Corporate Earnings Growth Suggests Business Sector Recovery

September 5, 2002

The recession that began in March 2001 has been termed a corporate sector recession because of pervasive weakness in the business sector, in particular business profits and investment.[1] Signs of this weakness include higher levels of corporate bankruptcies, higher default rates on corporate bonds, and higher levels of commercial and industrial (C&I) loan charge-offs at FDIC-insured commercial banks. During the second quarter of 2002, insured commercial banks charged off $4.2 billion in C&I loans, the second-highest level of C&I charge-offs on record and 40 percent of all charge-offs in the quarter. Amid recent economic data that do not clearly point to a turn in the business cycle, business analysts naturally look to other measures to try to discern a turning point in business conditions.

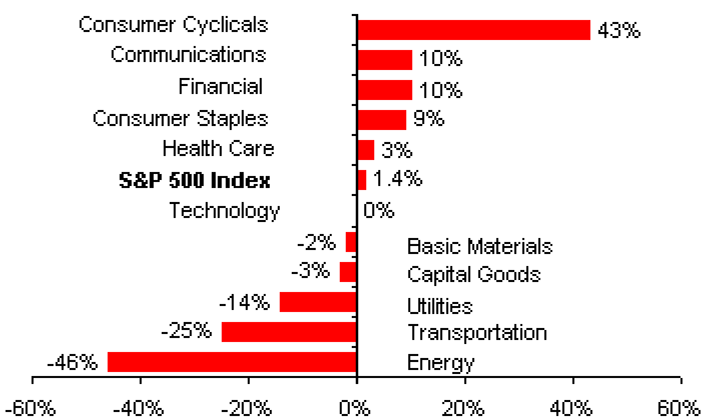
Recent earnings reports from companies in the ***Standard and Poor's*** (S&P) 500 index suggest that the trend of declining corporate profits may have run its course. Using the S&P 500 index as a benchmark is instructive because it is a broad measure comprised of companies that are fairly well-known to investors. After five consecutive quarters of negative year-over-year growth in earnings from continuing operations, companies that comprise the S&P 500 index reported positive growth of 1.4 percent for the second quarter of 2002.[2]

The second quarter earnings performance tended to exceed analyst expectations. According to ***Thomson First Call***, 421 (85 percent) of the companies that have reported earnings matched or beat expectations while 73 (15 percent) fell short of expectations. Overall, composite reported earnings exceeded expectations by 1.3 percent. Although this performance is low by comparison to the post--1994 average of 2.8 percent, nevertheless, there are a greater number of companies matching or beating expectations than the historical average.

Chart 1

Second Quarter 2002 Earnings Performance Varied Widely Among Sectors That Comprise the S&P 500 Index

Second Quarter 2002 Year-over-Year Growth in Earnings from Continuing Operations in Sectors That Comprise the S&P 500



Note: Earnings based on 494 companies reporting as of August 30, 2002.
Source: Thomson First Call; FDIC

Earnings growth in the second quarter of 2002 was led by the consumer cyclicals (which include automobiles, furniture, and clothing) and telecommunications sectors (see Chart 1). Demand for durable goods such as automobiles and auto parts has remained especially strong throughout the recession. The strong housing market also boosted demand for housing related purchases such as furniture and appliances, contributing to strong earnings growth for the consumer cyclicals. Year-over-year growth in earnings for the telecommunications sector tended to be artificially inflated because earnings in the second quarter of 2001 were particularly low, and, in the case of some sub-sectors, were negative. The worst-performing sectors included energy and transportation, both of which experienced negative year-over-year growth. The energy sector was affected by price weakness in the oil and gas markets, while the poor financial performance in the airlines industry led to declining earnings in the transportation sector.

One factor that must be taken into account when making period-to-period comparisons of S&P earnings performance is that the composition of companies that make up the S&P 500 index changes over time. According to S&P Compustat, sectors that experienced a decline in the share of listings in the index from 1983 to 2001 include energy, materials, industrials, consumer discretionary, consumer staples, and utilities. The health care, financial, information technology and telecommunications sectors now comprise a larger share of the companies that are included in the index. Not surprisingly, the information technology sector has enjoyed the largest share increase in percentage terms with a 9.4 percentage point increase in its share of the companies represented in the index. The financial sector comes in second with a 6.2 percentage point increase.

Future earnings at companies listed on the S&P 500 index are expected to continue to show positive growth. First Call currently estimates that earnings in the third quarter of 2002 will be 11.2 percent higher than a year earlier, while earnings in the fourth quarter will be 22.9 percent higher than a year earlier. However, these estimates may be optimistic in that they follow a string of overestimated earnings figures. Over the past eight quarters, earnings estimates at the beginning of each quarter have exceeded actual performance as earnings for the quarter have been much lower than expected (see Table 1). It appears, however, that estimates have come closer to actual earnings performance over the past two quarters. With the direction of the economy still uncertain and with corporate financials being more highly scrutinized, it remains to be seen whether forecasted earnings will become more in-line with actual performance in the third quarter of 2002 and beyond.

Table 1

S&P 500 Earnings Growth Has Been Overestimated During The Past Eight Quarters

Year	Quarter	Year-over-Year Earnings Forecast for the S&P 500 at the Start of the Quarter	Actual Year-over-Year Earnings Growth for the S&P 500 at the End of the Quarter	Difference Between Actual and Forecast
2000	2	17.6%	21.6%	4.0%
2000	3	18.7%	18.4%	-0.3%
2000	4	15.6%	3.2%	-12.4%
2001	1	5.3%	-6.1%	-11.4%
2001	2	-6.3%	-17.0%	-10.7%
2001	3	-6.2%	-21.6%	-15.4%
2001	4	-8.2%	-21.5%	-13.3%
2002	1	-6.2%	-11.5%	-5.3%
2002	2	2.4%	1.4%	-1.0%

Note: Second quarter 2002 results based on 494 companies reporting as of August 30.

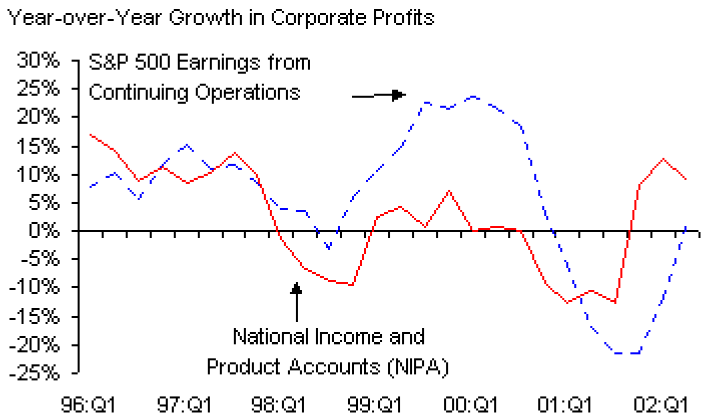
Source: Thomson First Call; FDIC

According to First Call analysts, the earnings outlook is highly dependent on sustained recovery in the economy and demand in key sectors such as technology, financials, and consumer cyclicals. It is difficult to see many bright spots in the technology sector, although game software makers appear to be showing some strength, and business spending on software grew by 10 percent in the second quarter. Financial market weakness has hurt some market-sensitive revenues at many large financial institutions, although a favorable interest rate environment and a widening of net interest margins have so far outweighed any negative effects of market weakness.[3] Finally, consumer demand for both durable and nondurable goods has remained strong, sustaining the economy and the profitability of producers of consumer cyclical products such as automobiles, furniture, and clothing. However, the ability of consumers to maintain current spending patterns depends on the resilience of the job market, future real income gains, and the ability to service future debt burdens.

Another measure of corporate earnings is provided from the National Income and Product Accounts (NIPA) compiled by the ***Bureau of Economic Analysis***. This measure of corporate earnings is very different from that of the S&P 500, and they are not always in sync. NIPA corporate profits, which include profits of every corporate entity, showed strong year-over-year growth in the fourth quarter of 2001 and the first two quarters of 2002, even as S&P 500 profit growth remained weak (see Chart 2). In the ***Federal Reserve Board's semiannual monetary policy report to Congress***, Chairman Alan Greenspan suggested that some of the historical differences could lie with stock options because the NIPA numbers include the cost of stock options, while the listed company profits do not. Thus, "real" listed company profits may have been inflated in the late 1990s and 2000. Chairman Greenspan also attributed the recent strong growth in NIPA corporate profits to strong productivity gains and declining unit labor costs.

Chart 2

Earnings Growth at S&P 500 Firms Outpaced NIPA Corporate Profits in 1999 and 2000 But Fell More Sharply in 2001



Source: Thomson First Call; Bureau of Economic Analysis; Economy.com; FDIC

The disparity between the growth in S&P 500 profits and NIPA corporate profits from 1998 to 2000 may also reflect some of the accounting issues that have now come back to haunt many listed companies. ***Economy.com*** analyst Michael Burt suggests that, despite the differences in the measurement of the two earnings figures, the strong growth in S&P 500 profits relative to NIPA corporate profits should have alerted investors to the potential for inflated profits at S&P 500 firms. [4]

Institutions both public and private have been working on solutions that would help to prevent executive malfeasance, clarify corporate reporting, and strengthen corporate governance. For instance, the ***U.S. Securities and Exchange Commission*** (SEC) has required the CEOs and CFOs of the largest 947 listed companies in the U.S. to personally certify the accuracy and completeness of periodic financial reports.[5] Thus far, only a handful of CEOs and CFOs of S&P 500 firms have not completed this certification. In addition, the recently passed Sarbanes-Oxley Act introduces far-reaching measures that will limit the operations of audit firms to reduce potential conflicts of interest and introduce stricter punishment for corporate executives who are found guilty of wrongdoing. Finally, ratings agencies have engaged the analyst community in the debate by introducing more uniform and representative measures of corporate performance, such as the S&P "core earnings" concept.[6]

A recovery in corporate profits is an essential element for renewed growth in business investment. As corporate profits begin to grow again, businesses should have more free cash flow to invest in productive projects and resources, which would in turn help to spur economic growth. There are some signs that such a recovery may be taking hold. Advance data indicate that orders for non-defense capital goods increased by 13.5 percent in July, suggesting that business investment may be poised for a rebound. In time it will be easier to discern what is a real trend and what is simply noise in the data. In the meantime, though, analysts can continue to focus on some basic indicators of profitability that could tell us much about the underlying strength of the U.S. economy.

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[1] For a more detailed discussion on the performance of the business and consumer sectors during the current recession, see also, "Back to the Future: How This Downturn Compares to Past Recessions," Regional Outlook, Second Quarter 2002.

[2] ***Thomson First Call***, "S&P 500 2Q02 Earnings Scorecard," August 30, 2002. Second quarter earnings for companies in the S&P 500 index are based on 494 companies reporting as of August 30.

[3] See also "Favorable Interest-Rate Environment Drives Record First-Quarter Bank Earnings," FYI, June 3, 2002 http://www.fdic.gov/bank/analytical/fyi/index.html

[4] Michael Burt, "Missed Signal," July 30, 2002. http://www.economy.com/dismal

[5] For more information about executive certification of periodic financial statements, see the Securities and Exchange Commission at http://www.sec.gov.

[6] For more information about the S&P core earnings concept, see Standard and Poor's at http://www.standardandpoors.com.