https://www.wsj.com/articles/second-quarter-earnings-to-test-soaring-market-11563096602

MARKETS

Second-Quarter Earnings to Test Soaring Market

Contracting profits and declining margins could weigh on stocks

JPMorgan Chase and others are set to report second-quarter earnings. **PHOTO:** BRENDAN MCDERMID/REUTERS

By Michael Wursthorn and Corrie Driebusch

Updated July 14, 2019 9:19 pm ET

The next test for the highflying stock market begins this week as companies kick off reporting what could be their biggest quarterly profit contraction in three years.

The second-quarter earnings season begins in earnest, with Citigroup Inc., JPMorgan Chase & Co., Netflix Inc. and others giving investors an early look at how some of America's biggest companies are coping with tepid economic growth and billions of dollars in tariffs.

Stocks have busted through records recently, rising thanks in large part to dovishness from the Federal Reserve. The central bank has positioned itself to cut interest rates this month for the first time since the financial crisis.

Investors' outlook on rates has helped equities outdistance weaker growth around the globe that has been crimped by a continuing trade dispute between the U.S. and China, the world's two biggest economies.

Now a bleak outlook for corporate earnings is being added to the mix. More than 80 S&P 500 companies warned that their second-quarter financial results will be weaker than initially expected, including online-streaming giant Netflix, software maker Adobe Inc. and industrial conglomerate Honeywell International Inc., according to FactSet.

That is more than usual, analysts said, and puts the broad index at risk of facing its first period of two or more consecutive quarters of declining earnings since 2016. Analysts predict second-quarter earnings will contract by 3% from a year earlier, which would be the biggest earnings decline since the second quarter of 2016, according to FactSet.

Other investors say despite downbeat estimates, they expect second-quarter earnings to be flat compared with this time last year, if not a little higher. Analysts tend to be conservative with their earnings estimates, making it easier for companies to beat lowered expectations. This happened in the first quarter, with earnings contracting just 0.3% rather than the 4% analysts predicted at the end of March. Twenty-four companies in the S&P 500 have already reported, and 20 of them have beaten estimates.

“Even though the stock market is at an all-time high, expectations about earnings is very low. That sets you up for a very good market response to earnings,” said Andrew Slimmon, senior portfolio manager with Morgan Stanley Investment Management.

So far, the prospect of the Federal Reserve cutting interest rates sometime this year has given investors an incentive to buy stocks. The S&P 500 has climbed 20% this year, rallying on days central-bank officials suggested it would slash rates to help the U.S. grow despite trade tensions and a shaky global economy. That happened this past week, when Fed Chairman Jerome Powell sent a strong signal to investors during two days of congressional testimony that a cut could come as soon as this month. This year, major stock indexes have hit records for the first time since the fall, after more than recouping what they lost during a fourth-quarter rout last year.

But some analysts and money managers worry whether the insight companies offer while reporting earnings will erode investors’ confidence in U.S. stocks.

“Though few, if anyone, expected Powell to push back against the odds of a July cut, it’s still a bit surprising to see his testimony so weighted toward the negative, which suggests that the economy could be struggling even more than many investors had feared,” said JJ Kinahan, chief market strategist of TD Ameritrade . “The focus could be on whether corporate executives see some of the same concerns as Powell.”

Dozens of companies forecast as early as April that economic conditions had grown more challenging, citing rising labor costs, the strength of the U.S. dollar and deteriorating growth in

Europe and Asia. Corporate executives at chip makers, various manufacturers, food companies, retailers and others added that trade tariffs were eating into profit margins.

Many investors and analysts say a potential decline in profit margins—a measurement of how much a company's sales exceed its costs—is more worrisome than contracting earnings in the second quarter.

Technology stocks have been the stalwart of the stock market's run in recent years, and a decline in margins for the sector, as is widely expected, threatens to change that. Most of the second-quarter profit warnings have come from technology and consumer-discretionary companies, sectors that have borne the brunt of trade tensions between the U.S. and China, as well as slowing economic growth. Of the 88 warnings, 26 came from tech firms, including Intel Corp. and Micron Technology Inc., according to FactSet.

"I think some of these tech stocks are up a lot, and if they miss because of margins, I think they're very, very vulnerable," said Mr. Slimmon.

For big social-media companies, analysts estimate costs—stemming from regulation and security, for instance—are rising faster than sales, squeezing margins. Facebook Inc. is expected to see a 19% compression in its profit margin in the second quarter, according to Credit Suisse analysis.

Other technology companies, like big chip makers such as Micron and Western Digital Corp. , are seeing margin pressure as a result of underwhelming revenues and a decline in production, said Patrick Palfrey, senior equity strategist at Credit Suisse.

While these drops appear concerning, Mr. Palfrey believes much of the profit-margin compression will be transitory. For instance, in the case of companies whose margins are dropping because of higher investment costs, that could end up being a boost for shares in the long-run.

Third-quarter earnings estimates have also deteriorated. Analysts predict third-quarter earnings will fall another 0.9% from a year earlier, potentially extending the S&P 500's profit-growth slump, according to FactSet data.

"Investors are re-evaluating what these earnings are actually going to look like and whether it justifies the prices," said TD Ameritrade's Mr. Kinahan. "If earnings aren't what they are, the price of stocks have to change."

Write to Michael Wursthorn at Michael.Wursthorn@wsj.com and Corrie Driebusch at corrie.driebusch@wsj.com