

Economic Insights

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Operating Leverage: 2010 Earnings Engine

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Though 2010 will likely see slower economic growth than typically occurs during cyclical recoveries, investors can still anticipate a healthy earnings expansion. A faster increase in economic activity overseas should add an extra boost to the revenues of any firm with foreign exposure, while the operating leverage of American business generally should allow operating earnings for the companies in the S&P 500[®] Index,¹ for example, to expand in the neighborhood of 30%.

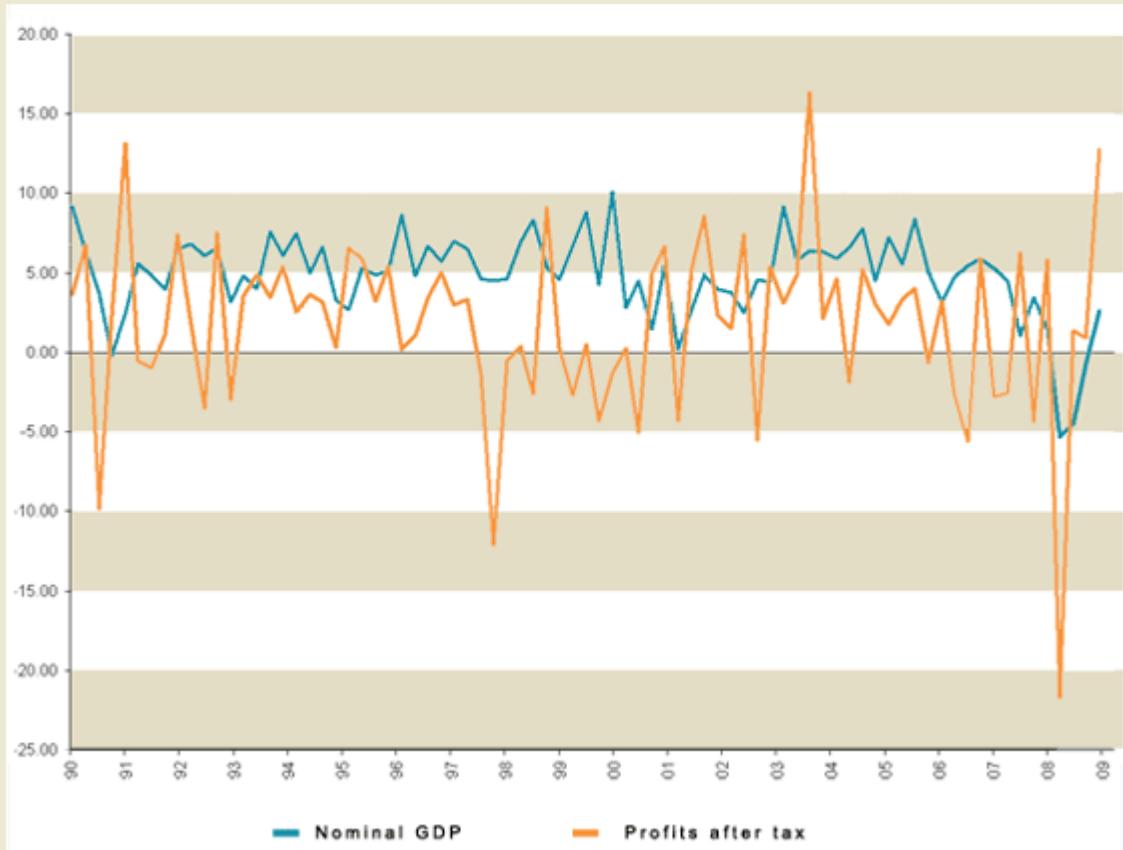
Relatively slow domestic growth will, of course, put a cap on how fast top-line revenues can expand. With real gross domestic product (GDP) expected to increase by around 2.5% and inflation to come in around 2.5% as well, nationwide revenues from domestic sources should expand by about 5% at most. But since the International Monetary Fund indicates about 8.0% average nominal growth outside the United States, and since a little less than half of S&P 500 revenues come from abroad, revenues for this group of companies should grow in the range of 6–7% in 2010. If the dollar loses value on foreign exchange markets, which is not at all an unlikely event, overseas revenues would add still more to the overall top-line growth.

But revenues—fast or slow growing—are only part of the earnings story. Costs, after all, seldom rise or fall in lockstep with sales. Especially because many costs are fixed or close to fixed, the difference is most pronounced at cyclical turns. In recessions, for instance, firms can seldom reduce costs as fast as sales fall. No matter how little they use their equipment or facilities, they still must pay for maintenance, depreciation, and previously incurred financing costs. Neither can they lay off workers, particularly at headquarters, in proportion to the drop in their sales volumes. Their payroll expense shrinks only so far. Earnings accordingly suffer disproportionately. But when the recovery begins, these ill effects work in reverse. The underutilized equipment, staff, and facilities, for which the company is already paying, at last generates revenues with little or no increase in costs, boosting profits disproportionately.

Because profits are the small difference between the much larger revenues and costs figures, minor divergences can amount to a huge percentage of that bottom line. The accompanying chart shows how much wider profits swing than revenues, proxied here by nominal GDP. In the case of 2010, this operating leverage, as it is called, should exceed 20% of the earnings base of 2009 and explains how such modest economic and revenues growth over the coming year can still produce a healthy earnings expansion.

Chart 1. Growth in GDP and Profits

Earnings typically show much more volatility than revenue, as represented by GDP.



Source: Bureau of Economic Analysis at the Department of Commerce.

¹The S&P 500[®] Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times*, *Financial Times*, *The Wall Street Journal*, *The Christian Science Monitor*, and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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