Corporate Profits Aren't What They Seem

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NEW YORK (AP) — Is the great profit engine of corporate America running out of steam?

While other parts of the economy struggled the past two years, large companies managed to rack up higher profits quarter after quarter. Now reality is catching up with big business.

As companies close their books on the final three months of last year, the big ones that make up the Standard & Poor's 500 stock index appear likely to earn about $230 billion. That would be $12.6 billion more than a year earlier.

But the increase, 5.8 percent, is less than half the speed at which quarterly profits grew the first nine months of 2011. In the average quarter since the beginning of 2010, earnings have grown five times as fast.

Analysts expect profit growth to accelerate later this year. But so far, almost all the growth comes from two companies, one of them among America's most favorite, the other among its most hated — Apple and the bailed-out insurance company AIG.

Take away those two companies and profits for the remaining 498 are expected to grow a measly 1.1 percent, according to FactSet, a provider of financial data.

The immediate future looks about the same. For this quarter, which ends March 31, profits for the S&P 500 are expected to be up about 1 percent from the year before. And that's with Apple and AIG thrown in.

"Were the economy to sustain a shock, this makes us more vulnerable," says Barry Knapp, chief U.S. stock strategist at Barclays Capital.

In a report Thursday highlighting "unusually weak" results so far, Goldman Sachs strategist David Kostin noted that stock analysts have been cutting their estimates for what S&P companies will make for all of 2012.

His projection has profits rising 3 percent this year versus 2011, and it has stocks in the S&P 500 no higher than they were when the year started. That would reverse a strong 6.9 percent rise so far this year.

The darkening profit picture comes at the wrong time for the economy, which is finally gaining momentum. The country added an unexpectedly robust 243,000 jobs last month, and unemployment has fallen to 8.3 percent, the lowest in three years.

Rising profits have helped the country heal from the Great Recession. They have allowed companies to hire, invest in equipment and software and raise stock

dividends. The danger is that as profit growth ebbs, so will the boost to the economy.

The reasons for the slowdown are myriad:

— Among the almost 300 companies in the S&P that have reported profits so far, some seem to have run out of ways to cut costs, and are making less profit from each sale, a first in the recovery. To help lift its drooping profit margins, for instance, Colgate-Palmolive said last week that it was raising prices in North America for the first time in two years. Profit fell 5 percent last quarter.

— Other companies point the finger overseas. Dow Chemical, the nation's largest chemical maker, blamed "considerable weakness" in debt-mired Europe for its profit last quarter of 25 cents per share, before a one-time charge. That was less than expected. 3M, which makes Scotch tape and Post-It notes, is worried about slower growth in emerging markets like China, and says that helps explain its tiny 3 percent profit growth last quarter.

— Still others point to the strengthening U.S. dollar, which means profits that companies collect in foreign currencies like the euro translate into fewer dollars when they're brought home. In cutting profit forecasts for 2012, Procter & Gamble and Pfizer both cited the stronger dollar. Their stocks have dropped this year.

But perhaps the biggest reason for the small gains is simple — an investing version of the law of large numbers.

With profits crushed by the Great Recession, it didn't take much early in the economic recovery for companies to report big increases. But now that profits have climbed fast for two years, it's harder to show a jump by a similar proportion.

"The base is much more challenging," says John Butters, senior earnings analyst at FactSet.

Profits per share at Exxon Mobil rose just 2 percent last quarter, and the stock has fallen. But the company still made $41 billion last year, more than the annual economic output of nearly half the world's countries.

To keep growing profits at the rate of the past year and a half, the company would have to earn $65 billion this year — more than three times what it generated two years ago.

If profit growth for the S&P continues to ebb, it will mark the end of a remarkable run.

At the start of the bull market in March 2009, when stocks hit 12-year lows, many professional investors worried that the weak economy would keep a lid on profits. But companies cut staff, squeezed more out of the workers who remained and made more money than nearly anyone expected.

Skeptics noted that companies could only cut so much. But companies kept cutting and squeezing and posted even higher numbers. Then, when domestic revenue didn't grow as quickly as expected, companies compensated by finding buyers abroad, and posted higher profits again.

For eight quarters in a row through last year's third, companies in the S&P increased earnings by double-digit rates. The average increase was a blistering 41 percent. By contrast, the average increase over the past quarter-century is 8.2 percent — not counting the fourth quarter of 2009, when earnings growth was astronomical but the comparison was misleading because of the financial crisis a year earlier.

A return to a more normal rate of increase may seem unremarkable. After all, the expected 5.8 percent rise for last quarter is still expected to push annual combined S&P profits to a record $96.33 per share, according to FactSet. And for every company that has posted profits lower than analyst expectations so far, two companies are meeting or surpassing them.

But again, look closer and fissures appear.

Companies are beating expectations mostly because the expectations have been lowered. In the three months before companies began reporting profits last month, analysts cut estimates for profit growth by more than half.

Then there's the Apple-AIG effect. The maker of the iPhone and iPad is making everyone else in the S&P look good thanks to its huge $13 billion profit last quarter, more than double what it made a year earlier.

As for AIG, the good news is not that it's making much money — it isn't — but that it's not losing money anymore. Later this month, it is expected to report $1.1 billion in operating profits last quarter, compared with a $2.2 billion loss a year earlier, according to FactSet.

Add it up and the two companies will contribute four of every five dollars of profit growth.

The stock market appears to be ignoring all this, and perhaps for good reason.

Investors buy and sell stocks mostly based on what they expect companies to earn in the future, not on what they made in the past. And though dour in the short run, investors expect big gains as economies of the U.S. and some of its big trading partners pick up later in the year.

Profits at aluminum maker Alcoa fell in the fourth quarter, and are expected to slump again this quarter. Yet its stock has risen anyway — 24 percent this year. The reason is that investors are banking on a 23 percent climb in earnings in the last three months of the year.

Overall, profits in the S&P are expected to jump nearly 18 percent in the final three

months after a 5 percent increase in the first nine months, according to FactSet.

Sam Stovall, chief equity strategist at S&P Capital IQ, a research firm, says profits from big companies are like a high-speed train that seemingly can't be stopped, and he's betting it won't. But even he's worried with so much riding on an upturn late in the year.

"The train is approaching a switch," he says, "and if it isn't thrown, we could go tumbling down the cliff."

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