October 12, 2005

Corporate Profits Drive Investment Returns

Summary

Corporate profits, along with the valuations investors are willing to assign to equities are the main drivers of investment returns in the stock market. These all important corporate profits are inherently cyclical from a historical perspective. The root cause of this cyclicality is the very nature of capitalism. That is, entrepreneurs attack profits especially when they are high. With the tremendous increase in open societies around the globe as a result of closed economic systems failing, the competitive pressures are presenting themselves from the other side of the planet rather than just the other side of the country. This large increase in more free-market based economic systems is placing an ever increasing demand on finite natural resources which results in higher input prices. This adds additional pressure on profit margins. Passing the costs on to the consumer through higher prices is extremely difficult in light of the open world competitive pressures. This leaves the consumer of "core goods and services" strong but weaker when purchasing the now higher priced natural resources – think energy for starters.

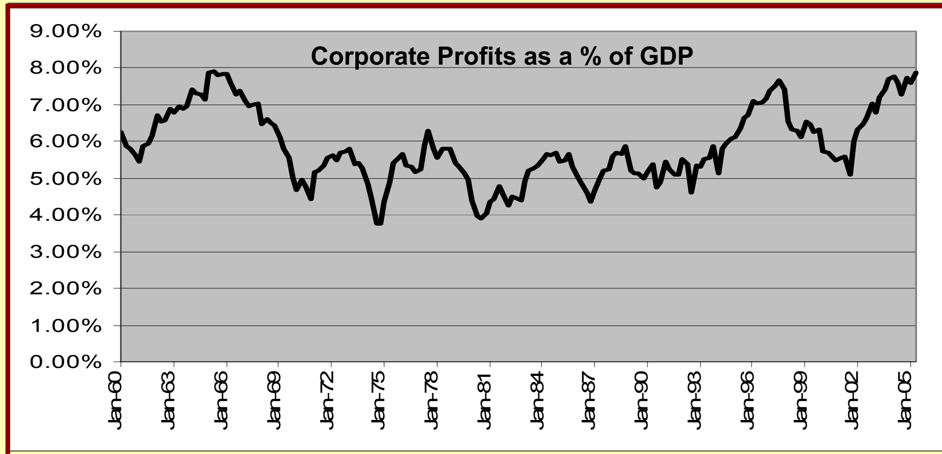
Simultaneously, the laborer/producer in all of us is challenged on the wage front with the large global increase of labor as a result of the aforementioned opening of global societies. This places a squeeze on the consumer's wages from a purchasing power perspective. Simply put, their wage increases have a difficult time keeping up with higher overall prices. The consumer is also challenged in supplementing their consumption through additional debt as they are at historic highs. Aiding consumption through the drawdown of their savings is difficult because their savings are at historic lows. The continuing cash-out refinancing of their home to aid consumption is difficult in light of the Housing Affordability Index plummeting and interest rates not going lower. At the same time corporations cannot raise prices in light of their inability to "pass through" the higher costs to the consumer. This adds pressure to profit margins.
Put these together and you begin to see problems brewing for corporate profits to remain near their historical highs from a margin perspective and a revenue perspective.

Overlay onto this dilemma the fact that valuations are near historic highs and we have a potential storm developing where high profits are being attacked at a time when investors are assigning rich valuations to equities out of expectations for higher profits to come. In a nutshell, this presents a climate where the market "weather" could become problematic. The market "weather" has been deteriorating through the lens of key leading sectors inside the market. We have seen the market have a positive fourth quarter the previous three years only to watch those returns go negative in the ensuing first quarter. If we do see a positive fourth quarter, I do not believe, in light of the evidence below, that it will be the market "weather" suggesting a change to a more positive climate.

I invite you to scroll through this extensive chart-based presentation and weigh the evidence for yourself.

Analysis

Corporate Profits



Inherent laws of capitalism assure entrepreneurs attack profits - hence cyclical

Data: St. Louis Federal Reserve Graph: Reinhart Asset Management

The above chart reflects corporate profits as a percent of GDP dating back to 1960. As the chart depicts, these profits are cyclical. There is no “law” that states these profits cannot go even higher than what we have seen in the last forty-five years. It is important to remember though the inherent “laws” of capitalism dictate that competitive forces will attack these high profit margins.

Are Profits Going To Decline ?

Two different “pressures” may answer this question

MARGIN PRESSURES

-Corporate Dilemma

Competition, Wages / Benefits, and input prices

REVENUE PRESSURES

-Joe Main Street Dilemma

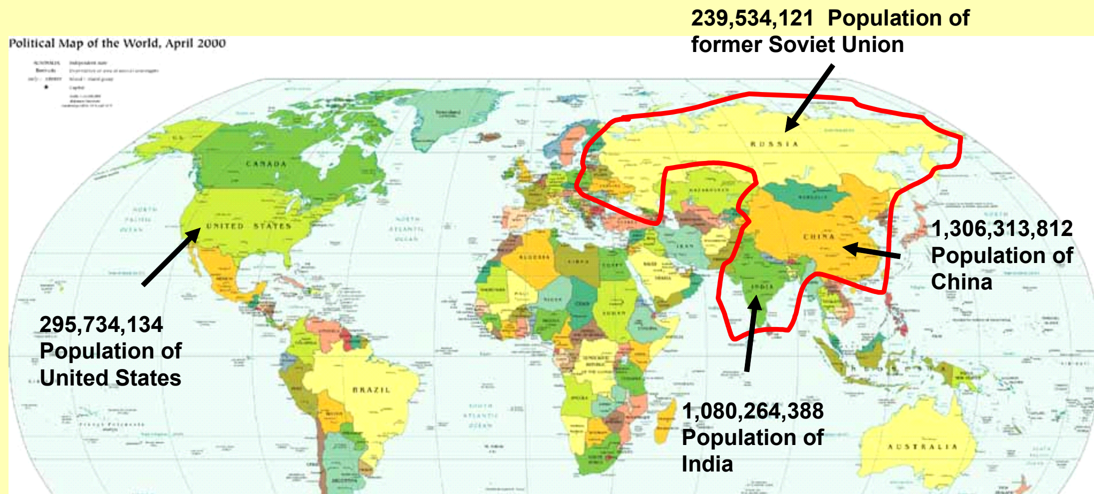
May equate to corporate revenue pressures

The key question is will the high profit margins decline or will they continue to hold or go higher. To answer this we will look at profits through the margin and revenue side of the question. We will begin with the margin side and the pressures that are building that will likely present problems for margins to stay high.

Open World

Competing for Margins, Wages, and Natural Resources

Margin Pressure



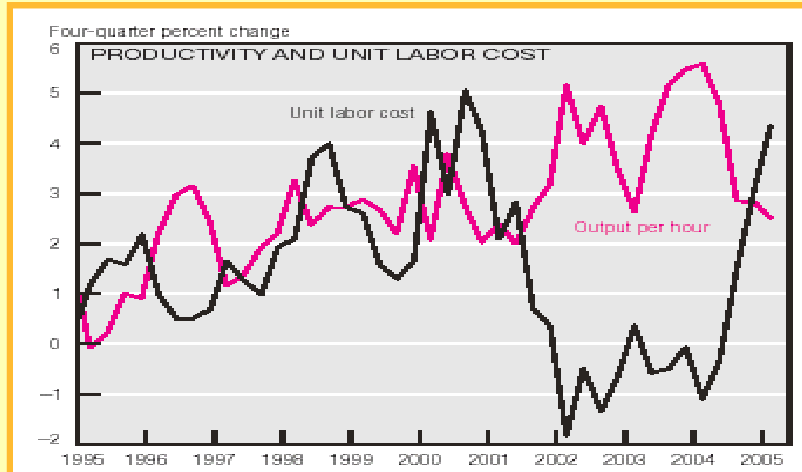
- Ever more, competition is not just coming from the other side of the country, but rather the other side of the world.
- Open world offers huge increase in labor supply, which offers a release valve for the pressure on margins from wages, but adds to the "Joe Main Street" dilemma.
- Adds to demand for finite supply of natural resources.

Source: CIA world Facts

As shown above the population bases of various countries that have been entering into a more open economic system. The highlighted areas are not fully representative of all the countries that fit this label. Total population sizes reach close to three billion people which clearly dwarf the U.S. population. This is a huge increase in the labor pool (within a global economy) as well as a significant increase in entrepreneurial activity. This equates to competition for wages (slower wage growth domestically) and competition to satisfy consumer demands (attack on profits).

Unit Labor Cost and Productivity

Margin Pressure



… that slowing reflected a moderation in structural productivity growth and if firms believed that the associated increases in the growth rate of labor costs were permanent, these cost pressures might be passed through to consumer prices fairly quickly to preserve profit margins.

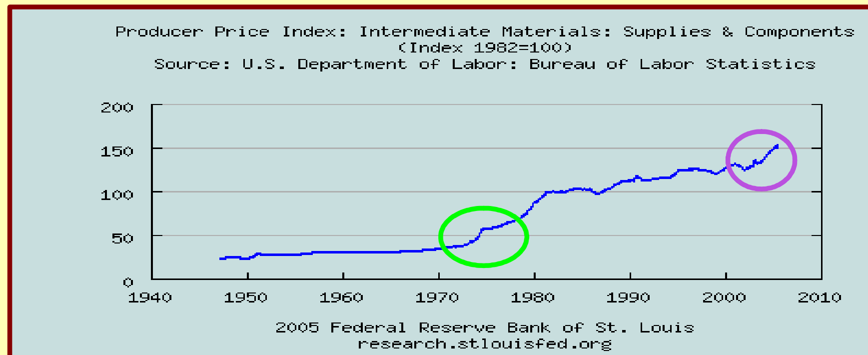
- From the FOMC Minutes, February 2005

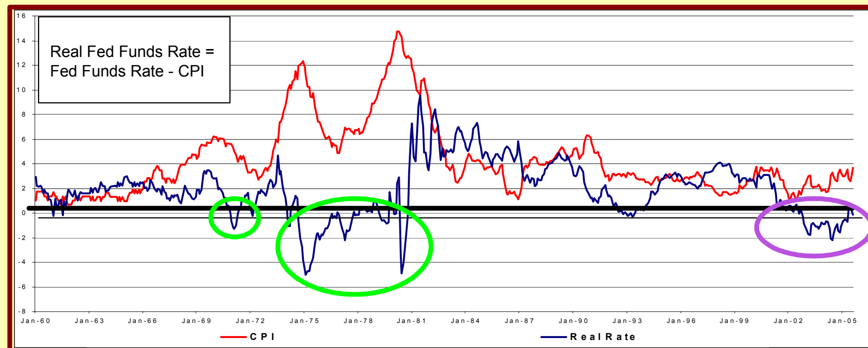
Graph: Cleveland Federal Reserve

In the above, the red line is output per hour (productivity) and the black line is unit labor costs. With productivity turning over from high rates the labor cost per unit of production is increasing rapidly. To maintain profit margins, producers will want to pass these higher costs on to consumers (inflation), but with intense competitive pressures they likely will not be able to pass these costs on in order to protect their margins. If they cannot, profit margins will be impacted. If they can pass them through to consumers the Federal Reserve is watching with the prospects of higher short term interest rates as reflected in the excerpt from a recent release of the Minutes of the Federal Open Market Committee (FOMC).

PPI – Intermediate Materials and Real Fed Funds Rate

Margin Pressure





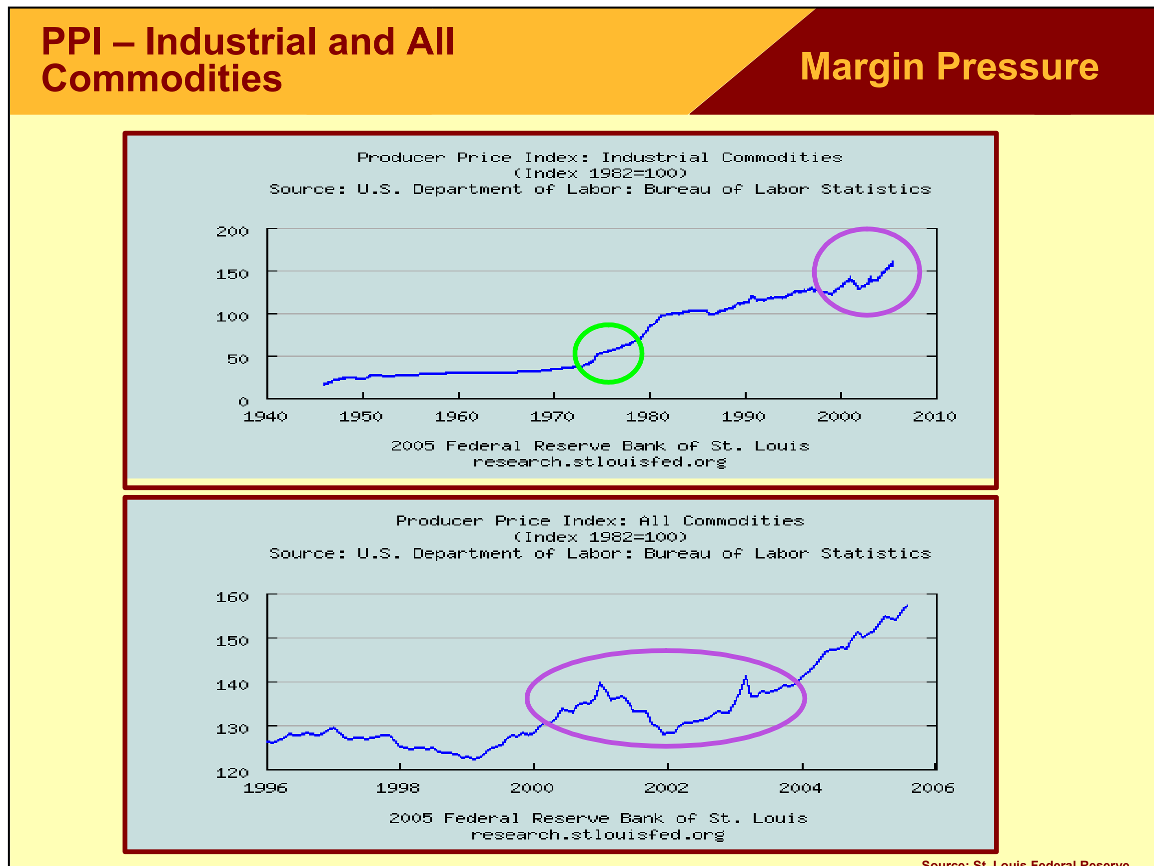
Source: St. Louis Federal Reserve and Reinhart Asset Managment

The above slide offers two charts. The lower chart is the Fed Funds Rate on a real basis. This is the Fed Funds Rate less the overall inflation rate. It is a historical aberration for this number to be negative when factoring in the inflation rate (real rate) as highlighted by the green and purple circles. The green time period was in the early 70's while the purple reflects our recent experience. When the Federal Reserve aggressively reduces interest rates below the rate of inflation, the system is flooded with money. Simply, lenders are highly incentivized to lend and borrowers are highly incentivized to borrow and not save.

The result of this (upper chart in the slide) in the 70's was a significant increase in supplies and components costs to producers after twenty-plus years of stability in this price index. Then a return of stability in the 80's and 90's with a simultaneous positive real Fed Funds Rate. Once again, we have seen a significant breakout in this price index to producers after experiencing a negative real Fed Funds Rate depicted by the purple circle.

The crucial point to keep in mind for this presentation is profits and valuations ultimately drive investment returns. If input prices are rising significantly for producers while they cannot raise their prices to consumers due to an intense competitive landscape, they will not be able to maintain their profit margins. This calls into question equity investment returns in light of the rich valuations being assigned to their current profit levels by investors in the equity market.

In the 70's, producers were able to pass these higher costs on to consumers, which resulted in an inflationary spiral that was ultimately brought to its knees through astronomical interest rate increases by the Federal Reserve. At that time, the world had more closed economies and hence less competitive pressures to keep producers in check on the price front in order to preserve market share. With the competitive backdrop as it is now, profit margins will be in peril if market share is to be protected.

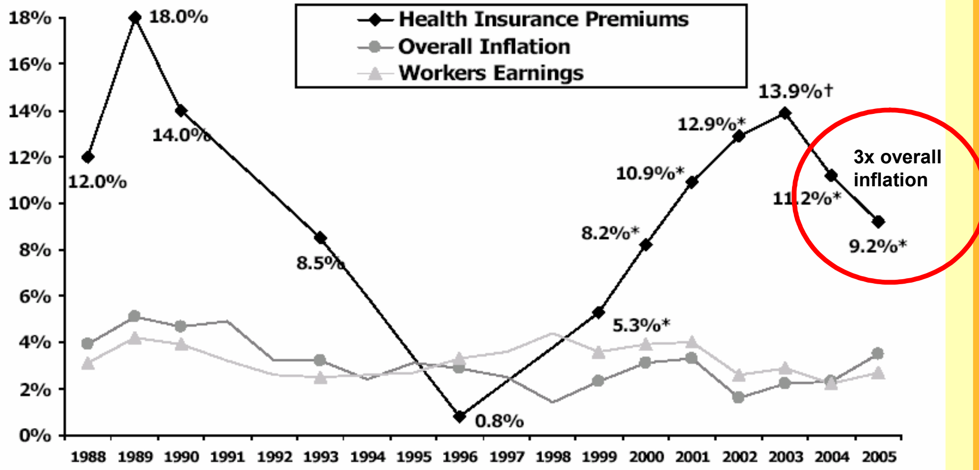


The two charts within the slide above further show input price pressures to producers through an Industrial Commodities index and an All Commodities index. The green and purple circles, once again, highlight the timeframes of the negative real Fed Funds Rate.

Input prices are building, which bodes poorly for a continuation of high corporate profits as a percent of GDP as depicted in our first chart of this presentation.

Health Care Costs

Margin Pressure



Source: KFF/HRET Survey of Employer-Sponsored Health Benefits,

The above chart reflects what we all know through experience. Higher health care costs which if paid by the company is yet another strike against profit margins. If the individual pays these in lieu of their company, it only adds to the "Joe Main Street" dilemma which ultimately becomes a corporate dilemma through lower revenues.

Quotes From Companies Feeling the Pressure

Margin Pressure

Cooper Tire "higher raw-material costs could reduce third-quarter operating profit by as much as $35 million to $40 million," Dattilo said.

Nu Skin "We will try to find ways to absorb the costs so that our customers won't feel the pinch as much," Lori Bush, the unit's president. This is the response to shoulder rising costs for raw materials such as packaging to avoid increasing prices for its customers.

KRAFT has concerns of inflationary pressures resulting from increasingly expensive commodity costs due to rising energy prices.

COTT rising raw material costs, continued softness in the U.S. carbonated soft drink business, and a product mix shift to lower-margin bottled water. We'd do well to remember that there's always tap water, the ever-cheaper alternative, waiting to steal sales

INTEL "We believe INTC has lost as much as five points of market share in servers and has seen ASPs fall in both servers (due to competition) and mobile (due to mix)," CSFB said

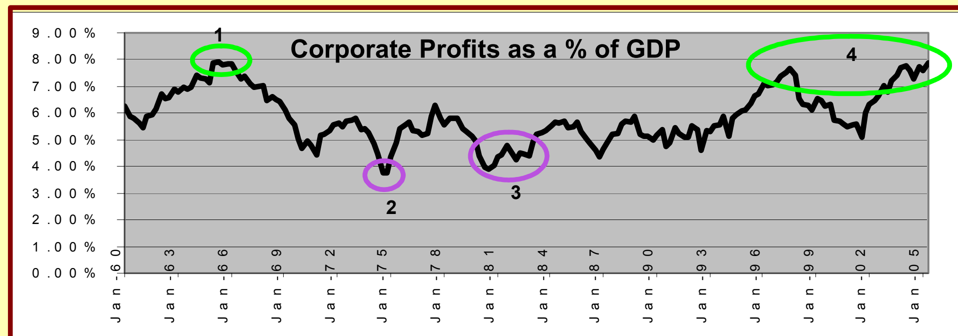
CITIBANK told investors that flattening yield curves will weigh on profits through the rest of the year

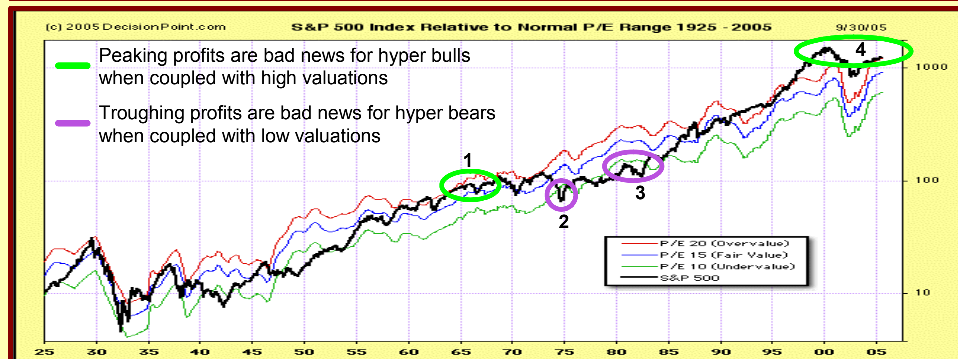
Titanium Technologies said on Tuesday said it will raise prices for all titanium dioxide grades in Europe and the Middle East, effective Oct. 1, citing reduced margins caused by rising raw material and energy prices

Above are a few company excerpts that are experiencing margin related pressure from input prices and the overall competitive backdrop. This is not to focus on these companies in particular. This is presented only to provide evidence of the macro predicament that companies overall are, or will be facing. Their dilemma continues as they work the fine line of trying to maintain profit margins while not being able to raise prices without giving up market share.

Corporate Profits and P/E Ratios

Margin Pressure





Sources: St. Louis Federal Reserve, DecisionPoint.com, Reinhart Asset Management

The lower chart dates back to 1925. The relationships I mention here are simply the historical interactions of the four lines depicted in this chart. The green line represents what the index value would be at with a price-to-earnings (P/E) ratio of 10 (a ten P/E being historically a low valuation or cheap market). The blue line represents what the index would be at with a P/E ratio of 15 (historically a fairly valued market ratio). The red line represents what the index would be at with a P/E ratio of 20 (historically an overvalued level on a P/E basis). The black line represents the current index price and how it relates on a valuation basis to the historical interactions of the three P/E levels depicted.

Looking at the two charts together, while matching up the green and purple numbered circles, you can see how high profit margins with simultaneous high valuation levels is a negative scenario for equity returns. Conversely, low profit margins with low valuations have been an excellent backdrop for positive equity returns.

With the cyclical nature of profit margins and investors being most enthusiastic - reflected in the high valuations they are willing to pay - about those margins when they are high, a negative set up for stock market returns occur. We are clearly in a high valuation - high profit margin backdrop, which bodes poorly for stock returns from a historical perspective.

Are Profits Going To Decline ?

Two different "pressures" may answer this question

REVENUE PRESSURES

-Joe Main Street Dilemma

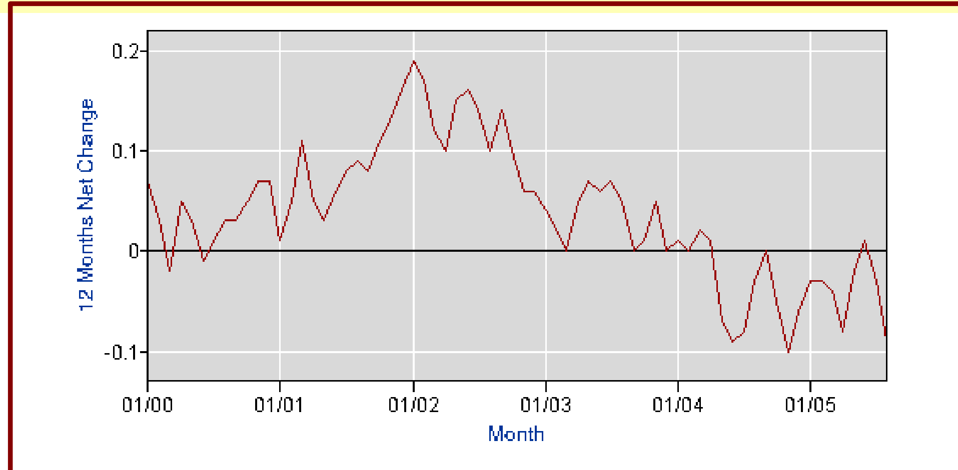
May equate to corporate revenue pressures

Now that we have looked at the margin side of the corporate profit question, let's delve into the revenue side through what we have coined as the "Joe Main Street" Dilemma. "Main Street" is all of us together as producers/laborers and consumers.

Real Wage Growth

Equals Average Hourly Earnings less CPI

Revenue Pressure



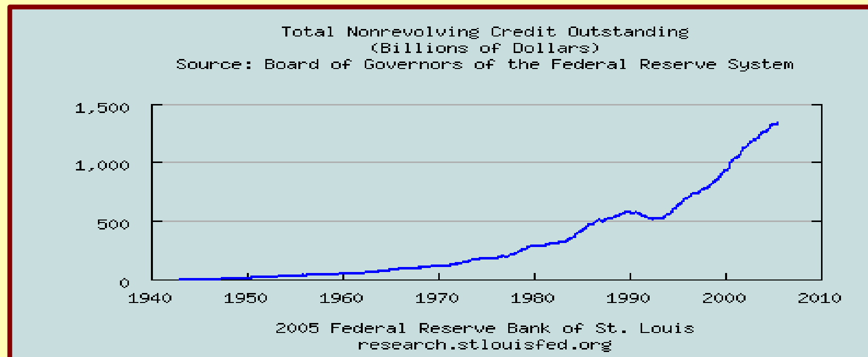
Source: Bureau of Labor Statistics

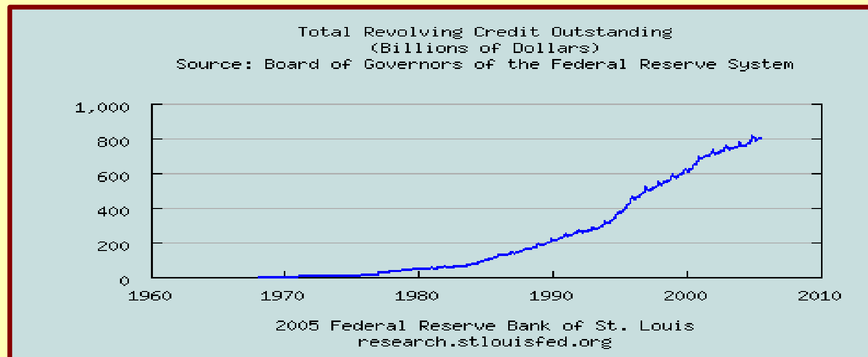
It starts with wages. Real wages that is, which is wage growth less inflation, so we can get a good sense of the consumers purchasing power. If inflation rises faster than wage growth, this leaves the consumers' ability to push corporate revenues higher in question. They are forced to "discretionary spend" in light of their lack of purchasing power. The chart above shows the limited to negative real wage growth "Joe Main Street" has been experiencing through their real average hourly earnings.

The tremendous increase in the supply of labor on a global scale, along with the simultaneous competitive pressures at the producer level, is weighing on domestic real wage growth. This is a large macro trend (globalization) that will not be reversed. Ultimately, the consumer in all of us is the key driver of this as we demand cheaper prices and better quality from producers' everyday.

Nonrevolving and Revolving Credit Outstanding

Revenue Pressure





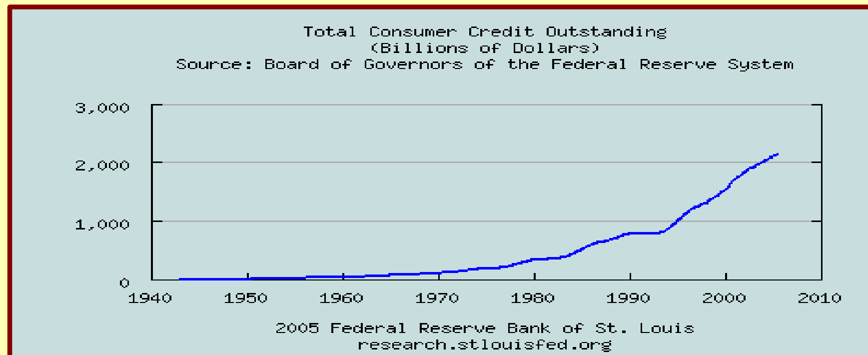
Source: St. Louis Federal Reserve

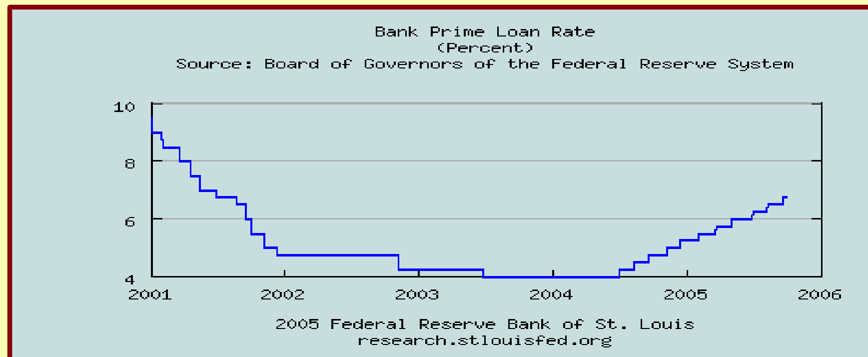
Consumers have proven their wages are not the only source of fuel for their spending power. They have taken on debt in droves to supplement their consumption. The above is a breakdown of consumer debt. The top chart is nonrevolving debt (example auto loans) while the bottom chart is revolving debt – think credit cards.

These are long term charts that give perspective on the large increase in debt that has been taken on in the last several years. Debt growth has been phenomenal.

Consumer Credit and Prime Rate

Revenue Pressure



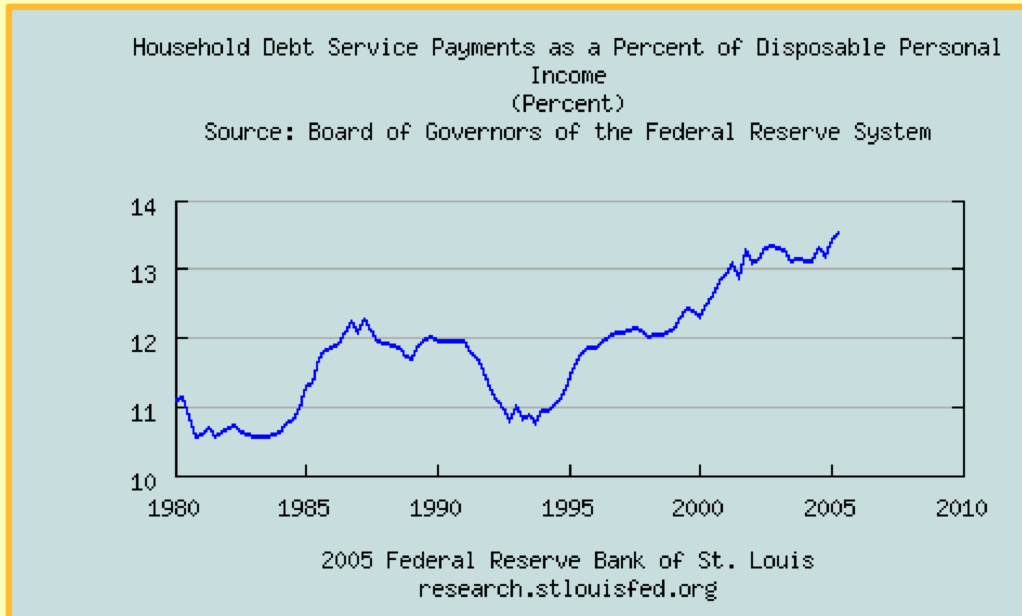


Source: St. Louis Federal Reserve

The top chart is the combination of nonrevolving and revolving which equals total consumer credit outstanding. The total is now over two trillion dollars and growing. The lower chart is the Prime Rate which plays a significant role in the cost of consumer credit. With the Prime Rate increasing, consumer credit is not getting cheaper to carry. This becomes more problematic within the realization of negative real wage growth.

Debt % of Disposable Personal Income

Revenue Pressure



Source: St. Louis Federal Reserve

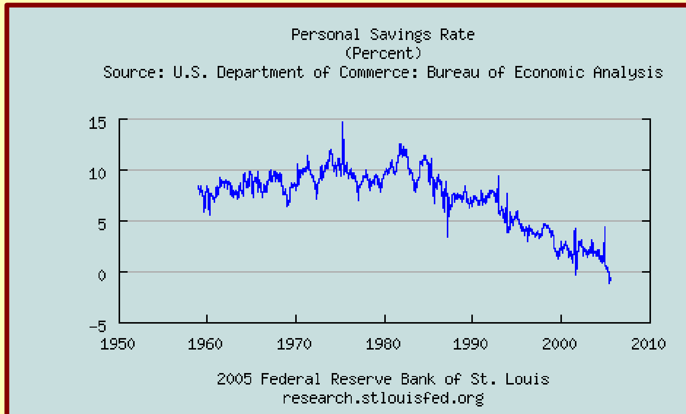
Now we put that consumer debt into some context with the above chart. This is debt service payments as a percent of disposable personal income. This long term chart reflects how much debt consumers have taken on to aid their consumption. This chart is at historic highs while interest rates have been at extreme lows.

In my opinion, this calls into question how much more debt the consumer can take on to aid consumption with higher interest rates, no real wage growth, and a tremendous amount of debt they are already servicing.

Remember, this presentation is about corporate profits being a significant driver of equity returns. Corporate profits are at very high levels and margin pressures are building. Simultaneously, the consumer is incurring difficulties which impacts corporate revenues. These present a negative set up for corporate profits to continue to new high ground in our view.

Personal Savings Rate

Revenue Pressure



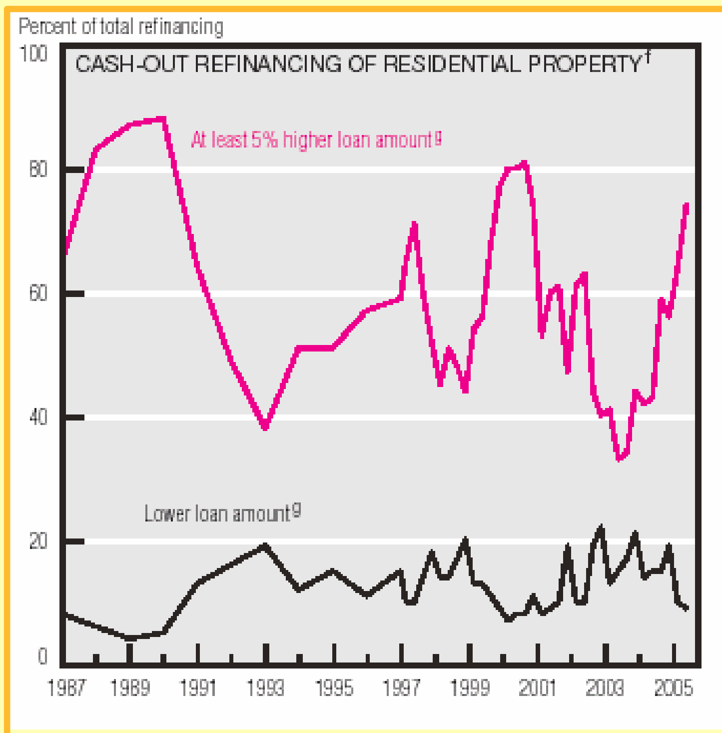
- **-No Cushion**
- **-3 months negative**
- **-Reflects extreme "outliving their means"**
- **-Ultimate rebuild of savings puts drag on economic activity**

Source: St. Louis Federal Reserve

This chart depicts the Personal Savings Rate which is now negative. Obviously there is little to draw upon to aid consumption from this view. More importantly, is the drag on consumption that will occur once "Main Street" begins to rebuild savings – which they ultimately will. Stability breeds complacency in all matters human. This is true in finances as well, which is borne out here in how complacent savers have become with the relative stability in our economic system since the early 1980's. History has proven stability is not a permanent condition and we doubt these "laws" have changed.

Cash out Refinancing

Revenue Pressure



Source: Cleveland Federal Reserve

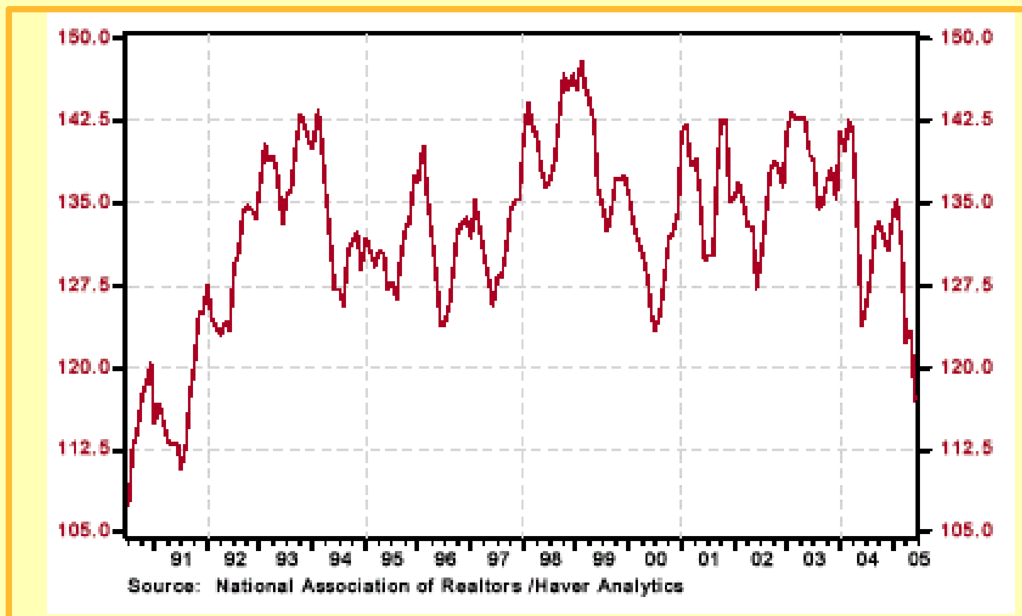
Home sweet home! It is well known consumers have aided their consumption with the refinancing of their home and the subsequent cash-out which is equivalent to using the home as a pseudo ATM machine.

The above chart (red line), reflects the percentage of refinancing deals that have been “cash-outs”. This is where the refinancing loan is at least five percent higher than their original loan amount. Clearly, these “cash-outs” have represented a large percentage of refinancing deals.

The question, as it relates to our overall theme of corporate profits going higher, is how will the consumer be able to continue using this “re-fi vehicle” to aid consumption? Interest rates are not moving lower to a level necessary to fuel a new refinancing boom. At the same time, the ever-increasing home price that provides the additional equity to “cash-out” is in question per our next slide.

Housing Affordability Index

Revenue Pressure

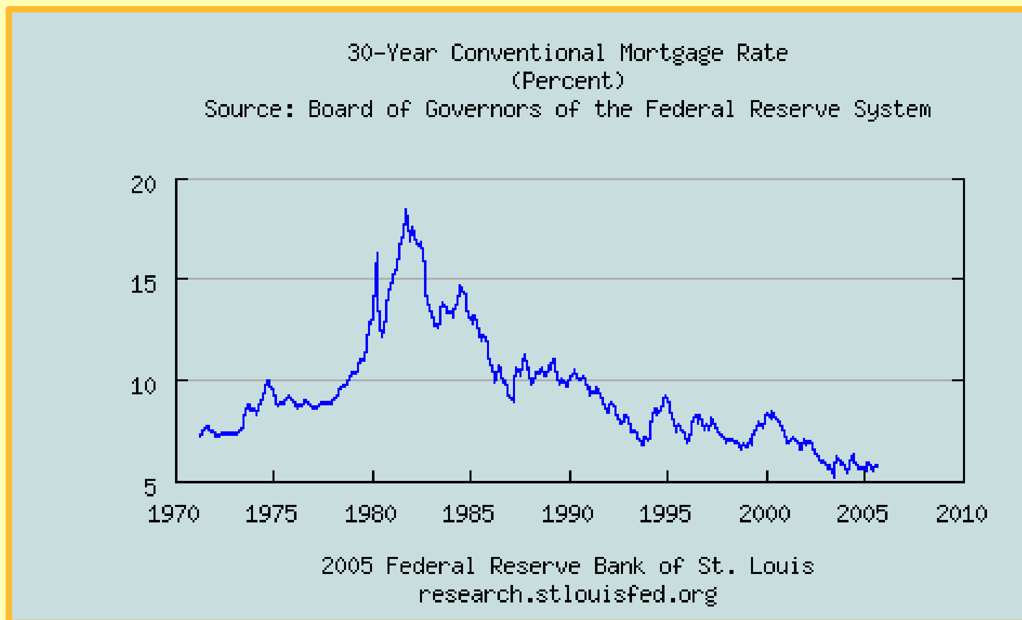


Source: National Association of Realtor / Haver Analytics

Above is the Housing Affordability Index which is plummeting without a significant increase in interest rates. With the Affordability Index sliding, I doubt this presents a positive backdrop for home prices to continue ever-higher. This adds doubt to the "cash-out" being a significant driver of additional purchasing power for the consumer to rely upon.

Mortgages Rates

Revenue Pressure



Source: St. Louis Federal Reserve

This conventional mortgage rate chart clearly depicts how tame rates have stayed while the Housing Affordability Index has turned down. I realize "unconventional" mortgages have become the "flavor of the day." This only raises more concerns since these types of agreements are more vulnerable to interest rate hikes by the Federal Reserve. The conventional agreements are exposed to the interest rates established in the Treasury bond market, which have been more stable than the Fed set short term rates.

Heating Costs

Revenue Pressure

Source: Stockcharts.com

-57% (60 Million) of Households are heated with natural gas

-More homes are heated with natural gas than all other fuels combined

-Source: U.S. Census Bureau, EIA, and American Gas Association

This is representative of the significant increase in natural gas prices which dominate home heating in the United States. These are expenses that will be coming to "Main Street". With no real wage growth, as well as the other pieces of evidence presented, how will corporate revenues grow to help offset the margin pressures already presented?

Corporate profits – the significant driver of equity returns - seem to be in peril of maintaining their lofty levels and going higher to support the rich valuations investors are currently assigning them. Through this high valuation level, investors are expecting profits to stay high and go even higher. In my opinion, I have serious doubts this will be able to occur, in light of the challenges corporations are facing from a profit margin and revenue perspective.

Climate vs. Weather

- **90 degree days in October** does not fool us to plan pool parties and barbecues in the upcoming weeks and months

- **40 degree days in May** does not lead us to get out the snow shovels and heavy coats in the upcoming weeks and months

A key question here at Reinhart Asset Management is what is the Climate (investment backdrop) and what does the near-term weather (market performance) look like within the context of that climate? We want to be well grounded in the realities of the climate so we do not get fooled and plan "pool parties in November" so-to-speak. Based in Ohio, we know the climate ultimately prevails even when we get a run of 80 degree days in late fall.

In my view, through the evidence in this presentation, I believe the climate is poor which continues to suggest caution as an overall investment posture. Identifying areas of opportunity within the climate are important, but to suggest this is a great new long term bull market where buy and hold wins the game is impractical in light of the structural evidence.

Key Sectors Turning Over

Market

Source: Stockcharts.com

Turning to key sectors is just one small way we identify the "weather". Simply, is the market suggesting we may have some near-term opportunity overall even if the climate is poor.

Above are two charts of key sectors that have been turning over. The Housing and Retail Indices had been leading the market at various stages but have turned over significantly. If the leaders are having trouble this suggest the overall market may not be far behind.

Key Sectors Turning Over

Market

Source: Stockcharts.com

We look at the financial sectors as "risk-o-meters" for the overall market. The top chart depicts the Bank index having significant problems. This is led by the compressing yield curve impacting profits. The lower chart is a sub index within the retail sector. This Consumer Discretionary Index is also really turning over. Is it suggesting that "Joe Main Street" has a dilemma on their hands in light of the structural issues?

Key Sectors Holding On

Market

Source: Stockcharts.com

Here are two key sectors that have been holding up. The Broker/Dealer and Semiconductor indices have been very strong in light of the overall market weakness. Both suggest a better market ahead. In light of the evidence, I doubt these are signaling a better overall investment backdrop, but rather a near term market opportunity.

Key Sectors Holding On

Market

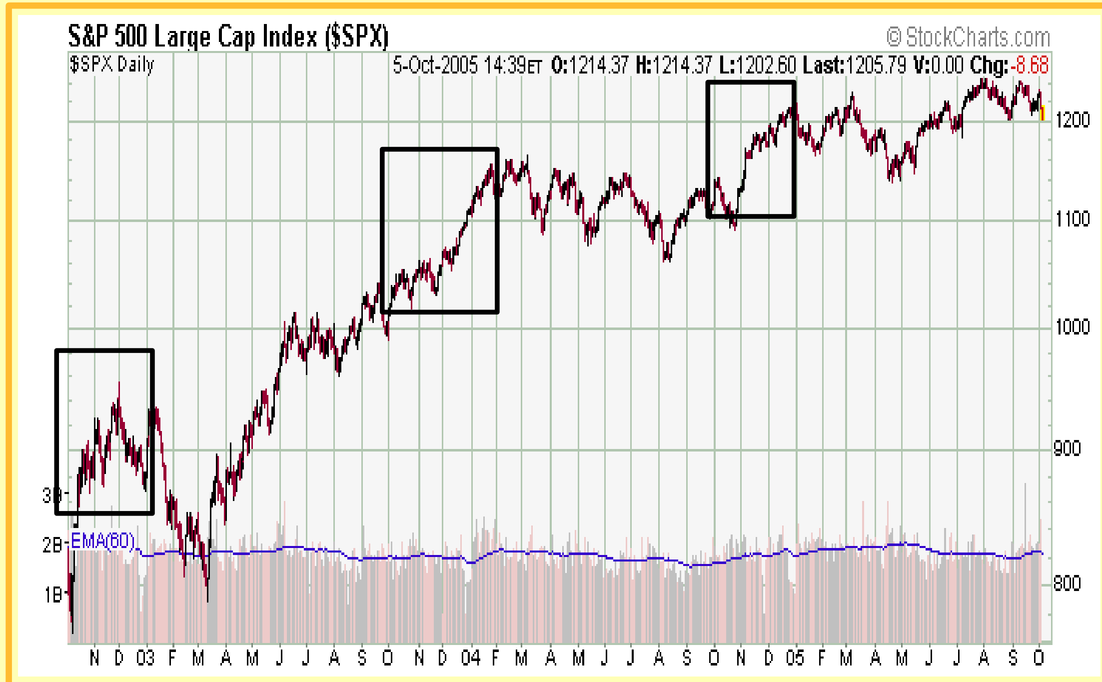
Source: Stockcharts.com

The Internet and Biotech indices have also been holding up or performing very well. We follow these leading sectors closely with the view that if the leaders do turn over then the overall market weather is looking ominous.

Interestingly, since I presented this Webex presentation a week ago, these leaders have begun to crack considerably.

4th Quarters of the Last 3 Years

Market



Source: Stockcharts.com

In the last three years the market has moved higher in the fourth quarter of the year only to give back a large part of the gains in the following first quarter. The black boxes highlight this experience. The obvious question is can we get a good weather scenario in this fourth quarter even with the climate being so poor?

The quick answer is it looks doubtful in light of the internal market action to date. We monitor these closely so we are aware of any change suggesting better weather is upon us even if the climate is negative.

This is why we employ our Hybrid Analytical Process that includes four key processes of analytics. You have seen this Hybrid executed in this presentation with the breadth of analysis presented.

Within the context of our climate versus weather metaphor, what I do feel certain about is this is not an environment for a new long term bull market where buy and hold saves the day. I have been suggesting for years now and will continue to do so until the evidence changes. One strong piece of evidence needed, would be a low valuation/low profit margin scenario of which we currently do not have. There are imbalances that need to be worked out and until those are active management is essential.

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