THE Economics OF Corporate Profitability

BY RAMONA DZINKOWSKI

JP Morgan Chase Chief Economist John Lipsky talks about the coming risks and opportunities.

AFTER STELLAR PERFORMANCE in the first few months of 2004, recent economic news suggests that the U.S. economy may be experiencing an unanticipated downturn. Gross Domestic Product (GDP) growth of 4.5% in the first quarter slowed in the second quarter to 3.3%, coupled with lower than anticipated consumer spending and weak jobs growth. We also see a variety of factors that may point to an overall softening of the U.S. economy, including a drop in the equity markets and record-high oil prices, to mention two. Is this really just a hiccup in the overall growth path of the U.S. economy, as some economists suggest, or should American businesses be getting ready for another slump in consumer demand and the next cycle of rising costs and shrinking profits? In an exclusive interview for *Strategic Finance*, John Lipsky, chief economist and director of research at JP Morgan Chase, discusses some of the forces that will influence the economy in the coming months and some of the risks to your company's ability to meet Wall Street's expectations going forward into 2005.

As chief economist at JPMorgan Chase, John Lipsky is responsible for the company's worldwide economic and policy views and directs JPMorgan's flagship *World Financial Markets* and *Global Issues* publications. He was also the chief economist of Salomon Brothers, Inc. from 1992 until 1997, and prior to that he was based in London, where he directed Salomon Brothers' European Research Group. He joined Salomon Brothers in 1984 after 10 years at the International Monetary Fund. Dr. Lipsky serves on the board of directors of the National Bureau of Economic Research, the Economic Club of New York, the American Council on Germany, and the Japan Society. He's also a member of the advisory board of the Stanford Institute for Economic Policy Research and the Economics Subcommittee of the Bond Market Association. Dr. Lipsky holds a Ph.D. in economics from Stanford University.

RD: **There seem to be mixed messages as to the current state of the U.S. economy. On one hand, we see double-digit growth in many sectors—like IT, for example—while, on the other, consumer demand is weak, reflecting what many refer to as the "jobless recovery." How healthy is the U.S. economy at the moment, and, in your opinion, are we on solid ground going into the new year?**

JL: In terms of demand growth, the U.S. economy looks very solid. Growth appears to have become self-sustaining at an above-trend pace, which means that the expansion is fast enough to eventually use up the excess capacity generated in the post-2000 slowdown. Once the expansion has become self-sustaining, a relatively solid growth pace will be maintained unless something gets in the way or until full employment is restored.

RD: **If we assume the current growth path, what does this mean for bottom-line results over the next two quarters? Are current levels of corporate investment sustainable, and for how long?**

JL: In broad terms, corporate liquidity is at all-time highs. Corporate profits are at modern highs, both in absolute terms and as a percent of GDP. Free cash flow currently is covering aggregate investment spending, with free cash flow to spare. Corporations, therefore, don't need to borrow to finance their current level of activities. In fact, cash flow is so strong that they could significantly increase their investment expenditures and still not need to borrow. The situation won't remain this favorable, but I don't see a dramatic change in the near term.

RD: **In the wake of the bursting of the dot-com bubble and the accounting crises of the past two years, it's not surprising that investors are nervous when they see record-breaking revenues and double-digit growth in profits. How would you explain this current state of success, and what do companies have to do in order to ensure that they continue along this path?**

JL: Since the end of the recession in 2001, productivity growth has consistently outperformed expectations. Corporations have been far more successful in their cost-cutting efforts than had been the case in the past or that had been anticipated. The counterpart of rapid productivity growth is the unexpected strength in profits growth. If you look back to the post-2000 period, the speed of corporate adjustment was a surprise, as was businesses' success in producing sustained cost cuts. This success, together with the unprecedented monetary and fiscal policy support for household income and spending, sharply limited the ensuing recession while allowing a quick restoration of corporate profits. Looking forward, a key issue is whether companies will continue to keep costs under control, so one of the critical issues is corporate America's ability to continue to improve productivity.

RD: **Where do you expect further productivity improvements to come from? What more can companies do to get rid of costs?**

JL: There are two aspects that seem to be notable. First, the investment in capital equipment—especially in information technology—continues to be exceptionally strong. Right now, IT spending is growing at a pace similar to that of the late 1990s. As a percentage of GDP, high-tech spending is nearly back to the 1990s peak. In real terms, IT investment is the highest ever. The late 1990s boom in IT spending, however, was associated with rising unit costs and falling profit margins. This time around it has been associated with falling costs and rising profit margins. In addition, the most recent figures reflect new strength in traditional capital spending. The other unusual aspect of the economy's performance has been the labor market's impressive flexibility. The workforce is becoming more adaptable in virtually every way you care to measure it.

RD: **Do you see any risks coming from rising wage costs or perhaps limits to labor flexibility and the structure of the workforce?**

JL: That is certainly a $64,000 question. The conventional analysis suggests that we're a long way from full employment. The Boston Fed recently suggested that the U.S. economy could add about 3.5 million to five million jobs before reaching full employment. In that context, you wouldn't expect increasing labor costs to seriously inhibit business expansion. With profit margins at record highs, it would be natural if wage gains accelerated somewhat. This wouldn't be inflationary—it would just tend to return profit margins back toward something more normal.

RD: **What about the political influence on labor flexibility and labor costs? With the results of the presidential election, do you see a new political agenda for the future that might impact the ability of corporations to continue to cut labor costs?**

JL: I don't see that right now. I don't anticipate that there will be a political effort to load more costs onto corporations and inhibit job growth. To the contrary, there's an effort under way by businesses (perhaps with union support in some cases) to offload the costs of retirees' and others' pensions and healthcare coverage onto the federal budget. At this point, however, I don't see anything being proposed that creates substantial worries about new productivity gains.

RD: **Do you see some other cost centers creating a significant risk to increasing profitability going forward, such as rising commodity prices or the funding of corporate pension plans?**

JL: Commodity prices are just not that important. It would take broader increases in business costs—other than just commodity prices—to create serious inflation risks. But one reason to keep an eye on commodity prices is as an indicator of the strength (or lack of it) of global demand. In terms of pensions, the untold story has been that because profits have been so strong, many corporations with problems have been able to make larger than anticipated payments to their pension funds. Over the long term, there are companies that will be challenged to meet their pension obligations. In almost every case, the problem isn't the pension *per se* but rather the firm's business performance. Typically, the firms with real pension problems are old firms that have a substantial group of retirees to whom they have made unexpectedly expensive promises yet their fundamental business is problematic. These companies' real problem is that their cost structures are out of line and that they have left themselves vulnerable to new competition. The underlying problem is their lack of competitiveness, of which the pension issue is only one part.

RD: **Will rising interest rates have a significant impact on corporate performance?**

JL: It's possible but not very likely, yet the expected rise in interest rates will have an impact on the composition of demand and growth. The decline in interest rates in the past few years has encouraged record levels of housing market activity. Very favorable financing encouraged purchases of big-ticket items such as housing, autos, and home appliances. The rise in interest rates will tend to refocus demand growth away from durables.

RD: **Do you have any concerns with the current rate of expansion in China?**

JL: Our base case is that the Chinese authorities are going to succeed in slowing the economy to a sustainable pace, easing pressures on the market for basic inputs like steel. Problems in the banking sector there are well known, and the Chinese authorities are working actively to improve the situation. While the challenges are large, the opportunities also are large. We have every expectation that in the coming year China will make a positive contribution to global growth rather than being a source of instability.

RD: **What are the risks of sustained increases in oil prices over the next year, and what likely impact will this have on profitability and consumer demand?**

JL: If there were a significant increase in the price of oil from current levels, you would have to ask what factor was it that pushed oil prices higher. The source of the new price rise—perhaps new political instability or some new crisis—likely would be more problematic than the oil price rise itself. With supply and demand in energy markets so finely balanced and with such limited excess capacity, heightened price volatility is always a risk. ■

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