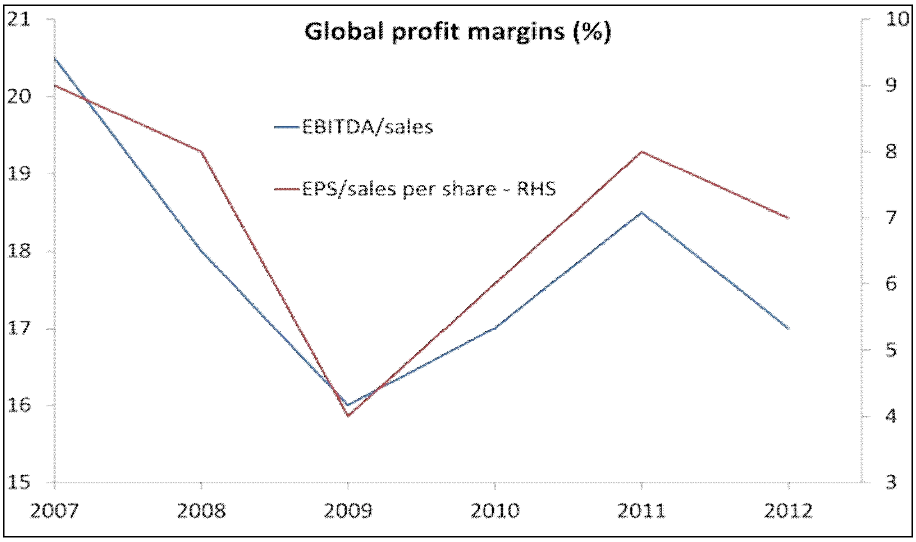
Deleveraging and profitability again

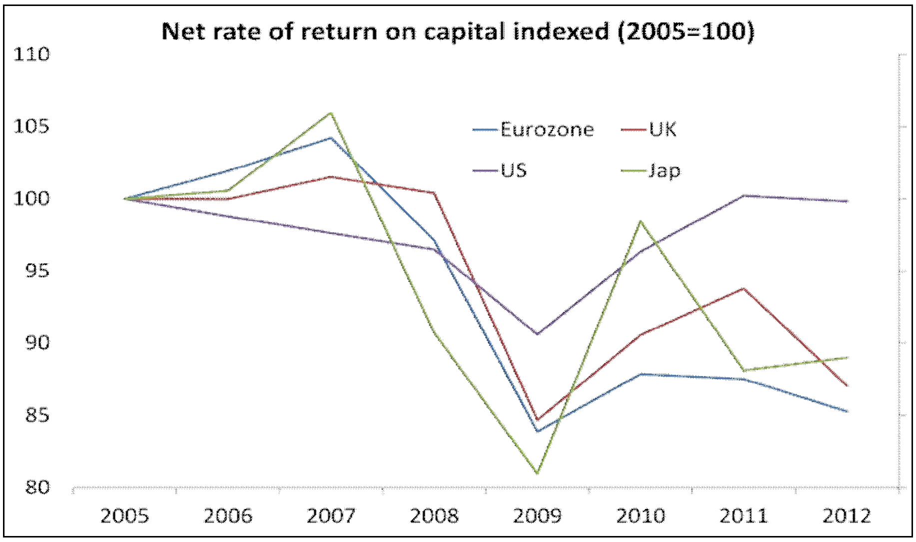
Michael Roberts, February 25, 2013

JP Morgan economists have recently made a study of global corporate profitability. They conclude that what they call 'profit margins' have fallen in Europe and in emerging economies over the past two years. They also conclude that US profitability has stagnated over the last six quarters, on their measure. JP Morgan's measure of profitability is not a Marxist one and it is not even a measure of corporate profits against corporate capital. Instead, JPM take corporate earnings as measured in the annual accounts of corporations in what is called the MSCI world index of stocks. Corporate earnings are measured before interest, tax and depreciation (EBITDA) and then earnings per share (EPS) are measured after deducting those items. These two measures of earnings are then divided by corporate sales (not the stock of capital invested, as in Marxist measures).

Even though the JPM measure is not a Marxist one, it does produce a global measure of corporate profitability that shows EPS to sales per share has fallen from near 9% before the Great Recession down to under 4% in the trough of 2009 before recovering to 8% in 2011. But in 2012, it has now declined again to 7%. And the EPS measure is now 13% below its peak in February 2008 when the Great Recession began. This decline in global profitability is driven by Europe and by a fall in emerging economies. For both regions, the EPS to sales ratio peaked in 2010/2011. In contrast, profit margins kept rising in the US in both 2010 and the first half of 2011. It was only in the second half of 2011 and in 2012 that US profit margins started flattening or slightly falling.



This confirms my own research on profitability since the Great Recession taken from EU AMECO and US data and indexed from 2005 (see graph below).



JPM's economists consider the reasons for the decline in profit margins. The EBITDA measure is currently at 17%, marginally above the lows seen during 2008/2009. This ratio peaked at 18.5% in 2011 and it is still well below the previous cycle peak of 20.5% seen in 2007. The EPS measure has done better and that's because this measure got a boost from lower corporate taxes and lower interest expenses during 2009, 2010 and 2011. But those gains seem to be over as interest rates have bottomed and corporate tax rates have too. And there is little sign that sales will pick up much to boost profitability further. JPM concludes, rightly, that this explains the weak rise in corporate investment and indeed a retrenchment through 2012 globally.

The EU Commission has also commented on corporate profitability and investment in Europe in its latest Winter Economic Forecast report – *see* Box1.2 on pp 18-21. It notes that non-residential investment (that excludes households buying houses) as a share of GDP *"stands at its lowest level since the mid-1990s".* And the main reason? *"A reduced level of profitability".* The report makes the key point that *"measures of corporate profits tend to be closely correlated with investment growth"* and only companies that don't need to borrow and are cash-rich can invest – and even they are reluctant. The EU Commission's measure of profitability is defined as the ratio of gross operating surplus in corporations to GDP. Again this is not a Marxist measure of profitability which relates profits to the stock of capital invested, but nevertheless the Commission finds that Europe's profitability *"has stayed below pre-crisis levels".* My graph above confirms that conclusion.

Interestingly, the Commission report suggests that investment and profitability are being held down because of the need for European corporations to deleverage excessive debt built up before the crisis. The Commission found a *"strong negative correlation between changes in investment since the onset of the crisis and pre-crisis debt accumulation, suggesting that the build-up of deleveraging pressures has been an important factor behind investment weakness".* The Commission reckons that Eurozone corporations must deleverage further by an amount equivalent to 12% of GDP and that such an adjustment spread over five years would reduce corporate investment by a cumulative 1.6% of GDP. Given that non-residential investment to GDP is at a low of 12% right now, that's a sizeable hit to investment growth.

As I argued in a previous post (*http://thenextrecession.wordpress.com/2013/02/10/why-is-there-a-long-depression/*), the current Long Depression is the product of two factors, the failure of profitability to recover to pre-crisis levels, let alone to the higher peak levels of the mid-1990s in the major economies; and the weight of excessive debt on investment and profit that must be reduced before profitability and investment can recover on a sustained basis. These two reports by JPM and the EU Commission support that view.

How much deleveraging is necessary? Well, I have recently looked at global liquidity as measured by the amount of bank loans, securitised debt and derivatives in the world. Global liquidity as a share of world GDP took off in the great credit bubble that began in the mid-1990s. After the credit crunch and the Great Recession, liquidating all that fictitious capital (as Marx called it) has been slowly under way. In my previous post (*op cit*), I cited various studies that suggest there is still some way to go. As the graph below shows, that is also the case, using a measure of global liquidity to GDP. This remains some 11% above the pre credit bubble trend line. At current rates, to get rid of the remaining fictitious capital will take at least until 2015 – and then it may only be achieved by a new global slump in production.