Workers of the World *Untied*: Has Capitalism Come Undone?*

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"In the long run the workman may be as necessary to his master as his master is to him; but the necessity is not so immediate."
Adam Smith, The Wealth of Nations (Book 1, Chapter 8)

IN RECENT YEARS, THE MOST CONSPICUOUS feature of the financial landscape has been the growing divergence between US labour and corporate profit trends. While household incomes have languished, corporate earnings have soared — despite the most difficult economic cycle in the post-war period. These trends are having a significant impact on current and future equity market index returns.

Bulls and bears may dispute the causes or disagree on forecasts, but everyone will gape at the numbers. From the fourth quarter of 2008 to the second quarter of 2011, real domestic corporate earnings have surged by almost 100% while real employee compensation has risen by a mere 3% (*see chart 1 below*).

Looking back further, a pattern has become well-entrenched — profit recoveries have become increasingly stronger, while labour market rebounds have become progressively weaker. Cumulatively since 1990, profits have risen more than 200% while employee compensation has risen just 20% (*in real terms*).

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Profit margins have also seen a veritable levitation in the last few years, even while the official unemployment rate remains stubbornly over 9%. The latest figures show that profits now account for 12.9% of national income — the highest proportion ever recorded (*see chart 2 on page 6*). (*The previous peak occurred in 1942 when wartime factors created a huge demand for materials, while wage and price controls were imposed by governments*).

What gives? Until recent episodes of isolated social upheaval, none of the above has generated instability, much less violence. Instead, they have produced a huge, yawning complacency. Looking ahead, even while income growth is forecast to remain sluggish, the consensus view is that more of the same lies in the future. Analysts are predicting record earnings next year (*as we write, 2012 forecasts for S&P 500 bottom-up operating profits currently stand at $112.35 per share, well surpassing the pre-crisis record of $91.47*).

Left Behind — Orphans of Prosperity.

On the surface, the above trends indicate that capital owners have had an extraordinary advantage over workers. The late Karl Marx foresaw this potential problem. (*Not surprisingly, his "workers of the world unite" ideas are witness-*

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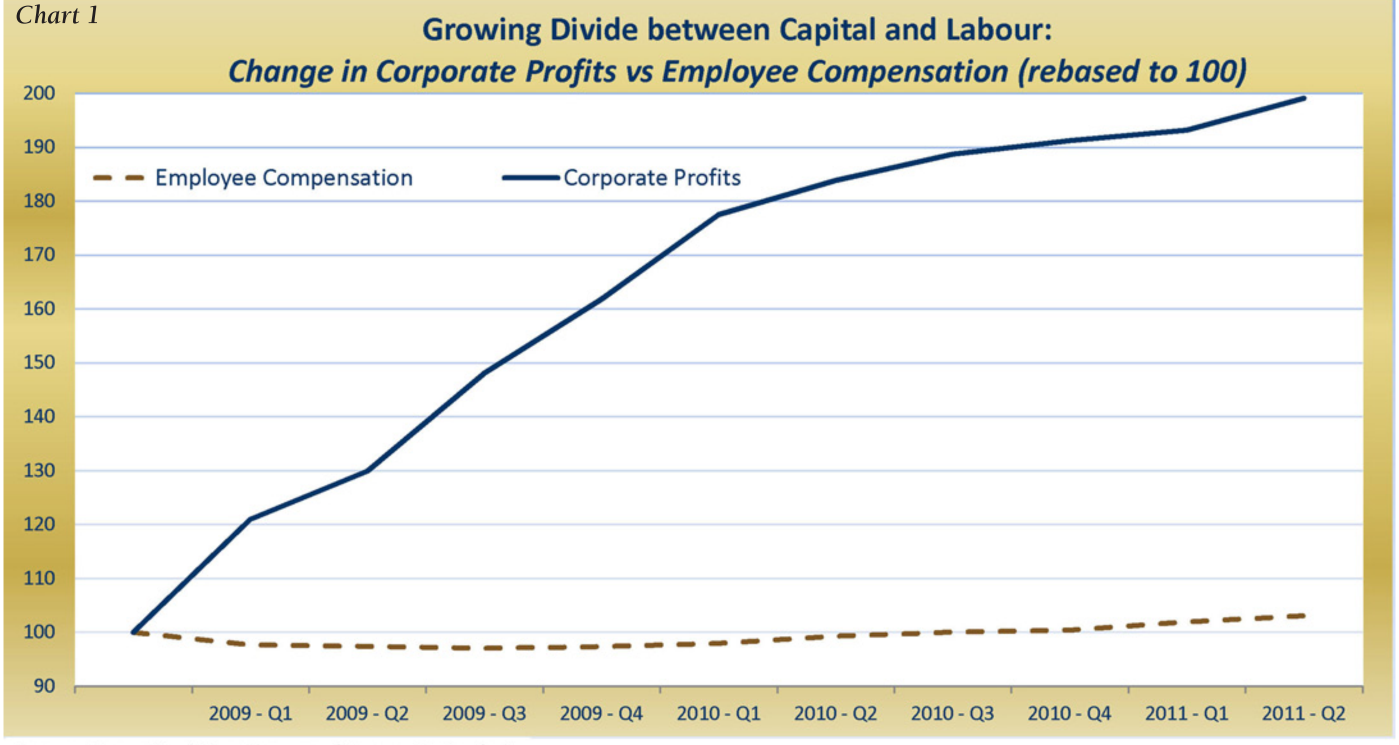
Chart 1



Source: Haver Analytics, Bureau of Economic Analysis.

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ing a popular revival). He argued that an inherently exploitive dynamic exists within the capitalist system, as employers attempt to hire workers for less than their value add, pocketing the difference in "profit". Of course, his interpretation is blasphemous for die-hard capitalists and has generally been rejected. Such profit is due reward for "risk taking" and "enterprise" (*according to Marx, mere euphemisms for theft*).

Admittedly, political economy is not normally the target domain of portfolio managers such as this author. We pledge no allegiance to any long-dead philosophers or other academic scribblers. Rather, our goal is the pragmatic stewardship of client capital ... focusing on the world as it is, not as it should be. Yet, trends in returns on capital versus returns on labour— the central battleground of many of these ideological debates — are inextricably linked with sustainable wealth creation. Even passive indexers and ETF enthusiasts must rely on a minimum level of balanced economic growth, and indeed a functioning capitalistic system, to tap into the other well-known benefits of indexing.

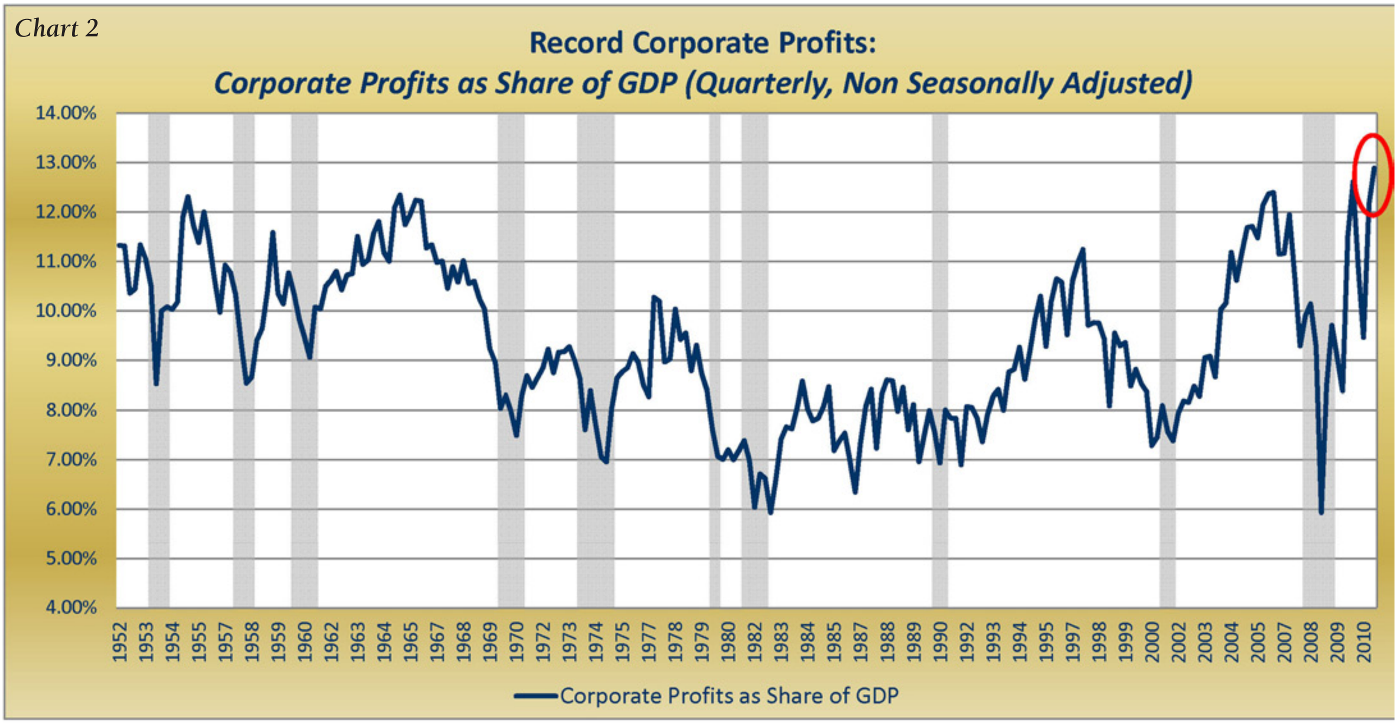
For investors and political economists alike, these developments need to be examined and understood. Can these trends continue? Or, is the capitalistic model broken? After all, classical economic theory — indeed, the very underpinnings of capitalism itself — asserts that higher profits and productivity should translate into higher wages. During boom times, margins should eventually be under pressure as workers gain bargaining power and competition drives up other cost inputs. And, as Henry Ford learned almost 100 years ago, the health of the corporate sector is ultimately tied to the health of its customer. Therefore, the combination of rising profits and stagnant income growth (*and thus weak aggregate demand*) cannot possibly last forever.

Or can it? In a globalized era, a new investment class has emerged —the multinational corporation. Rising out of a more interconnected world, these companies transcend the restrictions of individual nation states, roving the globe for arbitrage and profit opportunities. They can seamlessly shift production from country to country, accessing better tax regimes and, importantly, cheaper labour. The same advantages are now also available to global portfolio managers, as client capital can be invested in profitable economies or enterprises anywhere around the world.

A Crisis of Capitalism?

To be sure, predicting the demise of capitalism is nothing new. *Time* magazine's April 1980 cover story, entitled "Is Capitalism Working?", bemoaned the decline of free enterprise and the "vitality and élan" of capitalists. That article printed immediately before profit margins made a secular trough and a generational stock market upswing began.

Chart 2



Source: Haver Analytics, Federal Reserve "Flow of Funds".

"Capitalism, in its pure form, hardly exists today. If it did, governments would also allow market discipline to work on the downside."

Also, on one point, let's be clear. Capitalism, in its pure form, hardly exists today. If it did, governments would also allow market discipline to work on the downside. Clearly, that has not been the observable case recently. Witness banking bailouts, sovereign bond guarantees and numerous other government interventions. Clearly, the "socialization of losses" and "privatization of gains" is today's status quo.

Still, looking beyond this asymmetric form of capitalism, perhaps the largest threat to the long-term health of the domestic economy remains the disparity between labour and capital trends. To understand forward risks, a look back at historical trends in profit margins is instructive.

Beyond cyclical influences, secular forces were also at work. Two major margin troughs have occurred since the 1930s. The first occurred immediately after the Great Depression, where the combination of WWII military spending and the 1950s reconstruction boom restored profit margins from the difficult 1930s. For the next two decades, however, the environment was less hospitable, as rapid unionization and high inflation initiated a structural decline in margins to the end of the 1960s.

The second significant trough happened in the early 1980s. Then, so-called "Reaganomics" — supply-side reforms aimed at reducing both government regulation and marginal income taxes — swept across Western economies. This also led to the systematic dismantlement of unions, increasing labour mobility and competition. Meanwhile, free market capitalism was taking hold in developing parts of the world, creating a boom in international trade, cross-border capital flows and, of course, global labour arbitrage. The net result was a marked improvement in labour productivity and, consequently, profit margins.

Why is the above important? Because these trends have contributed to an income distribution progressively skewed towards capital at the expense of labour in many Western countries. Statistical measures of income inequality (*such as the Gini coefficient*) have steadily drifted higher over the last few years. Until recently, households did not take notice. Aided

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and abetted by easy monetary policy, they relied on lower savings, asset bubbles and housing-financed debt growth to plug the gap between subdued increases in wage growth and continuing increases in consumption.

Capitalism (*as it has been sold in the West*) is hardly supposed to work this way. Having a more egalitarian income distribution (*i.e. a middle class*) results in not only a more stable, equitable society but also generates greater prosperity over the long run. A prosperous middle class buys houses and cars, and whose children, properly educated, become leaders and entrepreneurs of tomorrow.

In a globalized world, the same trends that favour the multinational corporation also place workers in a weak negotiating position. It has become increasingly difficult for workers to overcome the pressures of mobile capital to regain a greater share of any prosperity. However, if a country cannot sell its products internally, which country ultimately wins? It should not come as a surprise that the most income-skewed nations such as the United States are now facing weak domestic demand.

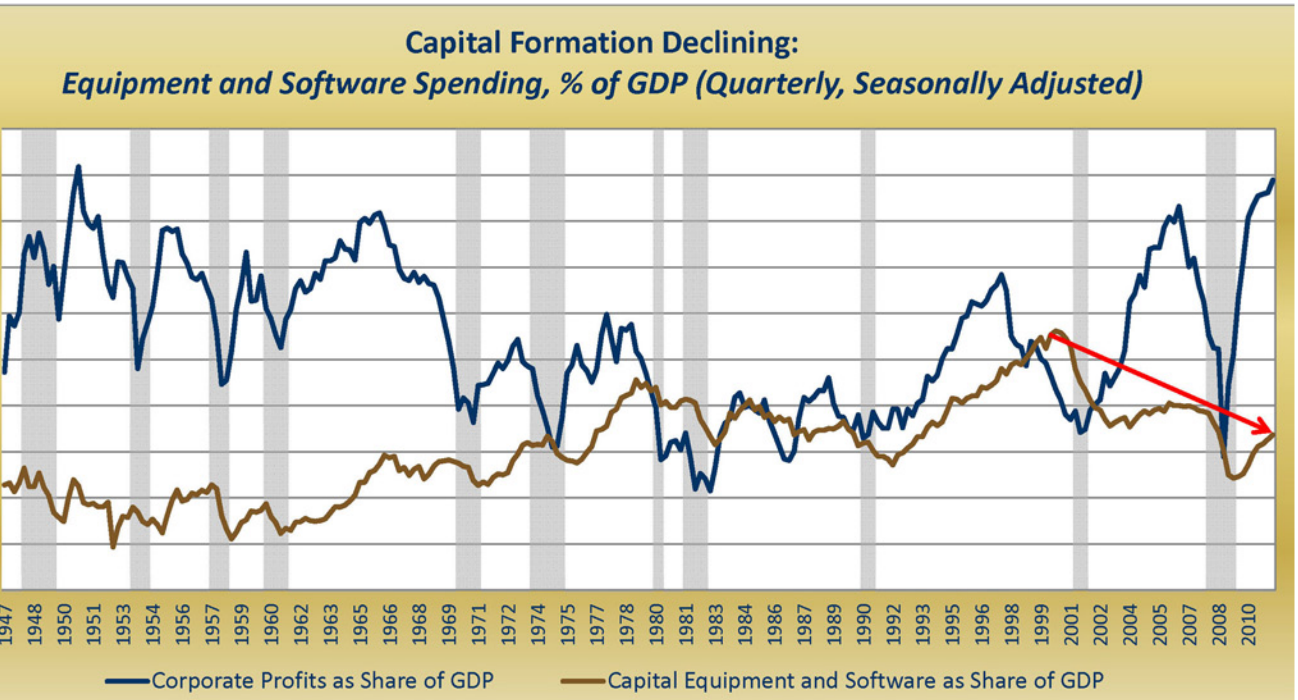
Shareholder Driven Capitalism.

Restrained wage growth has not been the only corporate cost-cutting measure supporting record margins. In fact, other structural trends, in place for some time now, have acted to bolster short-term profits while simultaneously undermining both labour growth and longer-term profits. Importantly, maximizing shareholder value has often been placed ahead of productive wealth accumulation. This is primarily an outgrowth of changing incentive structures since the early 1980s. Facing short-term quarterly earnings pressures, option-laden managers (whether consciously or not) favour measures that immediately boost share prices rather than securing long-term profit growth. For example, since the late 1990s, spending on capital equipment and software has significantly lagged earnings growth (*see chart 3 below*). Over time, these actions deplete productive capital formation, reduce macroeconomic growth (*and, ultimately contribute to a reduction in employment*).

Does all this matter to investors? After all, many of these trends in labour arbitrage and other short-term performance enhancers can persist for some time. And, much of the above may only be important over the very long run (*as Keynes once said, "... the long run is a misleading guide to current affairs. In the long run we are all dead."*). Yet, looking at the current economic cycle, many of these factors do indeed have a finite life, even for the indomitable multinational corporation.

In fact, profit margins will likely confront trouble in the period immediately ahead. Many factors that contributed to

Chart 3



Source: Haver Analytics.

"…further productivity gains will be more difficult in the period directly ahead without either employee hiring or renewed capital spending."

record margins, both on a cyclical and structural basis, have either run their course or have simply been "one off" profit boosters. Of course, subdued labour costs have been a key prop here. But other factors have been similarly important. For example, the Bernanke Fed has lowered interest rates to the near zero bound. Correspondingly, corporate net interest payments have fallen dramatically since the onset of the financial crisis (*see chart 4 below*). How likely is this to be repeated? Rates cannot fall much lower, certainly not to the extent that they have.

There are many more notable examples, not least of which is fading government stimulus and a shift toward austerity measures. But the important point is that further productivity gains will be more difficult in the period directly ahead without either employee hiring or renewed capital spending. In fact, a productivity downturn may have already begun. Labour costs and tensions have been rising this year. Figures from the BLS show nonfarm business productivity contracting in the first and second quarters of 2011 by 0.6% and 0.3%, respectively.

So far, our profit discussion has centered on "bottom line" factors. However, "top line" factors are equally crucial. Most of recent earnings growth has come from government-sponsored growth rather than organic expansion in aggregate demand or consumer incomes. Ultimately, however, growth in top line revenue depends on the financial health of its customers (*whether they are domiciled domestically or internationally*). In a post-credit driven world, consumer spending, certainly in most slow-growth Western regions, will rely more on income growth than rising debt burdens. Yet, it's highly unlikely that there will be wage growth acceleration given the high level of unemployment and corresponding weakness of labour's bargaining position. That makes the revenue outlook, which has already been anaemic, less than rosy (*see chart 5 on page 10*). Margins, and importantly earnings, will have little protection during the next economic downturn.

Undoubtedly, however, corporations will remain focused on cost control and productivity gains. As part of that equation, financial engineering will remain key. Consider that

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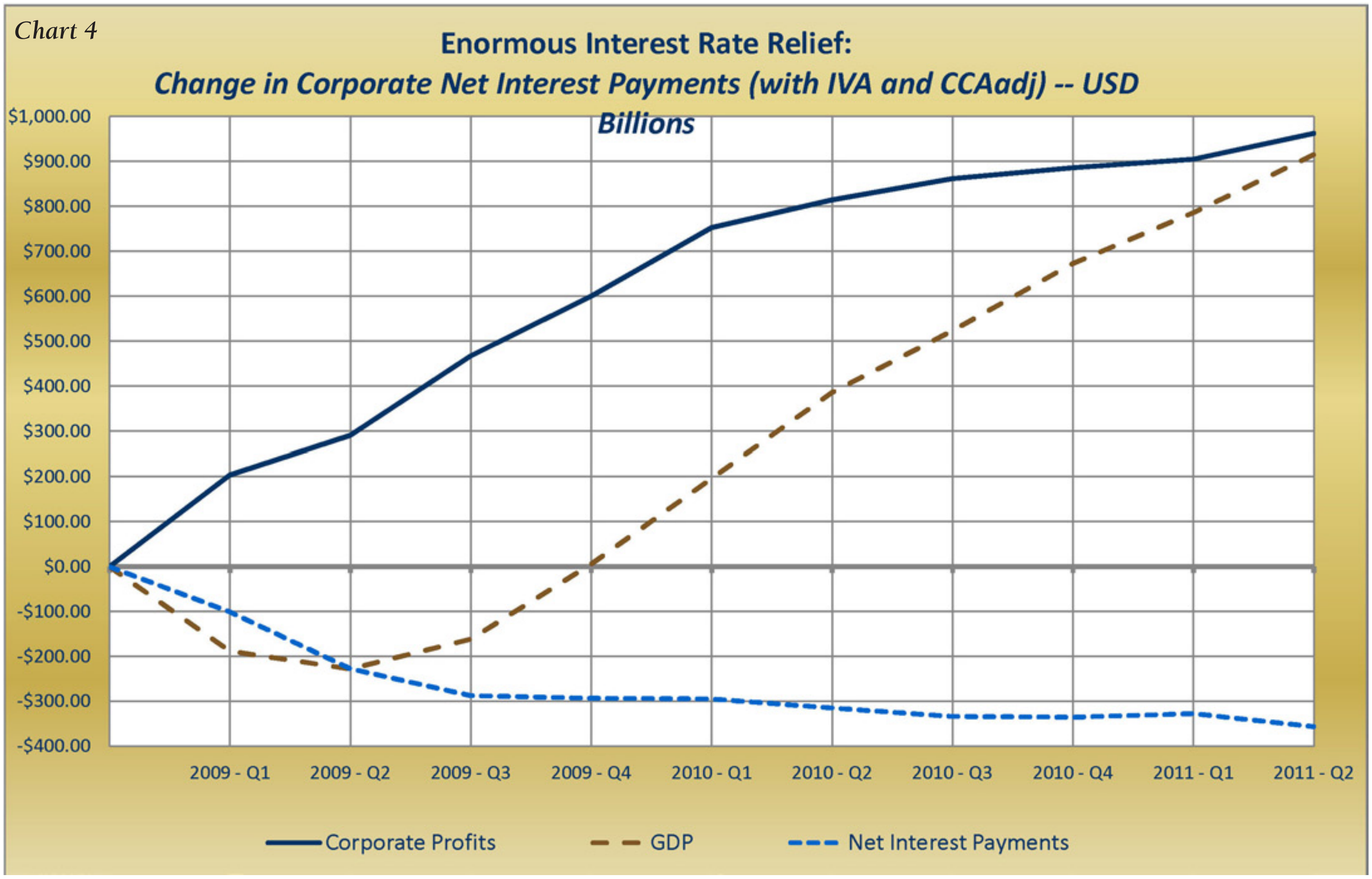
Chart 4



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companies have a number of options when utilizing their capital. They can reinvest back in the underlying business, retire debt, buy back shares, or pay out dividends. Why would corporate executives pursue the first two options when aggregate demand is weak and interest rates are at historic lows (*and pledged to remain there until at least mid-2013*)?

A more rational approach, even if not beneficial to labour, attempts to boost stock prices by reducing share count or increasing dividends. That has been the observable case, as corporations have been actively increasing dividends or share buybacks. For the first half of 2011, the net domestic common stock dividend increase of $30.2 billion already surpasses all of 2010, representing an 11.1% increase (*4.1% for Q2 and 6.7% Q1*). From a capital allocation standpoint, these trends are completely logical and likely to continue for some time.

Investment Outlook.

Many are predicting that high corporate cash positions and healthy balance sheets will lead to stronger domestic employment growth and higher incomes. However, a more likely scenario is that corporations will emphasize overseas expansion instead of domestic hiring and investment. This would be consistent with recent trends. In the past 5 years, US direct investment overseas has been 20% higher than domestic non-residential investment. During the 1960s and 1970s that ratio averaged 6%, before climbing to a 13.5% average between the mid-1990s and mid-2000s.[2]

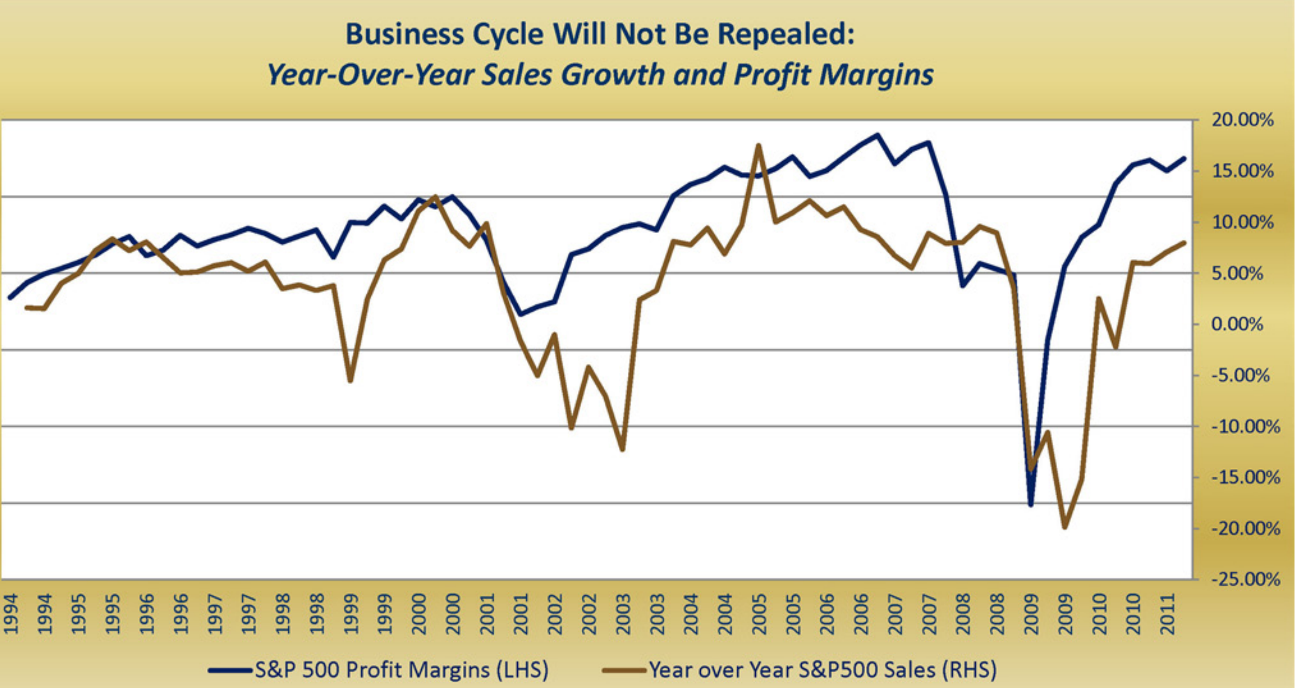
Investors — particularly passive indexers — need to gear their asset mix decisions in view of these labour market trends. Broad stock market exposures, especially those tracking the most income-skewed Western economies, are likely to show muted returns. A better approach will be to focus on index constructions that emphasize global opportunities, stable dividends and, importantly, overweight the world's great asset class — the multinational corporation.

Workers may indeed be untied from corporate earnings trends of late, but this hardly proves Marx's overall thesis correct. What he failed to recognize is that free financial markets, though not perfect, ultimately expose any underlying flaws and self-correct better than any type of government intervention. And, frankly, identifying distortions and allocating capital accordingly is also the job of portfolio managers.

[1] http://www.time.com/time/magazine/article/0,9171,924018,00.html

[2] Figures from the Bank Credit Analyst.

Chart 5



Source: Haver Analytics, S&P.