Corporate Profits Are Huge

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

In this articles, Mr. Grannis shows that rising corporate profits are supporting today's rising equity valuations.

The articles are reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Corporate profits are huge**

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

Friday, June 29, 2018

Corporate Profits Are Huge

I have had many posts over the years highlighting the strength of corporate profits. This post adds to the list, but it is notable for being the first to highlight the impact of Trump's tax reform on after-tax corporate profits.

As I mentioned last December, Trump's reduction in corporate income taxes translated (via math) into a 20% one-time boost to the after-tax profits of a given level of nominal profits. According to yesterday's release of revised GDP stats for the first quarter, after-tax corporate profits (adjusted for inventory valuation and capital consumption allowances, a measure Art Laffer convinced me was the best, being based not on GAAP profits but on true economic profits using IRS filings) reached a record $1.92 trillion (annualized), up almost 17% from a year ago. That is equal to 9.6% of GDP, a level that has been exceeded in only 4 quarters in our nation's recorded history. After-tax profits are likely to move higher still, once the full impact of lower corporate income tax rates filters through to the data as the year advances.

Corporate profits paint an attractive picture for today's investors, since equity valuations seem only moderately higher than their long-term averages, even as profits reach very high levels relative to GDP, as I discuss below.

Chart #1

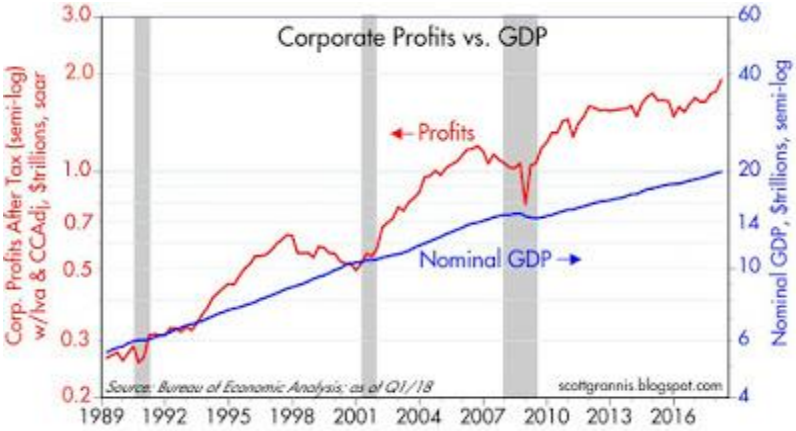


Chart #1 compares after-tax corporate profits to nominal GDP. Over the past three decades, profits have increased at a much faster pace than nominal GDP. (Note that the two y-axes have a similar ratio from bottom to top, and both are semi-log.)

Chart #2

Chart #2 above shows the same measure of profits, but as a percent of nominal GDP. Note that for many decades prior to the current business cycle expansion, the ratio of profits to GDP averaged just over 6%. Five years ago I thought that the market was skeptical that profits would remain at such "elevated" levels and would inevitably revert to their 6% of GDP mean. Yet profits just get stronger. If there has been any long-term theme in my posts since late 2008, it is that the future ends up being better than the market expected, even though the economy's growth rate has been sub-par. The market has held relatively dismal expectations for many years, and has been pleasantly surprised. That is why equity prices have been moving higher.

<continued>

Chart #3

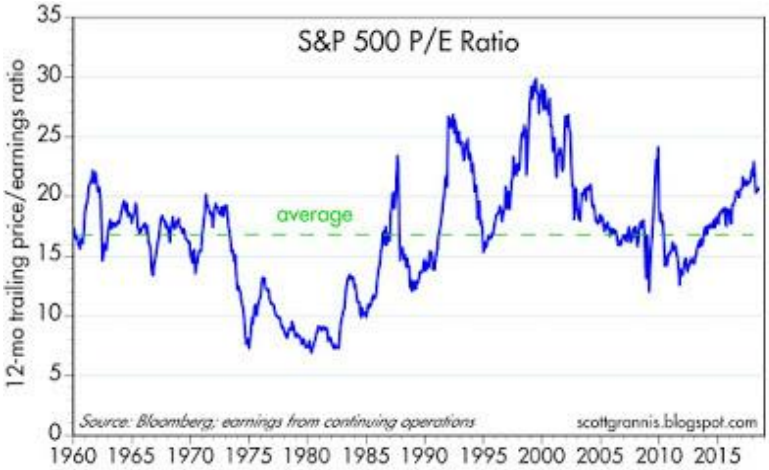


Chart #3 above shows the traditional measure of stock market valuation: the ratio of trailing 12-month after-tax profits per share to share price (using reported earnings from continuing operations). Currently, the PE ratio of the S&P 500 is 20.9 by this measure. That is higher than the 16.8 average since 1960, but it is also lower than past extremes.

Chart #4

Stocks are attractive today because they have an earnings yield of 4.8%, which is substantially higher than the 2.8% yield on 10-year Treasuries (see Chart #4 above). Consider: the PE ratio of a 10-year Treasury bond is 35! With stocks, you get a much better yield than risk-free Treasuries, plus you get plenty of upside should the economy continue to exceed what are still modest growth expectations. These conditions hold only because the market continues to worry that future profits will inevitably revert to their historical mean.

Chart #5

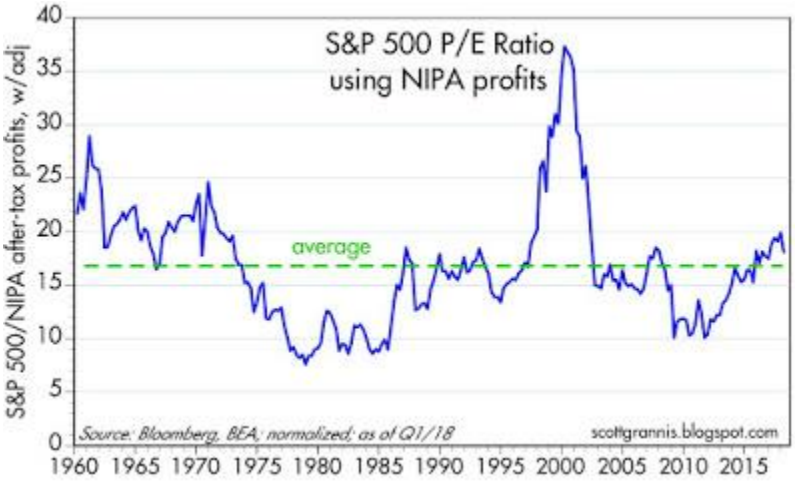
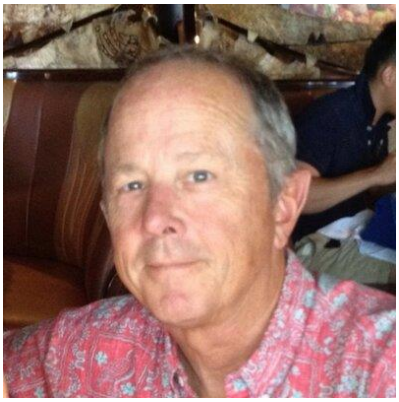


Chart #5 substitutes after-tax corporate profits using the National Income and Product Accounts for the traditional measure of GAAP profits (i.e., reported earnings). I have normalized the ratio so that the long-term average is similar to that of the traditional PE ratio. Note the extreme overvaluation of stock prices in the late 1990s. Today's valuations by this measure are very close to their long-term average. (I discuss the difference between NIPA and GAAP profits in this post.)

A disinterested observer might look at the charts above and wonder why stocks are not more expensive, especially relative to risk-free bonds. One reasonable answer would be that the market must be worried about another collapse or correction or even a recession. To be sure, there are legitimate things to worry about, chief among them being that Trump's tariff wars could get out of hand and precipitate a global recession. Quite simply, today's valuations imply that risk aversion is still alive and well, a theme I have revisited many times in recent years.

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.

#####