



WILLIAM STERLING



GLOBAL STRATEGIST

Are U.S. Corporate Profits Ready to Take Off?

What a change a few months can make. In the dark days of March, investors were worried about catastrophe for the world economy. Now the focus is on far more mundane issues like whether the recent rise in government bond yields will crimp the developing global economic recovery.

Or whether corporate profits will meet expectations. Three cheers for the mundane issues! We can deal with those.

The recent rise from 3.1% to 4.5% on 10-year U.S. Treasury yields has indeed been violent, but has mainly been a reaction to the equally violent move down in yields that occurred in May and June. Since May, investor concerns seem to have swung from worrying about deflation and a double-dip recession to figuring out what the right levels for equity and bond prices should be if the long-awaited global economic recovery arrives.

as good news on corporate profits has been offset by concerns about rising bond yields.

If we are right, then good news on corporate profits should become the dominant force driving equity markets higher over the next year. So it is worth spending some time thinking about how trends in U.S. corporate profits will play out in coming quarters. For a number of reasons, we think investors could turn out to be pleasantly surprised.

Why Corporate Profits Could Surprise

There are three reasons why we think U.S. profits will be surprisingly strong in coming quarters. First, the top-line growth rate of the economy should pick up to something in the range of 5.5% to 6.0% thanks to massive

We remain confident about our expectations of an improving global economy in the second half of this year. We also believe that as evidence shows the recovery to be sound, but not booming, 10-year bond yields should stabilize. That should have important implications for equity markets, which in recent weeks have been trapped in a sideways pattern

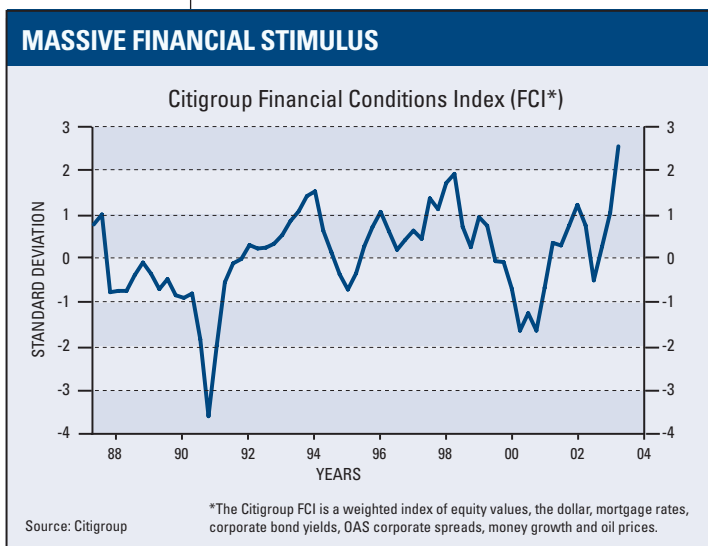


Chart 1: According to the Financial Conditions Index developed by Citigroup, the economy has just experienced the most massive dose of financial stimulus in many years.



Are U.S. Corporate Profits Ready to Take Off? (cont'd)

amounts of fiscal and monetary stimulus that are now in the pipeline. Secondly, the big drop in short-term interest rates and corporate bond yields in recent quarters have lowered the interest rate component of corporate expenses significantly. Thirdly, there is ample room for profit margins to expand. That means profit growth should be able to exceed top-line revenue growth by a wide margin for many quarters to come.

In short, profit growth of 15% or a bit higher for both this year and next year would not be surprising against the current backdrop of improving top-line growth and continued cost controls by corporations. If bond yields soon stabilize, and the market's price/earnings ratio also stabilizes around current levels, then the prospect for solid double-digit gains in earnings should become a dominant force propelling similar gains in equity prices as well.

during the boom years and sluggish growth in other major economies, the FCI trend is pointing toward a clear improvement in economic momentum in coming quarters. This has been confirmed by other recent data, such as the U.S. ISM survey (formerly the Purchasing Managers' survey), which rose above the 50% "boom or bust" level in July for the first time since February. A sharp rise in temporary employment in recent months is also pointing toward an improving economy.

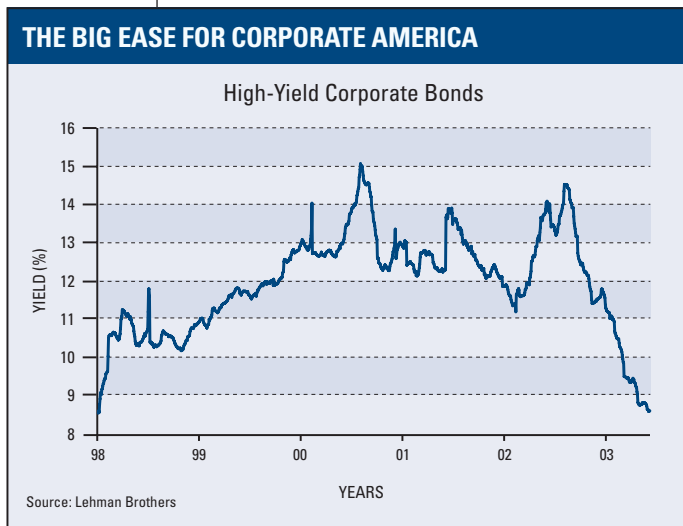


Chart 2: The huge drop in corporate bond yields this year means that the beneficial effects of the Fed's Big Ease have finally reached the corporate sector.

On the first point, consider Chart 1, which shows the Financial Conditions Index (FCI) created by Citigroup to track whether recent financial trends are providing stimulus to the economy. Typically, when the index moves up, it means that economic momentum over the next six to 12 months should begin to improve. The index is based on trends in government bonds, corporate bonds, stock prices, and oil prices and has had a good history of anticipating the economy's ups and downs.

As is evident in Chart 1, the FCI has moved up more strongly in recent quarters than any time since 1987. Even though the economy still faces headwinds due to over-investment

The Big Ease Arrives

A key component of the Financial Conditions Index is the trend in corporate bond yields, which dropped significantly this year. For example, as shown in Chart 2, there has been a massive drop in high-yield corporate bond yields this year from 14% to less than 9%. That drop has been driven by a wave of money in search of higher returns and by improving investor confidence in prospects for the economy. Similar trends have been seen across the board in other corporate bond markets, including the markets for higher-quality, investment-grade bonds.



Are U.S. Corporate Profits Ready to Take Off? *(cont'd)*

This is in distinct contrast to 2002 when – despite lower rates from the Federal Reserve – the corporate bond markets seized up in response to a series of accounting scandals and high-profile bankruptcies like WorldCom. Those problems effectively prevented the beneficial effects of Fed easing from reaching the corporate sector at a time when households were already benefiting from lower mortgage rates and lower rates on consumer debt.

The drop in corporate bond yields this year means that “The Big Ease” has finally arrived for the corporate sector as well. Just as households have benefited from the drop in mortgage rates, corporations this year have had much better access to capital markets and have been able to refinance their debt at far more attractive rates. Accordingly, interest expense should be falling and contributing to stronger corporate cash flow and profitability – all of which are prerequisites for business spending to begin to improve again.

accelerating top-line growth tends to coincide with continued restraint on corporate expenses. If this is the pattern that develops over the next year or so, then it would not be surprising to see profits’ share of income rise to 11.5% or even 12% over the next few years.

That is when the arithmetic gets interesting. For if national income grows by a modest 5.5% to 6.0% over the next few years, then a modest-sounding expansion of margins to 12% would imply solid profit growth of at least 15% per annum. In other words, prospects for margins to expand mean that profits may be able to grow much faster than national income for some time to come before margins once again approach peak levels. As seen in Chart 4, in the context of historical trends, 15% per annum profit gains for two years would represent an unremarkable cyclical gain in profits after a period of economic weakness.

Bullish Arithmetic

Obviously, there is no guarantee that this forecast will play out exactly as we hope. However, with enormous stimulus in the

Margins Have Room to Expand

Perhaps the most important reason we believe that corporate profits could be surprisingly strong is that profit margins are currently rather depressed and have ample room to expand as the economy recovers. Consider Chart 3, which shows total corporate profits as a share of national income. In the first quarter of 2003, profits’ share of income was about 9.6%, compared with a recent peak of nearly 13%.

Margins typically expand during the early stages of business cycle recoveries because

HIGHER MARGINS AHEAD?

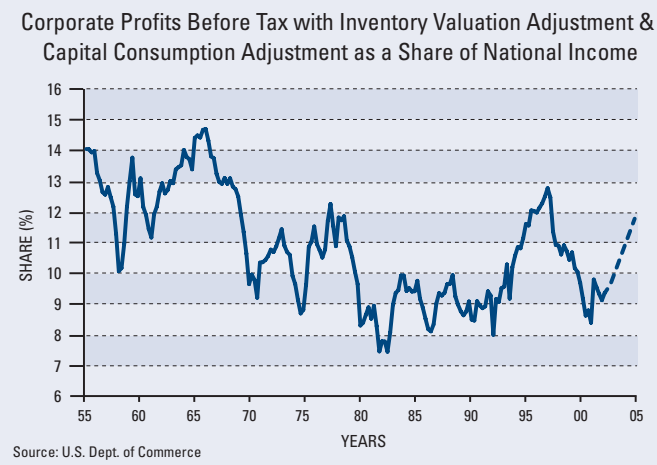


Chart 3: Margins have ample room to expand, with profits as a share of national income now at a low 9.5%. As margins expand, profits should grow much faster than the economy.



Are U.S. Corporate Profits Ready to Take Off? *(cont'd)*

system and depressed margins, the stage is set for impressive gains in corporate profits. And if these gains happen to follow a period when investors have been seriously concerned about oil market Armageddon on the one hand and global deflation on the other hand, a few years of solid double-digit profit gains would be a pleasant surprise indeed.

We have cast our argument in terms of the broadest measure of corporate profits available from the government's national income

accounts. These data were rather conservative during the boom years because they consistently included stock options as an expense charge against corporate profits. But with that issue having faded in importance, we suspect the national income profits will move in line with other profits measures such as the S&P 500 operating profits data.

Based on survey data for the first half of this year, S&P 500 operating profits are expected to come in at \$56.61 for the 12 months through June 2004. With the S&P 500 Index recently trading a level of about 980, that means the market is putting a multiple of about 17.3 times on forward earnings.

If S&P 500 operating earnings can be expected to gain another 15% in the following 12 months, expected forward earnings on the market by the middle of next year should be around \$65.10. If we are also correct that bond yields are able to stabilize under 5%, then a forward P/E multiple of 20 times would not be out of the question (according to the Fed model.) That would imply an S&P 500 value of about 1300 – or more

than 30% above its level at the time of writing. So a combination of higher earnings and an improving multiple would suggest rather strong markets gains.

As it says in the fine print, "Past Performance is Not Indicative of Future Results." There are still multiple risks in the environment, including well-known geopolitical risks. Equity markets often tend to be very choppy in response to rising government bond yields, or when they shift gears from a liquidity-driven dynamic to a profit-driven dynamic.

That said, there can also be "upside risk" in markets. Historically, upside risks have tended to be greatest when margins are depressed, financial stimulus is high, and investors are skeptical.

Like now.

Enjoy the rest of your summer.

*William Sterling, Global Strategist
CI Global Advisors LLP*

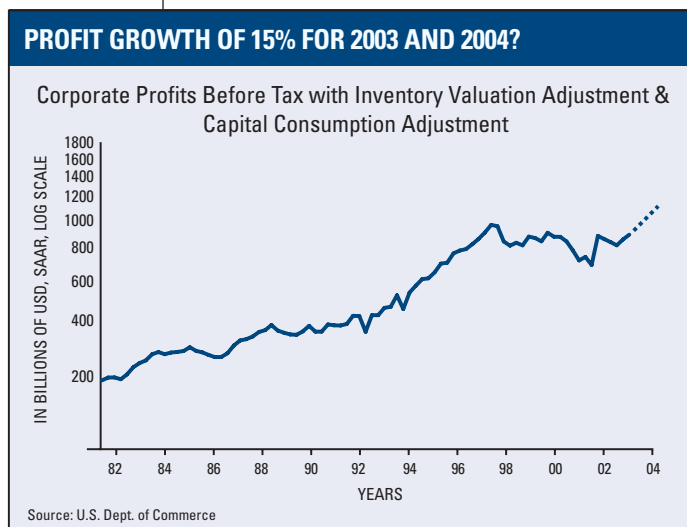


Chart 4: Profit growth of 15% per annum for 2003 and 2004 would be unremarkable compared to what has been seen in other business cycle recoveries.