stocks could provide buying opportunities.

"They're going to have an awful earnings season, but the carnage in the stocks is enough that, in certain cases, there's definitely long-term value," said Mr. Peters.

Mr. Peters owns shares of integrated oil giant Chevron Corp. and exploration and production firm Apache Corp.

The stronger dollar is likely to hurt profits of multinational companies. Thanks to big gains in the dollar against the yen and the euro, the Wall Street Journal Dollar Index—which tracks the U.S. currency's performance against 16 other currencies—was on average 9.4% higher in the fourth quarter of 2014 than in 2013.

As a result of that currency move, a reduction in revenues for multinationals by "4% to 5% wouldn't be out of line," said Tom West, head of equity research at Columbia Management, which has $357 billion under management.

One question mark will be financial companies, which are expected to a show a 1.7% decrease in earnings and have blindsided investors with massive legal charges.

"The thought was that they would be done with the write-downs and all of that by now, but it's been a slow process working out," said Curtis Holden, senior investment officer at Tanglewood Wealth Management, which manages $850 million out of Houston. "That's been a big drag on the earnings."

Wells Fargo & Co. and J.P. Morgan Chase & Co. are set to kick off U.S. bank earnings season Wednesday.

—Rob Copeland contributed to this article.

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