Current Economic Conditions

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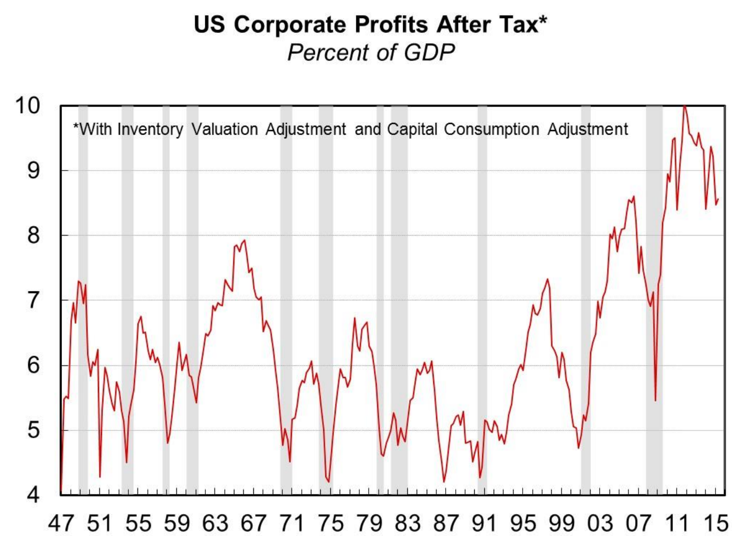
October 19, 2015

THE FANTASY OF DOUBLE-DIGIT EARNINGS GROWTH

For at least two decades, sustained double-digit growth in earnings per share has been regarded as a hallmark of successful publicly-traded companies, and leaders of such companies have seemingly felt obligated to target, even promise, such growth. Economists who understand the long-term relationship between corporate profits and nominal economic growth (real growth plus inflation) know that such targets are usually not realistic, especially when the U.S. dollar strengthens and nominal growth slows.

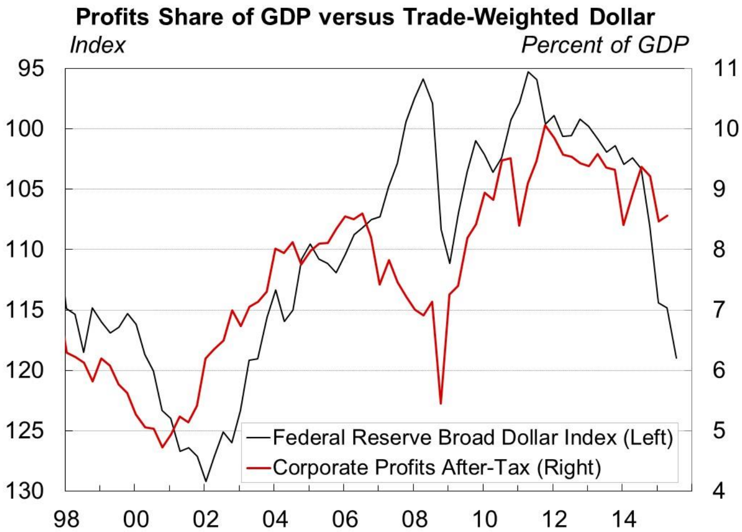
The ratio of (after-tax) U.S. corporate profits to nominal U.S. Gross Domestic Product was once the most mean-reverting series in economics. From the second quarter of 1947 through the end of 2001, U.S. corporate profits averaged 5.45% of nominal GDP. Profits were 5.48% of GDP in first quarter of that period and 5.41% of GDP in the last quarter. Profits never fell below 4.2% of GDP or rose above 8%. Based on the stability of the profits/GDP ratio, it would be appropriate to conclude that over the long run, profits grow at the same rate as nominal GDP. Earnings per share (EPS) for S&P500 companies generally grow a little faster than the "economic profits" measure in the National Income Accounts, for two reasons. First, companies that make it into the S&P500 and stay there are more successful on average than companies in general, some of which fail in any given period. In other words, the S&P500 is a biased sample. Second, earnings per share can be boosted by reducing the number of share outstanding through share repurchases. I've always regarded that as cheating and believe that companies should be required to focus their earnings reports on total earnings rather than on earnings per share, but lazy analysts who would rather multiply EPS by a price/earnings "multiple", rather than going to the trouble of calculating the discounted present value of future dividends and share repurchases, would rather work with EPS.



More than a decade ago, Richard Berner, then Chief U.S. Economist at Morgan Stanley explained in a report that given the historical relationship between earnings growth and nominal GDP growth, double-digit earnings growth was very unlikely for the vast majority of companies and for the corporate sector as a whole. He took to task Morgan Stanley's own analysts, who were forecasting double-digit earnings growth for 85% of the companies they covered and showed that that was almost impossible. As it turned out, corporate profits after tax grew at a 10.6% annual rate from the fourth quarter of 2001 to the fourth quarter of 2011, much faster than the 4.0% growth rate in nominal GDP. Rising prices for commodities (oil, copper, grains) coincided with and might help explain the strong growth in profits from 2001 to 2011, but the main reason for the surprising outperformance of corporate profits vis-à-vis nominal GDP was strong growth in profits from overseas operations. Some of this growth was due to strong real growth in the rest of the world, particularly in Asia, but because of slow growth in Western Europe and Japan, global growth has not been much faster than U.S. growth. Some might be due to growing market share, but while

U.S. companies expanded sales in the rest of the world, they lost share in the United States. However, **most** of the growth in (dollar) profits from overseas was due to the depreciation of the dollar. From February 2002 to July 2011, the Federal Reserve Broad Trade-Weighted Dollar Index declined by 27%.

The weakening of the dollar boosted corporate profits through two effects: the competitiveness effect and the translation effect. Other things equal, a weaker dollar makes U.S.-produced goods more competitive in global markets, allowing U.S. companies to gain market share from foreign competitors. The translation effect means that when the dollar declines, foreign-currency earnings simply "translate" into a larger number of U.S. dollars. The dollar hit bottom in July 2011. The profit share of GDP peaked in the fourth quarter of 2011 at 10.1%. Since those two turning points, the trade-weighted dollar has appreciated by 27%, and corporate profits have declined at a 1% annual rate, well below the anemic 3.7% growth rate for nominal GDP, taking the profit share of GDP down to 8.6% in the second quarter of 2015.



With the profit share of GDP still well above its 1947-2001 average, profits are likely to rise more slowly than GDP unless the historical relationship has permanently broken down or the dollar reverses course and begins to depreciate again. And given the downshift in real GDP growth (actual and potential) and the difficulty the Federal Reserve is having getting inflation up to its 2% target, nominal GDP growth isn't likely to accelerate much from the 3.7% rate of the last few years. The 2.4% year-over-year increase in **real** retail sales in September isn't especially strong, but is roughly in line with trend. The 2.4% increase in **nominal** retail sales, which is what matters for corporate earnings, is well below historical norms. Multinational companies should perhaps focus on the dollar value of global nominal GDP, which depends on real growth, inflation, and the value of the dollar, but barring a surprisingly strong rebound in real growth and inflation and a decline in the dollar, global nominal GDP won't rise very fast either. China in particular is not likely to bail out U.S. multinationals. Given the enormous debt burden of Chinese companies, China might have to choose some combination of debt deflation, which brings down yuan prices, and a devaluation of the yuan. Either way, the U.S. dollar price of goods sold in China declines.

The profit share of GDP is the macroeconomic analog of the profit margin of a business. If profits grow less rapidly than GDP so that the profit share of GDP declines, profit margins can be expected to decline at most companies. This might come as a shock after the persistent increase in margins in the 1990s and 2000s, but in a competitive economy where new firms can enter and antitrust laws are enforced, margins should not be expected to rise over time. A broad increase in wages and salaries in response to tightening labor markets would put downward pressure on profit margins, but it would be the best thing that could happen to the U.S. economy over the medium term.

Successful young companies in rapidly growing industries can be expected to grow earnings at double-digit rates, but for the vast majority of mature companies, expectations for double-digit earnings growth over the course of a full cycle are totally unrealistic in the current low-growth, low-inflation economy. In fact, as long as there are new companies, the average existing company will grow less rapidly than GDP, so that a business that grows with GDP is, by definition, above average. When CEOs of mature companies target or promise double-digit growth, Boards of Directors and equity analysts need to push back hard. When investors realize that current expectations of earnings growth are unrealistic, stock prices could adjust further to the downside, but this impact will be at least partially offset as it becomes clear that interest rates are not going back up to historical levels.