ATLANTIC
FINANCIAL GROUP

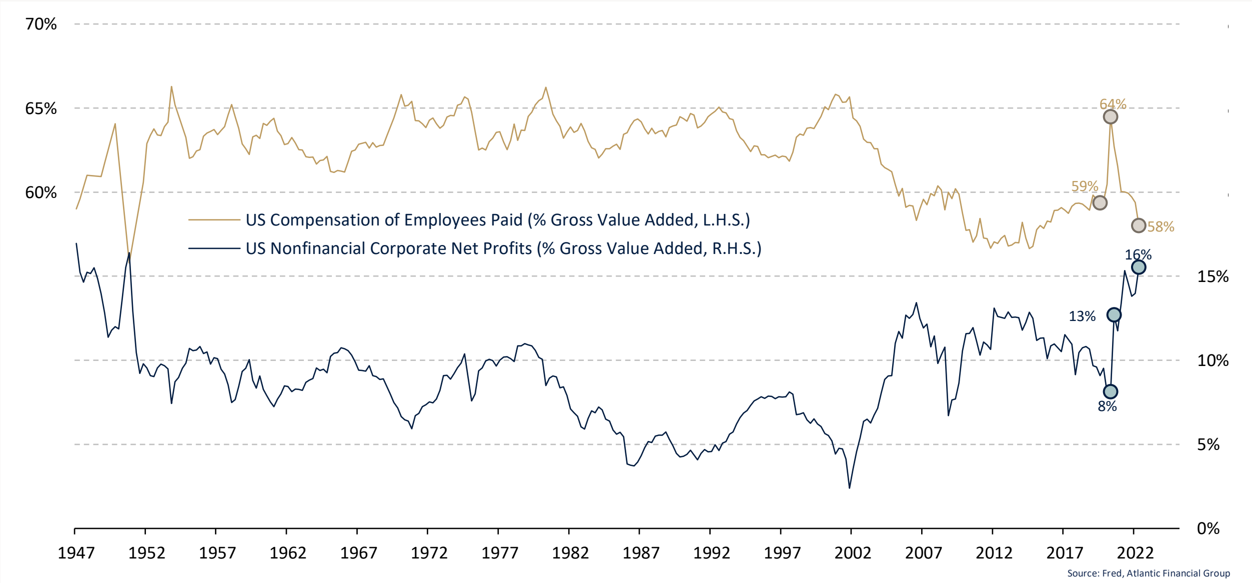
Weekly Investment Focus

12 September 2022

"THE PROFITS OF DOUBT"

- Listed companies have seen their earnings climb sharply
- In coming quarters, with falling sales and declining margins, they will contract
- This phenomenon will be accentuated if governments decide to tax super-profits
- Therefore, valuation multiples are higher than they appear

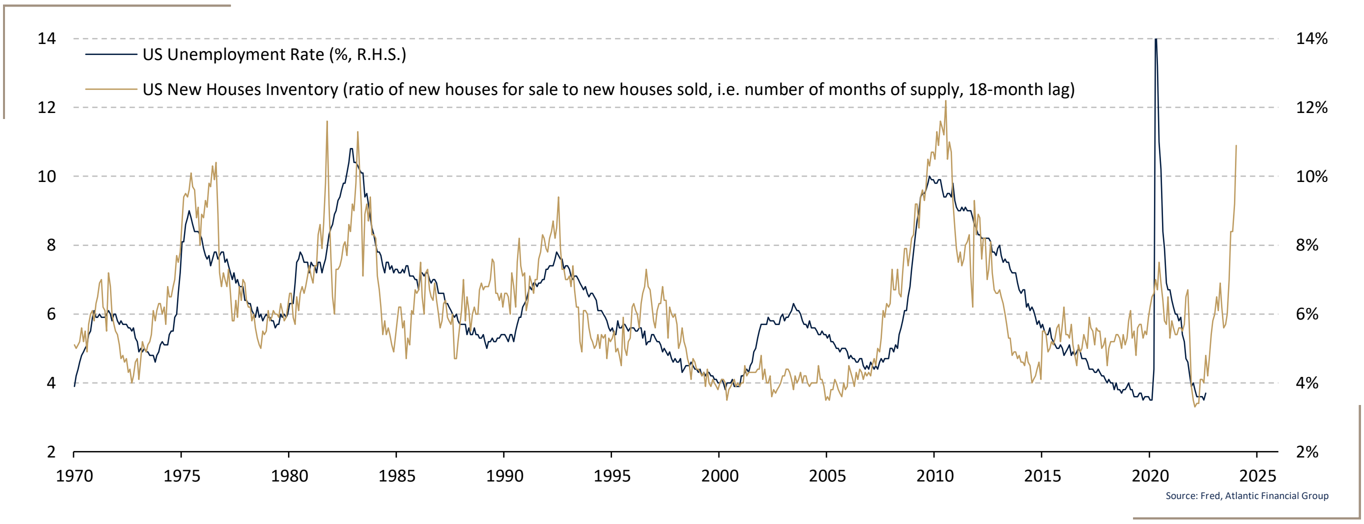
CHART OF THE WEEK: "Profits hit record highs: good or bad news?"



STOCK MARKET ANALYSIS

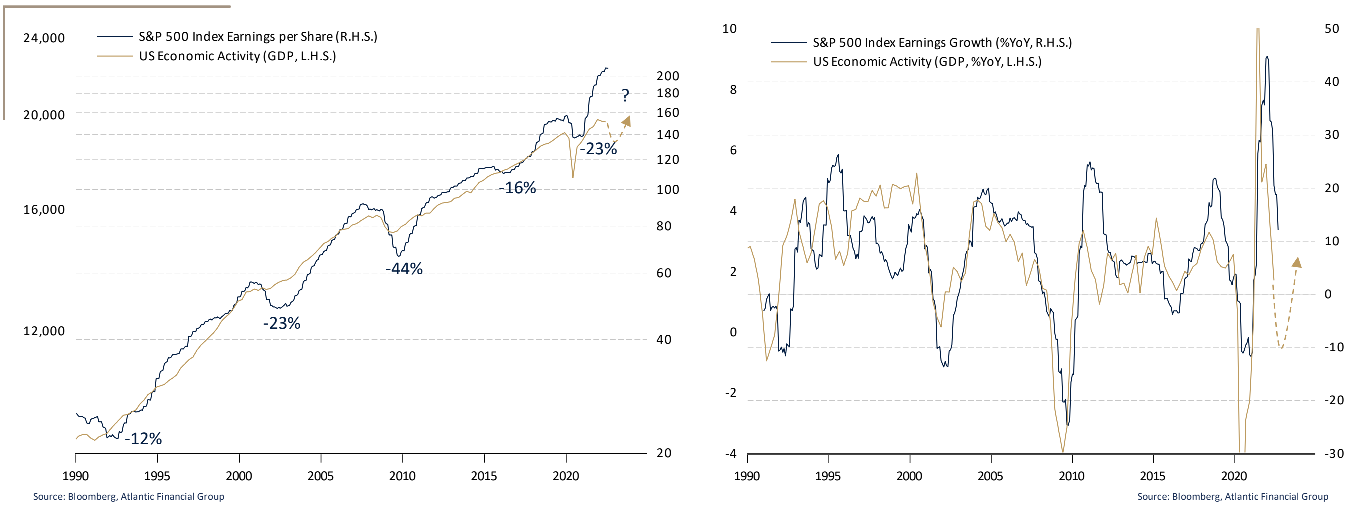
Markets are falling despite a healthy labour market and corporate earnings growth. We have regularly analysed the first argument to dismiss it as a lagging indicator of the business cycle. For the record, it is only once demand has slowed, companies have stockpiled, and then stopped investing... that the unemployment rate soars. Once again, the labour market will follow the US new houses inventory with an eighteen-month lag (see Fig. 2). Recent job creation in the US should therefore not be seen as reassuring, nor should it be used to discount the start of a new bull market. They are the final touch to the fireworks that closed the previous cycle and will be followed by a deep silence.

Fig. 2 - Unemployment rate and new houses inventory in the United States



In this analysis, we will focus on the second argument: earnings growth. Corporate profits have risen by +12% over the last twelve months. This may sound positive, even reassuring. But it is not. The first key element is that energy companies have played a decisive role in this growth: they weigh only 4% of the stock market but they have generated 100% of the annual earnings growth. If we exclude this sector from the calculation, growth is close to zero (see [WIF of 8 August 2022]).

Fig. 3 & 4 - Earnings and economic activity in the United States, raw data and annual growth



The analyst consensus is very optimistic about S&P 500 earnings growth of +12% over the next 12 months. Unfortunately, this outlook will not be met. **Typically, during recessions, corporate profits contract by -10% to -45%** (see Fig. 3 & 4). Future earnings revisions will therefore be significant.

If profits can no longer rise in absolute terms, they probably won't be able to rise in relative terms either. Indeed, if they improved after the Covid-19 pandemic, when economies reopened, it is also **because profit margins climbed to their highest level since 1950** (see Chart of the Week). The data show that companies initially benefited from state support (see Fig. 5). Secondly, they have managed to pass on higher production costs (materials and labour) to consumers. The combination of these two phenomena led to an increase in the profit share from 8% **to 16% of value added.**

Fig. 5 - Ricardo, Cobb, Douglas, Bowley and other wise economists

Value added is divided into three main areas: the remuneration of capital (profits, gross operating surplus), the **remuneration of labour** (wages) **and taxes** (on production and social contributions). Profits are then schematically divided into three: investments that serve to finance the future remain in the company, profit-sharing and incentive schemes for employees, and dividends for shareholders.

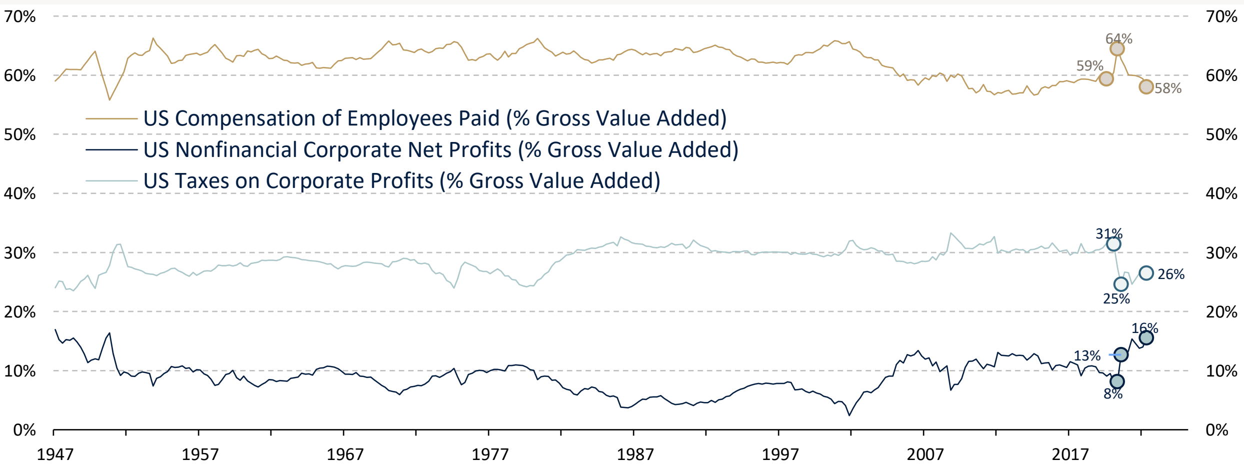
For centuries, economists have sought to determine whether there is an optimal distribution of value added. For David Ricardo, in his 1817 book "On the Principles of Political Economy and Taxation", determining the laws that regulate this distribution is the main problem in political economy.

In econometrics, analysts use the Cobb-Douglass function, proposed and tested in 1928 by the mathematician Richard Cobb and the economist Paul Douglas (see photos), to quantify the link between input and output. This function is a neoclassical approach to estimating the output (Y) of a country. It uses capital (K) and labour (L) as variables, to which technological productivity (A) can be added:

$$\Delta Y = A + \alpha \times K + (1-\alpha) \times L = 1.5\% + 0.3 \times (0.2\%) + (1-0.3) \times (1.7\%) = 2.75\%$$

In this approach, it should be noted that capital is considered on a gross basis, including taxes. Bowley's empirical studies have shown that in the US the distribution is relatively constant over time. **In concrete terms, labour absorbs 63% of value added and capital 37%.**

Distribution of value added in the US



Until the end of the last century, economists considered that this distribution was stable over time. However, the last few decades have shown a distortion in the distribution of value added. In 2007, Alan Greenspan, the former Chairman of the Federal Reserve, expressed his perplexity that the share of wages in national income in the US and other developed countries is exceptionally low by historical standards. It also seems that the decline in the share of wages has not led to more investment but to more dividend payouts.

There are several reasons for this distortion in the sharing of value added:

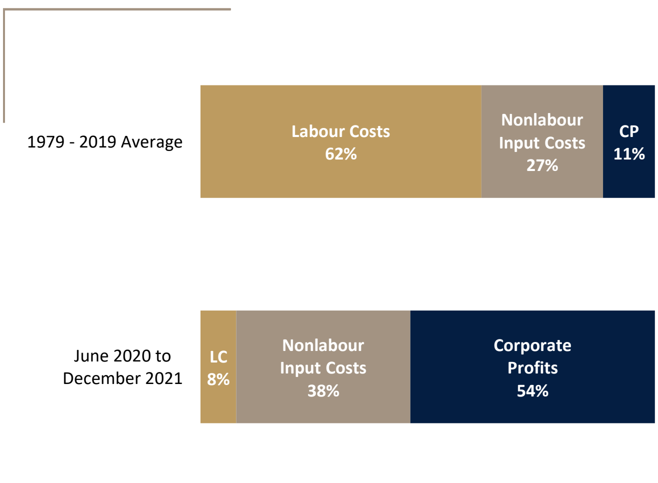
- Technological progress lowers the relative price of machinery and allows firms to substitute capital for labour, particularly in the case of low-skilled workers performing repetitive tasks.
- Globalisation is leading to the relocation of labour-intensive tasks to low-wage emerging countries.
- The concentration of companies ultimately weakens competition and allows the emergence of oligopolies, i.e. companies that cannot be ignored, such as Apple or Amazon for example.
- At the local level, low-skilled and geographically immobile employees are very dependent on a small number of companies, such as supermarket chains or fast-food outlet, as they account for a very high share of employment.

In all these cases, companies have more bargaining power to allocate value added between wages and profits.

Source: Fred, Atlantic Financial Group

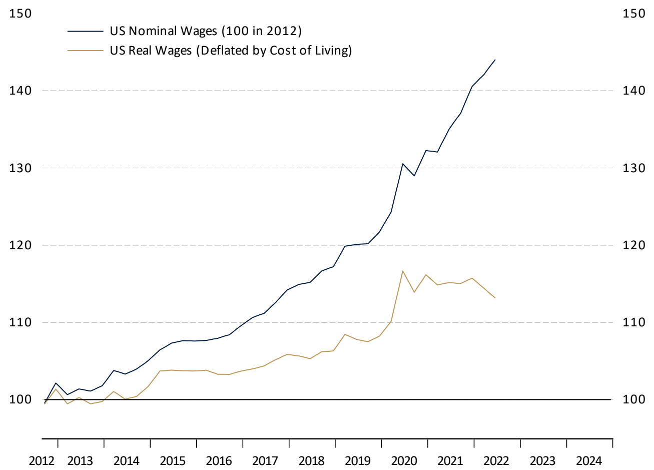
The consumer, on the other hand, has been hit hard by rising prices. Between the reopening of the US economy (in the second quarter of 2020) and the end of 2021, prices rose at an annualised rate of 6.1%. Unsurprisingly, soaring input prices – a good indicator of supply chain bottlenecks – contributed more than usual (38% vs. 27%) to consumer price growth (see Fig. 6). More surprisingly, over half of this increase (54%) can be attributed to higher profit margins. In contrast, labour costs contributed less than 8% to this increase. This is unusual. From 1979 to 2019, profits contributed only 11% to price growth, while labour costs accounted for 62%. Over the past two years, **as nominal wages have not grown as fast as consumer prices, real household incomes have fallen (see Fig. 7). This is not exclusive to the US but is also true in Europe.**

Fig. 6 - Price growth contributions in the corp. sector



Source: BEA, Atlantic Financial Group

Fig. 7 - Wages growth in the US

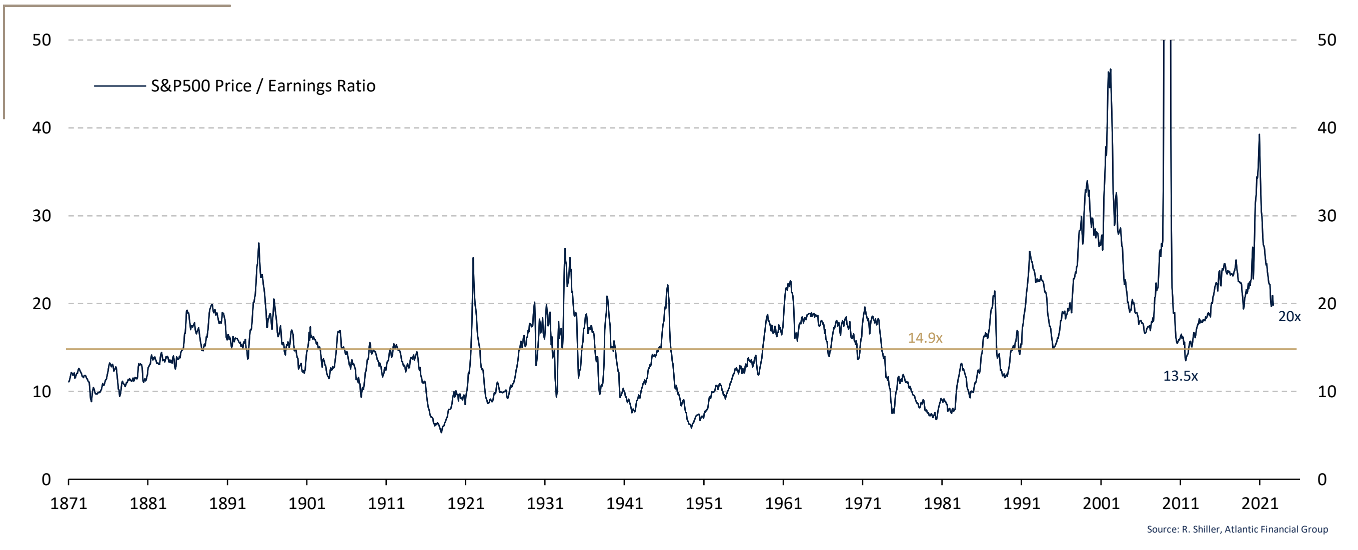


Source: Bloomberg, Atlantic Financial Group

At this stage of the economic cycle, it seems necessary that companies make a substantial effort to increase wages, otherwise demand will ultimately become sluggish. If households suffer too much and for too long from the recessionary impact of rising prices, they will no longer consume sufficiently to maintain the virtuous circle of the economy, when demand growth supports the supply expansion. **Unfortunately, if companies increase wages, this will be at the expense of profit margins and therefore profits.**

This imbalance in the distribution of value added is prompting governments on both sides of the Atlantic to tax "super-profits". In the United States, for example, President Biden's Democrats are wondering whether companies have been price gouging and whether they are responsible for the high level of inflation. Senator Ron Wyden has just proposed a one-off tax on "excessive" profits of energy companies. Similar taxes are being considered in several European countries to fund consumer support measures.

Fig. 8 - Valuation of major US listed companies since 1850



If corporate earnings are set to contract, then, all other things being equal, valuation multiples (Price/Earnings Ratio, PER) will rise, mechanically and temporarily. Contrary to popular belief among investors, P/Es are already relatively high (see Fig. 8). In the US, they currently stand at 20x current earnings... a far cry from the historical median and the previous bear market low, at 14.9x and 13.5x earnings respectively.

Conclusion:

Listed companies continue to report earnings growth. This is good news, but not enough to be confident about the future. This profit growth reflects the past activity of companies: increased sales and higher margins. With households losing purchasing power, profits will contract, and analysts will cut their estimates. The bear market is not over.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	622.9	49.55	2.7%	-2.0%	-16.1%	19.0%	16.9%
USA (S&P 500)	4 067	50.94	3.7%	-1.1%	-13.7%	28.7%	18.4%
USA (Dow Jones)	32 152	48.15	2.7%	-1.5%	-10.2%	20.9%	9.7%
USA (Nasdaq)	12 112	49.43	4.1%	-3.0%	-22.1%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	395.6	47.89	0.9%	-3.5%	-15.0%	23.5%	0.8%
UK (FTSE 100)	7 351	49.14	1.0%	-1.1%	2.5%	18.4%	-11.4%
Switzerland (SMI)	10 900	47.23	0.1%	-2.1%	-13.0%	23.7%	4.3%
Japan (Nikkei)	28 542	53.56	2.0%	0.8%	-0.9%	6.7%	18.3%
Emerging (MSCI)	970	41.03	-0.1%	-2.7%	-19.2%	-2.3%	18.8%
Brasil (IBOVESPA)	112 300	58.80	1.3%	3.4%	7.1%	-11.9%	2.9%
Russia (MOEX)	2 426	65.78	-1.8%	13.5%	-34.3%	21.9%	14.8%
India (SENSEX)	60 214	61.85	1.7%	1.7%	3.8%	23.2%	17.2%
China (CSI)	4 094	47.17	1.8%	-1.4%	-15.5%	-3.5%	29.9%
Communication Serv. (MSCI Worl	79.22	45.67	1.6%	-3.4%	-27.5%	10.9%	24.2%
Consumer Discret. (MSCI World)	319.5	53.56	3.7%	-1.0%	-21.5%	9.2%	37.0%
Consumer Staples (MSCI World)	262.6	44.79	1.2%	-1.9%	-8.3%	11.7%	8.8%
Energy (MSCI World)	228.1	52.28	0.0%	5.2%	25.6%	37.5%	-27.7%
Financials (MSCI World)	129.6	54.24	2.8%	-0.3%	-11.7%	25.1%	-3.1%
Health Care (MSCI World)	327.8	52.86	3.6%	-1.9%	-10.1%	18.0%	15.4%
Industrials (MSCI World)	274.4	48.74	2.3%	-2.5%	-16.0%	16.6%	11.8%
Info. Tech. (MSCI World)	427.6	44.81	2.9%	-5.3%	-25.0%	27.6%	46.2%
Materials (MSCI World)	300.6	51.07	3.8%	-0.5%	-14.7%	15.4%	21.6%
Real Estate (MSCI World)	191.7	49.51	3.4%	-2.9%	-16.5%	23.6%	-5.7%
Utilities (MSCI World)	160.4	57.23	2.7%	0.3%	1.1%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	3.34%	35.13	-0.8%	-4.0%	-11.9%	-2.4%	9.3%
Euro Area (7-10 Yr)	2.44%	30.33	-1.4%	-6.1%	-14.7%	-2.9%	4.5%
Germany (7-10 Yr)	1.75%	27.69	-1.3%	-5.4%	-12.9%	-2.7%	3.0%
UK (7-10 Yr)	3.10%	23.38	-1.6%	-8.3%	-14.3%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.03%	34.14	-1.1%	-4.1%	-9.8%	-2.3%	0.4%
Japan (5-10 Yr)	0.25%	37.17	-0.1%	-0.9%	-1.2%	0.0%	-0.1%
Emerging (5-10 Yr)	7.68%	46.95	0.8%	-3.1%	-18.4%	-2.3%	5.2%
USA (IG Corp.)	4.95%	38.01	-0.4%	-3.5%	-15.0%	-1.0%	9.9%
Euro Area (IG Corp.)	3.47%	33.36	-0.2%	-4.0%	-11.9%	-1.0%	2.8%
Emerging (IG Corp.)	7.56%	44.11	-0.2%	-1.0%	-15.8%	-3.0%	8.1%
USA (HY Corp.)	8.21%	49.68	1.3%	-2.8%	-10.2%	5.3%	7.1%
Euro Area (HY Corp.)	7.32%	43.37	0.9%	-2.9%	-11.2%	3.4%	2.3%
Emerging (HY Corp.)	10.99%	54.49	1.0%	-1.7%	-15.3%	-3.2%	4.3%
World (Convertibles)	369.3	54.16	1.9%	-0.4%	-15.7%	2.4%	38.8%
USA (Convertibles)	500.7	55.69	2.5%	0.3%	-15.6%	3.1%	54.5%
Euro Area (Convertibles)	3 541	41.56	-0.2%	-1.8%	-13.8%	-0.3%	6.1%
Switzerland (Convertibles)	171.6	30.99	-0.7%	-2.3%	-7.7%	-0.5%	0.5%
Japan (Convertibles)	199.0	64.09	0.6%	1.2%	-0.9%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	729	65.01	n.a.	0.5%	n.a.	8.2%	6.4%
Distressed	924	54.66	n.a.	-0.6%	n.a.	12.5%	3.8%
Event Driven	758	52.61	n.a.	1.1%	n.a.	12.9%	7.0%
Fixed Income	385	57.98	n.a.	0.7%	n.a.	5.2%	3.6%
Global Macro	1439	77.67	n.a.	1.4%	n.a.	9.6%	6.5%
Long/Short	862	50.94	n.a.	-1.6%	n.a.	8.3%	7.9%
CTA's	395	73.72	n.a.	-2.5%	n.a.	8.2%	1.9%
Market Neutral	283	52.50	n.a.	-1.7%	n.a.	6.2%	1.7%
Multi-Strategy	688	57.72	n.a.	0.2%	n.a.	7.0%	5.6%
Volatility							
VIX	22.79	45.47	-10.5%	4.7%	32.3%	-24.3%	65.1%
VSTOXX	24.88	46.72	-2.4%	6.9%	29.1%	-17.6%	67.5%
Commodities							
Commodities (CRB)	572.2	n.a.	-0.2%	-1.9%	-1.1%	30.3%	10.5%
Gold (Troy Ounce)	1 715	42.25	0.3%	-4.8%	-6.2%	-3.6%	25.1%
Oil (WTI, Barrel)	86.79	43.39	-0.1%	-4.1%	12.7%	58.7%	-20.5%
Oil (Brent, Barrel)	91.71	42.13	-1.6%	-7.0%	19.2%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	108.76	54.01	-0.7%	3.0%	13.7%	6.4%	-6.7%
EUR	1.0099	53.64	1.7%	-1.6%	-11.2%	-7.5%	9.7%
JPY	143.35	29.74	-1.9%	-6.9%	-19.7%	-10.2%	5.1%
GBP	1.1628	39.53	1.0%	-4.2%	-14.1%	-1.0%	3.1%
AUD	0.6853	48.25	0.8%	-3.8%	-5.6%	-5.6%	9.6%
CAD	1.3021	49.40	0.9%	-1.8%	-2.9%	0.7%	2.1%
CHF	0.9600	56.75	2.1%	-1.9%	-4.9%	-3.0%	9.4%
CNY	6.9265	34.96	-0.4%	-2.5%	-8.2%	2.7%	6.7%
MXN	19.861	58.81	-0.6%	-0.1%	3.4%	-3.0%	-5.0%
EM (Emerging Index)	1 632.0	36.37	-0.2%	-1.8%	-5.9%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

DISCLAIMER