Earnings: Less Than Meets The Eye

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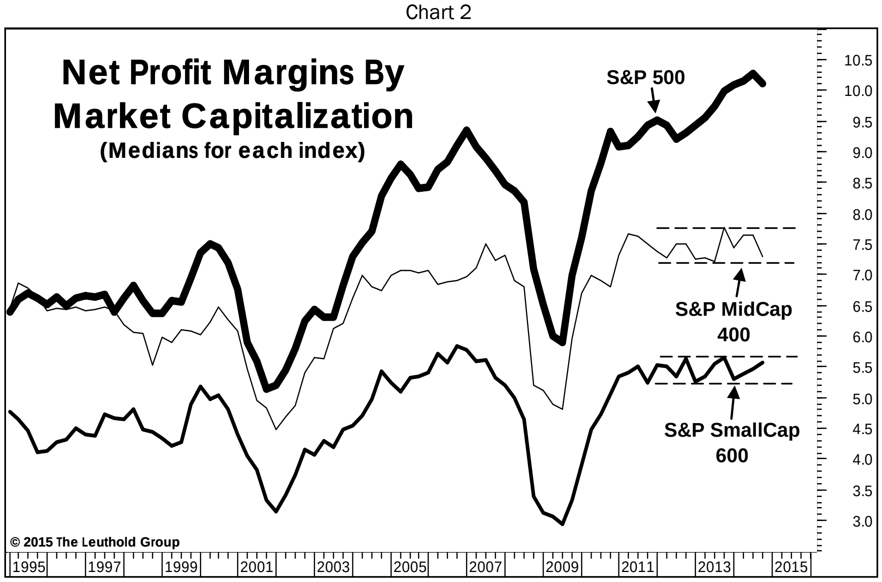
Amid all the praise heaped on the corporate sector for posting record earnings in the midst of a sluggish global expansion, allow us a respectful vote of dissent. **Earnings are abysmal—*especially* among the S&P 500 companies presumed to be the torch-carriers for this cycle's profitability rebound**.

Here's our rationale. From the earnings peak of the third quarter of 1937 through the earnings peak of the third quarter of 2007, S&P 500 Reported EPS grew at an annualized rate of 6.3%. This figure essentially matches the nominal GDP growth rate over that 70-year span, and represents a growth rate that is (within a quarter or so of a percentage point) generally assumed to be a sustainable one for S&P 500 EPS. It's been 78 months since that September 2007 profit peak, with 59 months of economic expansion and 19 months of recession—i.e., a fairly typical expansion/contraction split from an historical perspective. However, despite an historic shrinkage of the S&P 500 share base and near-record profit margins, **S&P 500 Trailing 12-Month Reported EPS—at a current $102.32** (Chart 1)**—is 24% below the $134.56 projected by the prior 70-year trend!** Put another way, if S&P 500 EPS managed to generate its historical 6.3% per annum growth from current inflated margin levels (we'd bet against it), that hypothetical profit target of $134.56 is still *4 1/2 years away*. Not good, considering that S&P 500 companies pulled a rabbit out of the hat just to make current EPS.

Chart 1

We first called for a peak in profit margins three years ago, and have been proven correct—but only on the basis of the **NIPA** profit figures. Median S&P 500 profit margins managed to grind higher for another 2 1/2 years, before finally rolling over (on a four-quarter trailing basis) in last year's fourth quarter (Chart 2). We think this roll over marks a *cyclical* margin peak, suggesting that the Reported EPS (Chart 1) could remain "below the line" for a long time to come.

Chart 2



Figures through 2014Q4.