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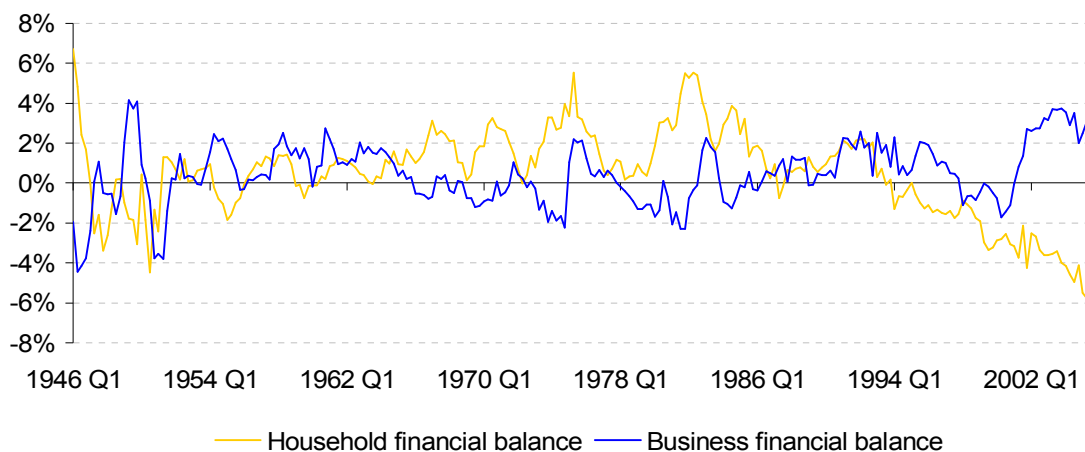
Bumper bucks for business – for now

WE SUGGEST: Rising profits, dividends, spell good news for shares, spending

SUMMARY: Corporate profits and dividends paid improved in Q2 (although profits data is tentative at best until we get this year's options exercise data next spring). This is good news, both for shares and for the outlook for household spending, but only in the shorter term – the next few quarters or so. Beyond that horizon, the continued widening domestic imbalances in the US economy are clearly unsustainable.

The second (provisional) release of US Q2 GDP growth was all but unchanged from the first (advance). Growth was revised down from 3.4% to 3.3% – an adjustment of \$3.4bn., which in an eleven trillion economy must be practically a rounding error. While the breakdown shows bigger changes (e.g. personal consumption, which grew by 3% instead of 3.3%, mainly concentrated in weaker durable goods numbers; somewhat worse net export performance; and so on), the main picture is one of an economy continuing to grow at or slightly above its trend rate, estimated by *LSR* at 3-3/4%.

Business and household sector financial balance, % of GDP



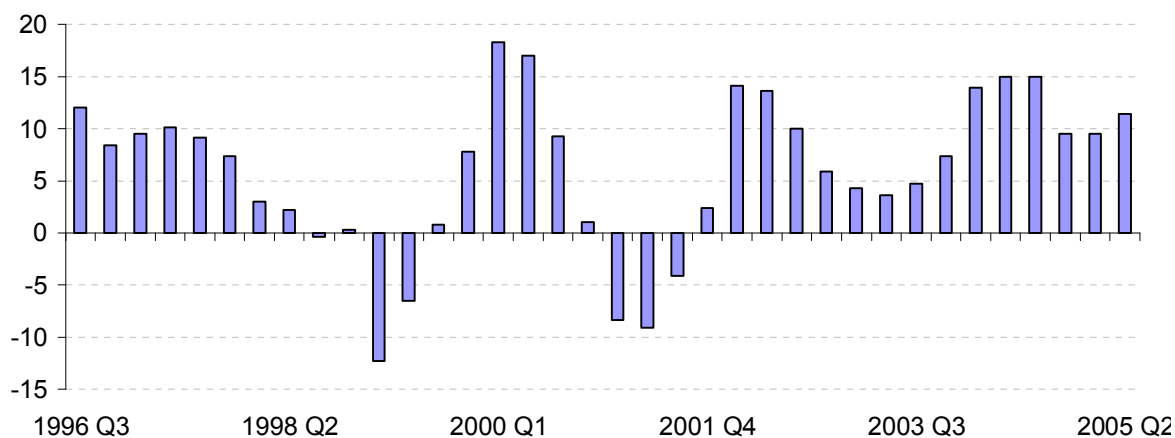
Other data, however, is much more interesting. Corporate profits grew faster in the quarter, as did dividends. Regarding the profits figure, this must in some sense be seen as tentative. As was shown earlier this year, we are now in the period ten years after the granting of options in the late 1990s stock market bubble. Since options tend to be held as long as possible, and this tends to be ten years, we are now likely to find household income revised every spring to take account of options exercises reported to the IRS over the winter. That

will also cause corporate profits to be revised down. But, for the moment, corporate profits are looking just fine.

Put another way, companies continued to maintain the substantial financial surplus relative to GDP that they built up following the bursting of the bubble in early 2000. Although the Microsoft dividend in Q4 2004 put a dent in this series, it is clear that companies are aiming for a balance sheet structure that puts their combined surplus around 3½-4% of GDP. However, as the chart shows, this is unusually high by historical standards. The long-term average corporate balance is a much smaller surplus of around 0.4% of GDP. As the public and – eventually – household sectors aim to narrow their financial deficits, this implies that there is scope for the corporate sector surplus to narrow as well. But that will be resisted, as it will entail weaker profits numbers when it happens. But for the time being, US corporate profits look very healthy. In the short term – over the next two or three quarters – that should be good news for equities.

The continued advance in dividends is also good news. The 1990s bubble did not distinguish itself by providing large dividends to those who bought into it. All too often, companies instead asked for ‘reverse dividends’ – extra capital injections. From Q3 1996 (arguably the beginning of the ‘irrational exuberance’ that Mr Greenspan attacked in December of that year) to Q1 2000, the quarterly change in dividends averaged \$4.6bn. By contrast, over the past six quarters, the average has been \$12.4bn. – and that excludes the Microsoft dividend in Q4 2004. Although this year’s dividend increase is somewhat smaller than last year’s, it too spells good news, in this case for continued household spending in the second half of the year.

US corporate dividends, quarterly change, \$bn.



With all this good news, however, there is still a dark lining. Good though the data is, it is overshadowed by the continued deterioration in the household sector’s financial balance. Over the past sixty years, the household sector has averaged a surplus of savings over investment of 0.5% of GDP. However, since 1992 (see the chart on the previous page), this has been steadily eroded and is now down to a deficit of -5.8% of GDP. This is clearly unsustainable over the longer term. It has worked because first share prices and now house prices have maintained a steady upward trajectory. But if – when – house prices no longer

rise, households, particularly in an ageing economy, can not afford not to save any more. And when they do start to save, that will bring the US economy to a spluttering halt.

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