American companies' earnings are under pressure from a rising oil price. This is bad news, because American companies' prospects aren't that healthy anyway

WHILE keenly aware of the instability of Nigeria and the precariousness of its oil supplies, few in the oil industry, let alone anyone outside it, are likely to have heard of the Niger Delta People's Volunteer Force. They have now. News that this obscure faction had told oil companies to stop production in Nigeria, the world's ninth-biggest oil producer, and that, improbably, it was about to wage all-out war on the state, was enough to send oil briefly over $50 a barrel this week. The price of crude has now risen by more than half this year—and the sharp rise in the price of oil for future delivery suggests that oil users think it likely to stay high. That will probably start to prove a drag not just on the American economy as a whole, the biggest consumer of oil, but also its companies, which in recent years had seemed to have remade themselves into profit machines.

Low yields on government debt suggest that bond investors, at least, think that a rising oil price, among other things, will slow economic growth. Yet with a few exceptions, equity investors seem to think that companies will be unaffected: American shares have fallen only a bit this year; indeed, they are still valued as though American companies will take this latest blow in their stride. That looks unlikely. Straws in the wind, perhaps, but on September 29th the Bureau of Economic Analysis (BEA) announced that corporate profits in America fell by 0.7%, after tax, in the second quarter compared with the first.
The worst-hit industries are well known to the stockmarket, and for them the rising oil price is just one more burden. Airlines are in a dreadful hole. United Airlines and US Airways are already in bankruptcy; Delta is teetering on the edge. So far this year, shares in airlines have fallen by 23%, and the International Air Transport Association said on September 27th that, partly because of higher fuel costs, airlines around the world would lose up to $4 billion this year.

Car companies, too, have been hit hard. This is partly because the high oil price has raised their manufacturing costs, but also because their most profitable lines have been sport-utility vehicles, which guzzle even more gas than the rest. Shares in carmakers are down by over a fifth this year.

But autos and transportation account for only some $200 billion of the $10 trillion capitalisation of the American stockmarket. The puzzle is why investors appear so unfazed by prospects for other firms. One reason, of course, is that the profits of many of them—financial firms, for example—appear unaffected by rising oil prices. And financial firms make up 40% at least of all corporate profits, and probably more like half if quasi-financial companies such as General Electric are taken into account. (In 1980, by comparison, the figure was a mere 6%.)

In fact, suggests Jim Bianco, who runs an eponymous research firm, surging oil prices are very likely to have an effect on financial firms' profits. The single most important determinant of these is the steepness of the yield curve—the difference between short- and long-term rates. When it is steep, financial folk rake in profits. In the past few years it has been very steep indeed. Last year, when it was at its steepest, banks made more money than ever.

Now the yield curve is flattening for reasons that are connected with the oil price. At the same time that the Federal Reserve is putting short-term rates up to more normal levels, the fear of bond investors that the rising oil price will contribute to a slowing economy has sent bond prices up as well, reducing long-term yields and flattening the yield curve. Since the yield curve is still very steep by historical standards, it is likely to flatten further.

Profits elsewhere seem to have held up admirably. As the chart on the previous page shows, since 2001 profits for non-financials have soared, though only earlier this year did they exceed the level they reached in 1997. But growth is slowing. In the second quarter of last year pre-tax profits were 14% higher than the quarter before. But in the latest BEA survey, they rose by only 6%.

Andrew Smithers, a stockmarket consultant not known for his bullish views, thinks profits will be hit as corporate cashflow falters. Both consumers and the government are so indebted that they cannot save less and spend more. So a slowing economy and higher oil prices cannot mean anything other than lower profits. “There are no circumstances under which rising oil prices do not hit profits,” he says.

Even bullish analysts who think that the rise in the oil price will have little effect on profits believe that profits will weaken nevertheless. Ajay Kapur, a strategist at Smith Barney, a brokerage firm, thinks that they will rise by 19.3% this year but only by 6% next year.

Flattening profits should draw attention to companies' still-suspect finances. Corporate-debt markets have risen strongly, mainly because so many investors have assumed that companies were using those bumper profits to pay off debt and repair balance sheets ravaged by the excesses of the late 1990s. In
the round, however, companies have done very little to pay off debts. Certainly, credit-rating agencies, which are supposed to notice such things, are unimpressed. The average rating awarded by Moody's has fallen by a notch over the past three years, from investment grade to junk. This year downgrades have outnumbered upgrades.

It is true that some of this trend is explained by lowly rated companies coming to the market for the first time, but the effect of this development is small because so many American firms already issue bonds. And in a sample of 175 big firms studied earlier this year by CreditSights, a research firm, total debts were still 40% higher than they were in 1999.

So if companies have not been investing much, what have they done with all the money? Given it back to shareholders by various means. Share buybacks are at their highest in some 20 years. In the second quarter, companies repurchased shares at an annual rate of $159.5 billion, according to Mr Smithers.

Alas, in the same quarter, American companies generated a financial deficit rather than a financial surplus. For the first time since the first quarter of last year, in other words, investment exceeded profits. Although the deficit was quite small, it is likely to get larger if profits and profit margins fall further. That seems very likely. Consumers are too indebted, the trade deficit continues to widen, tax breaks are to be scrapped and the price of oil is rising. The profits that people are most likely to hear about are those of gloom.

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