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US WEEKLY ECONOMIC UPDATE

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US Economic and Investment Perspectives

First-Quarter Profits Are Up, But Outlook Is Less Robust

First-quarter US company earnings have been exceeding analyst estimates. That's the good news. The bad news is that first-quarter operating profits appear to be more narrowly concentrated and of poorer quality than in prior quarters.

Moreover, operating profits appear to have been flat compared to the fourth quarter—a classic sign that the economy may be transitioning from the fast-recovery phase to one of more moderate growth. If so, profit growth will likely slow in coming quarters.

So far, slightly more than one third of the Standard & Poor's 500 companies have reported earnings for the quarter. Roughly 65% of these reports have topped analyst estimates, more than 18% have been in line, and 17% have been below estimates. Overall earnings growth is running 12% ahead of the first quarter of 2004—well ahead of the 8.3% profit growth that the consensus was predicting just a week ago.

But our estimate of profits, as measured by gross domestic product data, indicates that profits for the whole US economy during the first quarter grew more slowly, rising only about 10% from year-ago levels (**Display**). The GDP-based measure tends to run several points below the S&P 500-based one because it covers a broader universe of companies and is primarily based on a tax-accounting method. But if this estimate proves correct, then first-quarter operating profits will also have been flat compared with the fourth quarter.

Profit growth is typically very powerful during the early stages of economic recovery when gains are driven by greater operating leverage (i.e., higher plant-utilization rates) and greater volumes. The next phase of the profit cycle tends to be less powerful and less broad because sales growth is slower, utilization rates are more or less stable at high levels, and inventory building provides less support to overall growth.

Earnings Quality Is More Mixed

Prominent earnings disappointments also suggest that US profit prospects may be increasingly mixed going forward. While General Electric reported record first-quarter operating profits and Caterpillar also had strong results, General Motors reported a large operating loss and Ford posted a big earnings decline. Earnings disappointments were not limited to the auto sector, as IBM's earnings fell well short of expectations.

There are also nascent signs that the quality of earnings may be eroding. For instance, while 3M once again reported better-than-expected earnings, it was because of better pricing rather than improved volume. Its core volume grew just 1.5% in the period, the weakest in three years and well below 3M's guidance of 5% to 7%. GE and Caterpillar also benefited from solid pricing strength, while those that saw their pricing power erode—General Motors and Ford for instance—did poorly. This suggests that while the quality of earnings may be more mixed in the months ahead, those companies able to retain pricing power will be better positioned to cope with higher operating costs.

It is unclear how long this next phase of slower profit growth will last. It could endure for just two or three quarters, as happened in 1995, or it could be more protracted, as was the case over the course of 1985 and 1986. A lot depends on the size and the length of the Federal Reserve tightening cycle and the extent to which economic growth slows. Given the recent bad news on headline and core CPI inflation, the Fed likely will be inclined to raise official rates at least through the third quarter, in the process raising the target on the federal funds by another 75 to 100 basis points. That, in turn, points to a further slowdown in liquidity growth and slower GDP and profits growth over the course of 2005.

We still view the slowdown in liquidity, GDP and profits as a mid-cycle correction and believe that there will be another strong advance once the Fed tightening cycle ends. Before that occurs, however, the markets will still have to navigate through the down leg of this cycle. And as we have noted in recent commentaries, stocks and other riskier assets tend to perform poorly in this environment.

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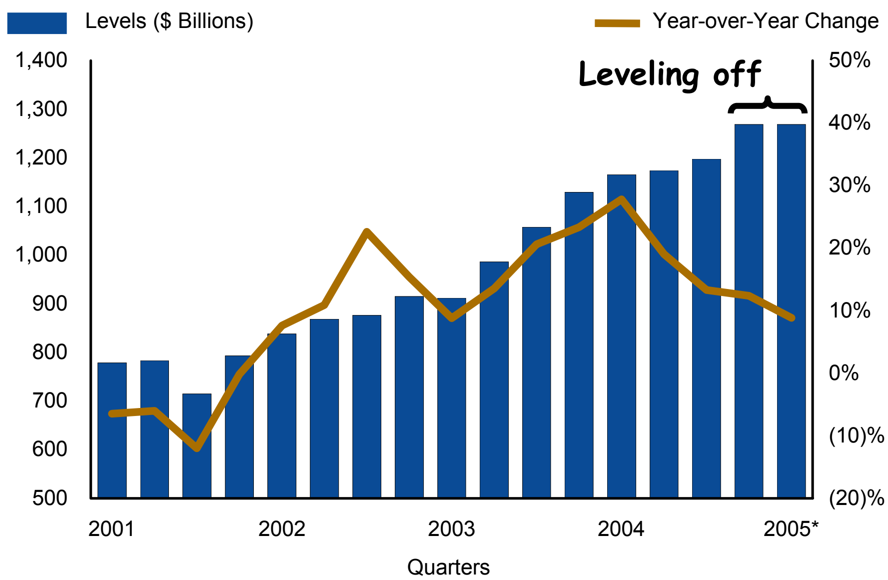
Display 1: Profit Growth Appears To Be Flattening
Corporate Profits



**First-quarter 2005 is an estimate.*
Third-quarter 2004 profits are adjusted for effects of the hurricane.
Source: Bureau of Economic Analysis, Haver Analytics and Alliance Capital Fixed Income, April 22, 2005

Based on incoming company reports, it appears economy-wide operating profits will be around 10% versus year-ago levels. That implies that first-quarter operating profits will be flat relative to last year's fourth quarter. This signals that the fast phase of the economic recovery cycle is over, and the next leg of the profit cycle will be less strong and less broad.