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As Dow Climbs, Worries Persist

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Stocks have burst out of the gates in 2012, surprising investors and pundits alike with the strongest start of the year in a quarter century.

A mix of positive economic data from the U.S., China and even Europe has helped drive shares higher, as some believed worries about the Continent would keep a lid on gains.

The bullish sentiment was on full display on Wednesday, with the Dow Jones Industrial Average up 96.88 points, to 12578.95 and the Standard & Poor’s 500-stock index up 14.37 points, to 1308.04, surpassing 1300 for the first time since July. The S&P 500 is now up 4% in the first 11 trading days of the year, its best start since 1987. The Dow is up 3%, managing its best start since 2003.

But the strong pace set by the market since Jan. 3 hasn't persuaded the skeptics that the rally has legs. The bears point to a number of issues lurking ahead, ranging from corporate earnings to technical signposts that are used to predict the stock market’s direction.

Among investors’ chief concerns: Companies are reporting disappointing profits for the first time in years. Also, some analysts said some indicators are flashing gloomy signals. And a barometer of shipping demand, the Baltic Dry Index, has plunged in recent days, sparking worries that overall economic activity may be stalling.

To be sure, some analysts said the relatively slow pace of gains—the Dow industrials haven't had a move of 100 points or more since Jan. 3—is a good sign. "We continue to move higher in methodical fashion, which can be more sustainable than a euphoric advance," said Richard Ross, global technical strategist at Auerbach Grayson.

The strong start had caught many off guard. After a tumultuous 2011, some stock-market strategists had forecast a decline in the S&P 500 for the year.

Many had pointed to the risk that corporate earnings may disappoint this season. Earnings have been particularly key for the stock market in the past few years. Record corporate profits have helped underpin stocks amid worries about the European sovereign-debt crisis and a sluggish U.S. economic recovery.

This earnings season, those concerns have proved valid. Some 43 companies in the S&P 500 have reported fourth-quarter results as of late Wednesday, and fewer than 50% beat analyst estimates. That percentage is well below the 70% average of the past four quarters, according to data from Thomson Reuters.

S&P 500 companies already had issued more profit warnings ahead of this reporting season than at any time since the fourth quarter of 2008.

As a result, analysts have ratcheted down expectations for 2012 earnings growth. Wall Street’s consensus forecast
for 2012 S&P 500 earnings growth has dropped to 13.2% in early October to 9.9% as of mid-January, according to Thomson Reuters.

"It surely doesn't bode well for the forward estimates, or for stocks to continue to rally in the next couple of weeks," said Barry Knapp, head of U.S. equity strategy for Barclays Capital. "From a broader macroeconomic perspective it doesn't say anything positive about economic momentum, either."

Still, it is early in the reporting season, Mr. Knapp said, and results to come from technology and health-care companies may paint a rosier picture. So far, investors have remained sanguine, preferring to focus on positive economic signals instead of Europe's debt crisis.

"I think generally speaking, the consensus is still too high for 2012," said Chris Hyzy, chief investment officer at U.S. Trust.

Another indicator grabbing some attention: the Dow Jones Transportation Average, an index of highly cyclical rail, trucking and airline stocks.

One of the tenets of the "Dow Theory" of market analysis, which was developed more than a century ago by Charles Dow, is that both the Dow Jones Industrial Average and the Dow transportation average should move in the same direction to keep an upward trend intact.

But on Tuesday, the Dow transports fell 0.1%, while the Dow industrials rose 0.5%. While some of the weakness can be attributed to the price of oil, analysts suggest a string of such divergences could portend trouble for stocks.

Moreover, watchers of a specific momentum indicator, which measures the rate of change in prices over a specific time period, are studying trends shown by the Dow transports and the Dow industrials.

The Dow transports' momentum indicator, which measures the rate of change over a specific time period, has been falling ever since reaching a 2½-year high in mid-October, according to FactSet Research. The Dow industrials' momentum has been declining, too, although not as fast.

That suggests buyers may be running out of steam, said Frank Longman, technical analyst at Brean Murray Carret & Co. "We're definitely not a buyer here," Mr. Longman said. He said the market is overbought, meaning that stock indexes have shot past the targets he expected.

Another cautious sign getting more attention lately is the Baltic Dry Index.

This tracker of the cost of shipping dry goods, which plummeted during the financial crisis, has tumbled 44% this year, hitting a three-year low. While such a move by itself wouldn't necessarily be bearish, the warning signs are adding up, some investors said.

"It kind of feels like the rally has lost momentum over the last few weeks, whether you look at the transports, the S&P 500 or the industrials," said Brian Lazorishak, portfolio manager and quantitative analyst at Chase Investment Counsel. "You've got a lot of mixed signals."

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