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Profits in recession

Experts say slow earnings likely sign of looming economic slump.
By Rich Miller | Of Bloomberg News
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U.S. corporate profits are in a recession, and the entire economy may not be far behind.
Slower sales and higher energy and labor costs are forcing companies from Bear Stearns Cos. to Pitney Bowes Inc. to reduce spending and hiring. Their efforts to keep earnings from eroding even further raise the risk that the economy, already weakened by the steepest housing slide since 1991, may shrink sometime next year.

''The earnings recession has already arrived,'' says David Rosenberg, North America economist for Merrill Lynch & Co. in New York. ''We are going to see an economic recession in '08.

Corporate profits, as measured by the Commerce Department, fell at an annual rate of $19.3 billion in the third quarter from the second, as domestic earnings dropped by $41.2 billion. The drag from sagging U.S. sales and huge write-downs offset robust earnings abroad,fueled by the weak U.S dollar. The fourth quarter may be an even bigger bust.

''In the third quarter, the tide shifted, and for the worse,'' says Joseph Quinlan, chief market strategist for Bank of America Corp. in Charlotte, N.C. ''The domestic-profits squeeze is in its early stages and will be severe enough to overwhelm strong foreign earnings.''

Caterpillar Inc. of Peoria, Ill., the world's largest maker of bulldozers and excavators, shocked investors in October when it said it expected the economy to be ''near to, or even in recession'' in 2008. At the time, Dearborn, Mich.-based Ford Motor Co., the second-largest U.S. automaker, was still ''optimistic,'' Chief Executive Officer Alan Mulally said Oct. 15. ''There's a lot to be positive about,'' he said.

Little more than a month later, in a Nov. 19 interview, Ellen Hughes- Cromwick, Ford's chief economist, said the economy was ''in some dicey territory,'' though would likely ''edge by'' without a recession.

Profits for the Standard & Poor's 500 companies fell almost 25percent on a per-share basis in the third quarter, the biggest year-over-year decline in almost five years. David Wyss, S&P's chief economist, expects their earnings to fall as much as 30 percent in the fourth quarter as companies take more write-downs for bad investments. Excluding such extraordinary items, operating profits may fall as well, he says.

Consensus estimates compiled by Bloomberg indicate S&P 500 operating profits may rise just 1.1 percent in the current quarter. That's down from the 8.8 percent increase analysts foresaw a month ago. Operating profits fell 2.5 percent in the third quarter, the first drop in more than five years.

Even if profits have peaked, that doesn't mean the economy is about to turn down, says Steven Wieting, managing director of economic and market analysis at Citigroup Global Markets Inc. in New York. In the last expansion, profit margins began contracting in late 1997; there was no recession until March 2001.

What's troubling this time is that much of last quarter's damage came in the financial sector, where operating earnings fell 25 percent, as banks and brokers were hurt by losses from subprime mortgages and related investments. Analysts' estimates compiled by Bloomberg indicate the industry's profits this quarter may decline more than 25 percent.

The plunge in financial profits is a triple whammy for the economy as banks and other institutions pare payrolls, cut capital spending and become stingier with loans. Bank of America, JPMorgan Chase & Co., Bear Stearns, Citigroup Inc., Lehman Brothers Holdings Inc. and Morgan Stanley have announced some 25,000 job cuts so far this year.

Gustavo Dolfino, president of New York executive-search firm Whiterock Group LLC, said in a Nov. 20 interview he expects them to fire thousands more. Claims for unemployment benefits jumped to a nine-month high in the week ended Nov. 24.

Economists polled by Bloomberg forecast that data to be released today will show payroll growth slowed to 70,000 in October from 166,000 in September, while the jobless rate rose.

''We see a significant slowdown in the growth of jobs and equipment spending in 2008,'' says Allen Sinai, chief global economist for Decision Economics in New York. Orders for non-defense capital goods excluding aircraft, a proxy for future business investment, fell 2.3 percent in October, the most since February, according to Commerce Department figures.

Weaker business spending held back sales at Cisco Systems Inc., the world's biggest maker of networking equipment. That disappointed investors, who have pushed the San Jose, Calif.- based company's shares down more than 17 percent since Nov. 6.

Chief Executive Officer John Chambers said orders have slowed from Cisco's top 25 U.S. customers, which include eight financial-services companies. Stamford, Conn.-based Pitney Bowes blamed weakness in the financial-services market for a 14 percent drop in its quarterly net income. The company, the world's largest maker of postal meters, also announced plans to fire 1,500 workers.

The biggest hit to the economy from fading financial profits may come from tighter lending standards. The Federal Reserve reported last month that banks were making it harder for businesses and consumers to borrow. Analysts including Sinai expect terms to tighten further.