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Business Outlook: Corporate Profits Growth Will Slow

Corporate profits have grown at better than a 10% annual rate for the past fifteen consecutive quarters. Economists have, for some time, expected profits and margins to flatten out as the aging economic expansion drives businesses to use less efficient and more costly resources. However, so far profit gains have held firm and reported earnings of the S&P 500 composite companies have exceeded Wall Street expectations for each of the last eight quarters. Clearly, robust profits have importantly contributed to the bull market we have all enjoyed.

Analysts generally cite six factors which have fueled strong corporate profit growth: (1) low interest rates; (2) corporate restructuring; (3) modest wage pressures; (4) a weak dollar relative to Europe and Japan; (5) strong capital spending; and (6) increasing exposure to faster growing economies abroad. As we look ahead, the outlook for profits has become somewhat less positive. Five of the six above noted reasons threaten to reverse. Fortunately, the rebound in global growth now widely expected to commence in 1997 will keep overall results positive, although it is likely that the sequence of double-digit profits gains is nearing its end for this cycle.

Lower interest rates have spurred corporate profits two ways. In addition to lowering corporate interest expense on floating rate or refinanced debt, lower rates have also boosted demand--particularly in the consumer area. With both interest rates and consumer debt burdens now higher, it is unlikely that rates will be a positive contributor to corporate profit growth in the next few quarters.

Corporate restructurings, which were never a long term growth driver, are yesterday's news. Many large companies have been able to increase sales and profits without adding to full-time staff. However, with the exception of a few slow-to-act companies and some industries in transition, the low hanging fruit has been picked. Looking forward, for most companies growth in profits will be more of a function of increasing sales than reducing costs.

Modest wage pressures have been central to growth in profits over the past few years. Now global competition is the rule rather than the exception. Companies and, indeed, employees have had little pricing power. Moreover, large corporate cutbacks have been the frosting on the cake. These factors have combined to put a cap on wage gains that has helped corporations maintain or increase profit margins. As companies shift their focus to growing their sales, there are signs of pressures appearing on the labor front. Overtime is high, demand for temporary help has exploded, and our contacts tell us that finding skilled labor is difficult. We would, therefore, not be surprised to see the wage cap begin to lift a bit in the coming quarters.

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The weak dollar, especially against the Japanese yen, has bolstered our "competitiveness" since our exports are cheaper to foreign buyers using their appreciated currencies. Additionally, our declining dollar has meant that foreign profits are translated into more dollars. More recently, the dollar has strengthened, again meaning profit increases will be harder to realize in coming quarters.

Strong capital spending, which has been an important stimulant to profits in this cycle, appears to be moderating, although some of the decrease in its rate of growth may be attributable to normal price declines in technology-oriented capital goods.

Increasing global exposure is likely to remain a positive influence. Between 1991 and 1994, foreign profits of U.S. corporations actually grew more slowly than their domestic profits. We believe this trend began to reverse last year. For the S&P Composite, dominated by large multinational companies, non-U.S. profits account for about 30% of the total, more than twice the percentage of the average domestic business.

Looking at these six factors which impact profit growth, it appears that the *rate of growth* is at, or very close to, a turning point. Double-digit profit growth will not be sustained into 1997 even if the 2-2.5% GDP growth we now envision is achieved.

Investment Strategy

If profit growth is slowing, is this the time to become more defensive? We cast our vote to hold course. We are forecasting a profit growth *slowdown*, not a decline. While the economic expansion may be old, it is still well balanced. Recent reports show inflation to be benign and interest rates are likely to remain within their recent ranges. Foreign economies are showing some signs of recovering, albeit at a snail's pace. Profit disappointments will be industry and company specific (e.g. Motorola) not across-the-board. Investors will move money, as they often do late in an economic cycle, toward those companies that are able to sustain strong sales and profit growth. We, therefore, continue to tilt toward *growth stocks* whose business are likely to show improvement next year. Their exposure to faster growing global markets, above average quality and financial characteristics, their ability to beat the competition as a low-cost producer/ provider and their dominant industry positions qualify them for the competitive environment we see ahead.

By and large, these *growth* companies are not excessively valued relative to their anticipated earnings growth. If we are right, they will become overpriced before this bull market is over. On the *value* side, we continue to favor financials such as Chase Manhattan Bank and selected growth industrials such as Nucor. We have also added to a handful of battered growth stocks such as Motorola and Pepsico whose current market valuations are compelling.

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