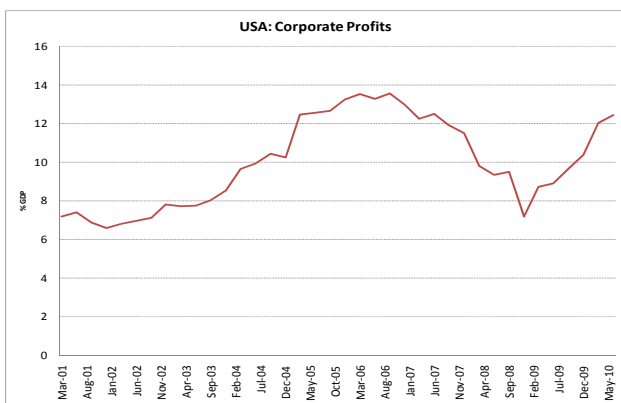


## The Myth of Corporate Profits

As the debate over a possible double dip in the global economy intensifies, many optimists are taking heart from last year's sharp revival in corporate profitability, which they clearly hope will sustain, if not global activity rates, then at least global share prices over the coming months. Interestingly, the consensus explanation for the revival in profits (and the explanation that is repeated ad nauseam by countless equity brokers) is that companies, most notably in the USA but also elsewhere, were simply ruthless in reducing their labour costs last year and it is further suggested that this revival in profits will be able to continue almost regardless of top line growth trends. Some even go so far as to suggest that we are embarking on a new era of cost reduction and attendant profit growth that will support share markets 'come what may'.



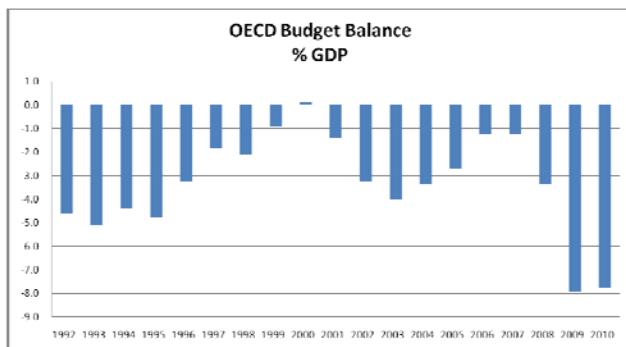
Unfortunately, this commonly accepted explanation for the revival in profitability and its accompanying forecast is logically flawed by virtue of a glaring fallacy of composition within the argument. Quite simply, if the majority of companies reduce their labour costs or even relocate their production

facilities into cheaper regions, then they will implicitly reduce the incomes and hence spending power of the majority of their customers. As companies reduce labour costs by either reducing wage levels or cutting employment, they will explicitly reduce the incomes of the vast majority of their consumers in the economy and this will clearly oblige these same consumers to spend less in aggregate, including on the goods and services provided by the cost-cutting companies. This is of course particularly true during the instance of a credit crunch or period of credit rationing, such as that which much of the world has experienced over the last few years, since an absence of credit facilities will ensure that there is a strong relationship between people's incomes and their ability to spend.



This situation naturally implies that other things being equal, during a period of labour retrenchment and credit market disruptions, corporate sales revenues will tend to fall in tandem with labour costs (or possibly even faster if the rise in unemployment causes households to save more of their dwindling incomes) and hence corporate profits will not rise but may in fact even decline sharply as sales revenues fall relative to labour costs. In fact, this scenario is merely part of the familiar 'Paradox of Thrift' whereby a rise in savings and a decline in spending by any one sector of the economy (be it the household sector, the government or even the corporate

sector) can lead to a drop in the revenues received by the other sectors and hence their ability to spend, thereby triggering a sequential decline in spending and incomes across the economy in a potential never-ending 'death spiral'. Indeed, much of depression economic theory is based on the Paradox of Thrift model whereby rising savings (even by companies on their labour costs) can cause intense economic disruptions.



Of course, in 2009 despite many people's fears this 'paradox' did not appear to occur and companies did seem to be able to produce profit growth through labour retrenchment policies last year. However, we would argue that this was only possible because governments, through their myriad of income support schemes, tax holidays, subsidies and other measures, effectively topped up household incomes so that households could continue to spend as much or almost as much as they had previously despite the decline in wage incomes that they experienced. By expanding their budget deficits by an almost unprecedented amount, governments broke the paradox of thrift and in a national income accounting sense; we can say that the rise in profits was the 'income counterpart' to the rise in government net expenditure. Or, to put it more simply, last year's rise in corporate profits was simply the mirror image of the sharp rise in budget deficits in the developed world.

Unfortunately, this situation implies that in order for profits to continue rising at the rate at which they did last year, budget deficits will have to continue rising at the same rate, a most unlikely prospect in the "post-Greece" world. In fact, many governments have

already embarked on a significant tightening of their fiscal regimes and it is for this reason that *total* household disposable income growth has plummeted across the developed world. In some cases, labour markets may now be looking a little stronger than they did a year ago but as governments now attempt to save by withdrawing subsidies and raising taxes, they are depressing people's aggregate ability to spend and this is one of the factors now driving the double dip process that seems to be taking hold in the global economy. With the fiscal stimulus now being withdrawn as governments begin to save, household incomes, household spending power, and by implication corporate profits, are once again coming under pressure. In practice, it seems that last year's escape from the paradox of thrift was only a temporary one and we are now at risk from a rise in government saving.

In fact, if we are to avoid a resumption of the recession / depression that afflicted the world economy in early 2009, the authorities will have to find another sector to start dis-saving in order to offset the public sector's now pressing need to save. This is of course the mirror image of 2009 when rising public sector dis-saving were needed to offset rising savings in the private sector.

In reality, the only practical solution to this savings problem would be for households to lower their savings rates once again but for the authorities to encourage this type of behaviour would seem rather unwise given the still deeply compromised state of many household sector balance sheets around the world. In our judgment, and we suspect in that of many of the central bank staffers (particularly in Japan) who we have encountered in recent months, the idea of further compromising people's long term financial health and security in order to generate a few more quarters of low-savings-rate driven growth would be a highly questionable strategy but we acknowledge that the political calculus is of a rather shorter term nature, particularly at present. The authorities probably should not try to force household savings rates down once again from a long term perspective but they may

yet attempt this nonetheless, particularly as fears over a double dip and deflation mount.

In practice, the onus of producing the required decline in household savings rates will once again have to fall on the central banks. In theory, these institutions could – if they so decided – attempt to reduce savings rates by improving the supply of credit (thereby encouraging dis-saving) or by raising asset prices, which potentially reduces people's desire to save. However, in today's still deeply compromised financial system, the condition of which seems to be deteriorating once again following the Greek crisis, we suspect that the only way in which the Federal Reserve and the other central banks could achieve these twin aims would be by 'doing it themselves' through direct lending to the private sector and direct purchases of private sector securities.

In short, some form of Quantitative Easing Mark Two would need to rely on a further expansion of central bank balance sheets and an acquisition of de facto credit and asset price risk by the central banks in an effort to boost asset prices. Such schemes would break pretty much every perceived rule of central banking and moral hazard avoidance, save perhaps the Banks' fundamental desire to avoid a deflationary double dip at all costs (although if they were really serious about this rule, the 1995-2006 credit boom would never have been allowed to occur...).

For investors, it would seem that if a double dip is to be avoided and the recovery to proceed, then central banks will have to not only decide to raise asset prices despite the issues and their own reservations noted above, they will have to succeed in doing so - two preconditions which are by no means sure things. Certainly, at present, it does not seem to us that the central banks have yet decided to act and therefore markets may well have to increase the pressure on the authorities to act in the near term but when they do act we can expect some form of positive reaction, although as to whether any rally will be sustained will depend on the character and effectiveness of their policy response.

Clearly, financial markets will interpret any softening or movement in central bank policy as being a prelude to such a determined effort and react accordingly in the near term but for any resulting rallies to be sustained, we will have to be certain that the policies are either designed to work (and not just ruses designed to insulate the Banks from any political fallout they might encounter from appearing to do nothing) and that they are in fact working as planned. The next few quarters may prove 'hard work' for investors and analysts alike.

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