LOOKING BACKWARD, GAZING FORWARD:
US CORPORATE PROFITS AND FINANCIAL TRENDS

(c) Leo Haviland, 646-295-8385 May 3, 2016

"And I'll be taking care of business, every day
Taking care of business, every way". Taking Care of Business", by Bachman-Turner Overdrive

****

CONCLUSION AND OVERVIEW

For a majority of earnest soothsayers, American corporate profitability is an important factor for US stock marketplace levels and travels. Use the S+P 500 as a benchmark for United States equities in general. In second quarter 2015, US after-tax corporate profits peaked (annualized basis). The S+P 500's record pinnacle occurred alongside this, on 5/20/15 at 2135. It mournfully plummeted about 15.2 percent to its 1812 (1/20/16)/1810 (2/11/16) depth. Despite the S+P 500's subsequent sharp rally, the current and near-term after-tax corporate profit trend likely will make it challenging for the S+P 500 to ascend much above (or even over) its May 2015 peak during the next several months. History reveals that several noteworthy bear moves in the S+P 500 have intertwined with noteworthy profitability slumps.

****

To explain past and current United States stock marketplace levels and trends, and in offering prophecies regarding future heights and patterns, diverse wizards tell competing tales. Their arguments and conclusions reflect their different marketplace perspectives and approaches, including the particular variables they select and arrange.

American and other corporations win or lose given amounts of money for all sorts of reasons. Factors influencing earnings and profitability change, as do the relative importance and interconnections of these variables. Long run inflation increases generally increase nominal values in general. Also, central bank policies, tax regimes, wage trends, and productivity (innovation; efficiency) developments influence sales and profits. The altitudes and paths of the US dollar, interest rate yields, and commodity prices also are relevant in various ways and degrees to particular corporations. Unemployment rates, fiscal situations (budget deficits), debt levels and trends (government, corporate, and consumer), regulatory structures, and population growth matter. America is not an island apart from the rest of the world; globalization has increased in recent decades.

****

Admittedly, the ongoing (extraordinary) very lax monetary policy of the Federal Reserve Board and other central bank guardians such as the European Central Bank, Bank of England, Bank of Japan, and China's central bank helps underpin equity prices in America and elsewhere. Stock-owning audiences around the globe (particularly the praiseworthy investment community) as well as Wall Street institutions, public corporations, and the financial media friends generally adore massive money printing (quantitative easing) and sustained yield repression. Low interest rate yields for US Treasury securities (and negative yields for many government debt obligations elsewhere) encourage fervent scrambles for acceptable returns elsewhere. These often-alluring territories include stock realms (hunting for dividends and potential capital gain), corporate debt, and commodities. American inflation has been quite modest in recent years. Yet as nominal prices in general (all else equal) tend to rise alongside (or on a lagged basis) a climb in US nominal GDP, so will a nominally priced index such as the S+P 500.

The S+P 500's retreat beginning in May 2015 interrelated with the preceding bear trends in emerging marketplace stocks and commodities (notably petroleum) and a further bull charge in the broad real trade-weighted dollar ("TWD"). Significantly, the S+P 500 (and stocks of other key advanced nations), emerging marketplace equities ("MXEF", MSCI Emerging Stock Markets Index, from Morgan Stanley; 1/21/16 at 687), and commodities in general (broad GSCI at 268 on 1/20/16) all attained significant troughs around the same time in first quarter 2016. The US Treasury 10 year note yield low was 2/11/16 at 1.53 percent. The TWD established its recent high alongside these marketplaces in January 2016. This interconnection across assorted marketplaces assisted the rally in the S+P 500 from its January/February lows.

Thus to some extent, the recent weakness in the broad real trade-weighted dollar encouraged the ascent of the S+P 500. In any case, central banks did not want the TWD to ascend by much, if at all, over its January 2016 high. They likewise wanted to arrest stock marketplace declines.

****

However, suppose the TWD declines further from current levels, perhaps ten percent or more from its January 2016 elevation. Although the first stage of dollar decline has managed to spark and assist a S+P 500 rally, additional sustained depreciation eventually may undermine equity prices. Besides, even if the TWD fall from its January plateau does not reach ten percent, the S+P 500 nevertheless may slide lower. Marketplace history reveals that a weaker dollar does not inevitably (or necessarily) push US stocks upward. And also suppose US interest rates or inflation expectations sustain modest climbs. Rising US Treasury yields can help to lead S+P 500 prices lower. Assume commodities in general manage to hold onto much of their recent gains.

In this environment, further suppose US corporate profits (and those in related regions) continue to remain sluggish (or decline further). Then the S+P 500's fall from its high probably will be significant, even though the Federal Reserve and its trusty allies will intervene with rhetoric and action to prevent dramatic stock marketplace drops (particularly watch the 20 percent bear market definition threshold).

US CORPORATE PROFITS: TWISTS AND TURNS

"Big boss man, can't you hear me when I call?" "Big Boss Man"; sung by Elvis Presley, the Grateful Dead, and others

****

Marketplace historians and clairvoyants review various measures of corporate profitability. Let's examine nominal after-tax profits (without inventory valuation and capital consumption adjustments) for all American corporations (not just those in the S+P 500) both over the past several decades as well as on the current scene. See the Federal Reserve Board Z.1 "Flow of Funds" (3/10/16; next release 6/9/16) and Bureau of Economic Analysis data.

****

Everyone knows that the so-called long run secular trend for US nominal after-tax corporate profits has been upward. In the post-World War 2 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 2015 have averaged an increase of 8.7 percent.

In the post-World War 2 epoch, US ATP saw several very substantial year-on-year percentage leaps and a few extended spans of noteworthy gains. Right after WW2, 1946 and 1947 displayed gains of 70.1pc and 29.7pc, respectively. The blessings of 1946 have not come close to returning. Around thirty percent represents an extraordinary year-on-year gain. Year-on-year profitability gains averaging over twenty percent per year extending over several calendar years are stellar.

For example, 1955 had a 26.7 percent jump. In 1973, profits climbed a majestic 30.9pc year-on-year, the four years 1971-74 manifested an average ascent of 20.7pc per year (1975 produced a 5.2pc fall, but 1976's soared 27.0pc). 1987 unveiled a 28.1pc rise. What about the glorious Goldilocks Era? The marvelous average yearly rise from 2002-2006 was 23.3pc, which surely assisted ("confirmed") the wonderful bull march in the S+P 500. They spiked 30.7 percent in 2004 and raced another 30.8pc upward in 2005 (2006's grew 11.1pc).

Of course above average profits over a very long time span may be striking, even if they do not reach twenty percent. In 1990-97's joyous eight year span of continuous year-on-year rises, ATP advanced an average of 10.9 percent each year (1994's 22.0pc the greatest).

****

Will American corporate profits forever keep rising? Numerous US stock investment cheerleaders promote gospels of long run American prosperity. Yet history is not destiny.

Moreover, US corporate profits frequently have declined. In the roughly seven decades since the end of World War 2 (1946-2015), they fell 22 times on a calendar year-on-year basis. Not all of these were small. Not all of them were in the distant past. The greatest ATP falls have been roughly eighteen percent. Recall year-on-year swoons in 2008 (17.6pc; 2007's fell 5.5pc year-on-year), 1986 (17.7pc), and 1949 (17.8pc). Even during the current global recovery, US profits dipped in 2011 (2.9pc year-on-year).

****

After the dreadful days of the 2007-09 worldwide economic disaster, US after-tax corporate profits resumed their nominal climb alongside the American and worldwide recovery. In addition to the sustained low policy interest rates (such as Federal Funds) and gigantic money printing (quantitative easing) by the adored high priests of the Federal Reserve and other key central banks, keep in mind the massive federal deficits generated by America (and its allies).

The S+P 500's major bottom was 3/6/09 at 667. Low interest rates (especially if they are near or beneath inflation levels), all else equal, can encourage spending (and borrowing) by consumers and corporations (and governments) and thereby boost economic growth. The more spending, the greater probably will be nominal ATP. Low interest rates tend to reduce corporate costs.

Within the first half of the 2009-2015 period, 2010 and 2012 had well-above average yearly nominal ATP gains; 2010's was 22.2 percent, 2012's 17.9pc. However, the average annual increase of 7.6pc for 2009-2015 was far less than the 23.3pc of the best years of the Goldilocks Era (2002-06). In addition, average yearly ATP growth over 2009-15 was about one percent beneath the 8.7pc long run average (1946-2015). Admittedly, the ATP trend covering 2009-15 seems rather strong relative to low inflation levels.

Yet ATP gains nevertheless have become mediocre in recent years. The 2013 total rose under one percent (merely .6pc) year-on-year, with 2014's about flat (up a meager .1pc). Those for calendar 2015 floated around 3.4pc higher versus 2014 to $1750.6 billion, a less than stellar shift.

Notably, the US ATP picture evidences actual drops in profits in recent calendar quarters. ATP peaked in second quarter 2015 at an annualized rate of $1844.6 billion. In 3Q15, they were $1783.6bb, with those of 4Q15about $1639.6bb. Thus the 4Q15 ATP (annualized) slumps a sizable 11.1pc relative to 2Q15.

****

Not all corporate profitability predictions clearly distinguish between (define) revenues, earnings, and profits (or types of profits). Many forecasts apply only to the universe of the S+P 500, not to all American corporations.

In any case, numerous gurus forecast "earnings" declines for first quarter 2016 relative to the prior year quarter. For example, for the S+P 500, FactSet predicts a 1Q16 fall of 7.6pc versus 1Q15 ("Earnings Insight", 4/29/16). Thomson Reuters indicates a 7.1pc drop for 1Q16 relative to 1Q15 ("This Week in Earnings", 4/22/16).

Suppose ATP as presented by the Federal Reserve (Z.1 report) decline by five percent. US overall first quarter 2015 after-tax profits were $1734.5 billion (annualized), so that total *.95 equals $1647.8 bb. Thus 1Q16 profits will be about flat with those of 4Q15 (and still significantly beneath 2Q15's pinnacle).

What will be US after-tax profit levels and trends over the next few quarters and thereafter? Of course much can happen, and pundits disagree. But calendar year 2016 as a whole probably will advance little if at all relative to calendar 2015's $1750.6 billion. FactSet predicts an "earnings" decline of 4.4pc for 2Q16 year-on year. A four percent decline in ATP relative to 2Q15's $1844.6 pinnacle gives $1770.8bb. According to FactSet, 3Q16 earnings growth will be only 1.6pc, though they will hop up 7.5pc in 4Q16. For calendar 2016, earnings edge up only .8pc (and revenues rise a paltry 1.5pc) year-over-year. Finally, underscore that although first quarter 2016 earnings declines were massive within the energy sector, a few other stock groups also showed earnings slides relative to 1Q15.

****

America's ATP trends are not the only important variable for US (and other) stock marketplace levels and trends. Yet at times in post-WW2 history, noteworthy falls in the S+P 500 roughly have accompanied declines in US after-tax profits. ATP fell 5.5 percent year-on-year in 2007 and 17.6pc in 2008. The S+P 500 attained its major summit on 10/11/07 at 1576, with its final high 5/19/08 at 1440. What about the S+P 500's major high on 3/24/00 at 1553? In 2000, calendar year profits fell 5.0pc. Though 1999's grew 5.8pc, 1998's had slumped 13.0pc. ATP did not surpass 1997's $551.5bb height until 2002's $596.6bb. What about late summer 1987's dramatic stock price fall (S+P 500 peak 8/25/87 around 338)? Although calendar 1987 ATP ascended very substantially year-on-year (28.1pc), they had slipped 17.7pc in 1986 and 5.2pc in 1985.

In this context, recall the coincidence of the 2Q15 ATP pinnacle and May 2015's high-to-date in the S+P 500. The roughly eleven percent ATP decline from 2Q15 to 4Q15 was significant, and 1Q16 evidences only a slight rebound. Thus the ATP variable probably remains a bearish warning indicator for the S+P 500.

And suppose full calendar year 2016 ultimately manages a meager advance in ATP. If it does, this would fit within the pattern of feeble year-on-year profit growth shown over 2013-2015. So for at least the next several months, from the ATP standpoint "alone" (other variables such as share buyback levels of course matter), it will be difficult for the S+P 500 to advance much, if at all, over its May 2015 peak.

THE NOMINAL WORLD: PROFITS AND GDP

Kenneth Burke remarks in "A Grammar of Motives" (Part One, chapter III): "And so one can seek more and more money, as a symbolic way of attaining immortality."

****

How do American corporate after-tax profits appear in the context of economic output? The average United States yearly ATP level relative to nominal GDP from 1946 to 2015 is about 6.5 percent. After World War 2, and before the 2004 to the present period, the last high over eight percent was 1979's (at barely over 8.0pc), with the only preceding years 1950's 8.6pc and 1948's 8.8pc.

During the enthralling Goldilocks Era economy, this indicator became very elevated from the long run historical vantage point. And since then, and even during the global economic crisis, this ratio has remained rather euphoric.

Recall the nominal ATP/GDP depths of 3.4 percent in 1986 and 2001's 4.6pc. Eventually a new golden age of corporate profits arrived. In 2004, ATP reached 7.7pc of GDP. They expanded to 9.5pc in 2005 and to almost ten pc in 2006. Look back to 1929, shortly before the Great Depression; the 2005 and 2006 percentages smashed above 1929's prior record of 9.1pc.

During calendar year 2007, the year the global financial crisis emerged, the US ATP/GDP ratio of 9.0pc remained lofty from the long run historical perspective. Even in 2008's savage US and worldwide downturn, accompanied by the crashing S+P 500, ATP relative to GDP stood at 7.3pc.

What about the fairly sunny recovery years thereafter? The S+P 500 made its 667 major bottom on 3/6/09. In calendar 2009, the ATP/GDP ratio was 8.3pc. For the next six calendar years, the relationship has been 9.2pc (in 2011) or above, with 10.4pc the record (2012; 10.2pc in 2013). It stood at 9.8pc in both 2014 and 2015.

For quarterly statistics (annualized) in the span since 2011, the high for this percentage occurred in 1Q12 at 10.8pc. However, it has sagged since 2Q15's 10.3pc (which occurred the same quarter as the record high in annualized after-tax profits), reaching 9.0pc in 4Q15.

Nominal first quarter 2016 US GDP stood slightly over $18.2 trillion (annualized). Suppose ATP for 1Q16 fell five percent relative to 1Q15 to around $1647.8 billion. Then for 1Q16, as a percentage of nominal GDP, ATP will remain about 9.0pc.

Will flat (or declining) corporate profits, whether due to wage increases, a weaker economy, or other factors further narrow this relationship toward the 6.5pc long run average?

****

Sustained highly accommodative Federal Reserve Board policies, paralleled in various ways by other key central banks, have occurred alongside the revival of US ATP, the sustaining of high levels in the ATP/GDP ratio, and the bull move of the S+P 500. So marketplace players should closely monitor Fed and other central bank rhetoric and actions. The Fed convenes 6/14-15/16 and 7/26-27/16.

What if the S+P 500 manages to hover at least fairly close to its May 2015 peak around the time of a Fed meeting? Assume that at the time of this gathering, the Fed has no great fear of domestic or international economic weakness and that the broad real trade-weighted dollar remains "sufficiently" beneath its 1Q16 peak. All else equal, such an elevated S+P 500 price raises the odds that the Fed will boost the Federal Funds rate.

****

The average percent year-on-year growth in United States nominal GDP from 1946-2015 also was 6.5pc. For 1946 through 2015, the difference between average year-on-year changes in nominal ATP and average year-on-year changes in nominal GDP is about 2.2 percent (8.7pc less 6.5pc).

The two percent fall in US nominal GDP in 2009 probably continues to terrify the Fed. It was the first drop since 1949's .7pc, though far less than the Depression's gigantic 45.3pc collapse from 1929 to 1933 (or 1938's 6.0pc tumble).

Nominal GDP expansion averaged 3.7 percent per year for the 2010-15 span (2015 output rose 3.5pc year-on-year).

FOOTNOTES: SHARE BUYBACKS, THE US DOLLAR, DEBT, S+P 500 HISTORY

The Federal Reserve Board reports statistics on "net issues" of corporate equities (Z.1, currently given at Table F.223). In recent years, net share buybacks (negative net issues) of US stocks often have been an important bullish factor in supporting stock prices (see "US Share Buybacks: Off to the Races"; 5/3/15). Particularly relevant to the first quarter 2016 S+P 500 rally, note a recent Financial Times article (4/27/16, p20). It headlines: "US groups expand taste for buybacks", pointing out a share count cut (thus a reduction in free supply) by many S+P 500 firms in 1Q16.

Given the feeble US 1Q16 earnings season, the S+P 500's rally from its first quarter 2016 depths arguably reflects not so much an economic growth spurt, but rather these net buybacks and the 1Q16 trend changes in the broad real trade-weighted US dollar, emerging marketplace stocks, commodities in general (especially oil), and US Treasury note yields.

Even if net share buybacks persist, a significant slowdown in their pace (reduction in their level) probably would be a bearish warning signal for the S+P 500.

****

The broad real trade-weighted dollar (Federal Reserve, H.10) fell about 5.2 percent from January 2016's 101.2 to April 2016's 96.0 (monthly average). It thus neighbors its major high of the global economic crisis, March 2009's 96.8. Note also that the TWD's last minor low before its January 2016 summit also was 96.8 (in October 2015).

The low in the nominal real TWD (which has daily data through 4/29/16), since its 126.2 summit on 1/20/16 is 4/29/16's 118.3, a 6.3pc erosion.

****

Debt problems around the globe have not disappeared. Many sovereign and corporate situations are worrisome. 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. The International Monetary Fund, in its April 2015 "Fiscal Monitor" (Executive Summary, p ix) says regarding government debt: "Fiscal positions have worsened significantly since the April

2015 Fiscal Monitor, with public debt ratios being revised upward in most countries….Fiscal risks are rising almost everywhere."

****

The S+P 500's May 20, 2015 peak at 2135 occurred the same calendar month as its key (second) final summit during the global financial crisis (5/19/08 at 1440, which followed 10/11/07's major peak at 1576). Marketplace history obviously need not repeat itself, whether in the S+P 500 or elsewhere. Yet on the marketplace trend change timing front, and given the projected likely drop in US first quarter 2016 after-tax corporate profits, keep in mind those noteworthy 2015 and 2008 tops in the S+P 500. The high in the S+P 500 since its first quarter 2016 trough occurred 4/20/16 at 2111, fairly close to these 2015 and 2008 calendar dates.

****