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What the Market Has Not Discounted

Today's market levels seem reasonable from several different perspectives. Monetary policy is approaching a neutral stance at the 5% level, and the market P/E on a trailing basis is approximately 16, a very reasonable measure. Then what, the wise investor might ask, could potentially tarnish this optimistic scenario? One potential answer could be the growing imbalance of the trade deficit. As far as trade is concerned, we get the goods and services provided by other countries, and our overseas trading partners receive our paper money in return. While they have to earn a dollar, we only have to print one! Because of this unsustainable relationship, the dollar will eventually fall. Still, if it falls 20% over three years, how bad can that be? And with a dollar decline, the trade deficit would certainly begin to improve. Another concern could be the fiscal deficit. But it is hard to imagine the fiscal deficit getting worse. In fact, based on second quarter government figures, it has already started to improve somewhat.

So, if the ballooning trade deficit and the weakening dollar won't necessarily result in a market slowdown, what will? We believe the real threat to current market levels is the possibility of a meaningful decline in the rate of growth of corporate earnings over the next several quarters. I am not sure when the trend will start but, to this money manager, it seems like an inevitability.

To support this assertion, I present the following analytical framework.*

Let us start with an equation- the first one most of us saw in Economics 101. Gross domestic product is the sum of four variables- Consumption (C), Investment Spending (I), Government Spending (G), and the difference between Exports (X) and Imports (M). Therefore, GDP (represented as Y) is expressed by this equation:

$$Y = C + I + G + (X - M)$$

Changes in these four variables drive corporate profits. Increases in C, I, and G plus rising exports relative to imports add to corporate profit growth. Along these lines, it is important to note that, over the past four years, each of these variables has been turbo-charged by various accelerants within the marketplace.

* *I am indebted to Doug Cliggot of Race Point for bringing this issue to my attention and I have used the same economic framework he employed.*

Consumption has grown faster than disposable personal income growth and this difference has meaningfully added to corporate profit growth. Investment spending has increased substantially due, in large part, to the above-trend growth rate in residential investment spending. The fiscal deficit has soared because government spending has vastly exceeded tax receipts, and this scenario has had a very positive effect on corporate profits. The one drag on profits has been the increasing trade deficit as imports have grown at a faster pace than exports.

Through the model presented above, we can create an even more nuanced and flexible representation of the drivers of corporate profits. Bear with me here, as the algebra becomes longer, but it still is the Econ 101 concept of C + I + G + (X – M) = GDP.

Corporate profits drivers over the near term can be defined as the sum of four variables:

C – DPI = Where C is consumption and DPI is disposable personal income. When consumption exceeds disposable personal income, it is an additional driver for profits. As our net savings rate in the U.S. fell below zero over the past four years, this decrement became additive to profits. The opposite is true as well. When net savings becomes positive again, as it will, profits will be negatively impacted.**

I = I represents investment spending by businesses (structures and equipment) and residential investment. When business spending (BI) is increasing, as it is now, profits are helped. The same concept applies to residential investment spending (RI). Here, however, the bloom is off the rose and a decline in the level of residential spending is already well underway.

G – T = Government Spending – Tax Receipts. Government Spending net of tax receipts (the fiscal deficit) has soared under the Bush administration and has significantly helped profits. This gap should narrow and that process will hurt profit growth.

X – M = Exports minus Imports have risen substantially and represent a real drag on profits. Should this change through a falling dollar, profits will benefit. Should the trade deficit worsen, the opposite is true.

** *See Martin Feldstein Article from Foreign Affairs May/June 2006.*

And now, the next formula:

$$\prod(\text{Profits}) = (C \underset{\substack{\downarrow \\ \Delta\text{ in} \\ \text{Savings}}}{-} DPI) + \underset{\substack{\downarrow \\ \Delta\text{ in} \\ \text{Investments}}}{I} + (G \underset{\substack{\downarrow \\ \Delta\text{ in} \\ \text{Budget Deficit}}}{-} T) + (X \underset{\substack{\downarrow \\ \Delta\text{ in} \\ \text{Trade Balance}}}{-} M)$$

$$\downarrow$$

$\sum$ of Business Investment and Residential Investment (BI + RI)

But how well does this formula work in terms of matching or predicting the actual movements of corporate profits? Let's plug in some historical data courtesy of Cliggot and the Federal Reserve. According to the Federal Reserve Flow of Funds Table, corporate profits rose $540 billion or 20% per year for the period 2002 through 2005. Let us see if our model can reproduce these numbers:

(C – DPI)	=	140 billion
I	=	440 billion (290 bil. from BI and 150 bil. from RI)
(G – T)	=	380 billion
(X – M)	=	-410 billion
		550 billion

As you can see, the results are remarkably accurate.

Now that we have verified the usefulness of this formula, let's look ahead to the trends that will emerge in tomorrow's investment landscape. First of all, the consumer cannot continue to dis-save. In other words, the C-DPI gap must decline. If consumption falls below disposable personal income growth, C-DPI will turn negative, which means that savings will grow, and will therefore be a drag on corporate profit growth.

Similarly, Residential Investment spending has to decline from present levels simply because this component of total investment in relation to GDP is currently far above any U.S. historical average level.

As for G-T, the budget deficit could get worse, but we doubt it. Even the current administration, which has been defined by its ongoing fiscal recklessness, must face the fact that our government paper is now held by non-US entities to a level that exceeds 50% of the outstanding treasury debt. If the coming year does not bring about another annual increment to the deficit, which seems likely, corporate profits would be negatively impacted.

The trade deficit resulting from M exceeding X in the quantity (X-M) should lessen in 2007 as the softening dollar begins to help exports and stabilize imports. This would be a positive for profits. Moreover, if oil declines in price, the shift in (X-M) could be a real profit accelerant.

Nevertheless, it seems no matter what scenario one might anticipate, corporate profits must slow, possibly to a very significant degree (Cliggot's work indicates an actual decline in profits in 2007). Our guess is that profits will rise in 2007, but only into the single digits, with the swing factor being changes in the trade deficit. The stock market, in our view, has not adjusted to this coming tipping point in corporate profits, and therefore remains vulnerable.

So, what is the informed investor to do? In order to sidestep the effects of slowing corporate profits, we recommend investing in those companies that will benefit from the changing trade deficit, and avoiding manufacturers of domestic-only goods and firms dependent on discretionary consumer spending. Aerospace, integrated oils, some chemicals, gold and consumer non-discretionary should be favored. Real estate, financial entities and retail should be avoided. In addition, we believe that dividend yield plays will work across the board. And, in many ways, the same fundamentals will continue to apply: the most investment-worthy firm will be a company with transparent financial statements, rising free cash flow available at a below-market multiple, and a management team that knows how to intelligently deploy free cash flow to the benefit of shareholders through either dividends or accretive internal projects and acquisitions.

In conclusion, we believe that the profits generated by corporations will decline in the next several quarters relative to GDP. But, by following the strategy outlined above- a focus on the positive effects of globalization, the financial metrics of running a business and, in particular, the intelligent use of free cash flow- investors can build a winning portfolio.

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