Godsey & Gibb Associates
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Life After Debt (Part IV of IV): Corporate Cost Cutting Drives Earnings Growth

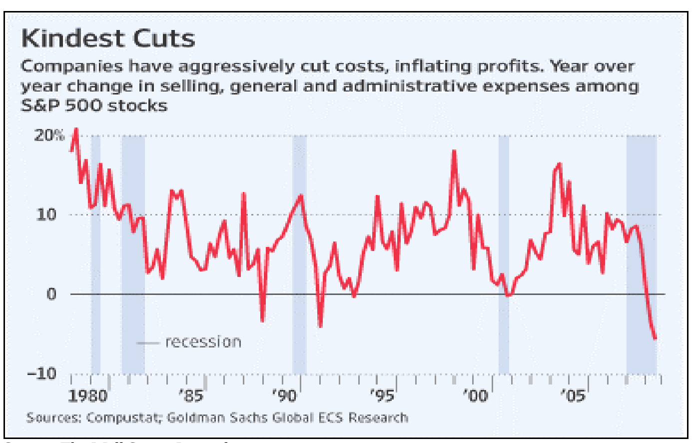
But Lack of Revenue Growth Could Delay Meaningful Increases in Spending and Hiring

As companies seek to maximize efficiency, aggressive cost cutting by the members of the S&P 500 Index is leading to record earnings results that are exceeding the levels anticipated by Wall Street analysts. In the third quarter, a record 80% of firms that comprise the S&P 500 Index beat analyst earnings estimates, even though revenues fell 10%. That is up from 73%, the previous record, in the second quarter of 2009.

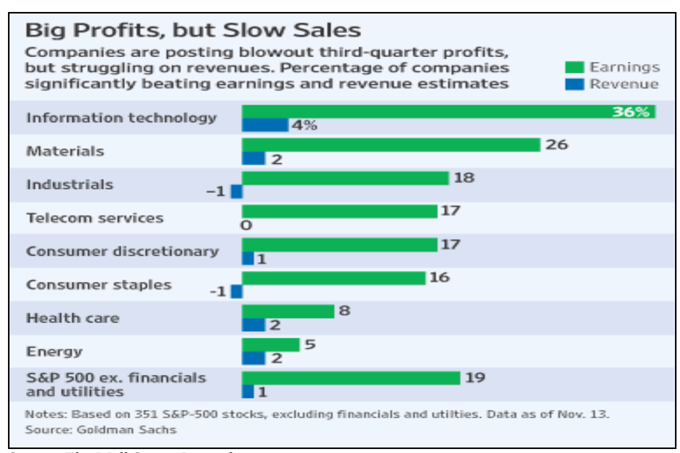
But despite the near-term gains in corporate earnings, it appears that large declines in selling, general and administrative expenses (SG&A), which include salaries, travel, advertising, and other costs of doing business, are the main driver of the positive earnings results. According to data from Goldman Sachs Research, SG&A expenses fell 6.4% in the second quarter from the year ago period, more than both the 4.1% drop in 1991 and the 0.2% decline in 2001, and the most since 1980. The labor market statistics seem to confirm that the profits of late have come with a cost as the economy has lost 8.2 million jobs since the recession began in December 2007. With the historically bleak jobs market, finding sources of meaningful revenue growth will be challenging given that consumer spending drives approximately 70% of domestic economic activity.

The good news is that companies, which are running as lean as ever with the unprecedented decline in overhead costs of late, have increased margins. And since profits are a function of both revenues and margins, earnings could continue growing if revenue sources materialize.

Given the uneven nature of the global economic recovery, the most likely source of near-term corporate revenue growth is outside the U.S. The declining value of the U.S. dollar raises the value of overseas profits for multinational firms. Companies with exposure to faster growth in emerging markets, such as China, India, and Brazil, could be poised for a pick up in revenue growth. While the companies that make up the S&P 500 Index generate approximately 32% of sales overseas, the industries that are best positioned to benefit from revenue growth outside the U.S. include Technology, Materials and Industrial companies, in our view. We continue to tilt portfolios to take advantage of these secular and cyclical themes, while maintaining below market exposures to companies and industries that are more reliant on consumer spending. However, even with the overseas revenue growth opportunities, it will take time for a large number of domestically based companies to feel confident enough to start the kind of investment and hiring that is needed to drive sustainable economic growth in the U.S.



Source: The Wall Street Journal



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