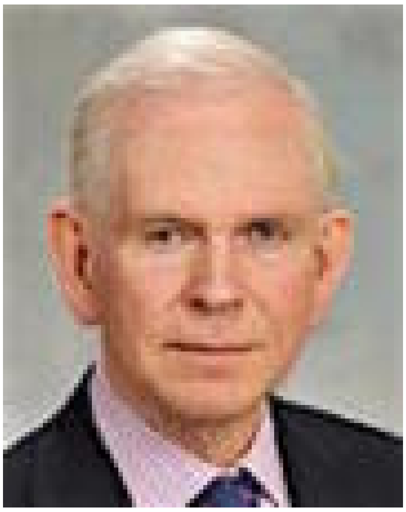
What Keeps Equities Aloft: Grantham

By Jeremy Grantham Wed, Jun 21, 2017

Low rates, high leverage, monopoly power, global brands and a friendly Supreme Court have all helped sustain corporate profits and keep P/E ratios high, writes the famous value investor.



We value investors have bored momentum investors for decades by trotting out the axiom that the four most dangerous words are, "This time is different." For 2017 I would like, however, to add to this warning: Conversely, it can be very dangerous indeed to assume that things are never different.

Of all these many differences, the most important for understanding the stock market is, in my opinion, the much higher level of corporate profits. With higher margins, of course the market is going to sell at higher prices. So how permanent are these higher margins? I used to call profit margins the most dependably mean-reverting series in finance. And they were through 1997.

So why did they stop mean reverting around the old trend? Or alternatively, why did they appear to jump to a much higher trend level of profits? It is unreasonable to expect to return to the old price trends—however measured—as long as profits stay at these higher levels.

So, what will it take to get corporate margins down in the US? Not to a temporary low, but to a level where they fluctuate, more or less permanently, around the earlier, lower average? Here are some of the influences on margins (in thinking about them, consider not only the possibilities for change back to the old conditions, but also the likely speed of such change):

- Increased globalization has no doubt increased the value of brands, and the US has much more than its fair share of both the old established brands of the Coca-Cola and J&J variety and the new ones like Apple, Amazon, and Facebook. Even much more modest domestic brands—wakeboard distributors would be a suitable example—have allowed for returns on required capital to handsomely improve by moving the capital-intensive production to China and retaining only the brand management in the US. Impeding global trade today would decrease the advantages that have accrued to US corporations, but we can readily agree that any setback would be slow and reluctant, capitalism being what it is, compared to the steady gains of the last 20 years (particularly noticeable after China joined the WTO).
- Steadily increasing corporate power over the last 40 years has been, I think it's fair to say, the defining feature of the US government and politics in general. This has probably been a slight but growing negative for GDP growth and job creation, but has been good for corporate profit margins. And not evenly so, but skewed toward the larger and more politically savvy corporations. So that as new regulations proliferated, they tended to protect the large, established companies and hinder new entrants. Corporate power, however, really hinges on other things, especially the ease with which money can influence policy. In this, management was blessed by the Supreme Court, whose

majority in the Citizens United decision put the seal of approval on corporate power over ordinary people. Maybe corporate power will weaken one day if it stimulates a broad pushback from the general public as Schumpeter predicted. But will it be quick enough to drag corporate margins back toward normal in the next 10 or 15 years? I suggest you don't hold your breath.
- It is hard to know if the lack of action from the Justice Department is related to the increased political power of corporations, but its increased inertia is clearly evident. There seems to be no reason to expect this to change in a hurry.
- Previously, margins in what appeared to be very healthy economies were competed down to a remarkably stable return—economists used to be amazed by this stability—driven by waves of capital spending just as industry peak profits appeared. But now there is plenty of excess capacity and a reduced emphasis on growth relative to profitability. Consequently, there has been a slight decline in capital spending as a percentage of GDP. No speedy joy to be expected here.
- The general pattern described so far is entirely compatible with increased monopoly power for US corporations. Put this way, if they had materially more monopoly power, we would expect to see exactly what we do see: higher profit margins; increased reluctance to expand capacity; slight reductions in GDP growth and productivity; pressure on wages, unions, and labor negotiations; and fewer new entrants into the corporate world and a declining number of increasingly large corporations. And because these factors affect the US more than other developed countries, US margins should be higher than theirs. It is a global system and we out-brand them.
- The single largest input to higher margins, though, is likely to be the existence of much lower real interest rates since 1997 combined with higher leverage. Pre-1997 real rates averaged 200 bps higher than now and leverage was 25% lower. At the old average rate and leverage, profit margins on the S&P 500 would drop back 80% of the way to their previous much lower pre-1997 average, leaving them a mere 6% higher. (Turning up the rate dial just another 0.5% with a further modest reduction in leverage would push them to complete the round trip back to the old normal.)

This neat outcome tempted me to say, "Well that's it then, these new higher margins are simply and exclusively the outcome of lower rates and higher leverage," leaving only the remaining 20% of increased margins to be explained by our almost embarrassingly large number of other very plausible reasons for higher margins such as monopoly and increased corporate power.

But then I realized that there is a conundrum: In a world of reasonable competitiveness, higher margins from long-term lower rates should have been competed away. (Corporate risk had not materially changed, for interest coverage was unchanged and rate volatility was fine.) But they were not, and I believe it was precisely these other factors—increased monopoly, political, and brand power—that had created this new stickiness in profits that allowed these new higher margin levels to be sustained for so long.

So, to summarize, stock prices are held up by abnormal profit margins, which in turn are produced mainly by lower real rates, the benefits of which are not competed away because of increased monopoly power.