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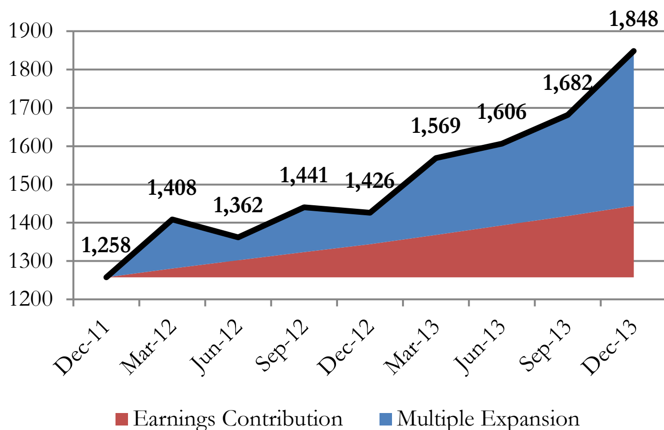
The Ever-Expanding Profit Margin

March 9th marked the fifth birthday for the current bull market in US stocks. Certainly this is cause for celebration, but also a call for a little introspection – an actuary would tell you this five year old has nearly outlived its life expectancy. The sixth, seventh, and "many more" birthdays are dependent on many factors, but perhaps none more important than the ability of corporations to continue growing profits at a healthy clip.

We showed the figure below in our *November 2013 Investment Bulletin* to illustrate the disproportionate impact multiple expansion has played in the market run-up. At this point, most financial analysis we read expects no more meaningful returns to accrue from multiple expansion. If this is true, then you would expect future S&P 500 returns to be bound by growth in corporate profits.

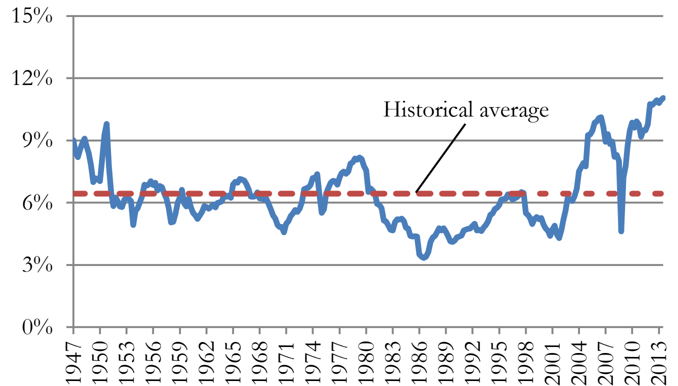
Figure 1: Make-up of an S&P Expansion
Cumulative Contribution of Earnings and Multiple Expansion to S&P Price Level
Source: Standard & Poor's



Unfortunately, the prospects for profit margins swim in a wide gulf that has opened up in the investment community. On the one hand are groups that strongly believe in the mean reverting tendency of profits. Economics teaches that, in a free market, high profits entice new entrants into businesses, capacity is subsequently built up, and profits are competed back down to a normalized level.

Figure 2 shows the share of GDP earned by corporations since World War II. Profits greater than 6% (the historical average) of GDP in the late '40s and late '70s reverted to below average levels in both cases. It's only in this century, with the brief exception of the credit crisis, that we have seen profits defy gravity.

Figure 2: Mean Reverting Profits?
Corporate After-Tax Profits as a % of GDP
Source: Federal Reserve Bank of St. Louis (FRED)



The other side of the profit argument posits that structural changes in the economy have permanently shifted the percentage of the pie claimed by companies. The internet and rapid improvements in machine intelligence have allowed for corporations to grow more efficiently. Jobless recoveries, such as those experienced after the past two recessions, are not anomalies – companies have figured out how to automate those jobs and capture more economic gains for owners. Those capital owners are poised to remain better off relative to workers in the current environment.

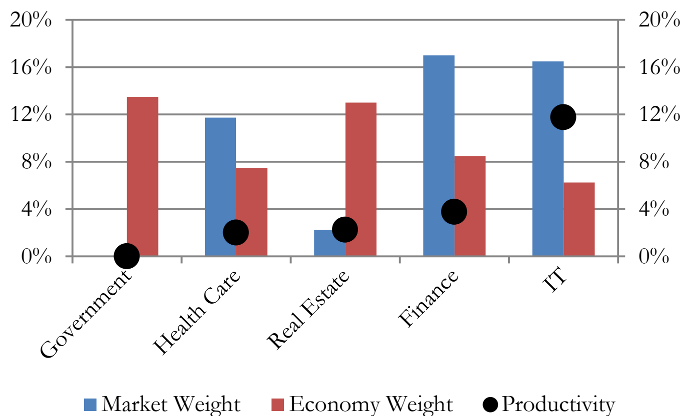
The implications of this debate are critical for portfolio design. Most in the reversion-to-the-mean camp believe future returns for the S&P 500 will be significantly below average and approaching zero on a real basis. Those in the structurally-changed-economy camp justify S&P returns near their long-term historical average. In the space that follows, we lay out the best arguments for both sides and where we stand on the debate.

The Best Argument Justifying Current Margins

The economy is not the stock market. First, the government is part of the former but not the latter. According to Fidelity, the government represents 13% of US GDP. Over the past twenty-four years, the less productive government sector has dragged down the productivity growth of the entire US economy to half that of the stock market. On the flip side the IT sector is heavily overweighted in the market relative to the economy (see Figure 3). The high productivity in this sector gives context to the elevated profit margins in Figure 2. If we were to plot profits as a percentage of stock market revenue the picture would not be so stark.

Deutsche Bank has broken down the components of higher profits relative to the stock market rather than the economy. Their analysis accounts for a 2.7% increase in profit margins (7.0% in 1995-97 rose to 9.7% in 2012) using five factors: changes in S&P 500 constituents, lower taxes, lower interest expense, higher foreign earnings, and a shift in the sector composition of the index. The biggest contributors to the increase are lower taxes (0.80%) and higher earnings due to foreign profits and the sector shift (0.85%). If you slice by sector, tech businesses alone contributed 1.3% to the 2.7% increase. The relevant argument may be over the sustainability of the tech sector's margins rather than those of the economy as a whole.

Figure 3: The Economy is not the Stock Market
Selected Sector Weights (LHS)
Productivity (RHS)
Source: Fidelity



The Best Argument Discrediting Current Margins

Margins are high right now simply because the government and households are spending beyond their means. John Hussman, a mutual fund manager, starts this argument with an accounting identity from Economics 101: investment must equal savings. Savings has four components: household savings, government savings, corporate savings, and foreign savings. All of these "savings" components can of course be negative or in deficit. Moving some terms around and cancelling out those that have little variability, Hussman arrives at the following:

Variability in Corporate Profits ≈
– Household Savings – Government Savings

In other words, elevated profit margins are traceable to leveraged consumers and government deficits. Both the household and government savings components have been negative for long periods in the 21st century. Hussman's argument is that those combined deficits make up the surplus for corporations. Think about it this way – compared to the post-WWII norm, in the last decade the corporate sector has sold more to consumers and the government and/or paid less in wages and taxes. It follows that, unless you believe the government will continue running large deficits indefinitely and consumers will sustain negative savings rates, corporate profits must revert to the mean.

If there is a silver lining in this argument, it is that a correction in profit margins would not happen overnight. The speed with which the government embraces austerity will dictate how quickly corporate profit margins will fall. We would expect any austerity to be implemented over many years. On the consumer side of the coin, recall the snail pace of improvement in the unemployment rate. As the slack slowly comes out of the labor market, the corporate bottom line is afforded time to adjust.

Where Do We Come Down on the Debate?

Our view is that margins likely will not stay as high as they are today (11% of GDP), but the reversion period will not be abrupt and the downward move will not go so far as the historical average (6% of GDP). The argument that the stock market is not the economy is a convincing one. Technological improvements, manifested most clearly in the tech sector of the market, will allow for a higher long-run return to the owners of capital in the economy. Technology has been rapidly changing ever since the industrial revolution of course, but change these days is far less physical-capital intensive. Intellectual capital has changed the calculus.

At the same time, downward pressure on margins will gather. Whether it comes from the government grabbing a larger share of profits through taxation, the labor force regaining leverage in salary negotiations, or the capitalist process of competing away profits, earnings as a share of GDP will deflate over a multi-year time period. If you subscribe to our view, the implication for stock returns is not so bearish as to be near-zero on an after-inflation basis, but perhaps not quite rosy enough to match historical averages over the long-run. □

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