DOW JONES, A NEWS CORP COMPANY

Stoxx 600 362.36 0.31% ▲ Nikkei 22614.82 0.37% ▲ U.S. 10 Yr -1/32 Yield 3.197% ▼ Crude Oil 69.42 0.43% ▲ Euro 1.1521 0.06% ▲

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BUSINESS

Bull Market's Latest Hurdle: Slowing Sales Growth

Many S&P 500 companies point to cautious customers, rising costs and a stronger dollar as reasons for weaker quarterly performance

Many S&P 500 companies cite rising costs and a stronger dollar among the reasons for their flagging quarterly sales. PHOTO: MICHAEL NAGLE/BLOOMBERG NEWS

By Michael Wursthorn

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Revenue growth at U.S. companies is slowing, stirring concern that a corporate-profit boom that has driven the Dow Jones Industrial Average and other major stock indexes to dozens of records in 2018 is in jeopardy.

Firms from asset manager BlackRock Inc. to computing giant International Business Machines Corp. IBM -1.11% ▼ this month have reported disappointing quarterly sales, citing such factors as cautious customers, rising costs and a stronger dollar. So far this quarter, 35% of the 85 reporting S&P 500 companies have missed Wall Street analysts' sales forecasts, according to FactSet. If sustained, that quarterly sales-miss ratio would mark the highest this year.

The misses are contributing to the latest bout of stock-market volatility. The S&P 500 has shed 4.8% over the past month, driven by concerns about rising interest rates and trade disputes that pushed investors to dump technology stocks and shares of other fast-growing companies.

The fundamentals of the U.S. stock market remain mostly strong. Rising earnings, boosted by last year's corporate tax cuts, have helped justify rich multiples and in some cases brought price-earnings ratios down. Sales growth remains solidly positive even if it is now falling back from the heady pace reached earlier this year.

Many analysts are now focusing on what the numbers might look like next year. If sales continue to slow in coming quarters, earnings growth will become more difficult to come by and a crucial pillar of support for markets will weaken, analysts said.

"We had a strong first half in the U.S. for growth and corporate earnings," said Talley Leger, an equity strategist at OppenheimerFunds. "Right now, we're staring at a softer second half heading into next year. That is the challenge for equity markets."

S&P 500 companies are on pace to grow third-quarter sales by 7.3% from the same period a year earlier, according to FactSet. Though a far cry from the tepid, low-single-digit figures sometimes seen earlier in this cycle, it is the lowest growth rate for the broad index in four quarters.

While hardly anyone expects a recession soon, investors are worried about how the stock market will react to slowing profit growth. With the immediate boost from tax cuts in the past, profit growth among S&P 500 companies next year is expected to decline by half, while sales growth is projected to contract to 5.4% from 8.2%, according to FactSet.

For now, companies continue to benefit from the tax overhaul passed late last year, which has helped bolster a domestic economy already characterized by soaring consumer confidence and the lowest level of unemployment in nearly 50 years.

Those consumer benefits have filtered down to companies like Netflix, which said this past week that it added nearly 7 million new users in the third quarter and brought in $4 billion in sales, in line with analyst' estimates. Shares initially rose, but investors' waning optimism sapped Netflix of all of its gains for the week. Still, the stock remains up 73% for the year.

But the economy's strength and the Federal Reserve's interest-rate increases have helped drive up the value of the U.S. dollar, which tends to weigh on U.S. exports and the earnings of multinational companies by making goods produced here costlier overseas.

IBM, for instance, said this past week that its third-quarter revenue fell 2.1% from a year earlier to $18.8 billion, snapping the computing giant's brief return to growth, even as profit topped expectations. James Kavanaugh, IBM's chief financial officer, said the dollar's rise dashed what would have been an otherwise flat sales quarter.

"The strengthening of the dollar is actually hurting our product-based businesses in hardware and software," Mr. Kavanaugh told analysts on a conference call on Tuesday. Shares of IBM fell 8.3% this past week, extending its loss for the year to 16%.

There are signs that effect is washing through the system more broadly. U.S. manufacturing activity decelerated last month, as the Institute for Supply Management's new orders gauge and its supplier delivery index both declined. In August, the Philadelphia Fed's manufacturing survey hit its lowest reading in 21 months, while the Empire State manufacturing index fell in September.

While the S&P 500 remains up 3.5% this year, some money managers are urging investors to focus on more durable companies that have strong balance sheets, better pricing power and higher profit margins—businesses that are expected to better withstand an eventual economic slowdown.

Unilever PLC and Nestlé SA, for example, recently reported stronger sales after using the bump in inflation to raise prices. Shares of both companies rose more than 4% this past week, paring losses for the year.

But sentiment clearly is under pressure. The American Association of Individual Investors' weekly survey indicated that the percentage of investors who expect stocks to fall over the next six months rose to its highest level in three months.

"Investors should be asking themselves at this stage how much better can things really get," said OppenheimerFunds' Mr. Leger. "Investors need to curb their enthusiasm."

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