

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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AUSTRALIAN PROFITS: HITTING RECORDS

Official statistics are pointing to some of the best conditions encountered by Australian business in recent history. The macro-economic measures of corporate profitability showed a sharp rise in the June quarter.

The Australian Bureau of Statistics has reported that private sector (non-financial) corporate gross operating surplus¹ rose by 11.1 per cent in the June quarter, the strongest quarterly rise since December 1986, to be 16.4 per cent higher than a year earlier.

This recent surge in business performance took the share of business profit in total income to unprecedented levels. As a share of non-farm income, the non-financial corporate operating surplus rose to 17.8 percent compared to an average of 14.8 percent over the past 45 years.

Over this time, the performance of the economy suggested that such a record was not attainable. Whenever the profit share had risen to the upper end of the historical 11½-16½ range (illustrated in the first chart on page 3), pressures emerged to curtail further rises. Usually, these pressures were associated with stronger wage demands as labour sought to restore its relative position. Sometimes, too, further increases were cut short as governments tried to hose down expectations of continuing price rises through interest rate increases.

The surprising strength of profits in this cycle might reflect at least in part a relatively weak negotiating position for labour in the modern Australian economy.

Decentralization of wage negotiations and the loss of economic clout by unions as their membership base has been eroded have been important structural changes for the Australian economy. Other changes reducing the dependence of the economy on manufacturing industry have also affected the wage negotiating balance.

Also important for business in being able to better manage its profit outcomes has been the opening of the economy to international influences.

- Reflecting relative cost considerations, whole manufacturing operations are being set up offshore with finished goods imported for the local market.
- Manufacturers are free to source inputs for their Australian manufacturing operations wherever they wish largely without the constraints of tariffs.
- Asian regional growth has created new markets for Australian exports supplementing domestic income sources.
- Asian growth is also supporting higher prices for Australian commodities.

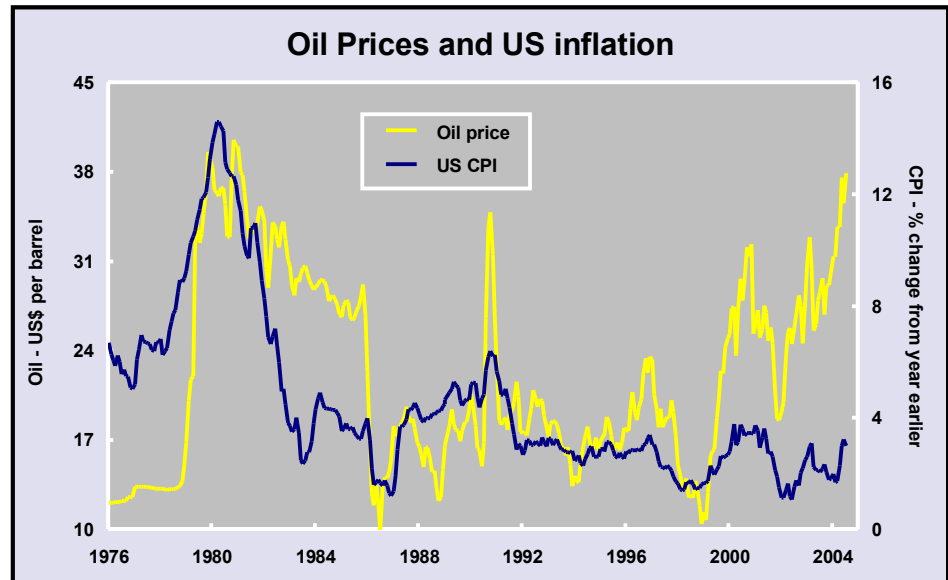
The strength of export prices was especially important for profit growth in the June quarter. Export prices rose by 5.2% as the GDP deflator, the broadest price measure for the economy, rose 4.6%, more than double the rate of consumer price inflation.

At the same time, the price of imports dropped by 6.0% gaining momentum from a

Unit Labour Cost Components		
	% change from	
	prior quarter	year earlier
Labour earnings	+1.1	+2.8
Productivity	-0.7	-0.8
Prices	-2.2	-4.6
Real unit labour costs	-1.8	-2.5

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THE WEEKLY CHART SPOT



Source: US Bureau of Labor Statistics, World Bank

"....business has moved to absorb much of the oil price rise expecting that the higher prices are going to be temporary and comforted by being able to cut costs elsewhere to compensate."

Higher oil prices do not appear to be having the same effect on inflation as in earlier years. That has left policymakers more relaxed about the outlook.

In the 1970s and 1980s, higher oil prices flowed into retail prices almost immediately, reducing consumer spending power and eroding potential rates of economic growth. They also reduced business profitability through their impact on sales and production costs.

In Australia, the effect was more pronounced. Unions used the centralised wage fixing system to seek compensation for the effect of oil prices on purchasing power. It was several years before the full impact of the higher prices fed through the economy and before expectations of continuing high wage rises could be reversed.

Extrapolating earlier experiences, with oil prices having been above \$30 a barrel for all of 2004, the impact on finished goods prices should be well and truly present.

The data available for the US economy (and illustrated in the chart) indicates that the effect has been surprisingly subdued.

There is some evidence that higher prices had a moderately adverse effect on activity levels in the middle part of 2004 in the USA but the price effects appear to have been minimal. Australia has fared similarly with little inflation impact being apparent since oil prices have moved higher.

One explanation is that business has moved to absorb much of the oil price rise expecting that the higher prices are going to be temporary and comforted by being able to cut costs elsewhere to compensate.

Its preparedness to do that reflects some sense that specific and transitory political events have been more influential in the current oil market. This view appears to have made life easy for those setting interest rates. They have not had to react as though they were managing a crisis. They would be hoping that the business attitude does not change. ■

1. The operating surplus accruing to all enterprises, except unincorporated enterprises, from their operations in Australia. It is the excess of gross output over the sum of intermediate consumption, compensation of employees, and taxes less subsidies on production and imports. It is calculated before deduction of consumption of fixed capital, dividends, interest, royalties and land rent, and direct taxes payable, but after deducting the inventory valuation adjustment.

Profits Deliver Valuation Boost cont'd

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used based on the historical relationships being tracked by the valuation model.

In other words, despite the improvement in equity prices over the course of the last

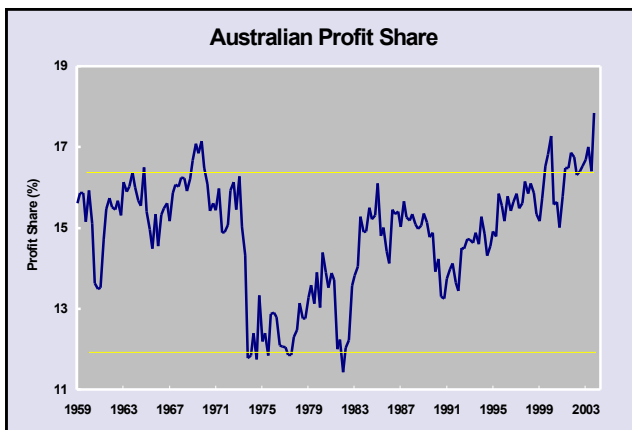
year, there are still grounds for believing that the Australian market is undervalued and that it offers value oriented longer term investors the chance of further capital appreciation. ■

Australian Profits: Hitting Records cont'd

(Continued from page 1)

stronger currency. No doubt the continuing threat of lower priced imports was also a warning to import competing businesses against conceding significant wage hikes.

Of course, labour costs did rise. Average earnings were 2.7% higher over the year. However, higher prices more than offset higher labour costs and supplemented continuing productivity improvements as a source of better profits.



A key measure of business performance, real unit labour costs, declined by 2.8 per cent in the June quarter to touch record low levels.

Real unit labour costs measure the extent to which productivity and price rises (which support higher profitability) are offset by nominal wage and other payments associated with employment. It could be viewed as a macro measure of operating margin.

The table on page one shows how the components of real unit labour costs varied over the June quarter and over the prior year.

In the most recent quarter, a 2.7 per cent increase in average earnings combined with a 0.2 per cent fall in average hours worked to give a 2.8 percent increase in hourly payments. At the same time, hourly output per person rose by 0.8 per cent providing a slight offset.

Companies would have been disadvantaged if that had been the full extent of the changes. However, the 4.6 percent increase in prices more than offset the adverse cost side effects.

These bigger picture movements do flow

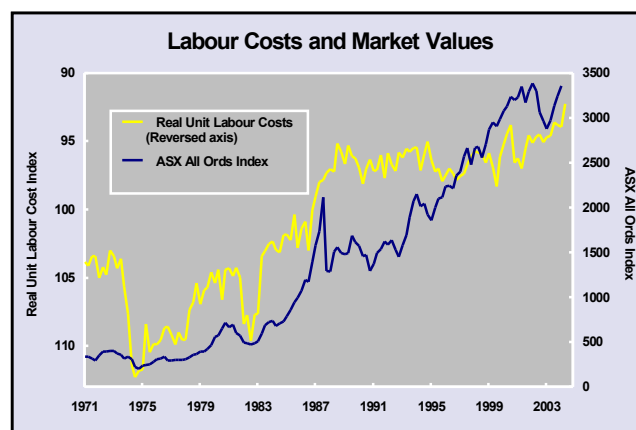
through to market outcomes. The second chart shows movements in real unit labour costs since 1977 (with the left hand axis reversed so that a fall in real unit labour costs is shown as a rise in the line) and movements in Australian equity prices. The recent strength of the market has been associated with falling operating margins (i.e. a rise in the yellow line).

There was, however, some sign in the latest period that the momentum of productivity growth was slackening. Whether business did not feel the need to try as hard or whether a more permanent impediment was emerging is too hard to tell from the data at this stage.

Looking at how these factors might move in the period ahead suggests that we are already in the midst of the best conditions imaginable for Australian business.

- Even assuming some permanent weakening in labor's relative power, it is likely that it will become more aggressive in pursuing wage increases.

In part, its negotiating position will have been made easier by the greater capacity to pay which goes with higher levels of profitability. In part, also, growing evidence of labour shortages is likely to tilt the balance



slightly.

Wage rises of 3-4%, still quite modest by history's standards, may be more likely outcomes.

- Even if companies were to pursue

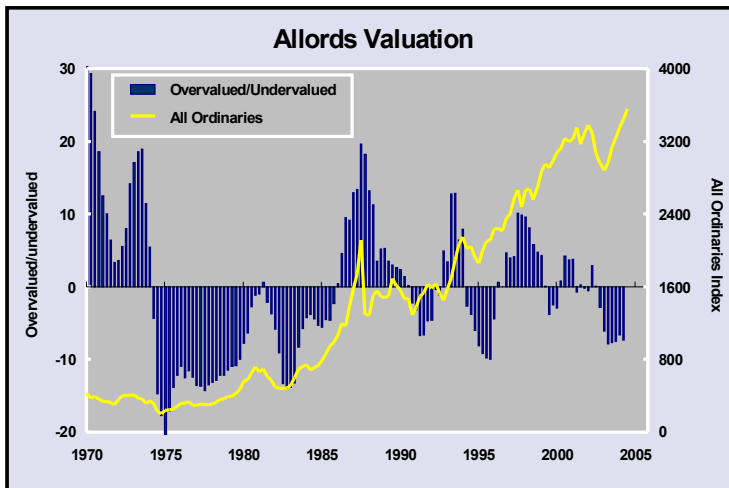
"The surprising strength of profits in this cycle might reflect a relatively weak negotiating position for labour in the modern Australian economy."

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PROFITS DELIVER VALUATION BOOST

Accelerating profit growth in the June quarter makes Australian stock market valuations more attractive.

thebigpicture uses the macro profit measures contained in the national accounts as a basis for deriving a market value indicator to help assess likely changes in market direction.



This top-down approach to valuing the Australian equity market indicates that it could sustain further price appreciation in the shorter term.

The model is based on the idea that value

comes from the interaction of current profits, prospective growth and a discount factor to be derived from prevailing bond yields. The model uses these three variables to infer a value for 'corporate Australia'.

This indicator approach is based on some underlying relationships, such as the connection between economy-wide profitability

and the profitability of listed companies, holding for the longer term.

thebigpicture top-down valuations have improved by 26% over the course of the past year. At the same time, the Australian market has risen by 20%. That is, the market appreciation seems to have been soundly based on an improvement in underlying economic per-

formance.

However, at the starting point a year ago the Australian market seemed underval-

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"...despite the improvement in equity prices over the course of the last year, there are still grounds for believing that the Australian market is undervalued...."

Australian Profits: Hitting Records cont'd

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productivity growth more aggressively than in the past six months, it would be unlikely for its growth to surpass the 2% rate which has characterized the Australian economy. Increases of 1½-2.0% would still leave a potential gap to bridge between nominal labour costs and productivity.

- Prices are unlikely to rise as fast as in the most recent period because the recovery in commodity prices is probably near its end and because of the Reserve Bank's determination to cut short any incipient change in inflation expectations before it takes hold. Increases of up to 3% might be more likely to occur.

Given the potential trajectory of these three factors, this indicator of business operating margins will be hard pushed to show similar gains to those in the past year. With wage outcomes at the upper end of their range and productivity gains at their lower end, for example, price rises of 2½% would be needed to simply hold this macro operating measure steady.

More substantial gains might be possible but they will require a renewed zeal on the part of managers to pursue workplace efficiencies.

The historical alignment of this important business performance indicator and equity prices would suggest that how business manages the wages-productivity relationship in the year ahead will be critical to market performance. ■