

ECONOMICS: US PERSPECTIVES—SEPTEMBER 24, 2010

Robust US Profits Rebound Poised to Continue

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During the first year of economic recovery, US companies posted exceptionally strong earnings growth despite a modest rebound in GDP. Our analysis suggests that cost cuts as well as revenue gains at home and abroad helped companies overcome recession and should fuel rapid earnings growth in the third quarter.

Now it's official. The Great Recession that began in 2008 officially ended 18 months later in June 2009, the National Bureau of Economic Research said this week. This declaration is more than just a formality. With a definitive marker set for the start of the recovery, we can now conduct an important comparison of the past year's corporate earnings and gross domestic product (GDP) recoveries against previous post-recessionary periods.

A curious anomaly has emerged since the downturn ended. During the first year of recovery through June 2010, corporate operating profits posted exceptionally strong growth, even though the overall economic rebound was relatively modest by historical standards.

Based on the GDP data, operating profits of US companies increased 39% during the first four quarters after the recent recession, matching the gain in the recovery of 1983. In fact, the recent earnings rebound fell just short of the 1975 recovery, which was the biggest

revival of corporate earnings after any recession in the last 50 years (**Display 1**). How did companies generate such strong profits in 2009–2010 when economic growth was relatively modest?

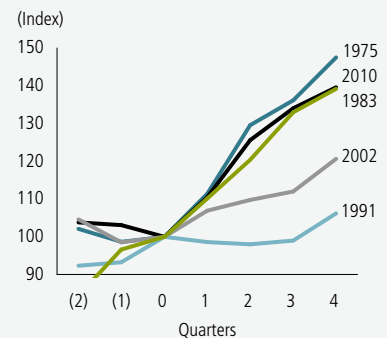
This question appears even more perplexing when we consider that during the earnings recoveries of 1975 and 1983, corporate profits were driven by extremely sharp GDP growth of 6.3% on average—more than twice the 3% gain over the past year. Moreover, in each of the previous cases higher prices helped fuel earnings, while today inflation remains particularly low.

What's Driving Profit Gains?

The strong earnings rebound today is being driven by rising nominal sales growth over the past year as well as improved earnings leverage, meaning that a higher proportion of revenue is filtering down to the bottom line as leaner companies have become more efficient. Revenue or sales of nonfinancial S&P 500 companies advanced 11.8% from

Display 1
2010 Earnings Recovery Ranks High

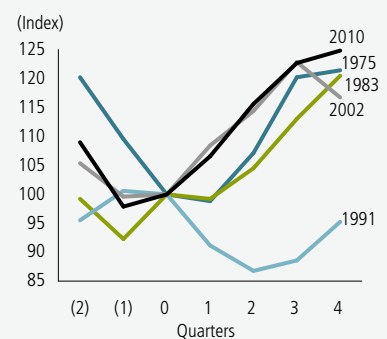
US Corporate Operating Profits
During First Year of Economic Recovery



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

Display 2
International Units Buoy US Earnings

US Corporate Operating Profits from Overseas
Operations During First Year of Economic
Recovery



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

year-earlier levels, according to second quarter earnings reports. Including financial firms, revenue growth reached 9.7%. These figures include revenue generated by majority-owned affiliates of US companies around the world, but it is difficult to distinguish between domestic and international sales from the data.

Growing Profits at Home and Abroad

The earnings breakdown is much clearer. Overseas arms of US firms contributed significantly to earnings growth, according to the GDP data. Earnings from overseas operations now account for 35% of overall US corporate profits—about 10 percentage points higher than a decade ago. In addition, the 25% growth in overseas earnings over the past year was the largest increase on record during the first year of a global GDP upturn (**Display 2, previous page**).

Even with help from abroad, earnings growth for US companies was driven primarily by domestic operations, with profits at home surging 47% as companies implemented unprecedented cost cuts. Indeed, labor costs plunged over the past year as companies reduced head count and cut back on pay. Measured per unit of output, employee compensation fell to a postwar record low of 61% (**Display 3**).

Beyond labor costs, US companies reduced spending in other ways, including through a sharp contraction of inventory positions and lower depreciation expenses. All of these factors helped produce a big rebound in real profits margins, which reached 13.1% in the second quarter of 2010, not far below the previous peak of 13.6% in 2006.

Is this sustainable? At this writing, analysts' third-quarter earnings estimates predict a

year-on-year gain of 28% for all S&P 500 companies, and 21% if the financial sector is excluded. Although these numbers look very strong to begin with, our analysis of the earnings outlook leads us to believe that the actual results may well exceed expectations once again.

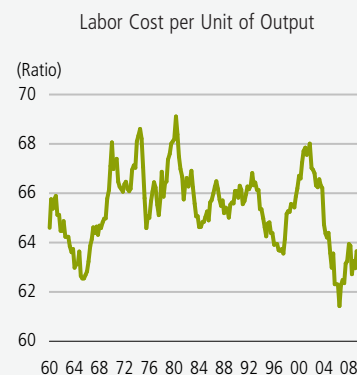
In order to assess underlying profit growth, we track estimated corporate tax payments. Companies are required to make estimated quarterly tax payments on the 15th day of the last month in each quarter. Back in June, we noted that estimated corporate tax payments had jumped by 39.3% from the year-earlier period. At the time, we had argued that the pace of growth in tax receipts set the stage for a relatively strong earnings season since analysts were expecting profit growth of between 27% and 30%. In fact, overall second-quarter operating profits advanced by 39.2% year on year, matching the gain in estimated tax payments (**Display 4**).

Tax Trends Predict Earnings Gains

When we conduct the same exercise today, we find that estimated tax payments made on September 15, 2010, show a sharp year-on-year increase of 53.7%, well above the gain recorded in June. This gain may overstate the earnings environment somewhat, as the surge in estimated corporate tax payments for the third quarter was coming off depressed levels a year earlier. In late 2009, companies were still emerging from the wreckage of recession and tax payments in September last year were especially weak due to low aggregate earnings.

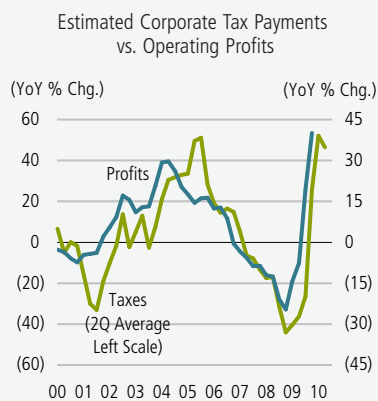
Still, based on the historical relationship between tax payments and profits, we project that US companies' third-quarter earnings will rise by 35% to 40%, well above consensus analyst estimates. It's

Display 3
Cost Cuts Drive Earnings Growth



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

Display 4
Taxes Point to Strong Third-Quarter Profits



As of June 2010
Source: Bureau of Economic Analysis and Haver Analytics

impossible to predict with any certainty which sectors or industries may post the strongest performance. However, given the strong gains in emerging-market economies, especially in Asia ex Japan and Latin America, we believe that US companies with significant international exposure are the best candidates to deliver welcome surprises to weary investors. ■

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