

Columbia's Bruce Greenwald: Are Corporate Profits Sustainable?

Michael Ricciardi, Mercury Capital Advisors:

Hi, Bruce.

Bruce Greenwald, Columbia University:

Rico, it's always great to be here with you.

Ricciardi: So Bruce and I have known each other for something anywhere to 36 years. Bruce was my professor at Harvard Business School and I am delighted to be chatting with him today. Bruce Greenwald is the Professor of Economics and Finance at Columbia University, the Robert Heilbrunn Professor of Economics and Finance.

Bruce has also been recognized across all of Wall Street as the guru to the gurus. And so we are delighted that he is here with us today. So Bruce, a couple of questions.

So Bruce, the mortgage has been on quite a tear since 2008, if you will, after the big downturn.

Greenwald: March 2009.

Ricciardi: Yeah, okay, 2009. So Carl Icahn has said that what's going on right now is in effect a replication of what took place in 2007, 2008. And in fact, the market is about to go off a cliff and that people are going to find themselves in dramatically worse shape, going forward, than they did at that point in time and I'm wondering if you have a view about that.

Greenwald: Okay, so let's talk about that in detail. The first thing is that the valuations are actually not as rich as they were in 2007.

Ricciardi: That's based on PE?

Greenwald: Yeah. The second thing is that the craziness where nobody thought there was any risk so that for example, in 2007, you could by credit default swaps on Dubai sovereign debt, the riskiest region in the world, dependent on the most unstable commodity in the world, which is oil for four basis points, which is once in 2,500

years, they're going to go completely under. So that craziness is not in the market.

The real issue is the earnings power of these companies so that, if you look at people like Jeremy Grantham, who has been now for nine years, doing the Carl Icahn story. Their view is that these earnings levels are not sustainable. And what you've seen is that is a share of total US income, corporate profits, which pre-1990 were about 8.5% are now around 13.5% to 14%. So there's been this huge increase in profits.

If that increase in profits is sustainable and it's likely to continue then we may have a flat market for a while. We may not have the kind of increase in prices that we've had, but we're probably not going to see the kind of crash we saw in 2008, 2009.

Now, I think that profits are going to stay where they are and I think that's the important thing to understand and then I'll talk about what the downside is that people are going to have to get used to.

Ricciardi: So, to the extent that profits do stay where they are, is your expectation then that the market will stay in a range?

Greenwald: I think that's right. I mean I think it's pretty fully valued at these profit levels. There are not screaming bargains out there. Things fluctuate and I think, for various reasons, interest rates are going to have to go up and that's going to make the comparison to fixed income a much tougher comparison. So it's not going to be so easy to buy equities on margin and levered equities and do really well.

But let's talk about what's really going on with profits. We are in the middle of a transition that's comparable to what happened in the depression. In the depression, what happened is agriculture died. So, you know, the third of the US population that was on the farms had their income fall 80%. That what happened then in the depression is all the countries with big agricultural sectors tried to save those sectors by exporting.

You had the kind of imbalances that you have now where everybody tried to export. Nobody wanted to import. And the problem was that, when you add it up over all countries, the surpluses and the deficits have to be zero. So it was a very long-term problem until the adjustment got made in the course of the second world war and they got everybody off the farms. What's

happening today is manufacturing is dying and everything is going to services.

Ricciardi: US manufacturing?

Greenwald: Global manufacturing. That's why the Chinese are going down the tubes. And that's why the Japanese have gone down the tubes. I don't know if you remember, but when you got out of business school, the Japanese were all the rage. Everybody was studying the Japanese.

Ricciardi: One square foot of property in Tokyo cost, you know, a million dollars.

Greenwald: A million dollars. Everybody was going to be dressed up as Mickey Mouse, entertaining Japanese kids at Disneyland. It didn't happen. It's because they concentrated in this sector, which is manufacturing, which is just going away and it's going away for the same reason that agriculture went away, which is productivity growth is 5% to 7% and demand growth is like 2% to 3%. And so employment is going away, value added is going away and you see that going on.

What that means is that everybody is trying to save those sectors. Everybody is trying to export. You have these huge imbalances where the Germans, who can control the appreciation of the Mark, now that they're part of the Euro where the Japanese, who control their currency or the Chinese who control their currency, where they all basically maintain their currencies to maintain exports are exerting extraordinary deflationary pressure on the world. That's the bad news and that's not going away.

On the other hand, there is a good news side to this. Everything is going to services now. Profits come from either fair returns on assets or barriers to entry, which is protected markets. What barriers to entry look like is guys dominating markets and keeping everybody else out, which is economies of scale of various sorts, whether it's network effects, whether it's just fixed cost or whatever, coupled with enough customer captivity so the guys, who want to enter, can't come in and steal their market share.

Big global markets, which are the manufacturing markets, which are the commodity markets are very difficult to dominate. The markets that you can dominate are local markets, either in the product space so that, if you look at the people in the personal computer industry, who have made all the money, it's not the IBMs

and the Apples who originally dominated it. It's the Microsofts and [genome] operating systems, it's the Intels, the [danome] CPU chips, it's Oracle, it's Google and so on. Or in geography, which is how Walmart made all that money. They dominated geographies. They kept other people out and they made a ton of money.

As you move to services, you move to local markets. And local markets, by their nature, are dominatable.

The other thing about these service markets is they're incredibly stable. It's not like you have a replacement cycle the way you always had with capital goods where you have these huge price wings the way you have with commodities. So you've got very stable and safe sources of income increasingly that are not dependent on investing a lot. So actually, the thing that's going to keep your kids at home until they're 55 years old because they can't get jobs, which is this transition out of manufacturing...

Ricciardi: This was supposed to be the good news.

Greenwald: Is going to be really good for companies. So I think in those terms that you're not going to see some big reversion to the main historical profit levels. So and because of the stability, I think you're not going to see things, like the housing market or any markets that are overextended, again, as I say, you don't see those levels of no fear in the options markets that you saw in 2007.