TANAKA CAPITAL ECONOMIC BULLETIN

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"High Corporate Profits & Low P/Es"

With 2.00% yields on 10-year Treasury bonds, 0.50% rates on money market funds and 0.003% on 3-month Treasury bills, common stocks appear cheap with dividend yields averaging 2.0% (S&P 500) and P/Es out of sync at only 11 times next year's earnings.

Equity valuations are being held hostage by two major fiscal crises, both of which will give us some answers within the next 6-12 months. Full resolution, however, will be a few years away as it took the last 3 years for Europe and the U.S. to use deficit spending to stimulate their economies out of a near depression. We have repeated that massive fiscal stimulus is only a short term fix resulting in either higher taxes or excessive government debt, both of which slow down GDP.

As we wait for resolution of the credit crisis in Europe and the massive budget deficits in the U.S., conversations with managements suggest that U.S. corporations will continue to generate tremendous free cash flow, strengthen their "fortress balance sheets," repurchase shares and grow dividends beyond their relatively attractive yields. As capital markets are paying unusually low premiums for growth, equity investors are getting an option on growth almost for free.

Critical to this view is that: (1) Corporate managements continue their disciplined focus on cost reductions and profitability; (2) the Federal Reserve continues to pursue monetary policies to prevent a double dip recession; and (3) Europe and the U.S. make significant progress on reducing excessive and burdensome fiscal spending.

Fear of a Global Double Dip

We believe that the biggest depressant on P/E ratios is the fear of another severe recession in the U.S., Europe and China. We feel that the Federal Reserve will manage to prevent a recession in the U.S. and that the Chinese government will manage growth of 6-7%. However, we think the odds of a recession in Europe are greater than 50% due to crippling cutbacks in government spending (long overdue) and a reluctance at the European Central Bank to provide enough monetary stimulus to create jobs.

As long as GDP continues to be positive in the U.S., China and Japan, we believe that there will be corporate revenue growth of about 3-4% per year, which should be high enough to sustain already high corporate profit margins. We are encouraged that managements remain cautious and protective of their bottom lines with memories of the 2008-09 near depression still fresh in their minds.

Four Graphs Show Why Stocks Could Move Higher

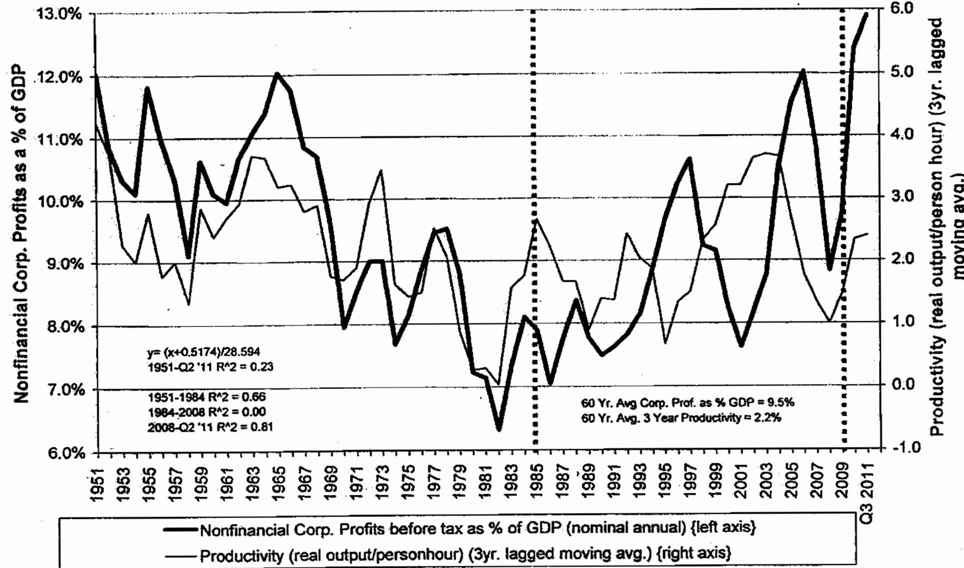
Pretax profit margins are already at a record 12.9% of GDP vs. a 60-yr. average of 9.5% shown in the Graph #1. While corporate profits would move lower in a recession, we note that profit margins typically rise in a stronger economy. Margins are benefitting from productivity gains and low labor cost inflation and could move modestly higher over the next 2-3 years as unemployment remains elevated and operating leverage kick in. We expect profits/share to rise 8%/year in the next 3 years.

Graph #2 shows that the S&P 500 is selling at 11 times next 12 months estimated earnings, well below the 15.3 average P/E of the last 50 years. In a less stressed economy in 3-4 years, a core PCE (Personal Consumption Expenditures) inflation rate of 2.0% (the upper end of the Fed's target range) would suggest a P/E on the S&P 500 of 17x offering a potential 50% upside for equity valuations.

Graph #3 shows that dividend yields are at or above 10 yr. Treasury yields for only the 2nd time in 50 years. The last time was the end of 2008 when we almost plunged into a depression. Given the inter-dependencies of global banks, we believe that European policymakers will know to avoid another Lehman-like failure which triggered the cascade of U.S. failures in 2008. Once Europe solves its credit problems, stocks could move significantly higher.

Graph #4 shows how stocks are out of favor versus corporate bonds and how investors are paying little for growth. In a deleveraging, slow growth economy over the next 2-3 years, investors might be happier with returns on stocks while waiting for earnings growth and possible P/E expansion vs. low yields on less lucrative alternatives.

Graham Y. Tanaka, CFA


#1
Pretax Profits % of GDP vs. Productivity Growth
Using Pretax Profit Numbers Through Q2 2011, Productivity Numbers Through Q3 2011
Nonfinancial Corp. Profits as a % of GDP
Productivity (real output/person hour) (3yr. lagged moving avg.)
y= (x+0.5174)/28.594
1951-Q2 '11 R^2 = 0.23
1951-1984 R^2 = 0.66
1984-2008 R^2 = 0.00
2008-Q2 '11 R^2 = 0.81
60 Yr. Avg Corp. Prof. as % GDP = 9.5%
60 Yr. Avg. 3 Year Productivity = 2.2%
Nonfinancial Corp. Profits before tax as % of GDP (nominal annual) {left axis}
Productivity (real output/personhour) (3yr. lagged moving avg.) {right axis}
Source: BEA, BLS
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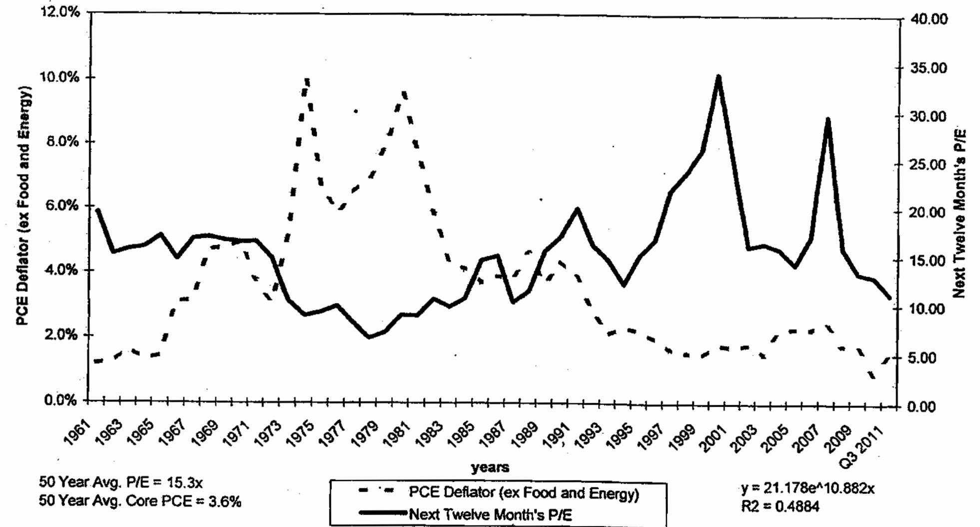
#2
P/E for S&P 500 on Next 12 Months Operating Earnings vs. PCE Deflator (ex Food & Energy)
Through Q3 2011
PCE Deflator (ex Food and Energy)
Next Twelve Month's P/E
years
50 Year Avg. P/E = 15.3x
50 Year Avg. Core PCE = 3.6%
PCE Deflator (ex Food and Energy)
Next Twelve Month's P/E
y = 21.178e^10.882x
R2 = 0.4884
Source: Standard and Poors, Federal Reseve Bank of St. Louis
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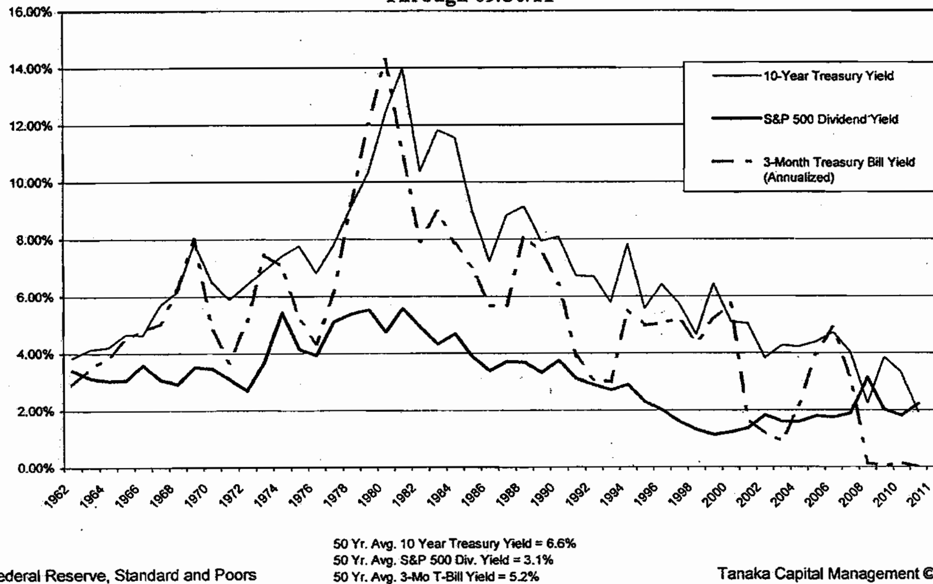
#3
S&P 500 Dividend Yield vs. Treasury Yields
Through 09/30/11
10-Year Treasury Yield
S&P 500 Dividend Yield
3-Month Treasury Bill Yield (Annualized)
50 Yr. Avg. 10 Year Treasury Yield = 6.6%
50 Yr. Avg. S&P 500 Div. Yield = 3.1%
50 Yr. Avg. 3-Mo T-Bill Yield = 5.2%
Source: Federal Reserve, Standard and Poors
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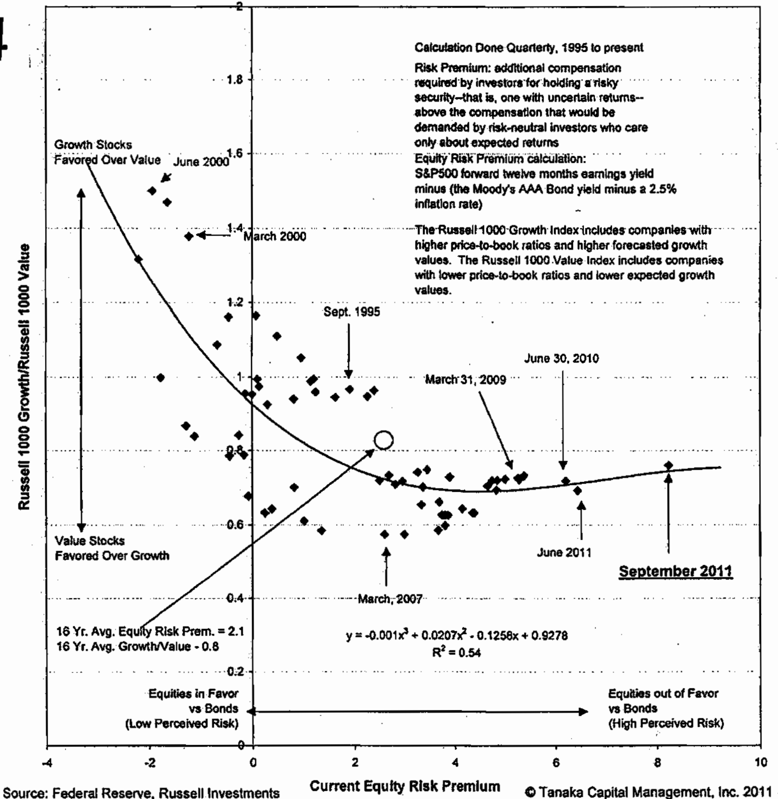
#4
Model of Preference for Growth vs Equity Risk Premium
(Russell 1000 Growth / Russell 1000 Value vs Equity Risk Premium)
Calculation Done Quarterly, 1995 to present
Risk Premium: additional compensation required by investors for holding a risky security--that is, one with uncertain returns--above the compensation that would be demanded by risk-neutral investors who care only about expected returns
Equity Risk Premium calculation:
S&P500 forward twelve months earnings yield minus (the Moody's AAA Bond yield minus a 2.5% inflation rate)
The Russell 1000 Growth Index includes companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index includes companies with lower price-to-book ratios and lower expected growth values.
Growth Stocks Favored Over Value
June 2000
March 2000
Sept. 1995
June 30, 2010
March 31, 2009
Value Stocks Favored Over Growth
June 2011
September 2011
March, 2007
16 Yr. Avg. Equity Risk Prem. = 2.1
16 Yr. Avg. Growth/Value - 0.8
y = -0.001x³ + 0.0207x² - 0.1256x + 0.9278
R² = 0.54
Equities in Favor vs Bonds (Low Perceived Risk)
Equities out of Favor vs Bonds (High Perceived Risk)
Russell 1000 Growth/Russell 1000 Value
Current Equity Risk Premium
Source: Federal Reserve, Russell Investments
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