INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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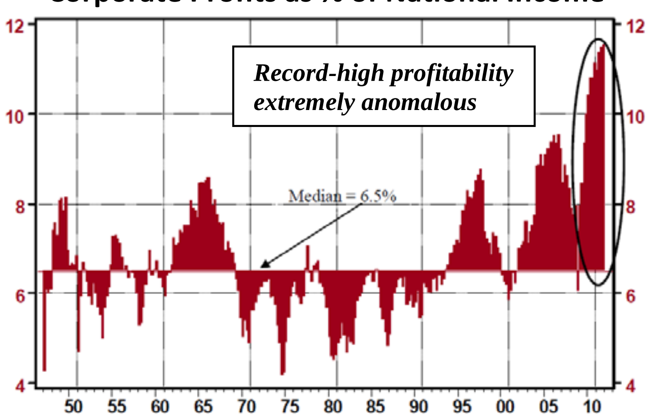
Margins, Multiples and the Risk of Heavy Weather

"For an individual company, having an exceptional profit margin deserves a premium P/E against its competitors. But for the market as a whole, for which profit margins are beautifully mean reverting, it is exactly the reverse. This apparent paradox seems to fool the market persistently."

Jeremy Grantham, GMO LLC

Our first chart this month helps explain the stock market's resilience over the last three years. U.S. corporate after-tax profits have recovered to become a greater share of national income than ever before in the post-WWII era.

Corporate Profits as % of National Income



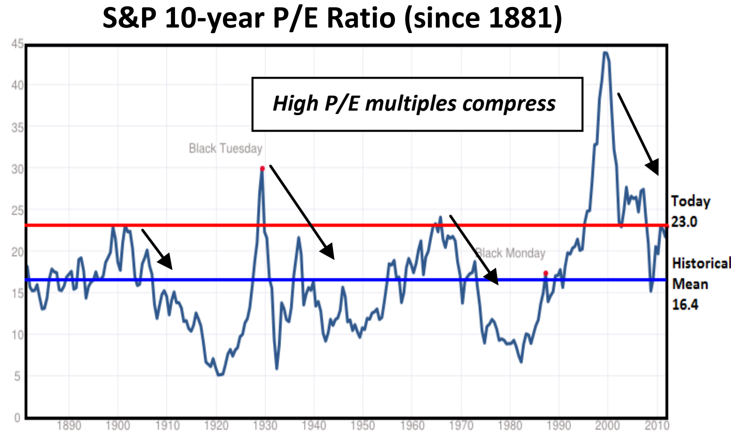
Sources: Paul Kasriel/Northern Trust, Haver Analytics

Even so (and this is counter-intuitive, Grantham's "apparent paradox"), high aggregate profit margins seldom mean great things for stock market returns on a *prospective* basis. Consider the poor multiyear stock market aftermaths of margin peaks in the 1960s, late 1990s, and mid-2000s. In contrast, durably great buying opportunities have followed instead on troughs in profitability (1947, 1958, 1974, 1982). How can this be? Fat margins expire because they attract competition, which forces companies to choose between margin and market share. Conversely, low margins diminish competition, causing companies to exit areas which have become less profitable; as competition eases, market share redounds to the survivors, who can then set about building margins anew. Thus, the business cycle. "Unless capitalism is broken" (Grantham again), profit margins can be relied on to pull toward their long-term average. This powerful central tendency suggests that today's anomalously high margins will resolve lower as companies elbow in on each other's business.

Where high stock market prices coincide with high profitability, they represent nothing so much as good news already baked into the cake. Given the impermanence of any margin level across the business cycle, we shouldn't get too excited about aggregate profitability at its present heights. If anything, we should tread lightly. Aggressive equity allocations will be better rewarded when margins scrape bottom in some future quarter.

Profits, of course, contribute the "E" to the P/E multiple (price/earnings). To overcome the distorting influence of margin fluctuation across the business cycle, we use a cyclical adjustment process popularized by Yale's Robert Shiller. The Shiller P/E measures stock prices relative to the prior ten years of earnings, a period long enough to capture the highs and lows of the cycle and everything in between:

S&P 10-year P/E Ratio (since 1881)



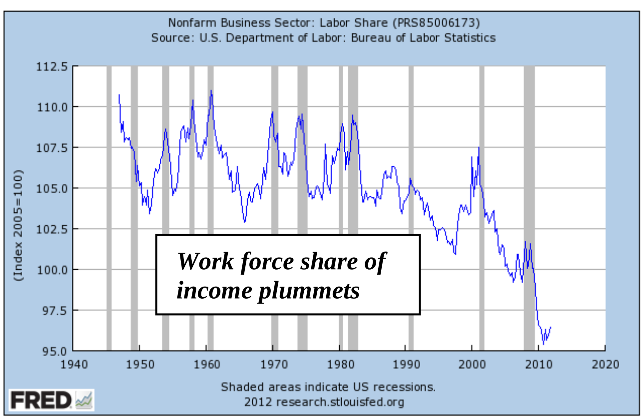
Source: multpl.com

The long time frame normalizes earnings so that we can assess market valuation free from distortions of margin volatility. The chart shows how P/Es don't stay high, just as high margins don't (and low P/Es don't stay low either for that matter, just as low margins don't). At present, the Shiller P/E of 23.0 (the red horizontal line) sits atop all valuation levels except those associated with bubbles and subsequent market crashes.

So unless we are entering a new bubble period (which we could well be – a bubble in reflationary global monetary policy), we may face a double whammy of not just profit margins compressing from record levels, but also the market multiple compressing. This would make heavy weather for equity investors counting on the stock market to continue climbing without turbulence.

In contrast to corporations' growing share of national income, the work force's share has dropped hard:

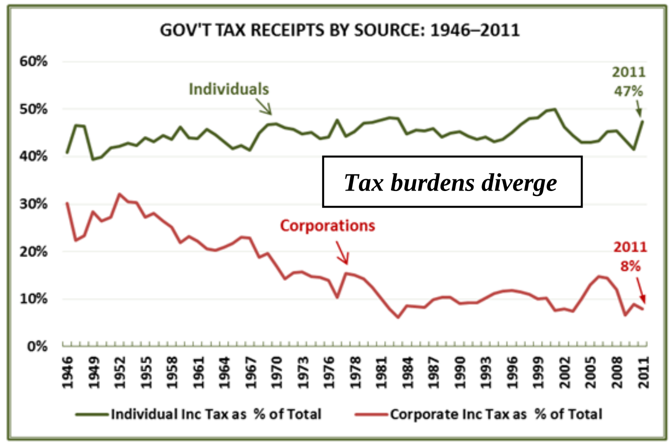
Work Force Share of National Income



Source: Federal Reserve Bank of St. Louis

This is important context for another potential hazard to today's market multiple and stock prices: today's high profit levels reflect relatively low corporate taxes. No surprise in an election year, we are hearing rhetoric that US corporate tax rates are the highest in the developed world; but this distracts from the reality that marginal rates are not the same thing as effective rates, and indeed the proportion of U.S. taxes paid from corporate income is near post-WWII lows:

Corporations vs. Individuals as % of Total Taxes



Data source: US Office of Management & Budget. Chart by ATC.

Following the war, individual income taxes comprised about 40% of total receipts and corporate income taxes about 30% for a ratio of about 4:3. In contrast, last year, individual income generated 47% of tax receipts, and corporate income just 8%, for a ratio of nearly 6:1… this in spite of corporate profitability being at post-WWII highs as a percentage of national income and workforce share plumbing new lows.

Meanwhile, the Federal debt and deficit continue rising, their pace of compounding restrained only by low interest rate policy. Addressing the fiscal issues will demand hard decisions and sacrifice, challenges unseemly in an election year. When the dust settles from November's balloting, however, and 2013's scheduled tax hikes on individuals heave to the foreground, leadership in either party may see with newfound clarity a chance to attach the least burdened income flows left in the nation: corporate profits.

Whether that would be a good thing for our country's future, I'll leave to tax policy experts, editorialists and cocktail party debate clubs to hash out. In the near-term and from an investment perspective, however, I can say with confidence that it would portend an unfriendly environment for profit margins and the market multiple, and as such, one hostile to ever higher stock prices.