US CORPORATE PROFITS- PATTERNS AND PERSPECTIVES

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"This is my generation, baby." The Who, "My Generation"

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CONCLUSION

Recent historically high nominal United States corporate profit levels are a key factor inspiring many to buy and hold US stocks. Bullish forecasts regarding future net earnings, especially when such predictions extend out to misty medium term or murky long run time horizons, sustain and bolster this enthusiastic ownership. In turn, stock rallies sometimes boost optimism regarding potential corporate profitability and overall economic growth, for many have faith that equity marketplaces are forward-looking indicators for "The Economy".

Has the US entered a blessed New Era of very high corporate profitability that will stretch happily out into the indefinite future? Probably not. Has America revived the wonderful time of the Goldilocks economy? Probably not. Higher nominal corporate profits and ascending nominal stock prices, when accompanied by rising nominal GDP, can assist national confidence and encourage spending in the short term. However, since the nominal levels are not the real (genuine) ones, they do not translate into an equivalent amount of real and permanent prosperity.

Yet even if very elevated corporate profitability does not continue, what may have caused a sustained notable upward shift relative to long run history in the ratio of nominal US corporate profits to nominal GDP? To some extent, it reflects corporate cost-cutting measures and other battles to improve efficiency. The easy money policies of the Federal Reserve Board (sustained low interest rates; money printing) and its allies and massive deficit spending (stimulus) perhaps play roles. But picture the context of sluggish to declining real US household income, still-damaged consumer balance sheets, high unemployment, weak housing prices, and very low consumer confidence. With that domestic (home) background, high US nominal corporate profits- and especially a more elevated nominal profit versus GDP ratio- also arguably reflects economic globalization trends and profits captured from overseas. If so, then relatively high American corporate profits do not entirely reflect (do not fully represent) actual overall US prosperity ("Our Economy"), merely that of many of its corporations.

If so, what else follows? Assume that over extended periods, broad-based US equity price indicators such as the S+P 500 or the Dow Jones Industrial Average roughly reflect American corporate profits and prospects. Then the US stock marketplace level and trend, though still a very important indicator for the US economy's overall real ("true, actual") health and prospects, recently has become a somewhat less reliable benchmark for them.

PROFITS IN PERSPECTIVE

"After all, the chief business of the American people is business." President Calvin Coolidge (Speech to the American Society of Newspaper Editors, Washington DC, 1/17/25)

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Analysts assess corporate profitability in assorted ways. Let's focus on the relationship between nominal GDP and nominal after tax profits (without inventory valuation and capital consumption adjustments). What does a historical review of the US scene reveal?

US third quarter 2011 nominal GDP was about $15.2 trillion, 2Q11 $15.0tr, and 1Q11 $14.9tr (seasonally adjusted annual rate; Bureau of Economic Analysis, "Gross Domestic Product: Third Quarter 2011", Table 3, 10/27/11). The average of the rates for these first three 2011 quarters is about $15.0tr. Assume continued strength during 4Q11 in nominal GDP, so that calendar year 2011 GDP is about $15.1tr. That represents about a 3.9pc increase versus 2010's GDP about $14.5tr.

US nominal after tax corporate profits for 2Q11 were about $1.47 trillion, with those of 1Q11 $1.45tr (seasonally adjusted annual rate; BEA, Table 11, 9/29/11). Though the government has not released 3Q11 profit numbers, evidence suggests overall business profitability remained strong. Suppose calendar year 2011 profitability is about $1.5tr. This would jump 6.5pc from actual 2010 levels of just over $1.4tr. At $1.45tr for 2011, the year-on-year increase is about three percent.

The generated 2Q11 profits set a new quarterly record, slightly exceeding 2Q10's level. The annualized first and second quarter 2011 sums both exceed prior calendar year records. Not only do they breach full year 2010's level, they clearly exceed the Goldilocks Era summits of 2006 (about $1.35tr) and 2007 ($1.29tr). The prior quarterly record was 3Q06's $1.37tr.

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US corporate after tax profits (ATP) do not mechanically move in lock step with US nominal GDP trends. However, in a land where business and its corporations are very important, there is some linkage between corporate profitability and economic levels and trends. Higher GDP will tend to create greater nominal business profits; slower (or negative) GDP moves will slow (or diminish) profits. The closer the relationship between US corporate success and that of America "as a whole", the more US ATP and nominal GDP will travel in tandem over time.

Statistics demonstrate that the relationship between nominal ATP and nominal GDP is not automatic. Since World War Two, nominal GDP has risen almost every year. After a meager 1.9pc climb in 2008, US nominal GDP fell in 2009 for the first time in sixty years, about 2.5pc (1949 slipped .7pc). In the post World War Two period, despite the ATP's overall rising trend, year-on-year ATP fell 21 times, or about one-third of the years. The S+P 500 has not motored higher every year, either.

These occasional past ATP declines indicate the potential for future ones, even if history need not repeat itself. Though many stock marketplace optimists would prefer to forget this, corporate profits can fall substantially and fast. The greatest percentage yearly drop in post war period was 2008's 18.7 percent (and 2007's were down 4.2pc), followed by 1949's 17.5pc and 1982's 17.1pc.

The world may always be changing, but there arguably is a greater risk of falling profits, or at least slower growth in them, when ATP levels relative to GDP are historically very high. Before the advent of the Goldilocks Era, say around 2004, what was the record high for ATP relative to nominal GDP? It was 8.73pc in 1948 (1950 8.61pc). Another key high in the distant past, just before the Great Crash in stocks and the Depression, was 1929's 8.88pc. From 1950 through 2003, that ratio never exceeded eight percent. It edged over seven percent only twice (and that was in consecutive years- 7.03pc in 1978 and 7.11pc in 1979).

The average ratio of nominal ATP to nominal GDP from 1929 to 2010 is 5.82 percent. For the entire post WW2 period, the average is 6.10pc. The post World War Two ATP versus GDP low was 1986's 3.06pc. Another noteworthy low was 2001's 4.95pc (the 2001 recession ran from March through November).

What about that ratio during the Goldilocks Era and its aftermath, from 2004 through 2010? It is much higher, at 8.91 pc. Look at individual years in 2004-10. Even during the very hard times of the US and worldwide economic crisis (gurus say America's recession ran from December 2007 to June 2009), it stayed lofty on a yearly basis. In 2004, the ratio stood at 7.79pc, with 2005 at 9.73pc, 2006 at 10.09pc (the all-time high, going back to 1929), and 2007 at 9.22pc. In 2008, they were 7.35pc (still above the 1979 height), 2009 8.49pc, and 2010 9.70pc.

The calendar 2011 ATP/GDP ratio likewise probably will remain quite high relative to the overall post WW2 era. Assume 2011 nominal ATP are $1.5 trillion, with GDP around $15.1tr. The resulting 2011 ratio of 9.93pc challenges 2006's 10.09pc pinnacle. Even if full year 2011 profits are $1.4tr (under first half actual annualized levels), the ratio reaches 9.27pc. At $1.3tr in profits, it still is significant, at 8.61pc.

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Though the long-lasting and ongoing international economic crisis may not worsen (or become disastrous), it looks likely to persist for a while longer. That continuation probably will make it difficult to sustain the high end (around the ten percent level) of the ATP to GDP ratio range from 2004 to the present, and perhaps even the 8.91pc average for 2004-10.

Even if the global crisis abates or disappears, the quite elevated 2004-11 levels suggest the possibility of a decline toward the long run average level of 1946-2010. Some may wonder if and to what extent accounting creativity has helped to generate recently high corporate profits. However, as the marketplace past does not determine its future, one should not be dogmatic about the probability of reversions to a mean or some other supposedly reasonable level.

Anyway, assuming GDP at $15.1 trillion, to what level would ATP have to plummet to reach the 1946-2010 average of 6.10pc? About $921 billion, about a $550 billion collapse (37.4pc) from 2Q11's $1.47 trillion (annualized).

Given forecast growth trends in nominal GDP, maybe such a dramatic profit slump in nominal dollar terms will not occur. The Congressional Budget Office predicts nominal GDP at about $15.8 trillion in 2012, $19.3tr in 2016, and $24.0tr in 2021 ("The Budget and Economic Outlook: An Update", Table B-1, August 2011).

Yet look at the past levels during the worldwide economic crisis and compare them with the $921bb level. After tax profits (ATP) hit bottom at about $644 billion in 4Q08 (annual rate), an enormous fall of around $515bb (44.5pc) from 3Q08's 1.16tr. Around the time of the S+P 500 stock marketplace low of 3/6/09 at 667, 1Q09 profits were about one trillion dollars.

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Is the overall economic US situation improving significantly? US real GDP increased at an annual rate of 2.5pc in 3Q11. Since US stock marketplace levels and trends interrelate to some extent with the level, pattern, and outlook for American corporate net earnings, what do recent moves in US equity price benchmarks suggest regarding near term potential ATP levels (and the ATP ratio relative to nominal GDP)? The S+P 500 slipped from its recent peaks (1371 on 5/2/11 and 1357 on 7/7/11) to its 10/4/11 low at 1075. However, by end October 2011, the S+P 500 rallied substantially, to 1285. The index thus remains rather high, and it of course soars far above the depths of March 2009. On balance, assume the S+P 500 remains above the 1000/1050 level, yet fails to advance over the May and July 2011 highs. Then corporate profits probably will flatten or decline modestly, as will the nominal ATP/GDP ratio.

However, keep in mind that increasing nominal GDP over time tends to support the nominal total level of ATP and nominal stock prices to some extent. The Fed is determined to sustain nominal GDP growth and to produce "sufficient" inflation. It seeks to rebuild nominal consumer balance sheets, including via supporting equity prices. The Fed policy of keeping its policy interest rates near the floor has encouraged many players hopeful of better returns to venture into stocks (and commodities).

THE RULES OF THE GAME

In "The Have Nots", the band X sings:
"But the bottom step of the ladder
It keeps getting' higher and higher
Dawn comes soon enough for the working class
It keeps getting' sooner or later
This is the game that moves as you play"

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Despite the joyful current nominal after tax corporate profit totals and the historically wide ratio of nominal ATP to GDP, most American consumers are rather unhappy. Consumer spending represents about 70 percent of GDP.

According to the Conference Board (10/25/11), October 2011 US consumer confidence fell to 39.8 (1985=100), down yet again from February 2011's height of 72.0. The present trend aims at the record valley of 25.3 of February 2009, which occurred right around the S+P 500's major low at 667 on 3/6/09. Even the modest February 2011 confidence level stands far beneath its 111.9 plateau in still-pleasant July 2007, when the fearful worldwide economic crisis was starting to emerge (S+P 500's initial high 1556 on 7/26/07, major peak 1576 on 10/11/07). The final top in the S+P 500 in 2008 was 5/19/08 at 1440; yet even at that substantial S+P 500 height, May 2008's consumer confidence was merely 58.1. Moreover, its current level wallows well under March 2003's 61.4, when the S+P 500 made its final major low (3/12/03 at 789). It sags woefully beneath December 1974's dismal 43.2 bottom.

The so-called average American can find several reasons for gloom. Nominal US household net worth at end 2Q11 was $58.7 trillion. Although this steps up quite a bit from end-2008's $51.5tr, it is still distant from the $64.3tr at end 2006 and 2007 (Federal Reserve, Z.1 "Flow of Funds", 9/16/11). Plus consumers have endured some inflation since 2007. Compare current household net worth levels with nominal ATP's mount to new records.

According to the Census Bureau, median household income adjusted for inflation fell 6.4 percent from 2007 to 2010 ("Income, Poverty, and Health Insurance Coverage in the United States: 2010", Table A-2, p34; September 2011). The NYTimes (10/10/11, pA1) cites a study by G. Green, Jr. and J. Coder, two former Census Bureau officials. Their research indicates that from the start of the US recession in December 2007 until June 2011, inflation-adjusted median household income slumped about 9.8 percent. From December 2007 to June 2009, the official recession period, it fell about 3.2pc. During the recovery (perhaps quotation marks should surround the word recovery) from June 2009 to June 2011, it tumbled 6.7pc more.

US house prices remain weak. Owner's equity in household real estate was $12.9 trillion in 2006, but only $6.2tr in 2Q11 (Federal Reserve, Z.1). Unemployment levels have stayed stubbornly high, with September 2011's headline rate at 9.1pc (a broader measure gives 16.5pc; Bureau of Labor Statistics). America's fiscal fiasco continues. Long run deficit problems remain extremely forbidding. However, if deficit spending is cut in the near term in America (and elsewhere), will that help to cause renewed economic weakness? Satisfaction with political leaders is low. Europe's sovereign/banking problem also troubles some observers.

Perhaps American consumers will become much more cheerful soon. Some of the troubling factors currently dismaying them may become less so. But perhaps not.

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Many intertwining variables influence corporate profitability (and stock marketplace trends). Numerous entangled factors affect consumer confidence. In any event, how should one explain not only current very sunny corporate profits, but also (and especially) the wide ratio of nominal ATP to GDP from 2004 to the present, given the rather dark US consumer situation and viewpoint?

Increased and sustained globalization and the rapid growth of developing and emerging nations probably account for some of the buoyant US corporate profits and the high ATP/GDP ratio of the past several years. From the standpoint of where it seeks and finds its profits, corporate America probably is less American than before. To the extent US corporations capture an increasing sum and share of their profits overseas (assume they still make fairly steady money in the US), nominal ATP growth may outstrip nominal US GDP gains.

Increased talk of globalization reflects the existence of connected marketplaces and their growing intertwinement. So does growth in world trade. According to the International Monetary Fund, the volume of world trade in goods and services rose 6.5 percent annually from 1993 to 2002. It says the 2003-2012 (they include 2012) rate is 5.8pc (World Economic Outlook, "Statistical Appendix", Table A9, p193; September 2011). This was faster than world real GDP growth. The average annual world GDP rise during 1993-2002 was 3.3pc. Based on the IMF statistics, the 2003-2012 average is 3.9pc. (Table A1, p178). The scope, size, and persistence of the recent worldwide economic crisis signal the existence of more substantial global interrelations than in the past.

From 1993 to 2002, real GDP in advanced economies grew at annual average rate of 2.8 percent. Emerging and developing economies grew at a 4.1pc rate, 1.3pc quicker. From 2003 through 2011, the IMF estimates advanced economies grew at just over 1.6pc annually. However, the annual percent change in real GDP for the emerging and developing nations group spiked to over 6.7pc. This 5.1 point difference versus the advanced nations is far greater than the 1993-2002 one. The predicted difference in growth rates for 2012 is 4.2pc. (Table A1).

In this context of growing world trade and booming growth in developing and emerging nations, keep in mind the recent high levels of US nominal after tax profits (particularly in the past couple of years), as well as the trend from 2004 to the present in the ratio of US nominal ATP to nominal GDP. Suppose many American corporations spread their business overseas in such a fashion to not only participate more widely in world trade opportunities (trade growth), but also to win profits in developing and emerging nations. Then arguably US corporate ATP could advance relatively rapidly (compared to nominal US GDP growth) due to sustained substantial real GDP growth in these foreign lands. In addition, capturing noteworthy profits from such relatively strong foreign real GDP growth (and that growth has been much greater than that of US real GDP) would tend to make and keep the US ATP/GDP ratio rather elevated relative to the period before 2004.

Suppose more and more profits are earned overseas in currencies other than the US dollar. All else equal, sustained weakness in the US dollar (relative to those currencies) will tend to boost US nominal corporate profits. The broad real trade-weighted dollar fell to a record low of 80.5 in July 2011 (monthly average; 1973=100; September 2011 82.7). It has been under 100 since September 2004, with its most recent notable high 96.8 in March 2009, the time of the stock marketplace bottom.

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Since the US and its corporations are less alone in the world than before, substantial international downturns elsewhere, particularly in developing and emerging countries, may significantly cut US corporate profits and reduce the lofty nominal ATP/GDP level of 2004-11. Thus American stock marketplace viewers should closely monitor GDP growth, corporate (and national) profitability, and stock trends in overseas nations in general, with an increasingly close eye on developing/emerging countries.

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Even allowing for these consequences of globalization, the current ratio of after tax profits to nominal GDP arguably seems elevated and vulnerable to at least a modest decline. It is right around the peak of 2006, when the overall world economic situation appeared much rosier.

For the US and many other advanced nations, globalization arguably has helped to reduce their domestic employment levels and to suppress real wage growth. In some situations, cheap labor and other factors have made lands such as Mexico, China (and many other Asian nations), and India relatively more attractive locations for building businesses.

The business of America may be business, but suppose that more and more business profits (and opportunities) derive from overseas sources. What else is implied by a sustained pattern of high nominal US corporate profits and elevated stock prices alongside sluggish US real GDP growth, damaged consumer balance sheets, flat or declining real household income, mediocre consumer confidence, and so on? The US stock marketplace (think of the S+P 500) would still be a very important benchmark for “The Overall US Economy” and “real, genuine” prosperity for “all of us” (or at least most of us). However, that stock marketplace indicator would be a bit less important signpost in that regard than it once was. Stock benchmarks such as the S+P 500 may remain rather high, or even keep going up, but the “real world” and confidence of American consumers may not necessarily improve dramatically.