thebigpicture

guideposts for the private investor

Week Commencing 27 June 2005

AUSTRALIAN PROFITABILITY: WHERE TO?

The profitability of Australian companies remains strong but the momentum of improvement has slowed. Losing this latter support is not fatal for market performance but makes for more market volatility.

The ideal circumstance for equity markets, for any given level of interest rates, is to have profits rising at an accelerating rate. The level of profits is important for absolute valuation but their speed of improvement and rate of acceleration dictates market movement.

When level, growth (speed) and momentum (acceleration) are aligned, investors can approach markets with some confidence. If one is lacking, some judgements have to be made about the trade-off between underlying valuation and the importance of the missing ingredient. That is where we are now.

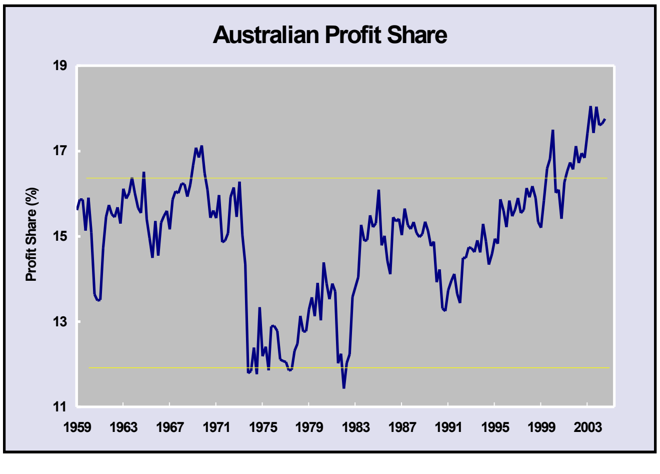
The most recently released data from the ABS show that corporate profitability among non-financial companies (using gross operating surplus) rose by 2.1% in the March quarter to be 8.3% higher than in the corresponding quarter of 2004, a slightly slower growth rate than the 10% long term average.

"….the indicator is decidedly negative suggesting that the market is still good value…. profitability has been so strong that scope exists for further market appreciation…"

Record Levels

Economy-wide profitability has been hitting new records. That should not be a surprise in a growing economy. However, more significantly, corporate profitability remains at near record levels relative to the size of the economy. As the first chart shows, private non-financial corporate profits as a share of non-farm product were 17.8% in the March quarter after having risen as high as 18.1% in the current cycle. Prior to that and since 1960, the share had not moved much above 16½% and, then, only briefly.

Whenever the profit share had broken above this apparent ceiling, there were pressures on it to retreat. Particularly important as a constraint on it going higher were labour costs. When trade unions were stronger, they would be tempted by high profits to push for higher wages.



Being relatively prosperous, business was more likely to succumb to wage demands near the top of the cycle. In a high inflation environment, managers could paper over some of the financial consequences by pushing for higher prices to compensate.

Policy also had an effect. High profits were often associated with cyclically high

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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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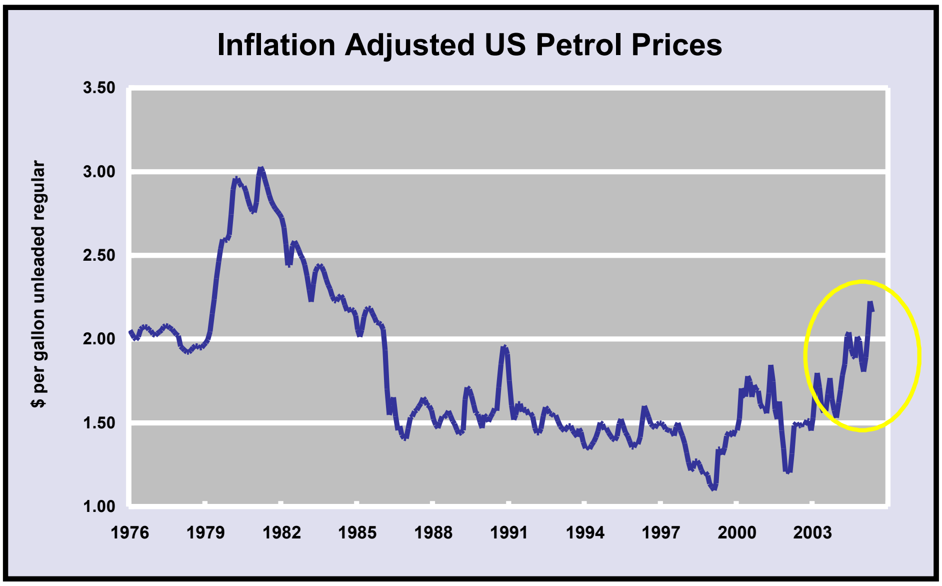
The most recent data on retail petrol prices in the USA show that they were 10.3% higher than they had been a year earlier. However, over a longer period of time and relative to other prices, the increase does not appear so dramatic. Inflation adjusted prices of unleaded regular petrol were still 29% below the high point reached in March 1981.

The Weekly Chart Spot



Source: US Bureau of Labor Statistics

Outstanding Growth: Why It Cannot Last

Outstanding growth cannot last forever. Markets often overlook this seemingly obvious warning but not indefinitely. Flight Centre is another topical example.

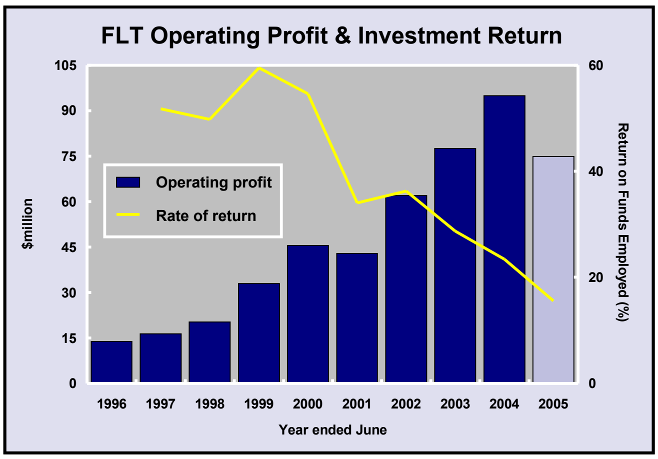
During the past two years, the share price of listed airline ticket retailer Flight Centre has fallen by 50% after rising by a factor of 15 during the 1990s.

The specifics of Flight Centre (and whether it should be bought or sold now) are less important than the bigger picture of a company unable to sustain the super-normal growth rates which it had convinced the market it could deliver.

There are at least five reasons why super-normal growth is hard to sustain.

- As a company gets bigger, high rates of growth simply become mathematically more difficult to achieve.
- A company depends on its immediate business environment for its customers. Their level of demand will ultimately determine its growth.
- Since some of the growth from high flyers ultimately comes from acquisitions of other companies, the dwindling number of potential targets and remaining former competitors upon which acquired growth depends inevitably declines.
- As the company gets bigger, acquisitions have to be proportionally larger or more frequent to be as meaningful, creating added execution risk for managers.
- Size and success sometimes also attract copy-cats eventually taking the edge from early-mover status.

Flight Centre is suffering most of these tendencies. As with other companies, there will also be more specific circumstances. In this case, the travel market has been afflicted by high oil prices and there are continual reminders of the dangers of international travel.



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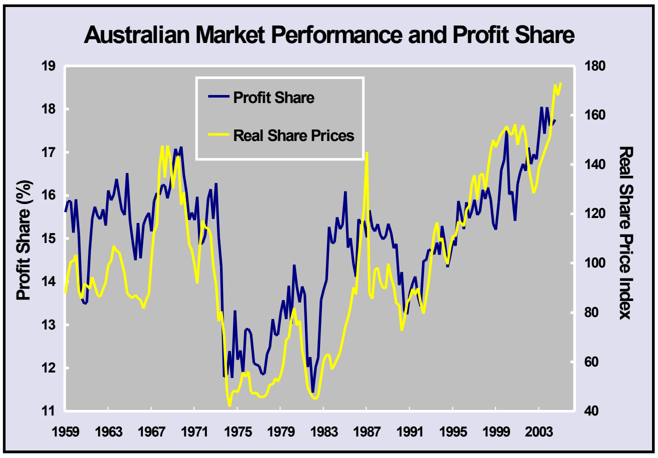
inflation. Monetary policy reacted and, although not targeted directly, profits were inevitably depressed as a result.



The reverse set of conditions put a floor below the profit share. A low profit share steeled business managers to resist demands for higher wages. Often, too, government policy encouraged business investment or employment when they were weak.

Easing Momentum

While the level of profitability is historically high, the momentum does not look so good.

The second chart overlays a measure of market performance – the inflation adjusted value of the ASX All Ordinaries index – on the profit share. It offers the clearest indicator of the importance of profit momentum as a driver of market prices. A rising (or falling) profit share has usually been associated with a rising (or falling) market.

History suggests that the profit share is unlikely to push higher from where it was in the last quarter and, therefore, the market is unlikely to receive the necessary boost to drive it higher.

However, the same inference would have been drawn in mid-2000 when the profit share had just broken through the upper end of its historical range. Since then, the market has appreciated by 30%.

The Changes Continue

Changes in underlying business performance have surpassed what was previously thought possible. The economic power balance between employees and their employers has tilted in favour of the latter. Business assumed an increasingly strong bargaining position vis-à-vis labour (and other input suppliers) at a critical time. A more competitive economic environment was forcing managers to contemplate new ways of doing business so they used their enhanced economic clout to build profits.

A relatively benign economic environment has also facilitated profit growth. The current economic expansion in Australia has lasted over a decade without any dramatic change in policy to disrupt business conditions. In earlier years, a policy change to curb growth, prompted by concerns about rising inflation, would have typically created excess capacity, denting profitability and leaving business to rebuild, sometimes over several years, to restore its previous position.

Despite the extensive changes already in place, there are more pressures in the same direction.

The Australian government, backed by a new Senate majority, is being encouraged by business figures to alter labour laws to give employers more flexibility in their employment decisions. The Prime Minister has put this near the top of the government's agenda.

Macroeconomic Support

Even an optimistic view of the world econ-

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"While the level of profitability is historically high, the momentum does not look so good."

OUTSTANDING GROWTH: WHY IT CANNOT LAST CONT'D

(Continued from page 2)

The combination of these influences tends to bring growth back to the norm eventually.

Sustaining the rate of return for a high-growth company is also a challenge. As ***thebigpicture*** has pointed out before, relatively high rates of return underpin any premium in the share price for superior performance.

Slowing growth and a declining return - the Flight Centre predicament - is akin to removing two legs from an equity market tripod.■

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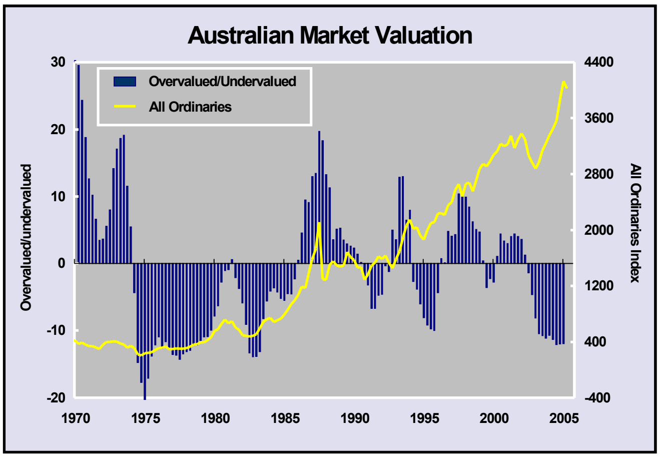
omy suggests that the growth momentum will be less strong in 2005 and 2006 than it was in 2004.

Domestically, private consumption spending – just over 60% of the economy - is slowing. So is spending on housing and the fiscal balance means less growth coming from the government, too. Business investment spending is taking up some of the slack. So, too, are exports now that the impact of higher commodity prices is being felt more fully.



Nonetheless, profit growth is slowing somewhat simply because the underlying pace of economic growth is weakening.

There are some more ominous storm clouds including the impact of high oil prices on rates of activity. Nonetheless, there seems little chance in the foreseeable future of officials moving aggressively to tighten monetary policy. Indeed, there is some evidence that the economy might already be near the top of the interest rate cycle.

Model Results

thebigpicture macro profit model attempts to pull some of these factors together to help judge the balance of forces on stock market valuations.

The model creates a valuation index from:

- existing profit levels;
- prospective growth rates; and,
- expected rates of return based on bond yields averages.

Implicit in the model is an assumption that economy-wide profitability parallels stock market profitability in a reasonably regular relationship.

The model's results are depicted in the third chart in an overbought/oversold form. Bars with a positive value suggest that the market is overvalued with a high probability of it subsequently falling. Bars with a negative value suggest the market is undervalued. The investment decision rule which goes with the model says 'buy' when the indicator is negative and 'sell' when the indicator is positive.

Currently, the indicator is decidedly negative suggesting that the market is still good value. This might come as a surprise with the market having appreciated so strongly in recent months. However, profitability has been so strong that scope exists for further market appreciation based on the accumulated performance.

Put another way, market prices are assuming either a historically pessimistic growth outcome of the sort which often comes with a dramatic external shock or a reversion to interest rates much closer to those which prevailed in the 1980s.

In Summary....

Economy-wide measures of profitability continue to suggest an essentially positive investment environment.

- Some of the boundaries of economic behaviour are already being pushed to their historical limits but a full-blooded reversal appears unlikely.
- Signs of an overbought market which have historically signalled a turning point are not evident.
- There is scope for market upside, based on the profit performance to date, despite the appreciation which has already occurred.

"Changes in underlying business performance have surpassed what was previously thought possible."