<u>AMERICAN CORPORATE PROFITS AND THE S+P 500</u>
(c) Leo Haviland, 646-295-8385 August 1, 2012

"Civilization and profits go hand in hand." President Calvin Coolidge, "The Supports of Civilization" (Chapter I) in "The Price of Freedom"

CONCLUSION

In recent decades, the overall United States debt outstanding relative to nominal GDP has substantially increased. America's national willingness to accumulate debt (borrow and spend) generally has played an important role in the generation of its economic growth. It of course is not the sole factor. This national debt increase thereby has tended to boost (be a bullish factor for) equity prices, at least up to now. A significant cut in America's debt burden (deleveraging) probably will promote a decline in the nominal after-tax profit to GDP ratio from current elevated levels. This reduction also may encourage a slowing of after-tax profit rises, or even encourage an actual decline in profitability levels. These processes in turn probably would be bearish for US equities. Debt levels and trends are not the only factor influencing US GDP, corporate profits, and stock levels and patterns. Will American corporate profits forever keep rising? History is not destiny, but they often have declined.

Besides, growing debt does not inevitably guarantee economic health, corporate profitability, or soaring stocks, whether in America or anywhere else. Sustained Federal Reserve monetary easing buys time and sells hope, but it does not solve the US national debt problem. History reveals that at some point more and more national debt can generate grave problems. America probably is at or very near the danger level from its current and near-term debt situation, not just over the so-called long run horizon.

PROFITS AND GDP

US and other corporations of course make or lose given amounts of money for all sorts of reasons. Not only do variables influencing earnings and profitability change, but also marketplace wizards debate the relative importance and interconnections of these assorted factors. Long run inflation trends generally increase nominal values in general. Think too about productivity (innovation; efficiency) gains. US dollar trends, interest rate patterns, commodity fluctuations, tax policies, wage trends, unemployment levels, and population growth. America is not an island apart from the rest of the world; globalization has increased in recent decades, as the ongoing worldwide economic crisis emphasizes.

****

Marketplace historians and clairvoyants review various measures of corporate profitability. Let's first examine after-tax profits (without inventory valuation and capital consumption adjustments) for American corporations relative to nominal GDP over the past several decades (Federal Reserve Board Z.1 "Flow of Funds" (6/7/12) and Bureau of Economic Analysis (BEA) data). Use the S+P 500 as a benchmark for American stocks "in general".

****

American corporate profits of course sometimes swing dramatically. Marketplace navigators obviously know profits often have dived from one year to the next.

However, in the post-World War II era, US corporations (as a whole) always have made money in each calendar year. **Year-on-year after-tax profits ("ATP") profits from 1946 to 2011 have averaged an increase of 9.1 percent.**

Profitability blossomed about 12.5pc in 2002 and 15.1 pc in 2003. ATP exploded the next two years. They spiked forty percent in 2004 and leaped another thirty-three pc in 2005. They grew year-on-year in 2006 by 9.9pc. Despite soaring from 2002-2006, US ATP sagged 4.2pc in 2007 and withered 18.7pc in 2008.

However, the overall long run general upward trend in profits resumed alongside the American and worldwide economic recovery. Keep in mind the massive federal deficit spending from 2009 and thereafter by America (and its allies), sustained low policy interest rates (such as Federal Funds), and massive money printing (quantitative easing by the Federal Reserve and numerous other central bank watchdogs). In 2009, American corporate profits ascended 11.4pc, climbing sharply in 2010 by 23.2pc. Yet in 2011, they edged only 2.2pc higher, reaching about $1.48 trillion.

Then in first quarter 2012, they advanced sharply, reaching roughly $1.67 trillion (annualized). This equals a rise of 13.3pc versus full calendar year 2011 and over 19.1pc versus 1Q11's $1.40tr (up 6.7pc versus 4Q11).

****

Let's place American after-tax profits in the context of economic output. The average United States yearly ATP level relative to nominal GDP from 1946 to 2011 is about 6.2 percent. However, during the marvelous Goldilocks economy, and even up to the present despite the ongoing worldwide economic crisis, this indicator has been remarkably strong. Recall lows of 3.1pc in 1986 and just under 5.0pc in 2001. Before the 2004 to the present period, the last high over eight percent was 1950's 8.6pc. From 1951 through 2004, it exceeded seven pc only three times (1978, 1979 and 2004). **Over 2004-2011's span, the average jumped to 9.0 percent**.

The ratio in 2004 was 7.8pc, rising to 9.7pc in 2005 and 10.1pc in 2006. Calendar 2006 thus established a new pinnacle (going all the way back to 1929 not just 1946). In the year the global financial crisis emerged, 2007, it remained high, at 9.2pc. Even in 2008's savage US and worldwide downturn, accompanied by the plummeting S+P 500, ATP relative to GDP were almost 7.4pc. The S+P 500 reached a major low on 3/6/09 at 667. In 2009, that ATP/GDP relationship was 8.4pc. What about the fairly sunny recovery years thereafter? The ATP total for 2010 bordered ten pc of nominal GDP, with 2011 elevated at 9.8pc.

****

What was the ratio of ATP for first quarter 2012 relative to GDP? Nominal 1Q12 GDP was about $15.48 trillion (annualized). Corporate profits were about $1.67 trillion (annualized). This is about 10.8pc of 1Q12 nominal GDP, thus marching beyond 2006's joyous Goldilocks Era height to establish a new record height for that measure.

Though 2Q12's earning reporting season has not ended, news reports suggest the nominal ATP level is approximately in line with 1Q12's, and maybe even a couple of percentage points higher. US 2Q12 nominal GDP inched up to about $15.60 trillion from 1Q12's $15.48tr. Thus the nominal ATP/GDP ratio probably remains around record levels.

****

Alongside these lofty 2012 profit levels, the S+P 500 attained new highs relative to its 2009 abyss (4/2/12 at 1422, 5/1/12 at 1415). These spring 2012 levels neighbor the S+P 500's final summit at 1440 on 5/19/08, though they remain quite a bit beneath the major high on 10/11/07 at 1576.

****

An army of intertwined variables interrelate to propel the S+P 500 up, down, or sideways. However, **suppose ATP slide lower relative to first half 2012 heights and that the ATP to GDP relationship retreats to fairly near the long run 6.2 percent average. All else equal, this probably will be a bearish factor for the S+P 500.**

DEBT AND GDP

Digging into, organizing, and analyzing Federal Reserve statistics reveals various trends for United States debt. Suppose one creates a category for the US grand total credit marketplace debt outstanding ("TCMD"). This domain encompasses domestic nonfinancial and domestic financial sectors as well as the relatively modest "foreign" category. The domestic nonfinancial sector includes not just "households" and "business", but also federal and state (and local) governments. See the Fed Z.1, Table D.3.

The trends of and intertwining of these various elements of TCMD can inspire many stories. Total household debt as a percentage of nominal GDP was 45.4 percent in 1976, 61.6pc in 1990, about seventy pc in 2000, peaking at 97.5pc in 2007 (about $13.7 trillion). Although that percentage has dipped, and at end 1Q12 is 83.5pc of nominal GDP, the absolute household debt level has not fallen much- around six pc to $12.9tr. Yet household debt is not the whole credit and leverage picture. Since 2007/08, the federal government's growing indebtedness has overwhelmed the modest reduction in arithmetic household debt and the notable fall in domestic financial sectors.

However, focus on the TCMD category as a whole. **There has been a significant increase in the nominal TCMD outstanding relative to nominal GDP ratio in recent decades**. **This suggests that America's overall willingness to accumulate debt (borrow and spend) generally has played an important role in the generation of its economic growth. It of course is not the only factor. In any event, this national debt pattern thereby has tended to boost (be a bullish factor for) equity prices.** As corporate profits (in general) presumably will tend to move (more or less) alongside overall economic growth, American willingness to add to debt (leverage) has helped to increase corporate profits. Rising nominal profits, all else equal, tend to rally equity prices (though of course traders also look forward and worry about potential profit trends).

TCMD as a percentage of nominal GDP was fairly steady from around 1945 to 1976. The average for those thirty years was just under 150 percent, with a high of 160.6pc in 1974 and a low of 132.4pc in 1951.

TCMD then commenced a steady rise from 1977's 159.2pc. That broad debt category marched to 204.2pc in 1985, 237.2pc in 1990, 250.8pc in 1995, and 273.4pc in 2000. The S+P 500 peaked on 3/24/00, well above its 10/3/74 depth at 62 (yes, under 100) and its 8/9/82 take-off point at 102 The S+P 500 indeed did not always rally over this time span, and indeed did not keep going up after its 2000 plateau.

Yet although the S+P 500 slumped to about 769 on 10/10/02, the TCMD to GDP ratio continued to race higher, especially during the wonderful Goldilocks Era of seemingly unlimited and guaranteed prosperity. Real estate prices would forever climb, equities would keep rising, recession would never visit, and the good life and better life of the American Dream was going to be within reach for just about anyone.

Anyway, nominal TCMD/GDP flew to 311.5pc in 2003, 345.2pc in 2006, and finally peaked at 380.6pc in 2009.

Debt trends probably are not entirely separable from profitability ones, or from central bank policy. But recall the jump in ATP in 2004-2006. And remember that for the entire 2004-2011 span, the average level of nominal ATP relative to GDP jumped to 9.0 percent, above the 6.2pc level covering the post WW2 period. The ratio of ATP for 1Q12 relative to GDP was about 10.8pc of 1Q12 nominal GDP, a new peak.

Admittedly, the S+P 500 rallied significantly alongside this debt percentage increase, yet peaked on 10/11/07 at 1576. Big debt obviously does not guarantee rising or high stock prices.

Other factors (such as very accommodative central banking policies in the US- and elsewhere- since late 2008/early 2009 have helped to support corporate profitability (and the S+P 500). However, the TCMD's decline since its 2009 decline has been relatively modest, with end 1Q12 at 353.0pc (down about 7.3pc versus 2009) of GDP. TCMD was $54.24 trillion at the end of calendar 2011 and $54.64tr at end 1Q2012. Thus, the still-lofty TCMD relative to nominal GDP percentage (also compare 2000's 273.4pc) probably has had the residual consequence of helping to support corporate profitability and thus the S+P 500. Aren't many wizards worrying about the consequences for economic growth of the looming "fiscal cliff" (reduced federal deficit) at end calendar 2012?

****

As a guideline, suppose that increased debt (leverage) means (the potential for, all else equal), higher rewards (and losses). Then reduced debt will tend to lower the potential for gain (and loss). **Thus a notable reduction in America's debt burden (deleveraging) probably will promote a decline in the nominal ATP to GDP ratio from current elevated levels. It also may encourage a slowing of profit rises, or even an actual decline in ATP**. **This in turn probably would be bearish for US equities**. Again, debt levels and trends are not the only factor influencing GDP, corporate profits, and stock levels and patterns.

Besides, growing debt does not inevitably guarantee economic health, corporate profitability, or soaring stocks, whether in America or anywhere else. History reveals that at some point more and more national debt can generate grave problems. And for America, the debt totals discussed above do not include future debt obligations (the long run fiscal challenge).

FEDERAL RESERVE POLICY

The slump in US stocks from their 2007 roof to their 2009 basement low despite rising national indebtedness underlines that other factors significantly influence corporate profitability and thus the renewed rally in stocks. The Federal Reserve's highly accommodative policy since late 2008/early 2009 has involved sustained rock-bottom interest rates, two rounds of massive quantitative easing, and other measures. The Fed promises to continue its easy money stance for the next couple of years.

This Fed accommodation (paralleled in various ways by many other key central banks around the world) has occurred alongside the revival of US ATP, the sustaining of high levels of corporate ATP/GDP ratio, and a rally in the S+P 500. In addition, Wall Street in general and especially US equity bulls (stock owners) and most corporations clamor for easy monetary policy. So Fed policy, like debt trends, should be watched closely though they do not guarantee ATP and S+P 500 levels and trends.

Lower interest rates, all else equal, encourage economic growth (and may motivate debtors to increase or at least sustain spending). The more spending, the greater probably will be nominal ATP. Sustained low interest rates probably reduce corporate costs, and thus that interest rate consideration helps to maintain an elevated corporate ATP/nominal GDP ratio. And very low nominal Treasury yields (and other low yields) encourage some players seeking "better returns" elsewhere to buy American stocks.

All else equal, money printing tends to raise the level of nominal prices, which includes the S+P 500. One can debate how much this increase will be and when it will occur, either in general or for a given variable such as US stocks, crude oil, and so forth. Though QE2 ended in June 2011, its termination does not prove that it has not influenced other marketplace variables (such as ATP levels and trends and the S+P 500) since then.

Whether quantitative easing (view it as an isolated factor) has helped to maintain the elevated ATP/GDP ratios of the past few years is conjectural, for both nominal ATP and GDP are affected. However, QE, to the extent it encouraged more spending, probably would help to keep the US ATP/GDP ratio elevated.

****

The nominal GDP fall in 2009 of 2.2pc terrified the Fed. It was the first since 1949's .7pc, though far less than the Depression's gigantic nominal GDP collapse (as in 1938's 6.3pc and the nearly 45.6pc cumulative drop from 1929-33).

US consumer spending represents about 70 percent of nominal GDP. Hence the Fed's ferocious fight to restore consumer balance sheets (net worth)- and thus consumer buying. The Fed assists economic recovery (and so corporate profits) in large part by rescuing households.

The Fed (via low rates, money printing, and other easing measures) has tried to rally the US equity marketplace, an important element of household net worth. Scan the fine print of Federal Reserve statistics. From end 2007 to end 2008, household net worth plummeted about $12.6 trillion, from about $66.2tr to$53.6tr; equity shares represent about $8.5tr of that fall. Household real estate of course is another important part of this 2007 to 2008 net worth slide (and real estate owner's equity) was even higher in 2005-06). By end 1Q12, US household net worth had moved up about $9.3tr to $62.9tr, with equity values representing about $7.3tr of the advance.

****

Sustained easy money policies eventually may assist rises in interest rates and inflation. Also, as recent European experience (and emerging marketplace history) underlines, high national (not just government sector) debt levels can help to boost overall interest rates (and help to induce equity price declines) regardless of the national central bank's policy desires.

A FOOTNOTE: SHARE BUY BACKS

Net share buybacks have encouraged US stock marketplace rallies. In 2011, net share buy backs returned for US corporate equities (see Z.1, Table F.213). For calendar 2011, they were about $228bb. On a quarterly basis (seasonally adjusted annual rate), they were about $45bb in 1Q11, $205bb in 2Q11, $247bb in 3Q11, and a massive $414bb in 4Q11. Net buybacks remained significant in 1Q12 at an annual rate of about $250bb. The 2Q11/1Q12 rate rivals the net buyback period of 2006 ($369bb) and 2007 ($461bb). Don't forget the stock marketplace peak was 2007.

The year 2008 saw notable net issues ($263bb), as did 2009 ($313bb), and 2010 had only tiny net buybacks were small (only eight billion dollars). However, in these years nonfinancial corporate business had net buybacks, with the financial sector (recall the pressure on banks/investment banks) being net issuers. The financial sector also was a net issuer in 2006 and 2007; they remained net issuers in 2010 and 2011. However, their 1Q12 net sales were modest, at only $27bb.

****