

Corporate performance

A world awash with profits

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Business is booming almost everywhere

GIVEN how easy it has been to find something to worry about, be it the plummeting dollar, war in Iraq or the crookedness of so many corporate bosses, it has been easy to miss one extraordinarily positive economic trend: for companies around the world, on average, business has never been better. Balance sheets are strong, boardroom confidence is sky high and, most striking of all, corporate profits are at record levels.

Profits tend to grow fastest in the early part of a recovery, when firms use spare capacity to raise output at little extra cost. As America's economy began to grow again in early 2002, profits duly shot up. But, ordinarily, profit growth slows as the cycle matures, firms hire more workers and costs rise. Intriguingly, this has not yet happened in America, despite three years of strong growth. Last year, the operating profits of the big, publicly-listed firms that make up the S&P 500 stockmarket index grew by an estimated 20%, after 19% growth in 2003. From tech firms such as Google to industrial and financial behemoths such as General Electric, America's bosses continue to spring pleasant surprises on grateful shareholders. With most results announced, profits for the fourth quarter of 2004 ought comfortably to beat the 15.1% growth, year-on-year, which the market has been expecting, says Thomson Financial, a research firm.

Things are similarly positive across the Atlantic. In Britain, the huge profits of two oil firms, BP and Royal Dutch/Shell—Shell's \$18.5 billion beat the previous British record set last year by HSBC, a bank—have even prompted wishful left-wing talk of windfall taxes. On the continent, Puma, Europe's third-biggest maker of sportswear, reported a 44% increase in net profit for 2004 on February 7th. Then Renault, France's second-biggest carmaker, reported a 43% rise in net profits to €3.6 billion (\$4.6 billion). France's two big luxury-goods conglomerates, Moët Hennessy, Louis Vuitton and Pinault-Printemps-Redoute, have also had a good year. Together, the operating profits of the big firms tracked by the S&P Europe 350 index rose by a striking 78% last year; they are forecast to grow by a further 30% this year. A survey this week of chief executives by Goldman Sachs found European bosses even more upbeat than their peers in America.

Economists take it for granted that profits cannot grow by more than nominal GDP over the medium term. But there are two reasons why profits could defy this conventional wisdom. The first is that it is all an accounting fiction: firms consistently overstate reported profitability. They tend to punctuate periods of oddly rapid growth with occasionally awful years of massive write-offs: admissions, in other words, that past profits were overstated. In 1989-2004, says Goldman Sachs, write-offs among the firms included in the S&P 500 index tended to fluctuate between 5% and 15% of total reported earnings per share (EPS) each year. But there were two notable exceptions: in 1991-93, write-offs rose to 30% or more of reported EPS, setting the conditions for lots of weirdly quick profit growth later in that decade. In 2002, write-offs soared to an astonishing 140% of EPS. Bosses have not looked back since.

The second explanation is that corporate profits can win a bigger slice of national income, and thus temporarily grow faster than the overall economy. According to Merrill Lynch, after-tax profits in America (based on national accounts data, which is more reliable than firms' reported data) rose from about 5.5% of national income in the



early 1990s to more than 9% in 2003. American profit margins are now close to a record. The picture is remarkably similar elsewhere. The share of profits in GDP both in Europe and Japan is close to a 25-year high. Taken as a whole, the share of profits in national income for the G7 rich economies has never been higher, calculates UBS.

Don't worry, be happy

Predictably, this profit boom is spawning its own worries. Some pundits agonise that profit growth built on the impoverishment of workers at home and the export of jobs abroad as firms outsource operations to China and India cannot be sustained: consumer confidence will fall, demand will plummet and profits will collapse.

Others worry that America, in particular, relies too much on financial firms as a source of profit growth. Since 1982, the profits of financial firms in America have risen from 4% of overall profits to more than 40%. (Neither Europe nor Japan has experienced the same phenomenon.) As a whole, the finance industry makes up nearly one-quarter of America's overall stockmarket capitalisation, up from a bit over 5% in the 1970s. Bill Gross, a bond-market veteran, adds these numbers to soaring consumer debts to arrive at what he calls the "finance-based economy"—a perilous venture sustained by the Fed's super-low interest rates.

More optimistic souls point to the sort of arguments that fuelled the sharp rise in share prices and talk of a new economy in the 1990s. Globalisation continues to combine with whizzy new information technologies to boost productivity. Compared with booming profits, rich-country workers have lost out, as Chinese factory workers, Indian software engineers and the spread of computer automation undermine bargaining power and wage growth. On the other hand, these same forces are depressing prices and ushering in life-improving products and technologies, making everyone wealthier and more eager to consume.

The beneficial impact of sourcing in the Chinese and Indian economies may continue for many more years. A recent survey of 248 chief financial officers in Asia by *CFO Asia*, a sister publication of *The Economist*, found many of them complaining of intensifying competitive pressures: 51% of manufacturing bosses said that they cut their prices in the past year, while only 23% raised them.

Meanwhile, Mr Gross's thesis has begun to be tested by the Fed, which has raised interest rates six times since the middle of 2004. So far, the sky has not fallen in. Stockmarket valuations imply that investors, probably sensibly, expect the profits of American financial firms to grow by less than 2% a year over the next five years, reckons UBS, compared with 14% annual growth for information-technology firms and 10% growth for industrial firms.

At some point, overall profit growth is bound to slow down. Unit labour costs will rise as wages improve and productivity growth slows. (Productivity growth already seems to be slowing a bit in America.) Alternatively, the naturally buoyant spirits of corporate book-keepers will eventually catch up with them, and firms will make another round of massive write-offs—laying the ground for another few years of booming profits.