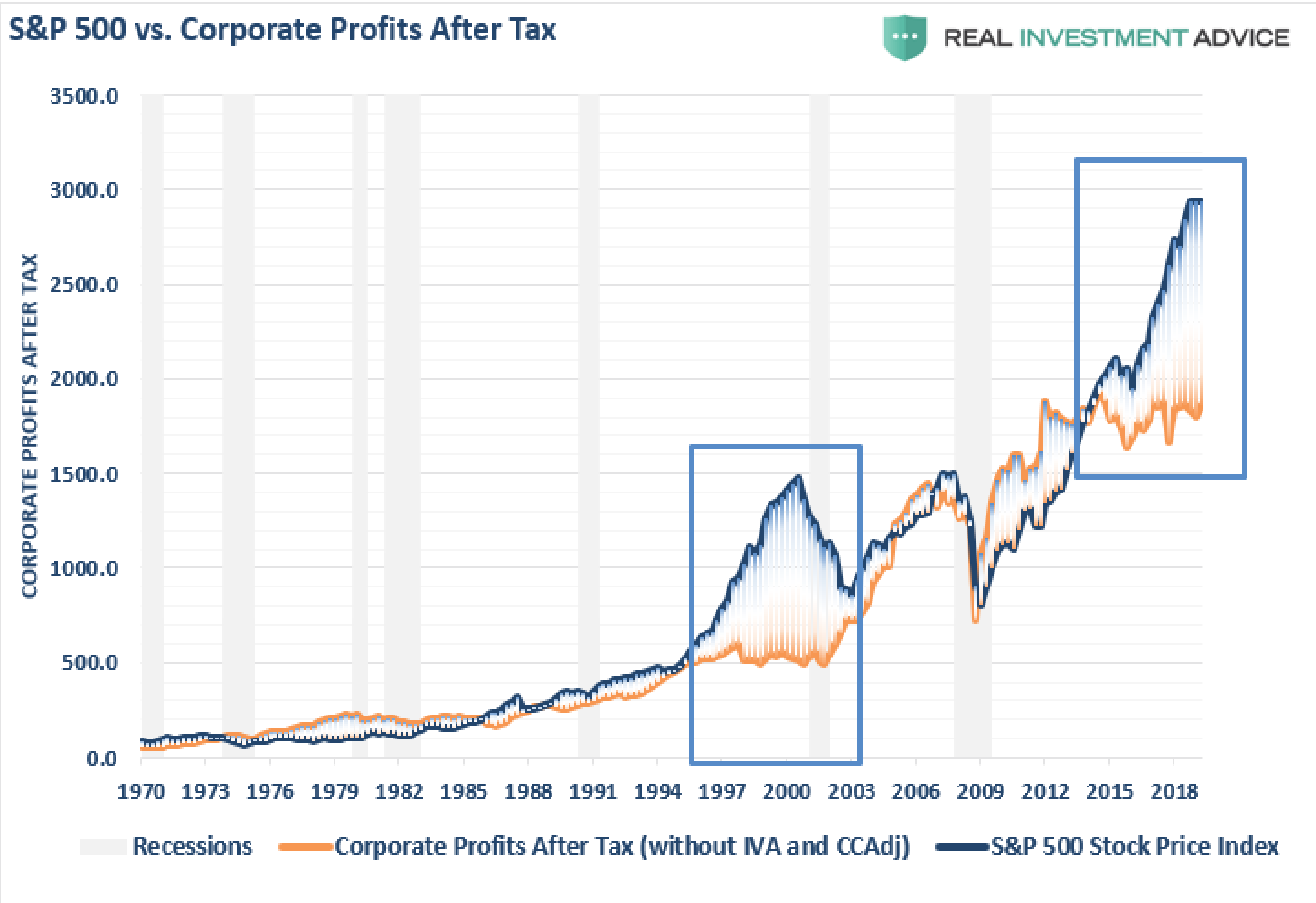
Corporate profits are worse than you think. In a recent post, I discussed the [deviation of the stock market from corporate profitability](). To wit:

> *"If the economy is slowing down, revenue and corporate profit growth will decline also.•However, it is this point which the 'bulls' should be paying attention to. Many are dismissing currently high valuations under the guise of 'low interest rates,' however, the one thing you should not dismiss, and cannot make an excuse for, is the massive deviation between the market and corporate profits after tax. The only other time in history the difference was this great was in 1999."*

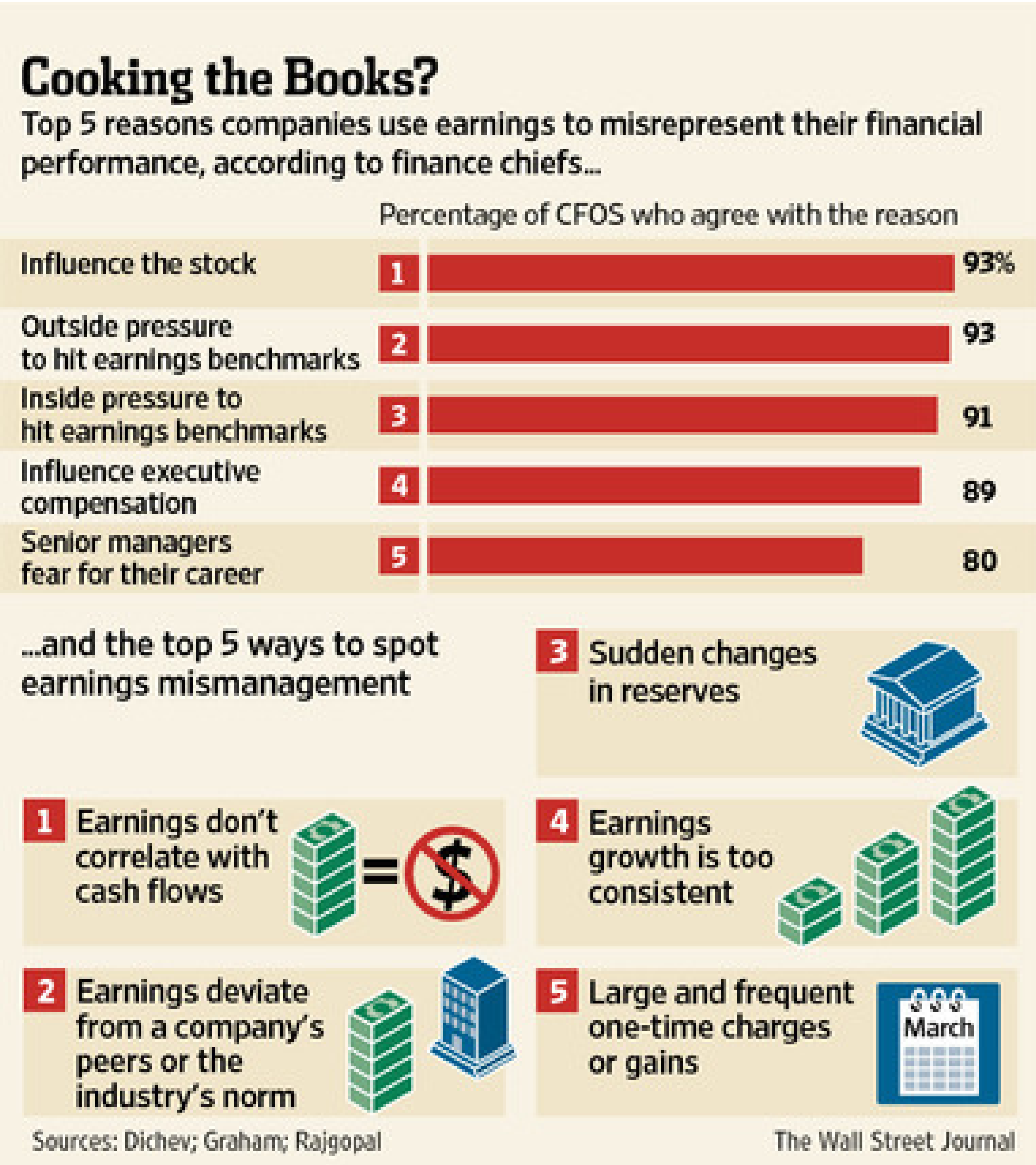


It isn't just the deviation of asset prices from corporate profitability which is skewed, but also reported earnings per share. As I have discussed previously, the operating and reported earnings per share are heavily manipulated by accounting gimmicks, share buybacks, and cost suppression. To wit:

> *"It should come as no surprise that companies manipulate bottom line earnings to win the quarterly 'beat the estimate'•game* ***By utilizing 'cookie-jar'•reserves, heavy use of accruals, and other accounting instruments they can mold earnings to expectations.*** *'The tricks are well-known: A difficult quarter can be made easier by releasing reserves set aside for a rainy day or recognizing revenues before sales are made, while a good quarter is often the time to hide a big ?restructuring charge? that*

would otherwise stand out like a sore thumb. ***What is more surprising though is CFOs? belief that these practices leave a significant mark on companies? reported profits and losses****. When asked about the magnitude of the earnings misrepresentation,* ***the study?s respondents said it was around 10% of earnings per share.'****?*

This is also why EBITDA has become an ineffective measure of financial strength. As I noted in ["What To Watch For This Earnings Season:"]()



> *?As shown in the table,•* ***it is not surprising to see that 93% of the respondents pointed to 'influence on stock price' and 'outside pressure' as the reason for manipulating earnings figures.•*** *For fundamental investors this manipulation of earnings skews valuation analysis particularly with respect to P/E?s, EV/EBITDA, PEG, etc.?*

[Ramy Elitzur, via The Account Art Of War](), expounded on the problems of using EBITDA.

> *?Being a CPA and having an MBA, in my arrogance I thought that I am well beyond such materials. I stood corrected, whatever I thought I knew about accounting was turned on its head.•One of the things that I thought•* ***that I knew well was the importance of income-based metrics such as EBITDA•*** *and that cash flow information is not as important.•* ***It turned out that common garden variety metrics, such as EBITDA, could be hazardous to your health.?***

The article is worth reading, and chocked full of good information; however, here are four-crucial points:

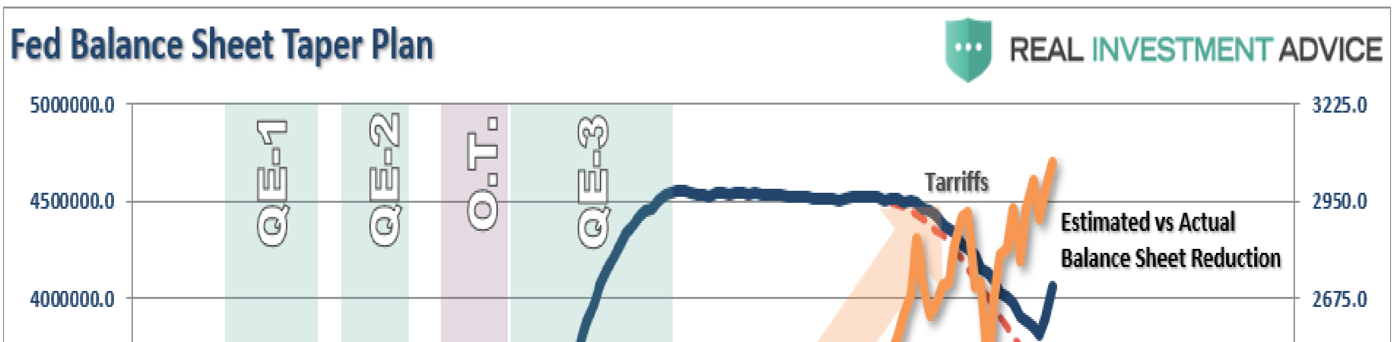
1. ***EBITDA is not a good surrogate for cash flow analysis because it assumes that all revenues are collected immediately and all expenses are paid immediately,•*** *leading, as I illustrated above, to a false sense of liquidity.*
2. *Superficial common garden-variety accounting ratios•* ***will fail to detect signs of liquidity problems.***
3. *Direct cash flow statements provide a much deeper insight than the indirect cash flow statements as to what happened in operating cash flows.•* ***Note that the vast majority (well over 90%) of public companies use the indirect forma****t.*
4. ***EBITDA just like net income is very sensitive to accounting manipulations.***

The last point is the most critical. As discussed above, the tricks to manipulate earnings are well-known which inflates the results to a significant degree making an investment appear•*?cheaper?*•than it actually is. As•[Charlie Munger]()•once said:

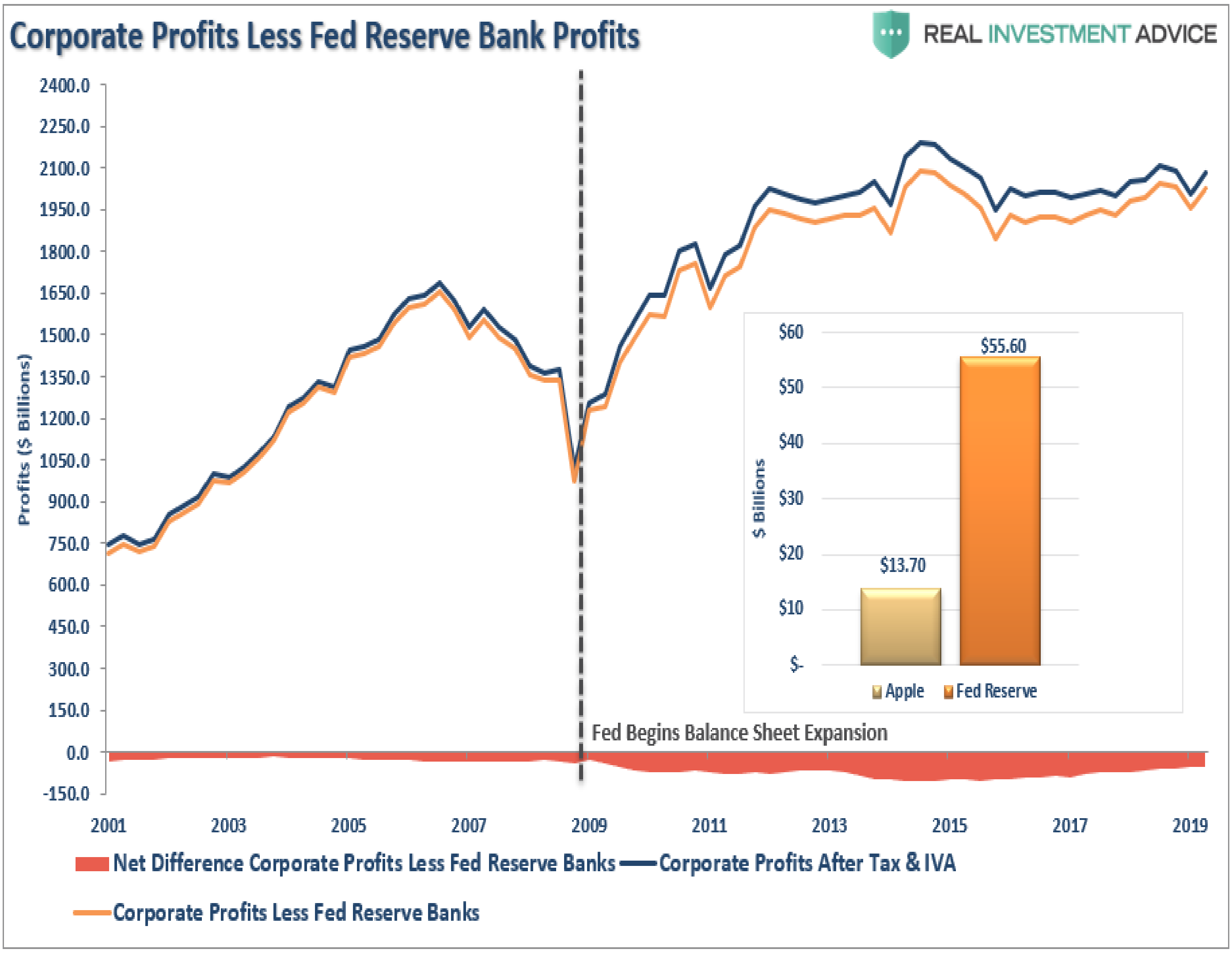
> *?I think that every time you see the word EBITDA, you should substitute the word 'bullshit' earnings.?*

What About Those Corporate Profits?

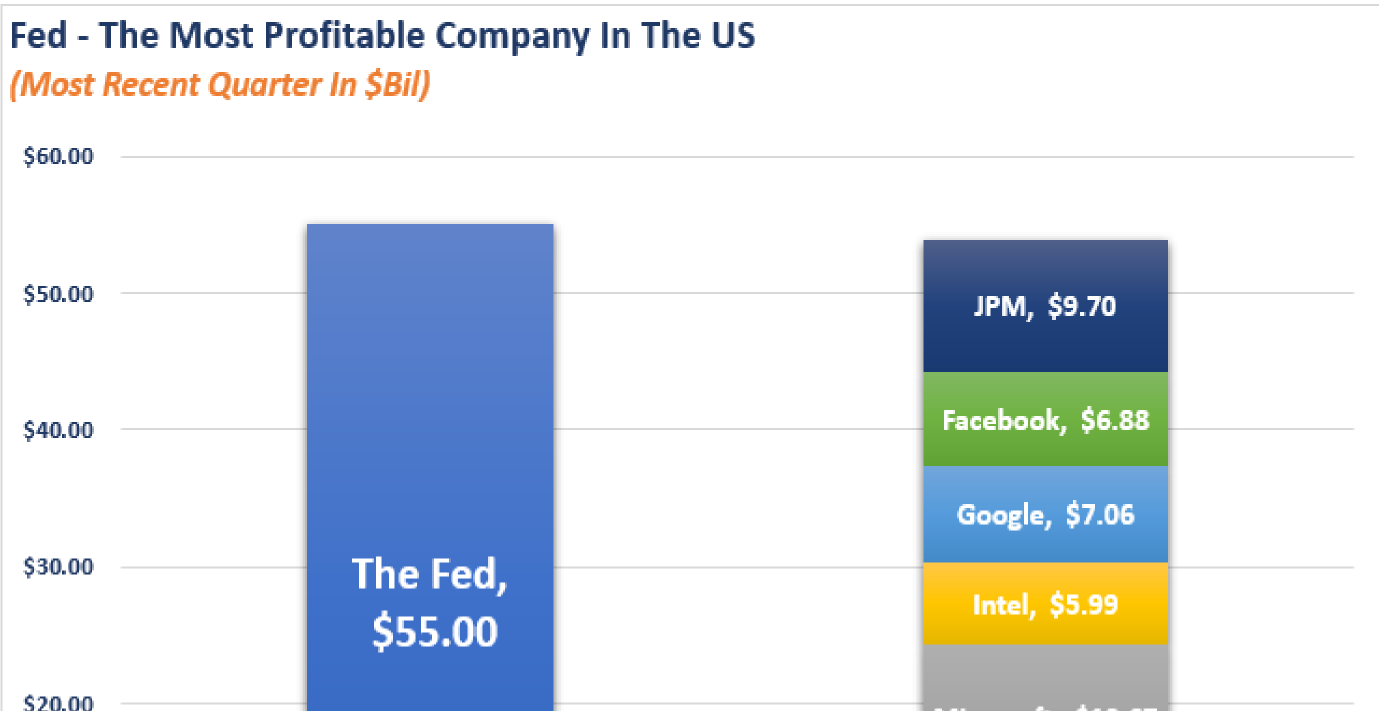
Currently, the deviation between reported earnings and corporate profits is one of the largest on record. This is an anomaly that should, in reality, not exist. However, it is worse than it appears. **There is an interesting company included in the calculation of corporate profits which is not widely recognized in most analysis.** If you are astute follower of our blog, you may recognize this particular company by the size of their balance sheet as shown below.



Yes, you guessed it *(and it's in the title)*. **It's the Federal Reserve.** When the Treasury Department pays interest one the debt, an expense to the U.S. Government, the Federal Reserve takes that in as *"profits"* which is reported on their balance sheet. Then, at the end of the year, the Fed remits a portion of the *"revenue"* back to the Government. **These *"profits,"* which are generated by the Federal Reserve?s balance sheet, are included** in the corporate profits discussed here. **As shown below, actual corporate profitability is weaker if you extract the Fed?s profits from the analysis.**



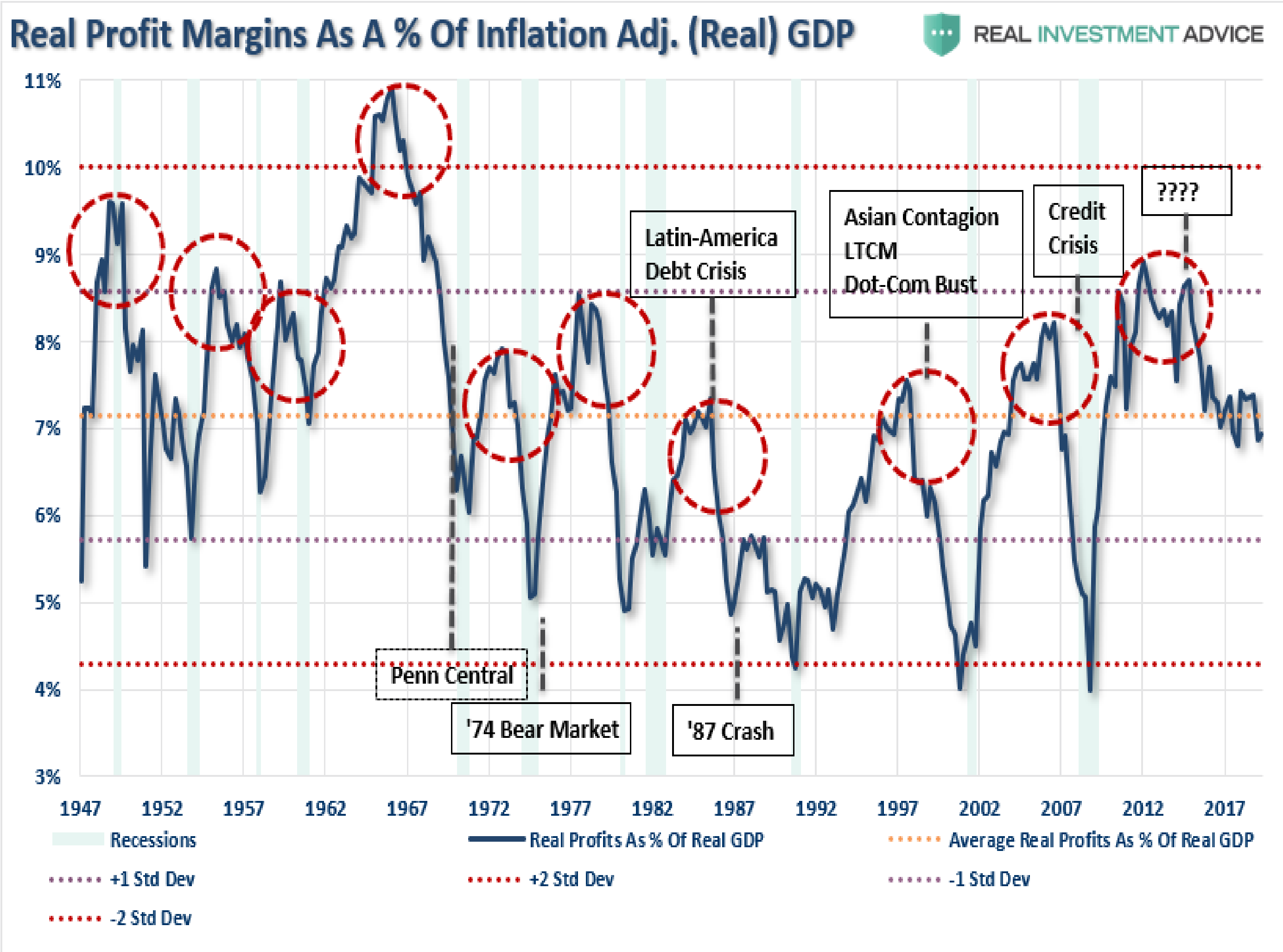
To put this into perspective, **the Federal Reserve generates more profit in the last quarter than Apple, Microsoft, JP Morgan, Facebook, Google, and Intel COMBINED.**



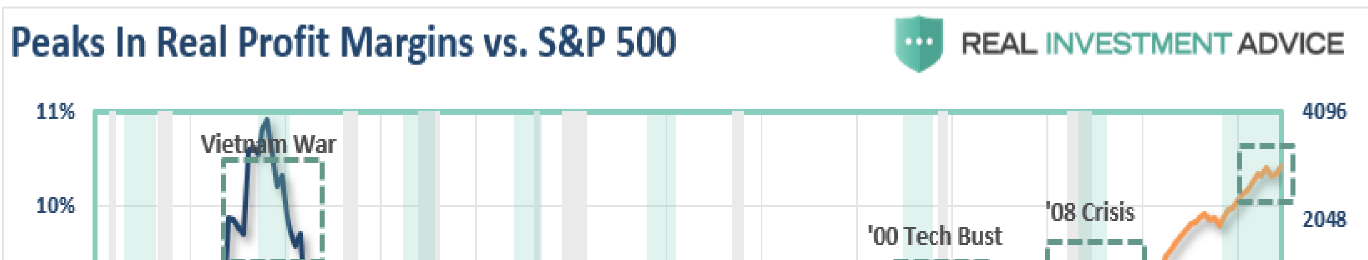
It's quite amazing. **Nonetheless, since the Fed's balance sheet is part of the corporate profit calculation, we must include them in our analysis.** While the media is focused on record operating profits, reported corporate profits are roughly at the same level as their were in 2011. Yet, the market has been making consistent new highs during that same period. **The detachment of the stock market from underlying profitability guarantees poor future outcomes for investors.** But, as has always been the case, the markets can certainly seem to ?*remain irrational longer than logic would predict,?* but it never lasts indefinitely.

> *?**Profit margins are probably the most mean-reverting series in finance, and if profit margins do not mean-revert, then something has gone badly wrong with capitalism.** If high profits do not attract competition, there is something wrong with the system, and it is not functioning properly.? - Jeremy Grantham*

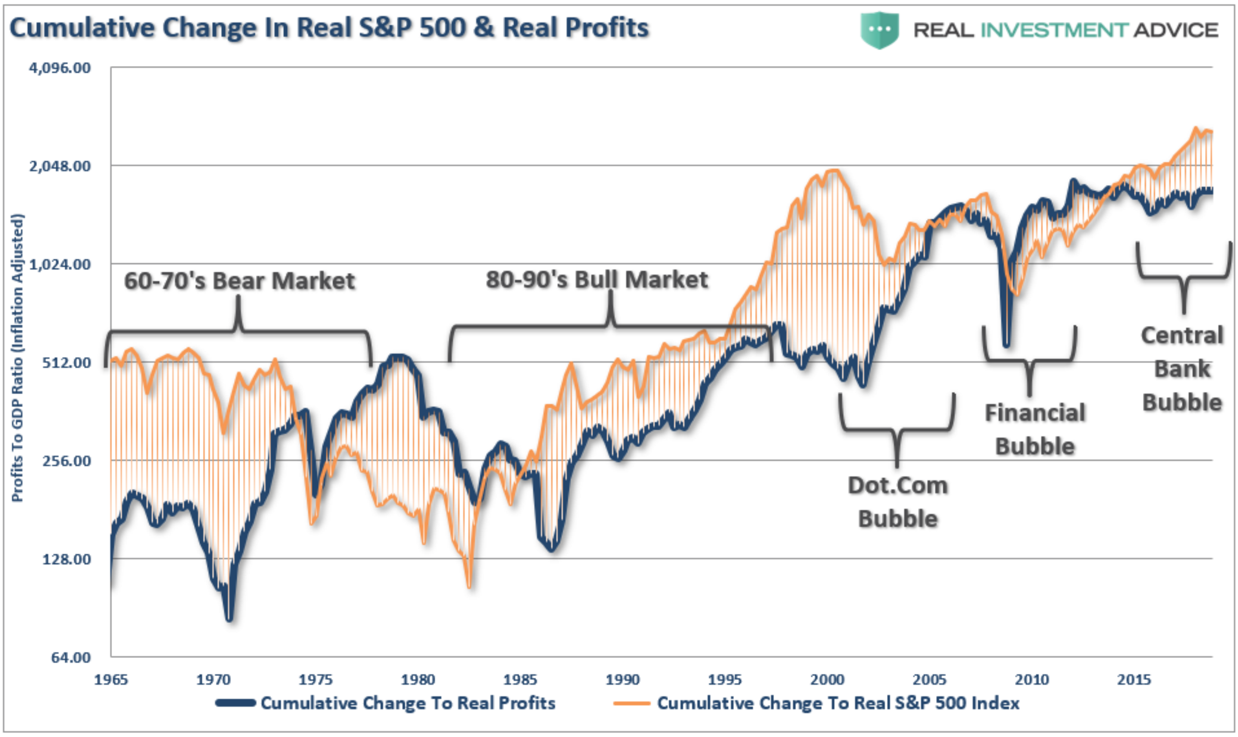
As shown, when we look at inflation-adjusted profit margins as a percentage of inflation-adjusted GDP we see a clear process of mean-reverting activity over time. **Of course, those mean reverting events are always coupled with recessions, crisis, or bear markets.**



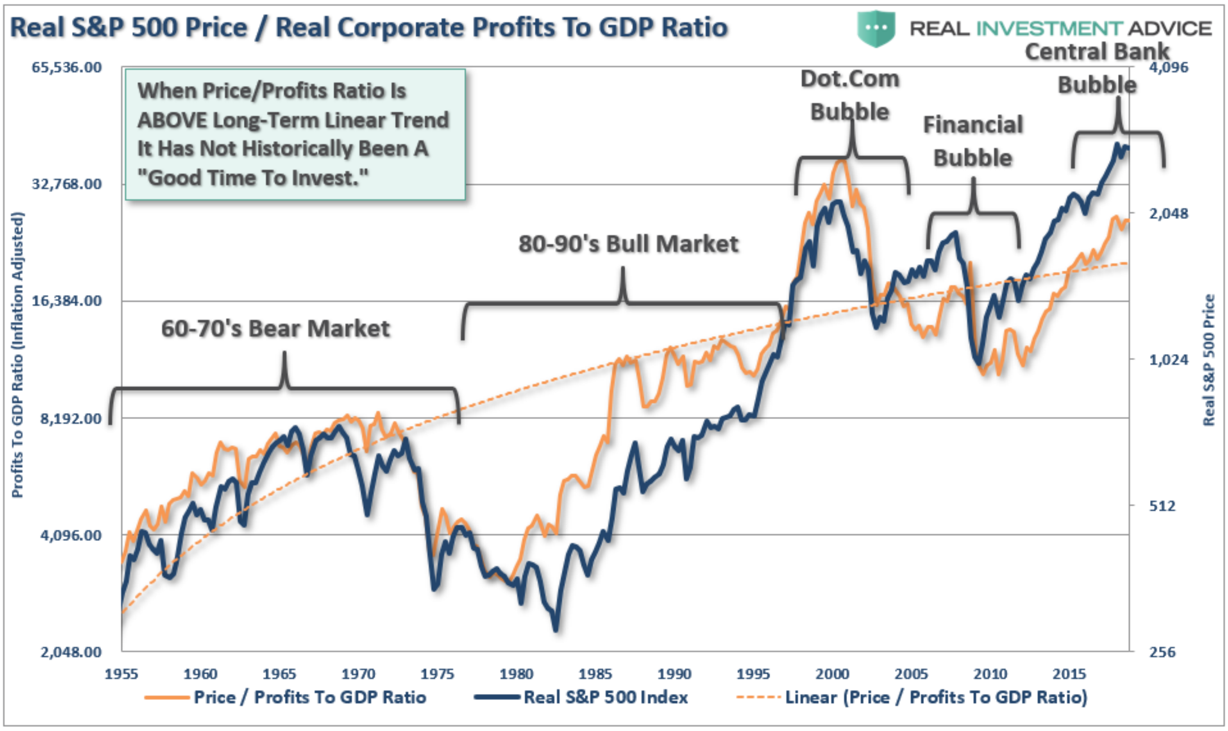
More importantly, corporate profit margins have physical constraints. Out of each dollar of revenue created there are costs such as infrastructure, R&D, wages, etc. **Currently, one of the biggest beneficiaries to expanding profit margins has been the suppression of employment, wage growth, and artificially suppressed interest rates which have significantly lowered borrowing costs. Should either of the issues change in the future, the impact to profit margins will likely be significant.** The chart below shows the ratio overlaid against the S&P 500 index.



I have highlighted peaks in the profits-to-GDP ratio with the green vertical bars. **As you can see, peaks, and subsequent reversions, in the ratio have been a leading indicator of more severe corrections• in the stock market• over time.** This should not be surprising as asset prices should eventually reflect the underlying reality of corporate profitability. It is often suggested that, as mentioned above, **low interest rates, accounting rule changes, and debt-funded buybacks• have changed the game**. While that statement is true, **it is worth noting that each of those supports are artificial and finite in nature.** Another way to look at the issue of profits as it relates to the market is shown below. When we measure the cumulative change in the S&P 500 index as compared to the level of profits, we find again that when investors pay more than $1 for a $1 worth of profits there is an eventual mean reversion.



The correlation is clearer when looking at the market versus the ratio of corporate profits to GDP.• *(Again, since corporate profits are ultimately a function of economic growth, the correlation is not unexpected.)*•



It seems to be a simple formula for investors that **as long as the Fed remains active in supporting asset prices, the deviation between fundamentals and fantasy doesn't matter.**•It is hard to argue that point. However, with investors paying more today than at any point in history for each $1 of profit, the next mean reversion will be a humbling event. But, that is just history repeating itself.