Corporate Profits and Equity Valuation

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis explains how he looks at equity valuation. He considers different ways to calculate corporate profits.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Corporate profits and equity valuation**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

***e*Research** was established in 2000 as Canada's first equity issuer-sponsored research organization. We write on a variety of small- and mid-cap, under-covered companies. We also provide unsponsored research reports on middle and larger-sized companies, using a combination of fundamental and technical analysis. We complement our corporate research coverage with a diversified selection of informative, insightful, and thought-provoking research publications from a wide variety of investment professionals.

Bob Weir, CFA: Director of Research

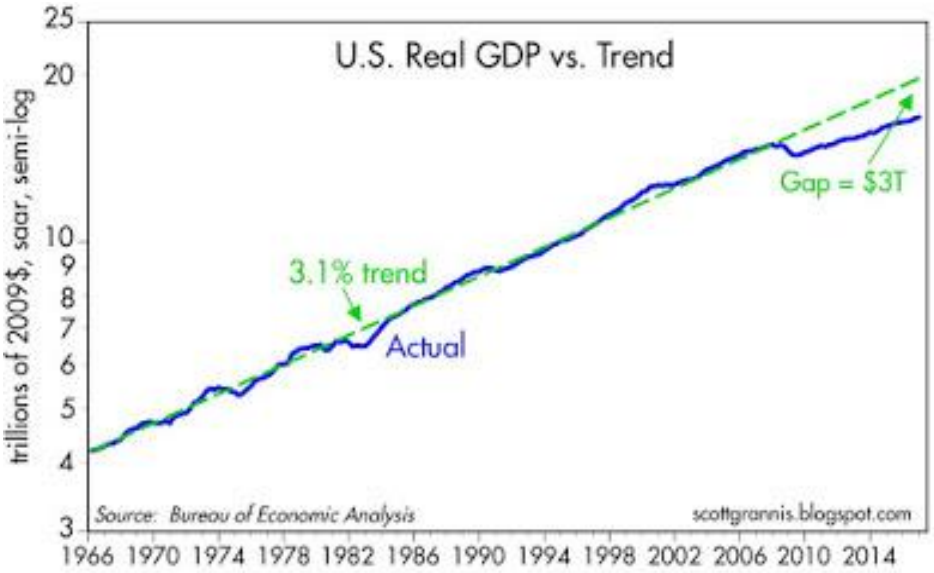
Thursday, March 30, 2017

Corporate Profits and Equity Valuation

Today's revision to Q4/16 GDP statistics brought with it our first look at corporate profits for the quarter. My preferred measure (HT: Art Laffer) is after-tax profits adjusted for capital consumption allowances and inventory valuation, and it notched an impressive $1.61 trillion annual rate for the quarter.

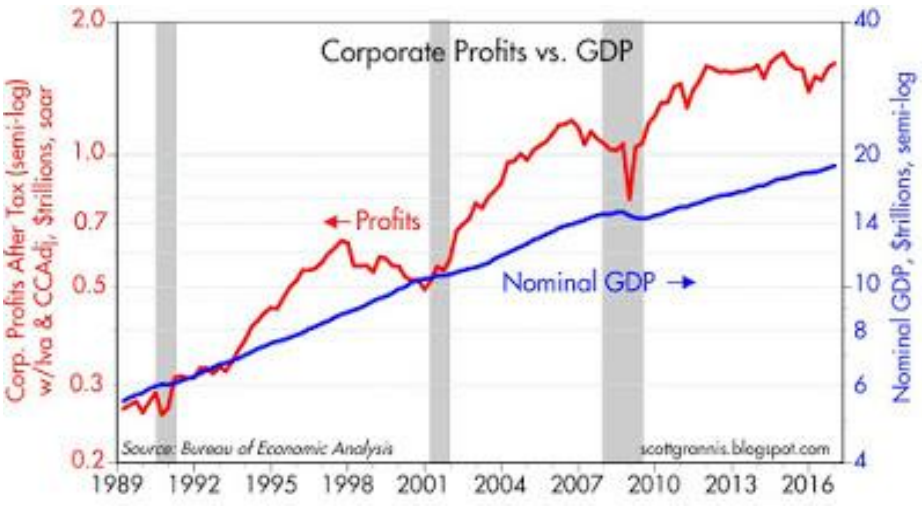
This measure has been consistently calculated ever since 1947 and, as such, it represents the most consistent and contemporary measure of the true economic profits of corporate America.

Profits by this measure rose by an impressive 15.7% last year, but most of that rebound was due to the waning effects of the severe drop in oil prices which began in mid-2014. Now that the crisis in the oil patch has passed and oil prices are stabilizing, corporate profits are regaining their prior levels which, from an historical perspective, are unusually high relative to GDP. Given that profits are historically quite strong, it is worth noting that equity valuations are only modestly above average.



Q4/16 GDP was revised slightly upwards to an annualized rate of 2.1%, which happens to be exactly the same as the annualized rate of growth of the economy since the current recovery began in mid-2009. It has been the slowest recovery on record. As the chart above shows, if the economy had instead regained its long-term average growth rate of 3.1% per year, the economy today would be roughly $3 trillion dollars bigger. I have called that the Obama Gap.

The charts below compare after-tax corporate profits to nominal GDP.

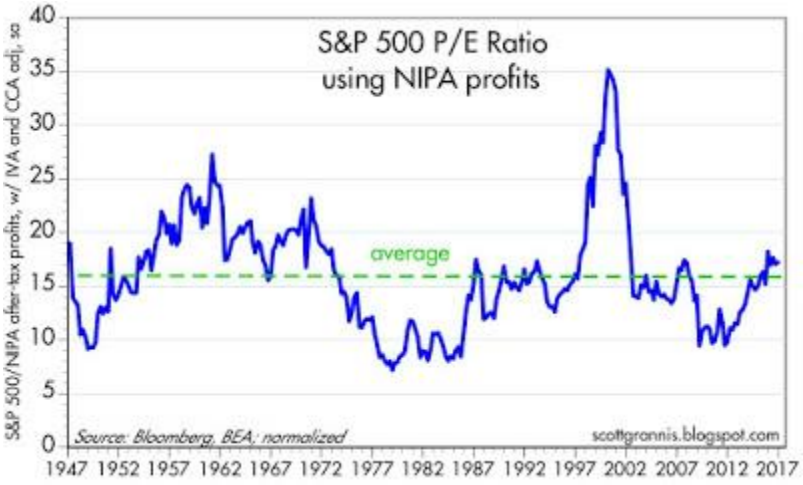


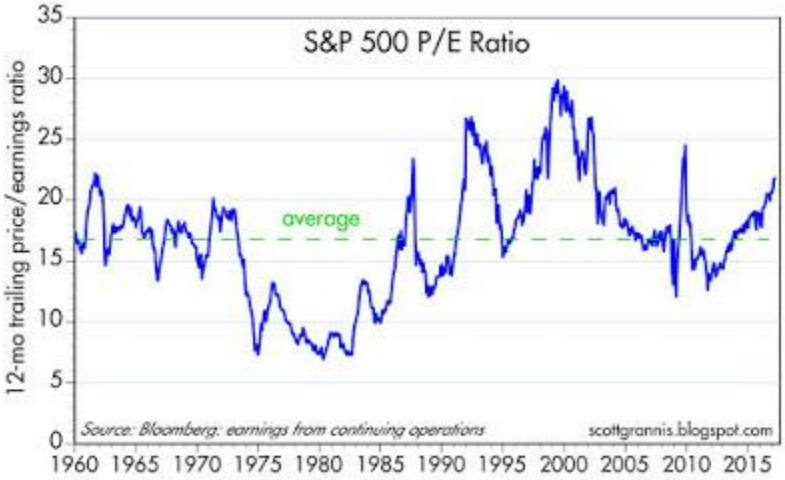
It should be clear that, despite this being a very weak recovery, corporate profits have been unusually strong. For years I have explained the shortfall in growth as being the result of very weak investment on the part of corporations; without investment there can be no productivity gains, and without productivity there can be no improvement in living standards. Both corporations and consumers have been generally risk-averse for the past 8 years, due to increased regulatory and tax burdens, and a general, anti-business sentiment emanating from Washington. Consumers have deleveraged significantly, while the government has borrowed heavily, absorbing ever penny of the profits generated by corporations since the recovery began. Corporations might have invested that money more efficiently but, instead, the government spent most of it on transfer payments.

As the next chart shows, the increase in corporate profits over time has corresponded rather closely to the increase in equity prices. As I argued a few weeks ago, the stock market is not rising simply because of a "Trump bump," it is rising because global economic fundamentals are and have been improving, as is the outlook for corporate profits.

The chart below compares NIPA profits with reported profits (using Bloomberg's calculation of profits from continuing operations). Note that the two measures tend to track each other over time, with the NIPA measure leading the reported profits measure (because it is based on quarterly annualized profits, whereas the reported profits measure uses a 12-month trailing average).

The rebound in NIPA (National Income and Product Accounts) profits last year is almost certain to show up in rising EPS in the months to come, and the stock market is priced accordingly. Ed Yardeni expands on this subject in a recent post here. For those interested in why the NIPA measure of profits has been consistently higher than the reported measure since the 1990s, see my post of a few years ago on this subject here.





The standard method of calculating equity multiples (PE ratios), is to divide current prices by a trailing 12-month average of earnings per share (see the second chart above). I have refined this a bit by using Bloomberg's calculations of PE ratios, which use only profits from continuing operations.

A better way, I would argue (as Art Laffer convinced me many, many years ago), is to divide current prices by the most recent quarterly annualized rate of profits as calculated in the National Income and Products Accounts (NIPA). This compares current prices to the most recent measure of true economic profits.

I have taken this analysis a step further (see first chart above), and calculated PE ratios for the S&P 500 using the NIPA measure of profits instead of reported corporate earnings (I then normalized the results so that the long-term average PE ratio using NIPA profits would be similar to the average PE ratio using reported profits).

By either measure, PE ratios today are modestly or moderately above average, whereas corporate profits using the NIPA calculation are significantly above average. If I had to choose one, I would go with the NIPA version of PE ratios, which shows the equity valuations today are only modestly above average.

The chart below shows the equity risk premium, which I define as the difference between the earnings yield on stocks (i.e., the inverse of the PE ratio) and the yield on 10-yr Treasuries. This is the extra yield that the market demands in order to feel comfortable accepting the added risk of equities vs. risk-free Treasuries. In the boom times of the 1980s and 1990s this risk premium was consistently negative, a sign that the market was quite confident that equities were attractive.

But for the duration of the current business cycle expansion, the premium has been consistently positive, a sign that the market has been quite reluctant to take on the added risk of equities. Risk aversion, as I have argued for years, has been one of the hallmarks of this recovery. It has been declining of late as confidence slowly rebuilds, but it would be difficult to argue from this chart that the equity market is priced to optimistic assumptions. I would further note that current risk premiums are about the same as they were in the late 1970s, during the infamous "Carter malaise."

Finally, I would note that these measures of equity valuation have nothing to do with surveys of investor and/or consumer sentiment. They rely solely on market-based measures and, as such, I think they are more reliable and informative.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

#####