By TOM LAURICELLA

In the face of what would normally be terrible news, the stock market continues to defy skeptics and grind higher as investors grow more comfortable with taking money off the sidelines.

"You certainly can build a case why the market should not be doing better," says Ted Oberhaus, head of stock trading at Lord Abbett & Co. He points to last week's news, which included the Chrysler bankruptcy, the flu-pandemic fears and a worse-than-predicted 6.1% drop in first- quarter gross domestic product. "These are the things that a few months back would have turned the equity markets sour. But now they're being overlooked," he says.

Instead, investors have been focusing on positive surprises among first-quarter corporate earnings and on the silver linings of the bad news, such as stronger-than-expected consumer-spending data within the GDP report and a steep draw-down of inventories that raised hopes for a quick snap-back in production once the economy stabilizes.

"The bottom line is that, yes, the economy continues to deteriorate," says Peter Scholtz, president of Scholtz & Co. "But the data is beginning to show that the bottom may be sooner than thought and that's translating into a shift in psychology."

View Full Image

Getty Images

A drop in market volatility means investors may be less pessimistic. Here, pain in the CBOE options pit.

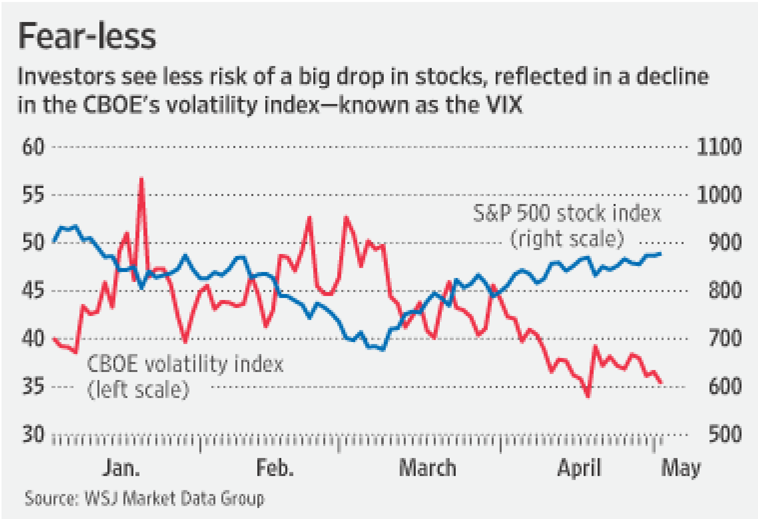
To some degree, the recent resiliency of stock prices reflects the fact that, while many shorter-term players such as hedge funds are negative about the immediate prospects for the market, longer-term investors such as mutual funds or pension funds have become more comfortable with the outlook for the next several years. Those big investors had significantly scaled back their stock holdings over the last six months.

Now, even if they're not wildly bullish and even think stocks could yet retest their lows, many longer-term investors have stopped defensive selling. Instead they're inching back into stocks amid a sense that governments around the world have been successful in containing the financial crisis.

"What's happening is portfolio managers are saying, 'gee, that's a positive, let me increase my [stock] exposure incrementally and that incremental shift is pushing the market higher," says Mr. Scholtz. For his part, Mr. Scholtz has been wrestling with whether its time to shift clients out of a defensive posture. "More and more we think we shouldn't wait."

The Dow Jones Industrial Average closed Friday at 8212.41, up 1.7% for the week. The index is up 25% from the 12-year low it hit on March 9. The Standard & Poor's 500-stock index rose 1.3% for the week.

Supporting the notion that investors are less fearful of another big down-leg in stocks has been the recent decline in the Chicago Board Options Exchange's volatility index, or VIX.



The VIX uses options prices to measure market expectations of how much the S&P 500 is likely to move up or down over the next 30 days. During periods of turmoil, options prices tend to rise, which lifts the VIX. The VIX hit all-time highs during last fall's financial crisis as it surged above a reading of 80. That compared to low-teen levels common during the middle of this decade.

Even as the stock market began to recover in mid-March, the VIX stayed stubbornly above 40, suggesting investors weren't convinced the worst was really over. But the VIX finally broke lower two weeks ago and finished last week at 35.3. By historical standards, that level would still point to acute fears about the future, but analysts say the move was a positive sign.

Sivan Mahadevan, head of equity and credit-derivative research at Morgan Stanley, says that a closer reading of options prices reinforces the idea that investors are less worried. Back in November, options prices suggested a 17% chance that the S&P 500 would fall 50% over the next 12 months, Mr. Mahadevan says. Late last week, that probability was 8%. However, Mr. Mahadevan says options prices don't suggest investors see a meaningfully higher probability of a huge rally.

Another trend has been a move toward more normal relationships between longer- and shorter-term expectations for volatility. In normal times, options prices reflect greater certainty about near-term stock movements than for developments further in the future. But during the crisis, investors showed greater fear about the risks for stocks in coming weeks, than, say, about what might happen 6 months or a year down the road.

Carl Mason, equity-derivative strategist at BNP Paribas, says investors have been pushing back the time horizon over which they are most concerned about stocks. "Instead of fearing the here and now, investors seem more concerned about year end," Mr. Mason wrote in a report published Friday morning.

Giving some comfort has been first-quarter corporate earnings. With 65% of the companies in the S&P 500 having reported, operating earnings appear on track to show a slightly smaller-than-expected 35.1% decline, according to Thomson Reuters. According to Morgan Stanley, 65% of companies have beaten estimates, compared with the 62% average over the past decade.

Some say caution is still warranted. Andrew Lapthorne, global quantitative strategist at Société Générale, says that while only 30% of S&P 500 companies have failed to top earnings-per-share forecasts, 62% fell short on sales. In addition, he notes that analysts continue to reduce earnings forecasts for future quarters. For example, second-quarter forecasts now call for a 34.6% drop in operating earnings, compared with the 33.7% decline expected a week ago.

Mr. Lapthorne says investors taking heart from the current earnings news also run the risk of being fooled by a seasonal tendency for April and May to be the "least bad" months for earnings downgrades.

Still, Mr. Scholtz says, first-quarter earnings suggest investors could be justified in having a more optimistic view of the ability for corporate profits to rebound from the downturn. Even if the economy continues to struggle, the balance sheets of U.S. corporations are in relatively good shape and many companies have aggressively cut costs. As a result, he says, "incremental sales can go straight to the bottom line...and the ability for earnings to recover is fast."

Write to Tom Lauricella at tom.lauricella@wsj.com