



The Economy, Profits, and Stocks

By John H. Makin

As we enter 2007, many market commentators describe themselves as “cautious” concerning the stock market. They should not be. The major determinants of stock prices are expected profits and interest rates. Both factors are currently supportive of higher stock prices. Profits are expected to rise by about 10 percent during 2007, while interest rates should remain stable and may even fall, providing further support for stock prices.

Based on historical norms since 1985, the current yield on ten-year government notes (about 4.75 percent) and the projected earnings of the companies in the S&P 500 stock index over the next year suggest that the present level of that index—about 1,420—equals only about 80 percent of its “fair value.” In other words, if we take our bearings from expected earnings and interest rates, if the stocks in the S&P 500 were currently valued as they have been on average over the past twenty years, the index would be at 1,775 instead of 1,420.

Stocks Are Tricky to Value

It is tempting simply to project that over the next year the S&P 500 will go to “fair value” at about 1,775. The problem with that outlook is that the stock market is seldom where it is supposed to be based on fundamentals. Rather, it spends large amounts of time either above or below its average expected fair-market value. The U.S. stock market has been about 20 percent below fair value for the past four years. Earlier, in the late 1990s until early 2000 when the NASDAQ collapse occurred, even the S&P 500 was 60 to 80 percent

above fair value in what, after the fact, can only be viewed as a bubble. After the NASDAQ collapse, the S&P 500 spent two years about 20 percent above fair value before plunging to 20 percent below in mid-2002.

Alternative assets play a role in determining the level of stock prices. Between 2002 and early 2006, as stocks languished 20 percent below fair value, American households turned to residential housing as their favored asset. The powerful run-up in the housing market may have been due, in part, to the widespread, post-crash abandonment of stocks by U.S. households as a favored store of value while the more traditional owner-occupied housing was embraced anew. The tax advantages of real estate also helped to draw money into housing. Now that the housing boom appears to be over—U.S. house prices are either flat or down on a year-over-year basis depending on the measure employed—the natural question arises: will stocks regain favor, rising at least to fair value now that the appeal of housing as an investment has been dulled by the chance of falling house prices?

The answer to this question depends not only on whether households, after a hiatus of nearly five years, return to stocks as an asset to which they are prepared to assign at least fair value, but also on the path of corporate profits and interest rates. The roughly 4.75 percent yield on ten-year notes reflects the best assessment by forward-looking markets of the outlook for all the factors, including Federal Reserve policy, that impact interest rates. Perhaps more interesting is to examine the primary determinants of profits and to ask whether the depressed level of the stock market is due to a market expectation that, on average, looks for prof-

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its to grow more slowly than the widely utilized Institutional Brokers' Estimate System predicts (about 10 percent over the current calendar year).

What Determines Profits?

While the profits of individual companies depend on many industry-specific issues as well as the performance of the overall economy, profit growth of a broad set of companies, such as those represented in the S&P 500, is determined primarily by the behavior of two variables: nominal growth of gross domestic product and growth of unit labor costs. Nominal GDP simply measures the current dollar value of all goods and services produced by the U.S. economy. In a sense, it is the size of the "pie" that is distributed between capital (profits) and labor (wages). Faster economic growth tends to boost both profits and wages. Unit labor costs measure the rise in real wages relative to the rise in labor productivity measured, in turn, by the growth rate of output per unit of labor. Faster growth of unit labor costs subtracts from profits.

It makes perfectly good sense to suppose that profits grow faster as the economy grows faster, as long as unit labor costs are contained. In other words, if faster growth is associated with an even faster rise in labor costs, profits may not rise as fast as the economy grows.

There are several interesting details about the relationship between the current growth of profits and its determinants—GDP growth and unit-labor-cost growth. The nature of the link between profit growth and GDP growth has changed in the period since 1984, when the Federal Reserve succeeded in lowering and stabilizing inflation. That important accomplishment prompted the "Great Moderation," during which time macro variables became less volatile, imparting widespread benefits to the economy.

Earlier, specifically between 1948 and the end of 1983, the growth of profits averaged about 8 percent a year, very close to the average growth rate of nominal GDP. Indeed, it was a rule of thumb that nominal GDP growth was a good proxy for the average growth rate of profits. From 1948 to 1983, profit growth was considerably more volatile than in the post-1984 period, as was nominal GDP growth. The standard deviation of profit growth in the earlier period was 15.3 percent—almost twice the average growth rate of profits—while the standard

deviation of nominal GDP growth was about 4 percent, or about half the growth rate of nominal GDP.

Since 1984, the standard deviation of corporate profit growth has dropped to 10.2 percent, just above the 8.6 percent average growth rate of profits. Meanwhile, the volatility of nominal GDP growth has dropped to 1.8 percent, or well below the average 6 percent growth rate since 1984.

While the growth rate of nominal GDP has dropped since 1984 (largely because of lower inflation), the growth rate of profits has actually risen, from an average of about 8 percent to 8.6 percent, and become more stable. The stabilization of profit growth has enhanced the ability of most companies to extract profits from a given level of GDP growth. On average, profits have risen 45 percent faster than nominal GDP growth, well above the one-to-one relationship that prevailed before 1984. The faster growth rate of profits relative to nominal GDP may be due to two factors: more efficiency in company management, aided by less volatile inflation and growth as part of the Great Moderation; and lower unit labor costs. Slower growth of unit labor costs has enhanced profit growth especially since 1995.

Profits in the New Millennium

The most recent cyclical expansion since the end of the mild recession in the first quarter of 2001 has been characterized by well-contained growth of unit labor costs, supported by productivity growth that is strong relative to the rise in real wages. During most of 2002 and 2003, unit labor costs were flat as productivity growth matched the growth of real wages. Since then, the year-on-year growth in unit labor costs has risen to about 3 percent as year-over-year profit growth has risen to a 20 to 30 percent rate. Over the last two to three years, the growth rate of corporate profits relative to GDP has accelerated even as unit labor costs have risen.

Such profit growth may not be sustainable, especially if unit labor costs should continue to rise because of either more aggressive wage settlements or a slowdown in productivity growth. That concern may partly explain why stocks are generally priced below "fair value" currently. If profit growth is expected to slow as unit labor costs rise, both factors would tend to depress equity prices. However, the current value of equity prices only assumes a 10 percent annual growth rate of profits over

the coming year, and so it may be necessary to look elsewhere for concerns about equity valuation.

The outlook for productivity growth is always difficult to predict. Broadly, U.S. productivity growth slowed in 1974 for reasons that have never been fully explained and reaccelerated in 1995, again, for reasons that have never been fully explained. That said, productivity growth has risen, on average, at a 2.7 percent annual rate over the past decade, thereby providing great help to monetary policy managers by permitting real wages to rise without threatening inflation.

As we move into 2007, real average hourly earnings are rising at about a 3 percent year-over-year rate while real total compensation, wages, salaries, and bonuses are rising at an annual rate of about 4.5 percent. Part of the jump in real wages is due to the drop in overall inflation tied to lower oil prices, and so it may not be too threatening to inflation, provided that productivity growth holds up in order to contain unit labor costs. However, members of the Fed's rate-setting Federal Open Market Committee have begun to sound alarms about rising wages. If the growth in real wages persists without commensurate strong productivity growth, unit labor costs will rise, and firms will be forced either to raise prices or suffer a reduction in profit growth.

Profits, Wages, and Politics

The outlook for profit growth has become entangled in American politics, and this may be one of the reasons that market participants have been reluctant to boost stock prices on average to fair value. The outspoken, articulate new chairman of the House Financial Services Committee, Barney Frank (D-Mass.), has served notice that he intends to press Fed chairman Ben Bernanke on wages and profits. Specifically, Frank has announced that following the testimony that Bernanke will deliver to his committee on February 14 and 15 detailing the Fed's outlook for the economy, in accord with the Humphrey-Hawkins Act, Frank plans to schedule a day of hearings at which labor experts and economists comment on Bernanke's presentation.

It may be that this unusual step will include representatives of labor unions who suggest that the Fed should be as unconcerned about rising wages as it is about rising profits. In short, the new Democratic Congress may wish to involve the Fed in issues of income distribution, not its traditional purview.

Bernanke's response will probably be to suggest that he is very happy to see real wages rise as long as

productivity rises as well. He may add that if rising profits threaten to boost inflation, the Fed would tighten to offset that threat as well. Whether or not Frank and the members of the House Financial Services Committee, as well as those of the Senate Banking Committee, will accept these views remains to be seen.

The Bottom Line

It is important to remember that stock prices, like other asset prices, are determined in forward-looking markets. Right now, the outlook for profits and the level of interest rates suggests that the broad stock market ought to be about 20 percent above current levels, notwithstanding the strong run-up during the last half of 2006.

The reluctance of investors to push stock prices up to or beyond fair market value may be tied to uncertainties about the growth of profits, but is more likely based on concerns about rising labor costs and possible pressure on the Fed from the Democratic Congress to allow such costs to rise, regardless of productivity growth. That pressure would be counterproductive and likely to be associated with lower stock prices for two reasons. First, if Congressional pressure over wage and profit growth tends to politicize the Fed, or at least to create that impression, the Fed will be forced to take more active steps to prove its independence and to preserve the more stable, lower inflation rates that have been associated with the improved performance of the economy since the Great Moderation began in 1984. Second, erosion of Fed independence may lead to higher inflation, an outcome that has consistently been associated with a broad deterioration of economic performance and with lower stock prices.

All of that being said, while market concerns about possible friction between the Fed and the Democratic Congress may be elevated at present, the most likely outcome is that following Bernanke's Humphrey-Hawkins testimony in February and again in July, an accommodation will be reached. The Fed's primary task of maintaining low and stable inflation will continue, contributing to growth of the economy, rising profits, contained unit labor costs, and perhaps a fuller valuation of U.S. equity prices. It will be interesting to watch whether the tenor of Bernanke's testimony in February affects the market's valuation of stocks. Given the stake of most American families and their pensions in a strong stock market, everyone has a stake in rising profits and noninflationary wage growth driven by productivity growth.