Profit-loving markets may be in for a rude awakening

By Eric Reguly
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Like ravenous beasts, the stock markets need to be fed, or they retaliate by punishing investors. Last year, the markets gorged like pigs being fattened up for auction. Their sustenance was rising corporate profits, which in turn drove up share prices – the Standard & Poor's 500 was up almost 30 per cent per cent in 2013 after a 13 per cent return the year before.

Can that performance be repeated this year? Only if the profits bubble never bursts or you buy the typically fatal "this time it's different" argument.

There's a lot going right for the markets. Energy prices are falling, at least in North America. Jobs destruction has stopped, Europe is clawing its way out of recession and sovereign bond yields in the euro zone countries have plummeted. Inflation is tame and interest rates low. Central bankers have flooded banks with money. Governments have propped up industries, like the auto makers, that were on the verge of failing after the 2008 collapse of Lehman Bros. Some, like Chrysler Group LLC, have staged remarkable turnarounds and are pumping out rude profits.

Overall corporate profits, as a result, have climbed relentlessly, greatly outperforming the wider economy. The S&P 500's operating earnings per share grew 11 per cent last year, and are projected to grow another 12 per cent this year, while industry profit margins are at, or near, all-time highs. Corporate profits as a share of GDP have gone up; labour's share of the pie is smaller.

We all know that when any value – corporate profits, gross domestic product, fuel prices, bond yields, house prices, mobile phone bills – gets out of whack, natural forces, like human rage, kick in and bring them back to sane levels. The best cure for high prices is high prices; the best cure for low prices is low prices.

So what might bring corporate profits, and the stock markets that feed off them, back to levels that could be considered normal? The answer has to do with social justice as well as the inevitable loss of momentum.

Since the 2008 financial crunch and the deep recessions that followed (double dip recessions in some countries, like France and Britain), governments, central bankers and labour unions have put corporations on a very long leash. Taking the rather Catholic approach of forgiving the sinners, industrial companies and banks that behaved badly were bailed out. Antitrust laws suddenly became more flexible, unions pliable.

The do-gooders' motivation was employment, or lack thereof. With the jobless rate in many western countries climbing toward, or leaping above, 10 per cent, job preservation became policy goal No. 1 – hence the taxpayers' forced contributions to General Motors, Chrysler and other corporate heavyweights.

The largesse worked its magic and, when combined with heavy cost-cutting, corporate profits rose. Earnings per share rose even faster, thanks to the tsunami wave of cash devoted to share buybacks, which reduce the share count (from 2001 through 2012, the S&P 500 companies spent an astounding $3.5-trillion (U.S.) on buybacks and the pace was strong last year). As earnings grew, corporate cash piles became lavish. According to a recent study by Deloitte, about one-third of the world's biggest non-financial companies own the bulk of the $2.8-trillion global corporate cash pile. Apple alone is sitting on $150-billion.

Now suppose you are your average worker in the United States or Europe. You've taken a pay cut since the dark days of the crisis, or not seen your real pay rise at all, and some of your buddies have lost their jobs. Your university grad kid – age 25 – is colonizing your rec room with his equally unemployed girlfriend (in Italy, more than 45 per cent of 25-to-34 year-olds live with their parents). You're not happy. You get unhappier when you read about the soaring stock markets, rising earnings per share and the mountain of cash that seems to be used, when it is used, for buybacks, not investments in new products that would create jobs.

So you say: My turn – I'll take some of that.

Workers everywhere in the Western world are thinking the same thing, that it's time for the wealth conveyor belt to turn in their direction. Pressure from the wage slaves could come in many forms. They could lobby for higher wages and certainly higher minimum wages. Strikes might happen. They are bound to find allies in local and national governments, who would see a terrific vote-nabbing opportunity. Governments would urge them to dip into their cash piles to invest instead of hosing it out on buybacks. They might raise taxes, now that the corporate sector has recovered. Profits would come down.

The natural evolution of a recovering economy could easily accelerate any profits slowdown. Interest rates are likely to rise eventually, raising borrowing costs. New companies are launched as confidence rises, boosting competition and putting pressure on margins. Regulators swing back into action to keep the competitive market honest. The accumulated pressure could make the profits bubble go pop. Profits can't rise faster than GDP forever.