KAMP INSITE

Fireside Chat

Kamp Consulting Solutions, LLC

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"The U.S. has been experiencing a corporate profit boom in recent years, especially in 2011, when profis were about 10% of U. S. GDP…highest level in a least 80 years"

Profiting from New Insights

October is here again. Students are back in school, trees are changing color in some parts of the country and the financial world is entering another "earnings season", when quarterly corporate profits or losses are released to the public.

Did you ever sit back and think about how corporate profits arise and why this might be important? We'll explore the genesis of corporate profits and in the process, destroy a few myths that have been repeatedly reported as gospel.

The U.S. has been experiencing a corporate profit boom in recent years, especially in 2011, when profits were about 10% of U.S. Gross Domestic Product (GDP). This was the highest level in at least **80** years. Furthermore, 2012 is shaping up to be an exceptional year too, as profits as a percent of GDP increased to 10.6% in the second quarter alone. The previous peaks were 8% in 1964 and 2006. The long-term average for profits as a percent of GDP is about 6%.

This profit boom is occurring despite a very weak economic recovery from the deep recession experienced from late 2007 through early 2009. How is this possible? Theories include cost cutting, higher productivity, lower interest rates and foreign exposure (balance between foreign "financial" goods and services). These mainstream explanations for the increase in corporate profits and related margins have little or nothing to do with the increases we've witnessed recently*. So where do profits come from?

Sourcing the Answers

Profits at the macro level (economy as a whole) only occur when business incurs revenue without an associated cost. As an example, in a "closed society" where the only source of business revenue are the wages they pay, there is no room for profits, as business can only get back in revenues what it incurred in salary cost. Consequently, the profits must come from other sources, such as spending from prior savings, from borrowing, etc.

**The explanations for why these common beliefs are not true were beyond the scope of this note. If you are interested in these important explanations please feel free to contact us.*

Sourcing the Answers (con't)

There are four major corporate revenue sources that do not have an associated cost. These sources are investment, net exports, excess consumer spending, and deficits (public sector).

Investment, defined as net (after depreciation) private domestic investment, is a key activity that increases the nation's stock of productive capital. Examples include the purchase / building of machines, equipment, factories, inventories, etc. These activities are primarily funded out of past savings or current borrowings. These activities result in no income statement impact for the buyer; however, the revenues received from the manufacturers and builders of the equipment, inventory, housing, etc. go to the seller's income statement, creating a profit with no associated cost.

Net exports represent the second major source of revenue. Exports provide additional revenue from outside the country with no associated costs. Imports represent a loss of revenue with no associated decrease in costs. Hence, net exports are a source of profits. However, the U.S. has been a net importer for many years, which has been a drag on corporate profits to the tune of about $500 billion annually as of 2012.

"The federal deficit represented 94% of the total deficit spending in 2011."

Excess consumer spending is the third source of revenue. This is fairly straightforward. When individuals spend more than they earn, this "excess" creates additional corporate revenue with no increase in corporate costs. Similarly, when consumers spend less than they earn, business profits are reduced. The housing boom is an example of the creation of an environment where individual consumers, through home equity loans, spent much more than they earned, thus increasing corporate profits.

The final source of corporate profits is the public sector. When the public sector deficit spends, this money, if spent by the recipients, becomes corporate revenue without an increase in corporate costs (a profit). The federal deficit represented 94% of the total deficit spending in 2011.

Do the Math: Deficit = Net Private Savings

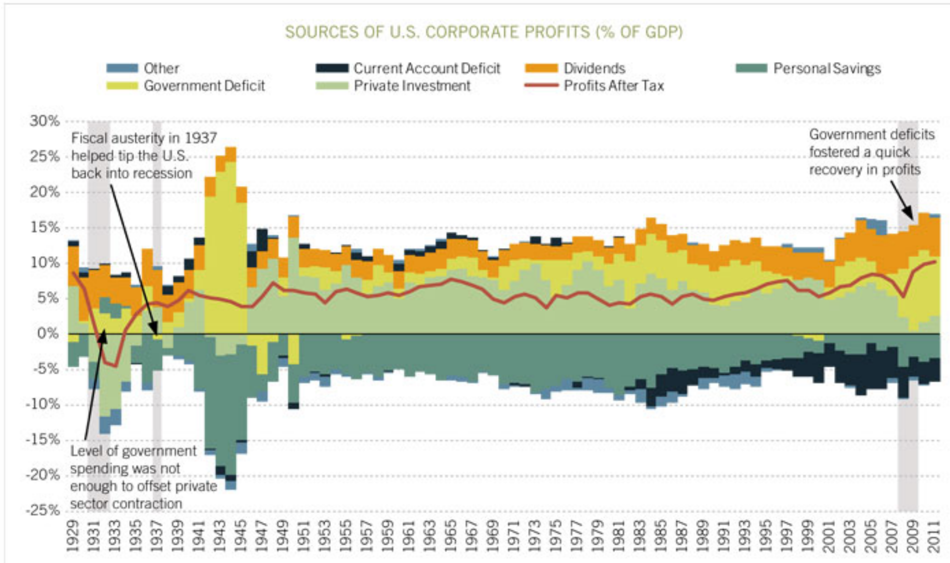
For your information, this relationship is a National Income and Products Account identity (holding the external sector constant). These savings are primarily corporate savings (profits), so profits come from these four sources and the profit equation is as follows:

After-Tax Corporate Profits =
Net Investment +
Negative savings by foreign countries (net exports) +
Negative savings by consumers (spending greater than earnings) +
Negative savings by the government (deficit)

> "…it has only been government deficits...which have been able to ' fill the gap'. Without these deficits, we would still be in a recession."

Understanding the Components

As the following chart from Fidelity highlights, without deficit spending by the U.S. Federal Government, corporate profits would have been nearly non-existent in the current cycle.



There are four components of GDP – consumption, investment, government and net exports. This cycle has been so unusual. In the wake of the deep recession and financial "crisis", the normal economic drivers have been slow to recover. Both businesses (investment) and consumers (consumption) have been more interested in improving their balance sheets than increasing their spending. Net exports have also weakened. Therefore, it has only been government deficits - where the government has "put more money in" the economy and private sector via spending than it has "taken out" with taxes – which have been able to "fill the gap". Without these deficits, we would still be in recession. Even with them, there has been a relatively weak economic recovery and expansion.

> "There seems to be a general "agreement" that the fiscal budget deficit is "unsustainable" and must be cut; however, there remains significant debate in how this should be accomplished and how fast."

As we enter the final stages of the U.S. Presidential election cycle, there has been much discussion on the current state of the U.S. economy, the federal deficit, the "fiscal" cliff, and which party is best suited to address these critical issues. There seems to be general "agreement" that the fiscal budget deficit is "unsustainable" and must be cut; however, there remains significant debate among the parties as to how this should be accomplished and how fast.

Unfortunately, we don't believe that either party is correct at this time. Given the fragile recovery, unemployment exceeding 8%, the nearly 15% U6 rate (includes people without work seeking full-time employment, those marginally attached workers and those working part-time for economic reasons), and the labor participation rate of 63.5% (lowest in more than 30 years), the U.S. economy (and obviously corporate profits) are very vulnerable to significant deficit reduction at this time.

Understanding the Components (con't)

The economy is currently operating about $1 trillion below full capacity utilization. Aggregate demand needs to **increase** if we are to see an appreciable pickup in employment and economic activity. With this amount of wiggle room, near-term inflation concerns should be replaced by fears of a double-dip recession if the deficits are significantly reduced through spending cuts or revenue increases (taxes). For example, the desire to raise taxes on the "wealthy", which would further remove money from the economy, reduces aggregate demand – and ultimately hurts the "poor" more than the "wealthy".

"…given our persistent negative current account balance, high unemployment, and lower corporate investment, it is hard to see how the proposed deficit reduction will be overcome"

Stay Focused on the Future

Plan sponsors, CIO's at endowments and foundations, and high net-worth individuals should keep an eye on corporate profit reports, which may come under significant pressure in the coming months and quarters, and have a significant impact on investment returns. It is estimated that a reduction in fiscal stimulus of $500 billion would result in a net reduction of corporate earnings by 31%, provided that the other three components of corporate profits **don't** make up for some of this shortfall. However, given our persistent negative current account balance, high unemployment, and lower corporate investment, it is hard to see how the proposed deficit reduction will be overcome. If the "fiscal cliff" is realized, U.S. corporate profits / earnings could come under significant pressure, and thus equity prices.

We have been exploring the history of U.S. surpluses and the subsequent effect on the U.S. economy. Let's just say that the idea of a surplus, although positive for any individual, corporation or state and local government, has a very different dynamic at the federal level and for the overall economy. But we will explore that subject in a subsequent *Fireside Chat*.

Finally, I'd like to extend a big thank you to Charles DuBois, a former colleague of mine at Invesco, who introduced me to many of these unconventional, but demonstrably valid concepts, and whose thoughts contributed significantly to this article.

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