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USA Inc feels the heat

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WASHINGTON: US corporate profits are in a recession, and the entire economy may not be far behind. Slower sales and higher energy and labour costs are forcing companies from Bear Stearns to Pitney Bowes 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 in New York. "We are going to see an economic recession in 2008."

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 US sales and huge writedowns offset robust earnings abroad, fuelled by the weak US 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 in Charlotte, North Carolina. "The domestic-profits squeeze is in its early stages and will be severe enough to overwhelm strong foreign earnings."

Caterpillar of Peoria, Illinois, 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, Michigan-based Ford Motor, the second-largest US automaker, was still 'optimistic,' chief executive officer Alan Mulally said October 15. "There's a lot to be positive about," he told reporters.

Little more than a month later, in a November 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 25% 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% in the fourth quarter as companies take more writedowns for bad investments. Excluding such extraordinary items, operating profits may fall as well, he says.

Consensus estimates compiled indicate S&P 500 operating profits may rise just 1.1% in the current quarter.

That's down from the 8.8% increase analysts foresaw a month ago. Operating profits fell 2.5% 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%, as banks and brokers were hurt by losses from subprime mortgages and related investments. Analysts' estimates indicate the industry's profits this quarter may decline more than 25%. 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, Bear Stearns, Citigroup, Lehman Brothers Holdings 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, said in a November 20 interview he expects them to fire thousands more.

Claims for unemployment benefits jumped to a nine-month high in the week ended November 24. Economists polled forecast that data to be released December 7 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-defence capital goods excluding aircraft, a proxy for future business investment, fell 2.3% in October, the most since February, according to commerce department figures.

Weaker business spending held back sales at Cisco Systems, the world's biggest maker of networking equipment. That disappointed investors, who have pushed the San Jose, California-based company's shares down more than 17% since November 6. Chief executive officer John Chambers said orders have slowed from Cisco's top 25 US customers, which include eight financial-services companies.

Stamford, Connecticut-based Pitney Bowes blamed weakness in the financial-services market for a 14% 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.

Advanta, a Spring House, Pennsylvania-based provider of corporate credit cards, cut its 2007 earnings forecast November 27 and withdrew its 2008 estimate as late payments rose.

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