

C A M B R I D G E A S S O C I A T E S L L C

U.S. MARKET COMMENT

THE SHOCKING TRUTH ABOUT EARNINGS GROWTH

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The Shocking Truth About Earnings Growth

Heady earnings growth has propelled equities sharply higher over recent months: since October 2002 the S&P 500 has returned 25.7%, while the Nasdaq is up 35.6% since January 2003. Analysts had been slashing their earnings forecasts for most of this year, but stronger-than-expected growth for the first two quarters—11.7% and 10.2%—prompted a wave of upward revisions. The consensus now expects the year to finish on a strong note, with operating earnings forecast to grow 14.3% in the third quarter and 21.2% in the fourth, finishing the year at a 14.2% pace (see Tables A and B).

The bulls herald these results as proof that the time-honored dynamics of a profits recovery remain intact, with aggressive cost-cutting allowing firms to leverage revenues into larger margins. The bears see the same figures with furrowed brows, however. They not only complain about the poor quality of earnings, but they also contend earnings growth has peaked and is now decelerating; if revenues do not pick up soon, they fret, the impact of high operating leverage on profits will surely fade.

What's really going on with profits and profits growth? Part of the bull-bear disagreement stems from their varied use of "profits." Most pundits refer to year-over-year earnings growth, which can be misleading because the calculation uses as its base year earnings that have been depressed by the recession. Furthermore, pundits often neglect to specify which profit measure and the relevant time period they reference.

Right on Target

Real reported earnings are currently growing at a 16.1% pace for the year ending August 2003 (see Table C, bottom panel). This certainly appears impressive, but by historical standards, it isn't especially unusual for periods immediately following recessions. Since 1930, real reported earnings posted an average growth of 82.0% from their trough, on average rising over 11.8 quarters until re-establishing their subsequent peak. In the current period, real reported earnings have grown 39.5% over the six quarters since they bottomed out in the first quarter of 2001. In other words, real reported earnings are currently expanding at a pace that tracks the 73-year averages.

However, reported earnings have been criticized for giving a misleading picture of corporate profits, largely due to their treatment of "extraordinary expenses"—for example, excluding employee option expenses, while including pension gains and goodwill impairment expenses.¹ Operating profits, which exclude extraordinary expenses, are generally considered a more accurate gauge of profits—and they have not snapped back with anything near the alacrity of reported earnings (see Table D). In fact, for the 12 months ending this August, S&P 500 real operating earnings grew at a -0.4% rate, a worrisome figure that certainly seems to support the bears' contention that profits are on the verge of rolling over (Table D, bottom panel). In addition, the *level* of real operating profits bottomed in the first quarter 2002, one quarter after the recession officially ended, and over the subsequent five quarters has expanded at a sluggish rate of only 3.1% (Table D, see top panel).

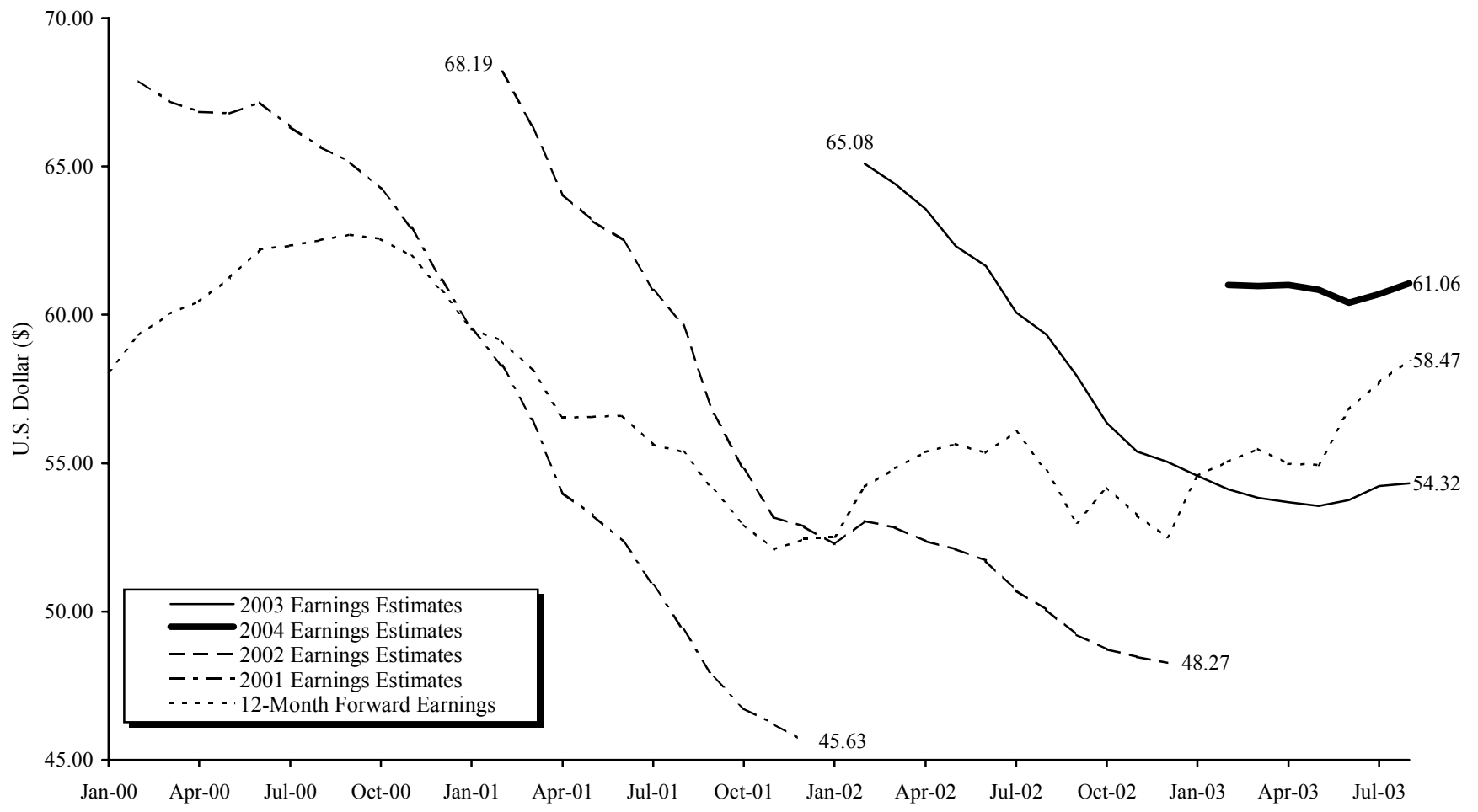
¹ For a detailed discussion of the varied definitions of corporate earnings, see our U.S. Market Comment: *Making Sense of U.S. Equity Earnings*, September 2002.

But wait. In historical context, real operating profits are in fact expanding at a rate that is normal and far from alarming. During the 1990-91 recession, the only other recession for which there are operating profits data, real operating profits actually grew slightly, peaking in the last quarter (first quarter 1991), then fell slightly over the subsequent four quarters. After bottoming, it took another five quarters until operating profits regained their prior peak, then embarked on a lengthy rise over the next 22 quarters until peaking in the third quarter 1997; from their bottom in the first quarter 1992 to third quarter 1997, operating earnings rose 107%. From this perspective, the current growth rate of 3.1% now seems downright conventional, its listlessness even reassuring. That said, however, it is perilous to draw comparisons with only one data point, and only further history will confirm or deny the persistence of this pattern.

Despite the pawing of the bulls and the roaring of the bears, the historical perspective indicates that there's nothing unusual about current corporate earnings growth, which is right about where one would expect it to be following a recession. In light of this banal state of affairs, the only shocking aspect of the subject is the ferocity of the debate among the blathering pundits.

Table A

I/B/E/S OPERATING EARNINGS ESTIMATES

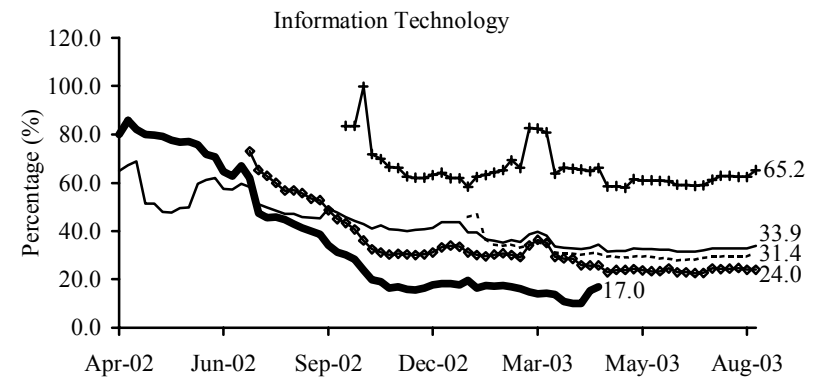
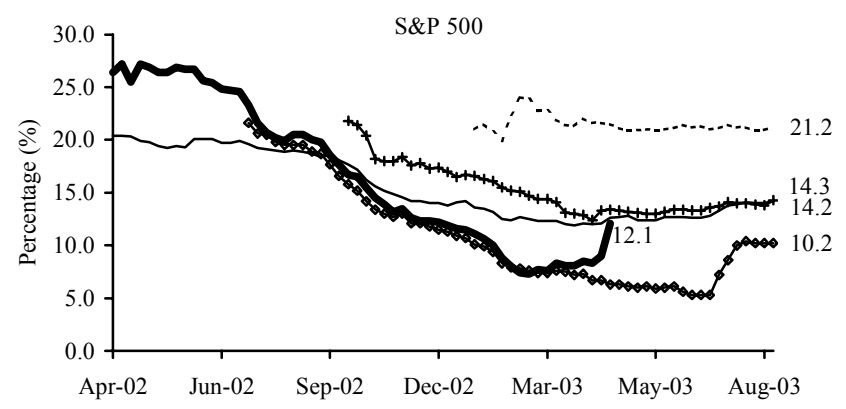


Sources: Ehrenkrantz King Nussbaum, Inc., Puglisi & Co., and Thomson Financial.

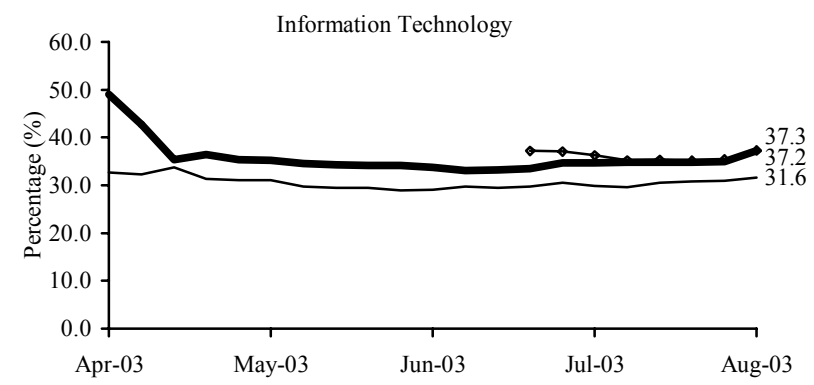
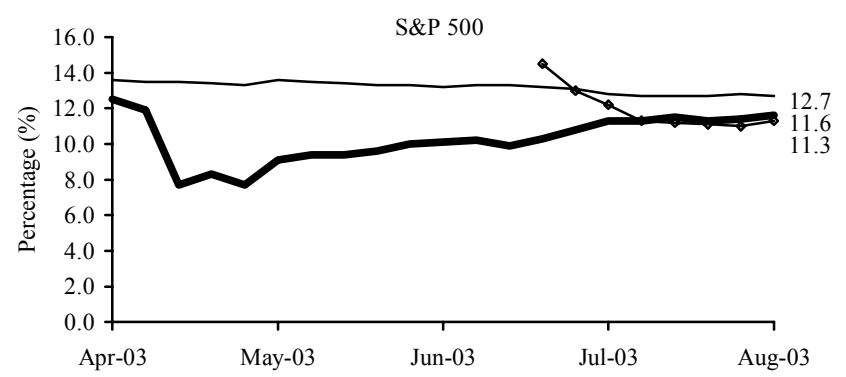
Notes: The beginning values for the 2001 and 12-month forward earnings estimates are \$67.87 and \$58.09, respectively. The 2003, 2004, and 12-Month forward earnings estimates are through August 31, 2003.

Table B

S&P 500 AND SELECTED SECTOR EARNINGS GROWTH EXPECTATIONS FOR 2003 AND 2004



1st Quarter '03
 2nd Quarter '03
 3rd Quarter '03
 4th Quarter '03
 Calendar Year '03



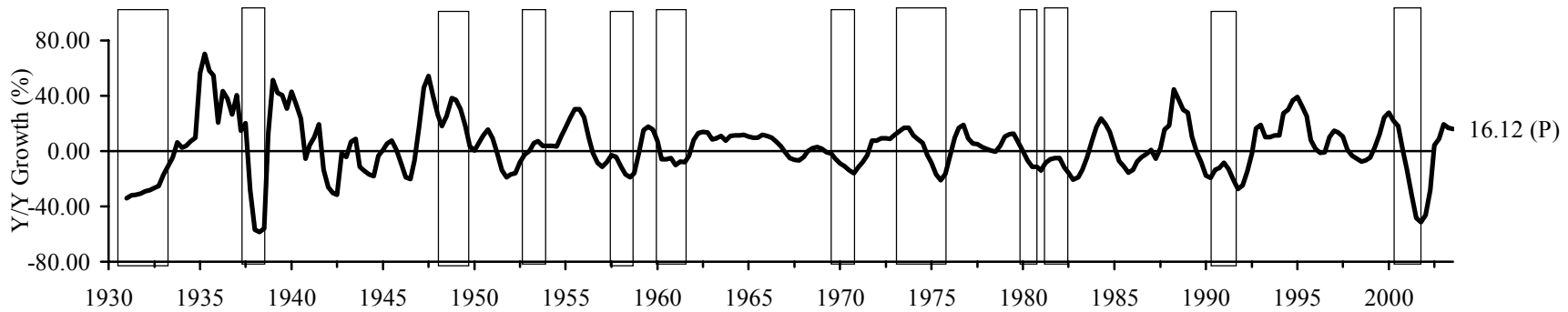
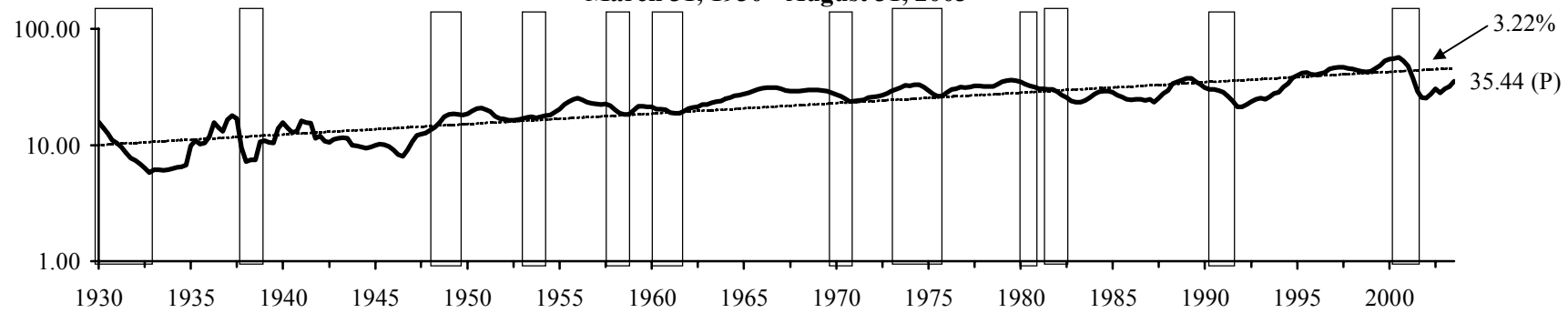
1st Quarter '04
 2nd Quarter '04
 Calendar Year '04

Sources: Morgan Stanley Research and Thomson Financial First Call.

Table C

S&P 500 REAL REPORTED EARNINGS PER SHARE

March 31, 1930 - August 31, 2003



	Average Growth	Maximum Peak to Trough	Maximum Trough to Peak	Longest Sustained Rise	Longest Sustained Fall	Average Recession Growth	Average Peak to Trough	Average Trough to Peak	Peak to Current Trough*	Trough to Current Level
Percent Change (%)	3.22	-63.52	210.64	599.15	-80.42	-9.68	-37.88	82.03	-55.32	39.51
Periods	'30 - '03	1Q '30 - 4Q '32	4Q '32 - 2Q '37	1Q '62 - 4Q '66	2Q '80 - 3Q '83	(n = 12)	15.30 qtrs	11.78 qtrs	6.00 qtrs	6.00 qtrs

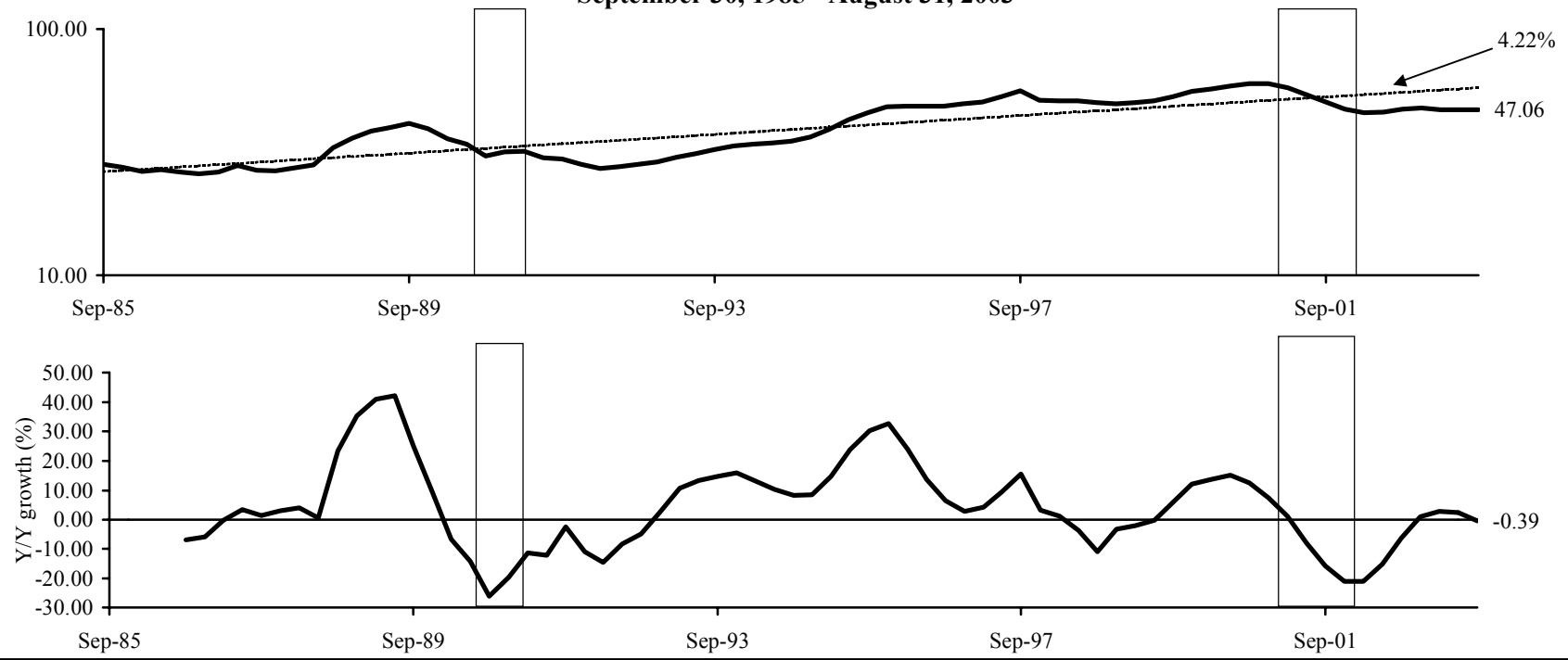
Sources: Calculated from data provided by Bureau of Labor Statistics, Standard & Poor's, Standard & Poor's Compustat, and *The Wall Street Journal*.

Notes: (P) Preliminary. Trendline earnings are shown on a logarithmic scale. Historically, graphs represent quarterly data. Boxed portions represent NBER-defined recessionary periods. The longest sustained rise and fall represent the longest period of consecutive positive and negative growth, respectively. Data in the table are based on year-over-year growth.

*This period represents 3Q 2000 through 1Q 2002.

Table D
S&P 500 REAL OPERATING EARNINGS PER SHARE

September 30, 1985 - August 31, 2003



	Average Growth	Maximum Peak to Trough	Maximum Trough to Peak	Longest Sustained Rise	Longest Sustained Fall	Average Recession Growth	Average Peak to Trough	Average Trough to Peak	Peak to Current Trough*	Trough to Current Level
Percent Change (%)	4.22	-26.18	47.36	1208.38	-76.05	-14.38	-20.60	33.94	-23.87	3.13
Periods	'85 - '03	3Q '89 - 3Q '90	2Q '88 - 3Q'89	4Q '92 - 1Q '98	1Q '90 - 3Q '92	(n = 2)	4.67 qtrs	6.50 qtrs	5.00 qtrs	6.00 qtrs

Sources: Bureau of Labor Statistics, Ehrenkrantz King Nussbaum, Inc., Puglisi & Co., and Thomson Financial.

Notes: S&P 500 operating earnings data are only available from September 30, 1985 through present. Trendline earnings are shown on a logarithmic scale. Historically, graphs represent quarterly data. Boxed portions represent NBER-defined recessionary periods. The longest sustained rise and fall represent the longest period of consecutive positive and negative growth, respectively. Data in the table are based on year-over-year growth.

*This period represents 4Q 2000 through 1Q 2002.