**What’s puffing up profits?**
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Investors are seeing what they want to see in the corporate-profits picture

THERE you are, trying to map-read your way to somewhere you’ve never been to, having already taken an unconscionably large number of wrong turns, and every other minute daughter number two asks how long it will be, exactly, until we arrive. And then, at last, there is a road that you recognise, and everyone is again wreathed in smiles. Buttonwood has been having similar troubles with the American stockmarket, with the added complication that not only is the map unfamiliar and difficult to read, but it keeps changing. It is not a market that he likes especially, though it is popular anyway for reasons that are largely unconnected with value. But the terrain is becoming familiar again: Buttonwood recognises irrational exuberance when he sees it.

Some 140 companies in the S&P 500 are due to announce their results this week. Doubtless they will be cheeringly good: those that have already done so have beaten analysts’ expectations by some 6%, and there is little reason to suppose that the rest have done worse. But then they will need to be good, so high are investors’ expectations. Stockmarkets have already climbed a long way from their lows in March of last year—the S&P is up by 44%, and Nasdaq by 69%; and judging by all the available indicators of appetite for risk, investors expect more of the same. A lot more, in fact. But how much will profits have to grow to drive stockmarkets still higher? And how sustainable is this surge in profits?

Investors are certainly gluttons for risk at the moment. There are any number of ways of measuring this. Most risk-appetite indicators look at the performance of risky assets, such as corporate or emerging-market bonds. These have flown, and risk indicators are correspondingly high. Perhaps the simplest way of discerning appetite for risk, however, is to ask fund managers how much risk they are taking. This is what Merrill Lynch has done in a monthly survey since the beginning of 1999. The latest results are striking. In the ten months since March of last year, when risk appetite among investors was the lowest the firm had recorded, appetite has climbed to the highest the firm has seen—higher even than during the euphoric months before the stockmarket bubble burst in March 2000. Buttonwood has said it before and he will say it again: if things can’t get better, they can only get worse.
There is certainly plenty of scope for disappointment. Investors have very little in cash; they hate Treasuries almost to a man (two-thirds of respondents think they are overvalued); and most think that shares are fairly valued, with prices likely to be propelled further upwards by higher profits. On this last question, a dose of scepticism is in order. Last week’s column looked at the astonishing profitability of American financial firms. Citigroup, to take one example, made more money last year than any company has ever made, and financial firms make up about a third of corporate profits, which is unsustainable. A bigger question is whether profits for non-financial firms are also being temporarily flattered, to which the answer is: most probably.

Profitability, it is true, seems to have been boosted by cost-cutting, which has allowed any growth in revenues to flow straight to the bottom line. There are, however, limits as to how much cost-cutting can drive future profit growth. To push profits up further, demand has to rise—in the jargon, companies need to boost top-line growth. In America, this is a problem. It requires the public to spend more than the huge amount it already spends. Yet America’s savings rate is anyway a niggardly 1.7%, and it seems unlikely that it can fall much further given how indebted Americans already are.

Perhaps demand would grow if job growth were not as anaemic as it apparently is, since more people would have money in their pockets. But if jobs do start to flow more freely, firms would presumably have to spend more to keep hold of treasured employees. Wall Street provides a nice example. Heartening though it was for its firms to have made record profits last year, this was at the expense (if that is the right word for an industry not known for its parsimony) of its employees. Were Wall Street’s finest to be paid more, profits would fall.

How about foreign demand? The fall in the dollar should clearly have been a boon, both by making exports cheaper and by increasing the dollar value of goods that American companies sell abroad in strengthening currencies. But the actual amount of goods that American companies are exporting has not risen that much—much of what America exports is not that sensitive to currency movements. And a rise in the dollar value of widgets can make foreign demand seem stronger than it is.

This is especially evident in the market for high-techery of one sort or another, shares in which are, to put it mildly, generously valued. In fact, IT spending around the world, though rising, is certainly not soaring, though it appears healthier than it is because of the effects on revenue growth of a falling dollar. In general, companies are making do with the technology they already have. Moreover, unless the dollar continues to fall, the effect on profits will fade. And the truly astonishing thing is that, despite the falling dollar, the anyway low proportion of profits earned overseas fell from 21% in 2001 to 14% at an annual rate in the third quarter of last year, according to the Commerce Department.

A much bigger (though much less talked about) source of profits has been a fall in the corporate tax rate. In the third quarter, according to estimates from Smithers & Company, a research firm, the rate was some 25%. From 1990-2000 it varied from 35-40%, but fell sharply after September 11th 2001, because companies were allowed to accelerate the depreciation of their assets for tax purposes. The mechanics of how all this works are complex, but the effect on profits is not: they have been hugely flattered. In the third quarter of last year, after-tax profits would have been a fifth lower at an annual rate had there not been this allowance and assuming a corporate tax rate of 40%. The allowance is due to run out at the end of this year.

As in the late 1990s, however, investors are seeing what they want to see. And what they want to see is their risk-taking rewarded and a nirvana in which corporate America, cleansed of wrongdoing and excessive debt, can get back to the business of making lots of money. Share prices reflect this—but there’s a long way to go yet.

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