The State of Corporate Profits

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"Risk is not knowing what you're doing."

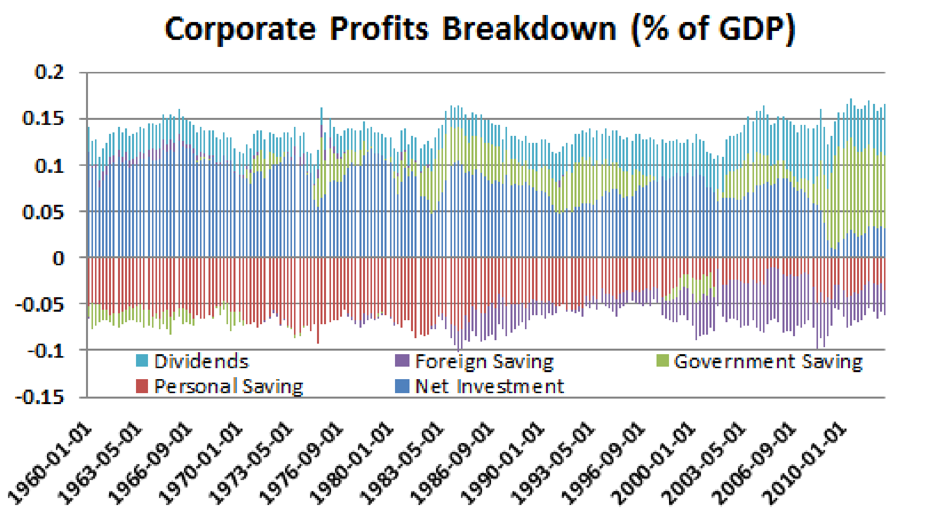
Warren Buffett

A Closer Look at Corporate Profits

The last few years have been unusual in that the normal driver of corporate profits is private investment. But the credit crisis did an odd thing to the US economy—it crushed private investment in a nearly unforeseen way. I won't get too wonky with you here, but corporate profits are derived from a rather simple flow of funds in the economy:

Profits = Investment – Household Savings – Government Savings – Foreign Savings + Dividends

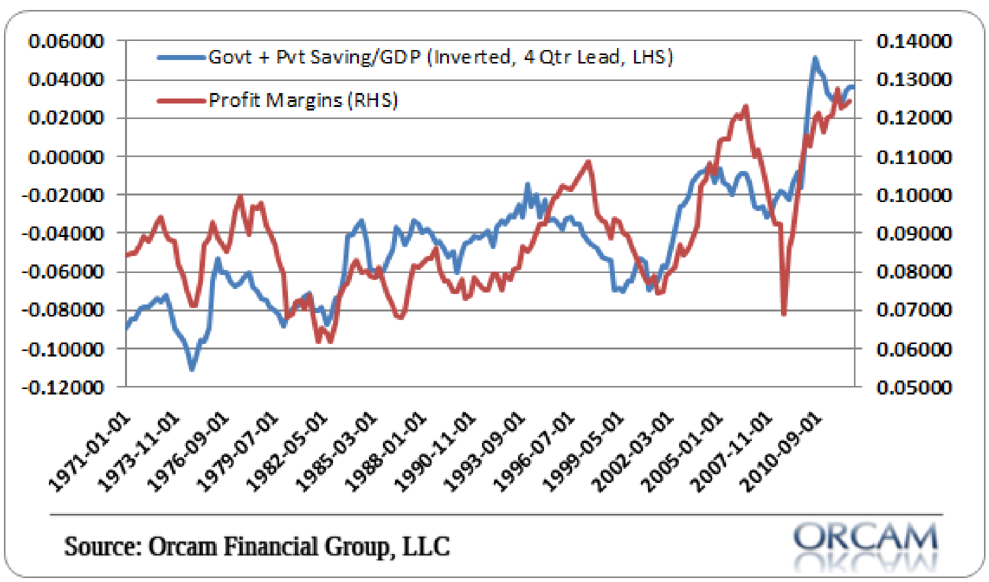
In simpler terms, that means that corporate profits are driven by how much firms spend buying things from one another, how much households *don't* spend, how much the government spends, how much we net to foreigners **plus** the amount corporations pay to shareholders (which is spent back to the corporations net of saving).



Source: Orcam Financial Group, LLC

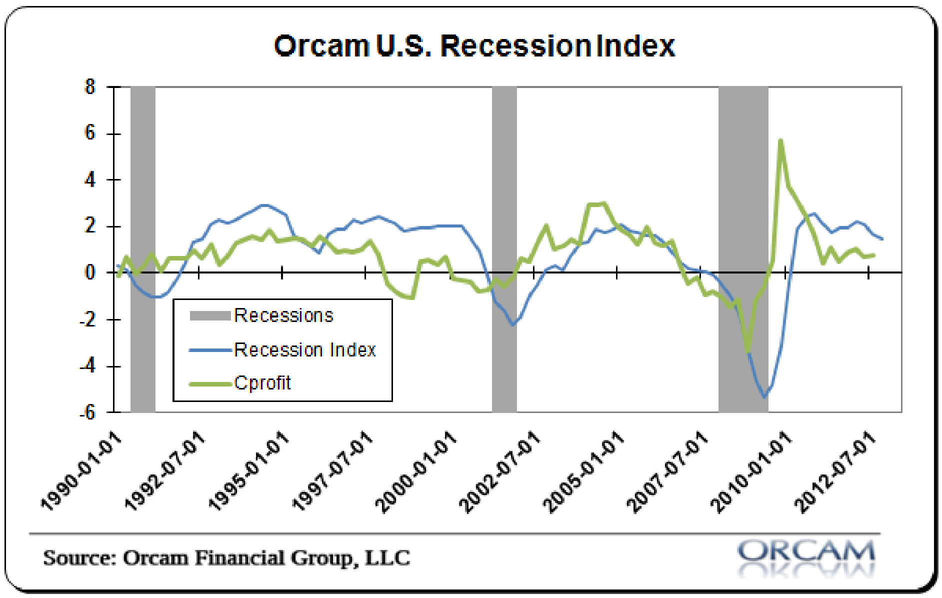
If you look at the figure on the previous page you'll notice a rather remarkable occurrence in the last few years. The driver of corporate profits is ALWAYS private investment at a historical average of about 7.5%. No other sector even comes close over the last 50 years. But when the debt crisis hit corporations froze up and stopped investing. Private investment fell in a way that was unheard of. But total profits didn't collapse in the ensuing years despite a very weak rebound in private investment. In fact, we remain at historically low levels. But what happened was the government stepped in and spent the balance of what corporate America wasn't able to spend. This kept the flow going through the US economy and it's the primary reason why profits are currently at record high levels. That green bar you see in the chart was the savior of corporate America. Without it, the stock market and the state of corporate America (and the American economy as a whole) would be a heck of a lot different today.

The story is largely the same from the perspective of corporate profit margins. We're hearing a lot these days about the state of corporate profit margins and how unsustainable they are. And if we look at the breakdown it's not hard to see why some might believe profit margins are unsustainably high—they're basically being propped up by the government's deficits. When that blue bar begins to turn down sharply (ie, when government spending pulls in sharply) you're likely to see the red bar slide with it. This is why I've been so vocal about the dangers of austerity in the USA in this environment. The accounting identities simply don't lie and they add up to one thing—with such weak private investment government spending is keeping our heads above water….



Looking forward, I wouldn't say a profit decline is an immediate risk, but private investment is coming back at a frighteningly slow pace and remains historically low. We should continue to see improvement there, but it remains a slow process. Thus far, we shouldn't expect any massive declines in the US government budget deficit, but we'll have to keep a close eye on spending trends as the year progresses. So far we can expect another year of substantial budget deficits and improving private investment. That adds up to a moderately positive, but very fragile corporate profits picture.

It's interesting to note that the Orcam Recession Index has also tracks corporate profits fairly well over the years. As I've maintained over the last few years, recession risk remains low and that appears true for a corporate profits recession as well. From our strategic view, this has kept us in the equity market through one of the great historical rallies.



As we kick up another earnings season here in a few weeks we should expect another set of decent figures, but slower than the double digit trends that many have grown accustomed to. Corporations have become notoriously adept at playing the analysts so don't be shocked when 70% of the corporations "beat their estimates". Wall Street's guesses are mostly fed to them by the corporations during the quarter so they can under promise and over deliver. The media loves to make a big fuss over this nonetheless. Ignore the noise. In all likelihood, this quarter will be more consistent with the general economic environment—sluggish, but not terrible. Though I do wonder what precisely the stock market is pricing in given the recent surge in the S&P 500—maybe a sluggish earnings season will be a bit of a wake-up call to what appears like market participants overly enamored with the mythical powers of the Federal Reserve's QE programs….

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