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MACRO ANALYTICS 24.04.2013

Corporate Profit Margins and Equity Returns

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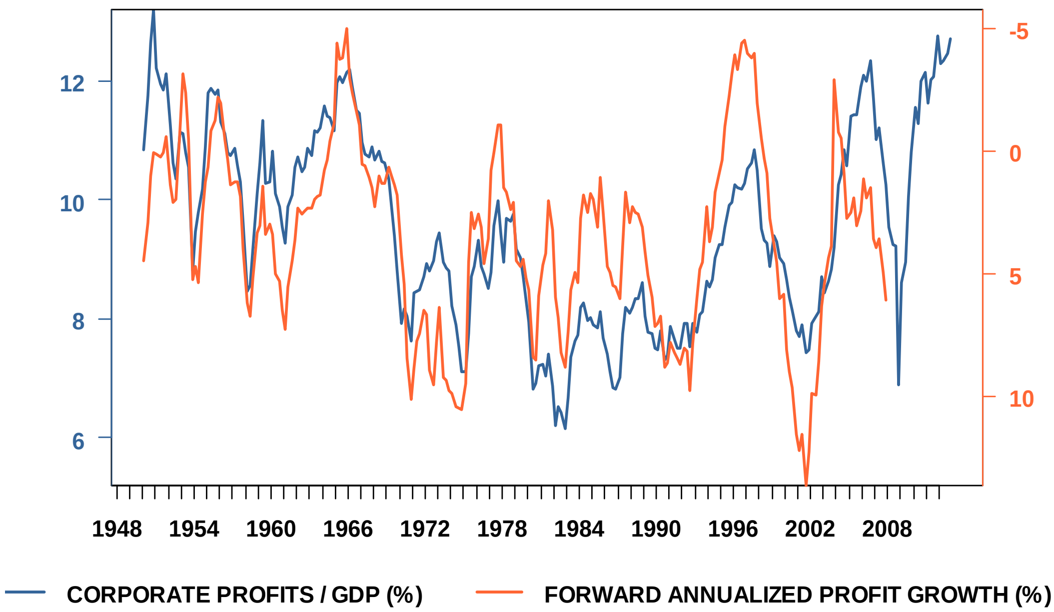
One of the most often quoted bearish arguments currently lies in the unsustainability of US corporate profits margins. Indeed, as a share of GDP, US corporate profits are close to all-time highs[1]. Additionally, US corporate profit margins are clearly mean-reverting, as evidenced by their negative correlation with subsequent five-year profit growth (inverted axis):

US CORPORATE PROFITS / GDP vs. 5Y FWD PROFIT GROWTH



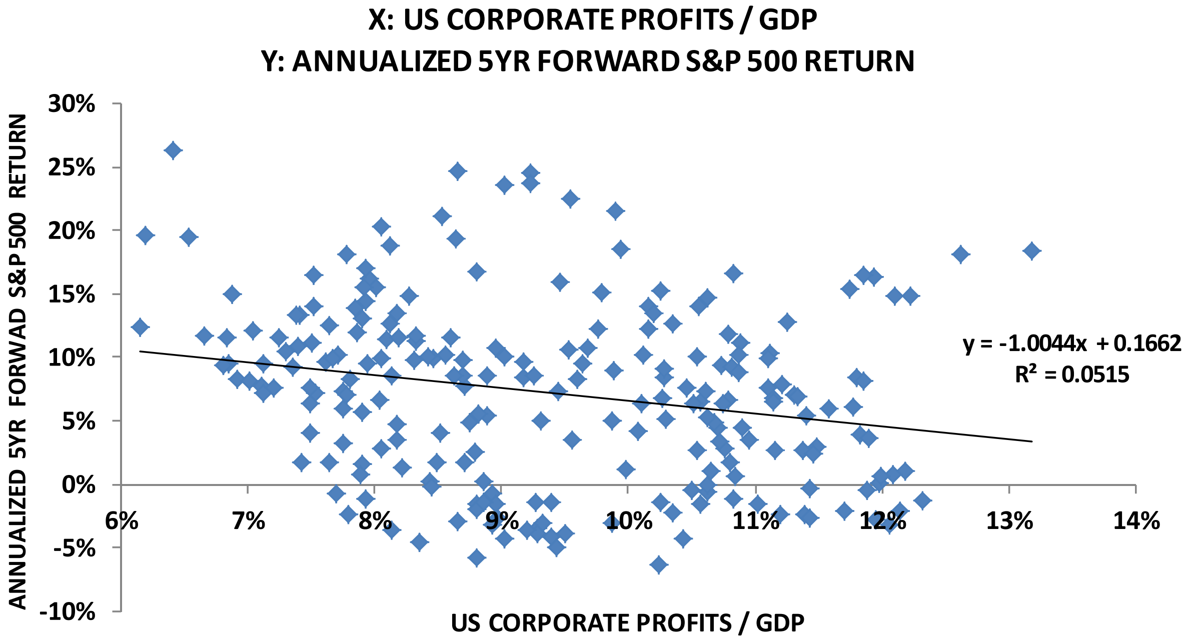
There is a simple economic explanation for the mean-reverting behavior of corporate profit margins: low profit margins lead to business failures, reduced competition, resulting in increased profit margins for surviving businesses. Inversely, high profit margins lead to overinvestment, which erodes profit margins further down the road. In other words, fluctuating profit margins are consubstantial with capitalism and the business cycle.

With our current long positioning, should we be consequently worried about the fact that corporate profit margins are bound to mean revert sooner or later?

A decrease in corporate profits can be compensated by an increase in P/E multiples, and therefore does not necessarily imply a corresponding fall in equity prices.

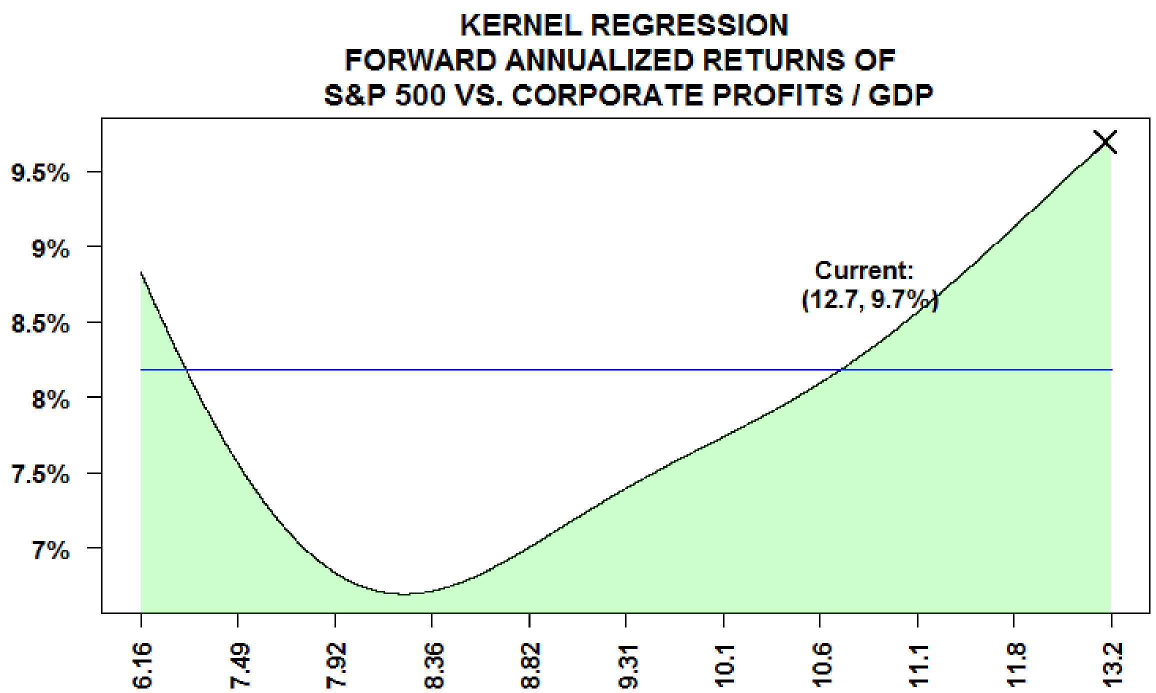
[1] Although not strictly equivalent, we call "corporate profit margins" the ratio between corporate profits and GDP.

Indeed, we observe a rather poor relationship between current profit margins and five year forward S&P 500 returns (R^2 = 5%):



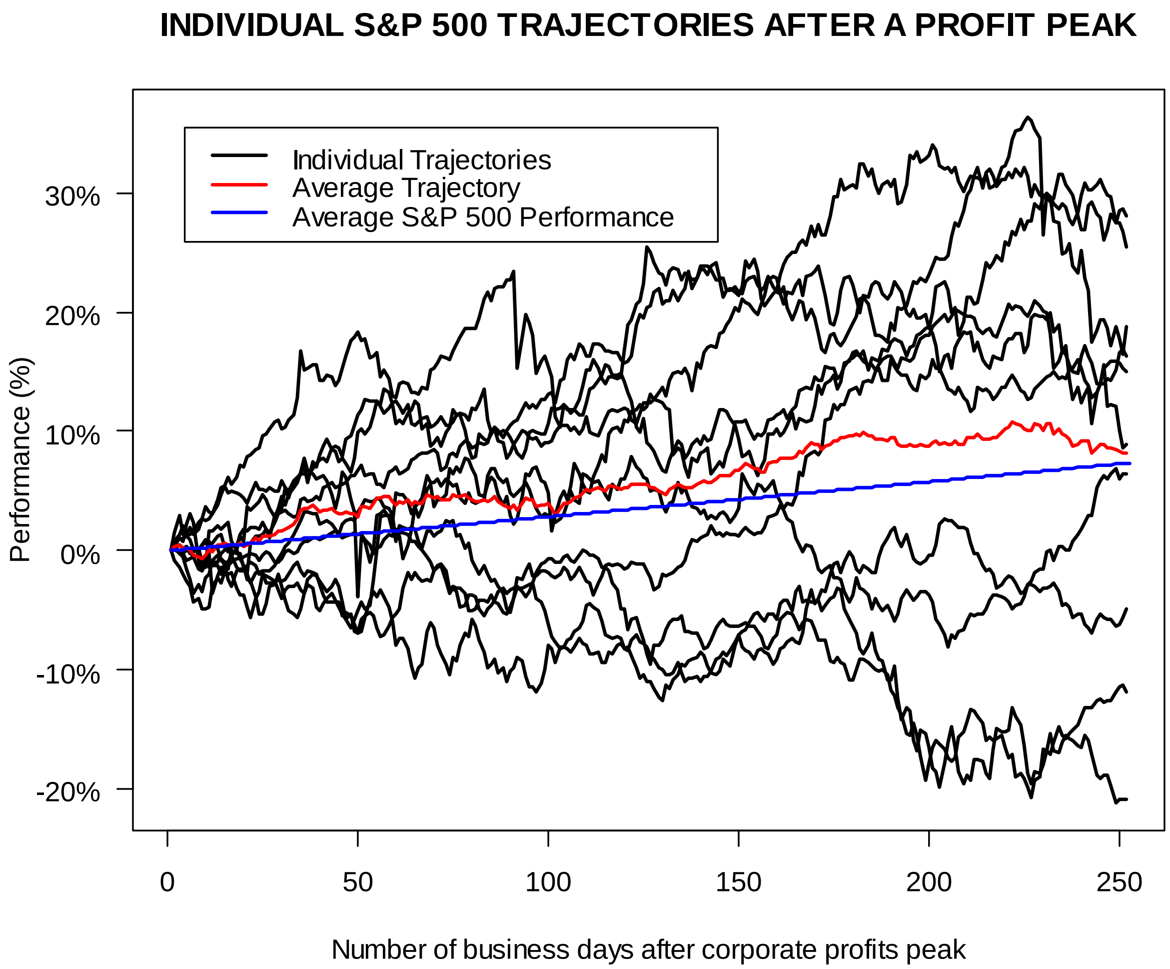
Corporate profit margins seem to be a moderately useful indicator, even from the point of view of a buy-and-hold investor.

For the rest of us, who are judged on an annual, quarterly and monthly basis, the link between corporate profits and equity returns is even more elusive. Here is a kernel regression between corporate profits and annualized equity returns:



High profit margins actually tend to correspond with slightly higher-than average returns for the S&P 500.

Another method for determining the usefulness of corporate profits as a market-timing tool consists in looking at the stock market's behavior after former profit margin peaks. Here is the subsequent trajectory of the S&P 500 after ten local peaks in profit margins between 1948 and 2007:



The average S&P 500 trajectory after a corporate profit peak is actually slightly higher than the average.

Therefore, even under the assumption that an investor would know the exact quarter when corporate margins have topped, acting on this information alone would not be of much help for him.

Although we do not believe that markets are perfect discounting mechanisms (if we did, we would work in another line of business), it appears that the stock market is generally efficient enough to integrate the mean-reversion of corporate profits.

For that reason, we do not believe that a fall in corporate profits alone will provoke a market crash. With a forward P/E of 12.5 and long bond yields stuck at around 3%, the market already "knows" that corporate profits are bound to mean-revert.

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