INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

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It's a Profit Cycle, After All

The chart below tracks corporate profits as a percent of GDP – US aggregate profit margins – across the post-war era. The whipsaw volatility jumps right out at you: high profit margins don't stay high, nor do low profit margins stay low. Neither extreme endures. In other words, it is a *mean-reverting* time series, never reaching high permanent plateaus nor slipping into interminable sloughs of despond, but rather oscillating around a central level of about 9.6%, a fair bit lower than 11.6% we see here at mid-year.

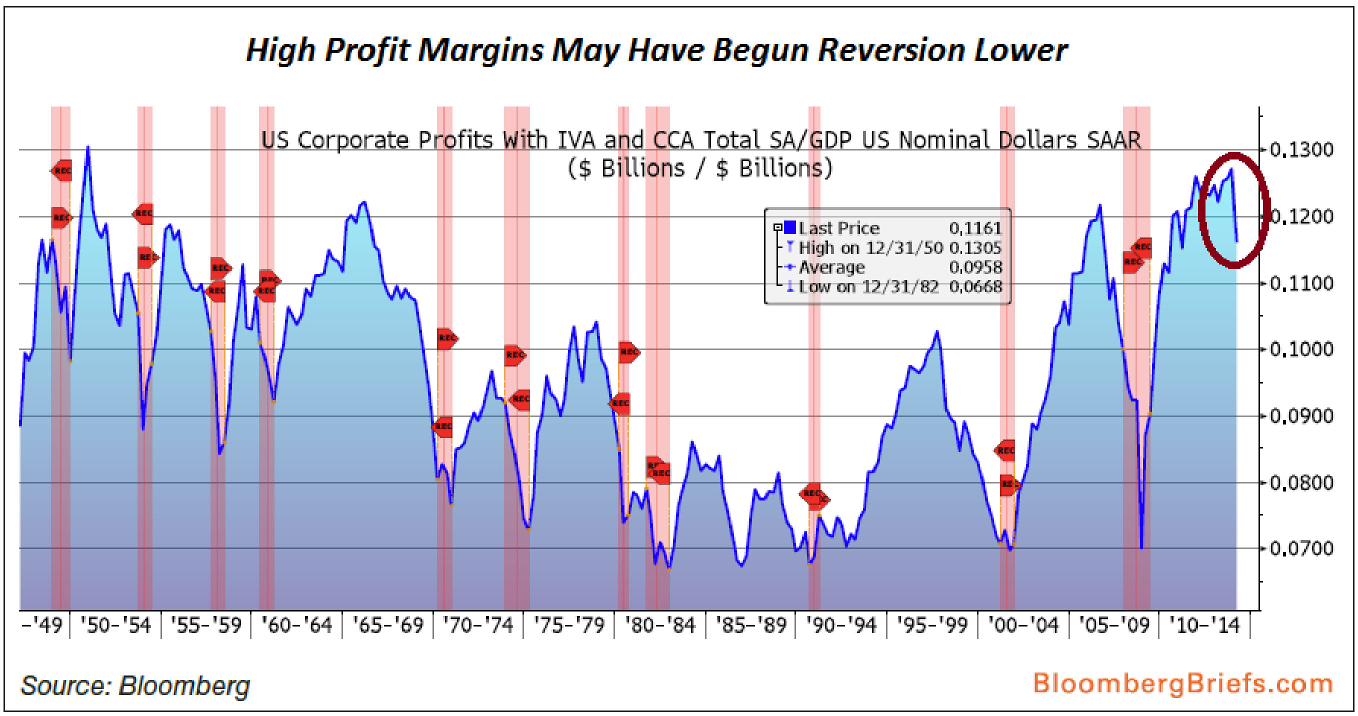

Chart adapted from Bloomberg, June 30, 2014

Occasionally, I've quoted Jeremy Grantham's axiom, "If margins don't revert, capitalism is broken." Let's rephrase that as follows: Because margins do revert, we know capitalism *isn't* broken. Sometimes we need to remind ourselves that volatility is not necessarily in and of itself a problem; it can be evidence of an appropriately functioning – and yes, messy seeming – system where competition is active and ongoing. Indeed, an absence of volatility in the economic data would be more troubling – smooth, steady lines persisting by way of fabrication or manipulation. Nor do we need to fear low profit margins; while precipitous drops attend most recessions (the red vertical bars above), so do sharp recoveries emerge from them. What's more, the *level* of profit margin doesn't always signify good times or bad times: Throughout the 1980s and half the 1990s, margins were actually below average amidst relative prosperity, whereas over the economically lackluster last half decade, margins have ridden near all-time highs.

Quarterly earnings season is just now getting underway. Some fear it will disappoint. For our part, we'll fix our eyes on a distant time horizon, not obsess over the inevitable short-term, saw-toothed tumult, and focus more on the central tendency of profit margins than on their extremes.