Fate of the V Shaped Profit Recovery

Corporate profits have been robust since rebounding in 2009. The question of a V shaped profit recovery has been answered strongly in the affirmative by corporate America (see Chart 1).

S&P 500 earnings per share estimates for 2010 of $67 (As Reported) and $81 (Operating) are probable. ("Operating" earnings do not include special charges, though this is the figure most quoted in the press). Few were predicting such a strong rebound in the first quarter of 2009.

Three troubling issues remain.

The first is unemployment. The recovery on Wall Street has not produced jobs on Main Street, at least yet.

The second is our financial system. The shock has been fully registered, the resuscitation of corporate profits largely complete. Yet, our financial system remains fragile and consumers and governments over-indebted.

The third is the V shaped recovery of another era (see Chart 2).

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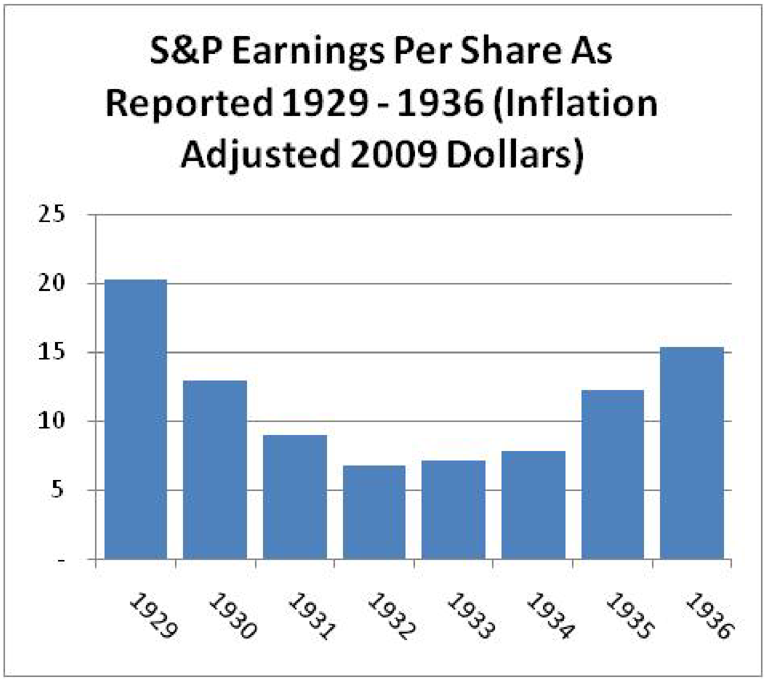


The V shaped recovery of the 1930s, unfortunately, did not have a happy ending. 1936 corporate profits were near a peak not fully eclipsed again until 1948.

In our view, today is radically different from the 1930s. Before discussing how different, describing how to survive a worst case scenario is apropos. One of our objectives is to preserve capital from permanent loss during periods of economic decline, and our benchmark for a worst case decline has always been a 100 year economic flood like the Great Depression.

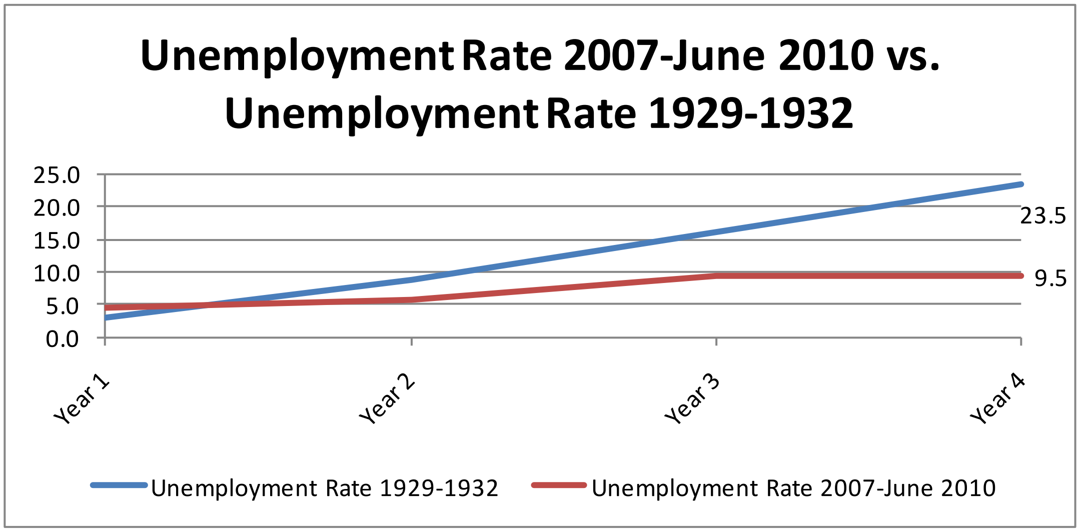
The process of building a quality equity portfolio that can withstand a severe economic contraction begins with fishing in the right seas. If the 100 year economic flood wipes out the bottom 20-30% of the economy, owning stocks among the top 20-30% of enterprises is necessary to assure you are protected from the rising tide.

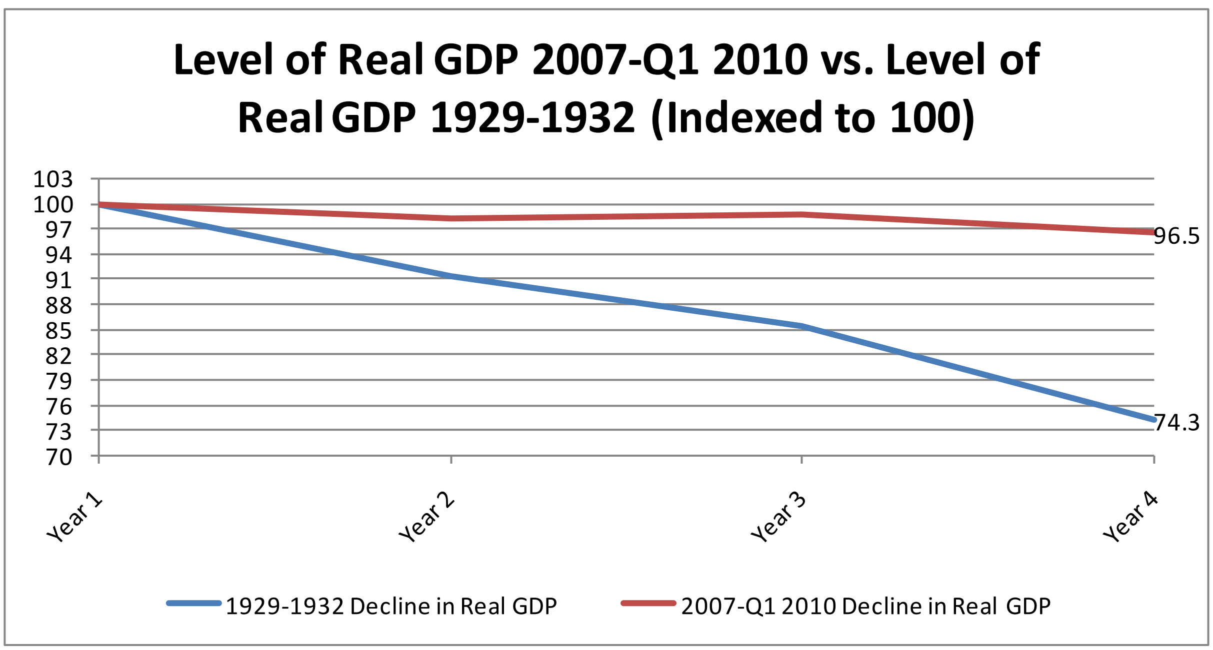
Our search process begins by eliminating approximately 60% of the companies available in the public company marketplace, either because they have too much debt or insufficient profitability. From there, we examine and value companies one by one to form a universe of quality businesses both qualitatively and quantitatively. The final result is a portfolio which comprises stocks among the top 20-30% of enterprises in the equity markets.

However, the quality of a business only goes so far when you overpay for it. Speculative prices were a key reason for poor stock returns from 1929 forward, and an even greater factor in Japan's abysmal stock market performance since the 1990s. Both a quality business and a quality price are necessary to protect capital against permanent losses.

Please see pages 4-5 for additional important disclosures.

Fortunately, today is no 100 year economic flood. Unemployment of 9-10% is bad, but nothing like the 20-30% levels during the 1930s (see Chart 3). Over-indebtedness remains, but is not insurmountable. GDP has declined, but nothing like the momentous declines of the early 1930s (see Chart 4).





The Great Depression was a contraction of epic proportions. For many reasons, the hole we are digging out of today is not nearly as deep. The issue for any contraction is ultimately absorption. In the case of the Great Recession, a debt driven boom which fueled overcapacity in much of the economy, housing and employment being two, must be absorbed, and this will take time.

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Whether unemployment will return to a normal 5-6% rate in three, five, or seven years is in our view too tough to estimate. The return to full employment is important for many reasons, most of all for those out of work. However, for our equity portfolios, regardless of how soon we reach full employment, valuations and therefore returns are very likely to work out well from today's levels.

This is true despite our belief that corporate profits today are again inflated. Stimulus spending is significant and temporary, and factors such as higher taxes are likely to erode profitability further. Our normalized cash earnings estimate for the S&P 500 is $55 per share, 18% and 32% lower than 2010 As Reported and Operating estimates, respectively.

The fate of the V shaped profit recovery, given these estimates, is a base level of profits which resets on the right side of the V somewhat lower than the left.

Nevertheless, $55 per share at today's market prices equates to a P/E of 19. The historical average is 16, so the market is a little high, but not nearly as high or dangerous as in 2000 or 2007.

Our equity portfolio is selling at a P/E of approximately 12 times our estimate of normalized earnings, a level which allows us to sleep well at night. The average cash balance in our equity accounts is approximately 20%, which is high considering that we prefer to be fully invested. Regardless, we will not force companies into the portfolio either at unacceptable prices or with insufficient due diligence. Given current conditions, we believe we can become more fully invested again in the coming months.

Nick Tompras
July 2010

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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