TOPICAL STUDY #18
DOW 5000

Economics

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We designed the following set of tables and charts to track corporate profits and cash flow. If you would like to receive this material on a quarterly basis, fax the front page of this report with the following information to 212-214-4066: (1) Name, (2) Company and Address, (3) Fax Number, (4) Prudential-Bache Salesperson.

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I. Earnings And The Market

We still expect to see 5000 on the Dow Jones Industrial Average by the end of 1993. To get there from here (2700), either profits have to nearly double or the price-to-earnings (p/e) ratio must do so. Alternatively—and very likely, in our opinion—each of these two determinants of stock prices could rise by 50%.

Last year, the earnings per share of the S&P 500 stock universe totaled $22.87, down 3.7% from 1988 (see following table). A 50% increase would raise profits to $34.31 by 1993. Profits would have to rise at a compounded annual rate of about 10% over the next four years (including this year) to get there.

Is this realistic? Yes, though we admit that such a scenario for profits is optimistic. However, recall that during the previous four years, earnings per share rose 56%, from $14.61 in 1985 to $22.87 in 1989. So it has been done before, and very recently.

We are assuming that the economy will continue to grow over the next four years with real GNP up about 2½% per year and prices up 3% per year, on average. We see no economy-wide recession up ahead. Instead, rolling recessions will continue to depress different industries at different times.

But can nominal GNP growth of 5½% per year produce 10% per year profits growth? We think so. We believe that as more and more business managers recognize that global and domestic competition will keep a 3% lid on price increases, they will act to boost profits by containing costs more aggressively. In other words, profit margins are likely to widen through cost cutting and productivity gains.

In addition, unit sales could grow more rapidly for many companies through exports. Real exports of goods and services rose 64% from the first quarter of 1985 through the first quarter of 1990, 3.8 times faster than the growth in real GNP over this period. Real merchandise exports soared 75% since early 1985.

Profits from overseas subsidiaries are also likely to boost reported earnings as American companies profit from the unification of the European market, the rebuilding of Eastern Europe, and the spread of consumerism in Asia.

A 50% increase in the p/e ratio would put it at 23 at the end of 1993, up from 15 at the end of last year, using four-quarter trailing earnings (see table). That would be a record high. But again, there are precedents. During the second quarter of 1987, the p/e hit a high of 21, which was the highest reading since 1961 when the p/e peaked at 22 during the fourth quarter.

Why should the p/e ratio soar to a new postwar high? If our rolling recession scenario continues to work, then more investors will conclude that the risks of an economy-wide recession have diminished. Therefore, the odds of a big bear market are also reduced. If this view becomes more widely held, it may be worth a couple of additional percentage points on the valuation multiple.

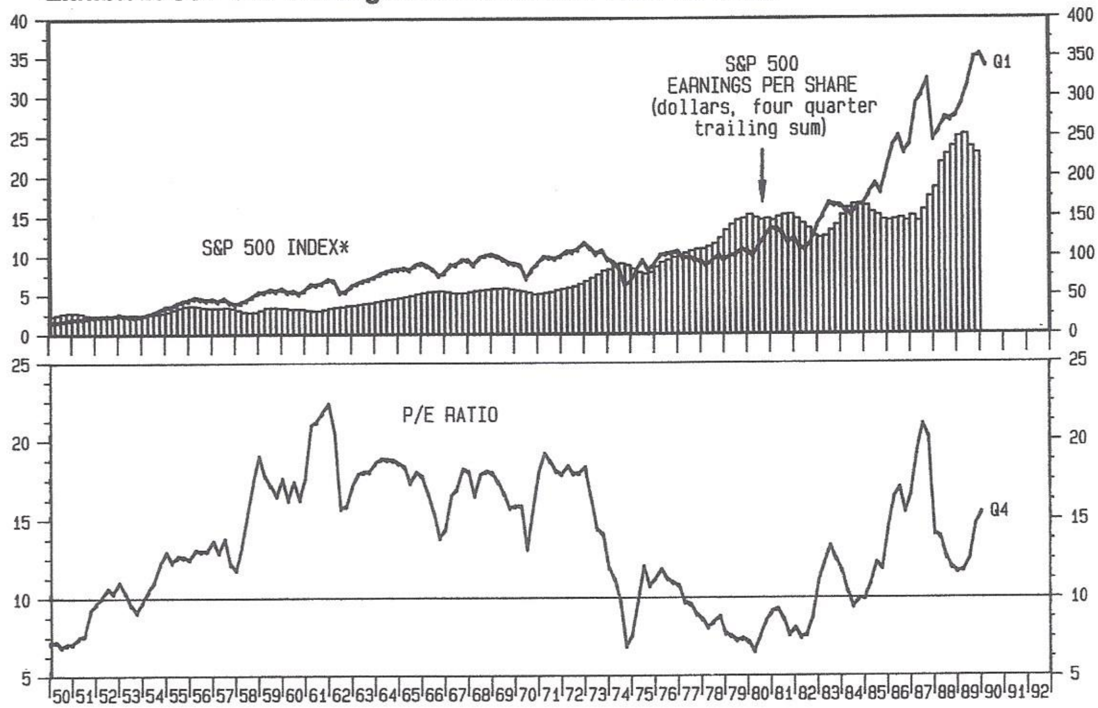
The most important development we see pushing the p/e ratio higher is the continuation of the secular decline in short-term and long-term interest rates. In our *Topical Study #13:* "The Coming Shortage Of Bonds" (June 20, 1988), we first started to argue that powerful demographic forces related to the aging of the baby boom generation would boost personal savings and dampen the growth in mortgage and consumer credit demands. So we predicted that the government bond yield could fall to 5% by 1993 and that the Dow could rise to 5000 by then.

Exhibit 1: Earnings And The Market.

	1989				1988			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
S&P 500 Index*	353.40	349.15	317.98	294.87	277.72	271.91	273.50	258.89
Trailing Four Quarters								
S&P 500 EPS	22.87	23.69	25.22	24.96	23.75	22.73	21.67	18.59
S&P 500 P/E Ratio	15.45	14.74	12.61	11.81	11.69	11.96	12.62	13.93
Current Quarter**								
S&P 500 EPS	19.20	19.40	25.92	26.96	22.48	25.52	24.88	22.12
S&P 500 P/E Ratio	18.41	18.00	12.27	10.94	12.35	10.65	10.99	11.70
S&P 400 Index*	403.49	397.95	363.48	339.42	321.26	311.67	315.73	300.39
Trailing Four Quarters								
S&P 400 EPS	26.25	26.96	27.31	27.23	26.02	24.93	23.76	22.07
S&P 400 P/E Ratio	15.37	14.76	13.31	12.46	12.35	12.50	13.29	13.61
Current Quarter**								
S&P 400 EPS	21.76	25.08	28.08	30.08	24.60	26.48	27.76	25.24
S&P 400 P/E Ratio	18.54	15.87	12.94	11.28	13.06	11.77	11.37	11.90
	Yearly Percent Change							
S&P 500 Index	27.3	28.4	16.3	13.9	12.4	-15.5	-10.0	-11.2
S&P 500 EPS (Current)	-14.6	-24.0	4.2	21.9	22.2	19.9	98.1	24.5
S&P 500 EPS (Trailing)	-3.7	4.2	16.4	34.3	35.7	43.3	50.3	23.1
S&P 400 Index	25.6	27.7	15.1	13.0	12.4	-17.1	-10.6	-10.5
S&P 400 EPS (Current)	-11.5	-5.3	1.2	19.2	21.5	21.5	32.2	39.3
S&P 400 EPS (Trailing)	0.9	8.1	14.9	23.4	28.2	38.1	46.8	45.8

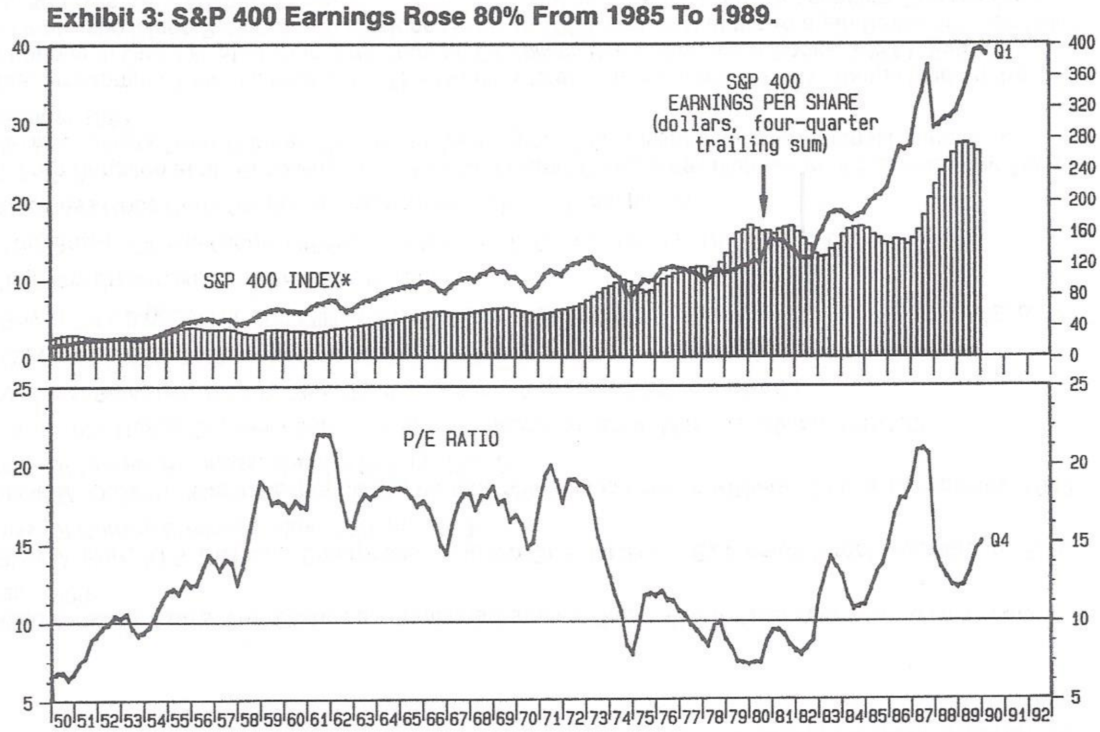
* End of quarter closing price.
** Annualized.

Exhibit 2: S&P 500 Earnings Rose 56% From 1985 To 1989.



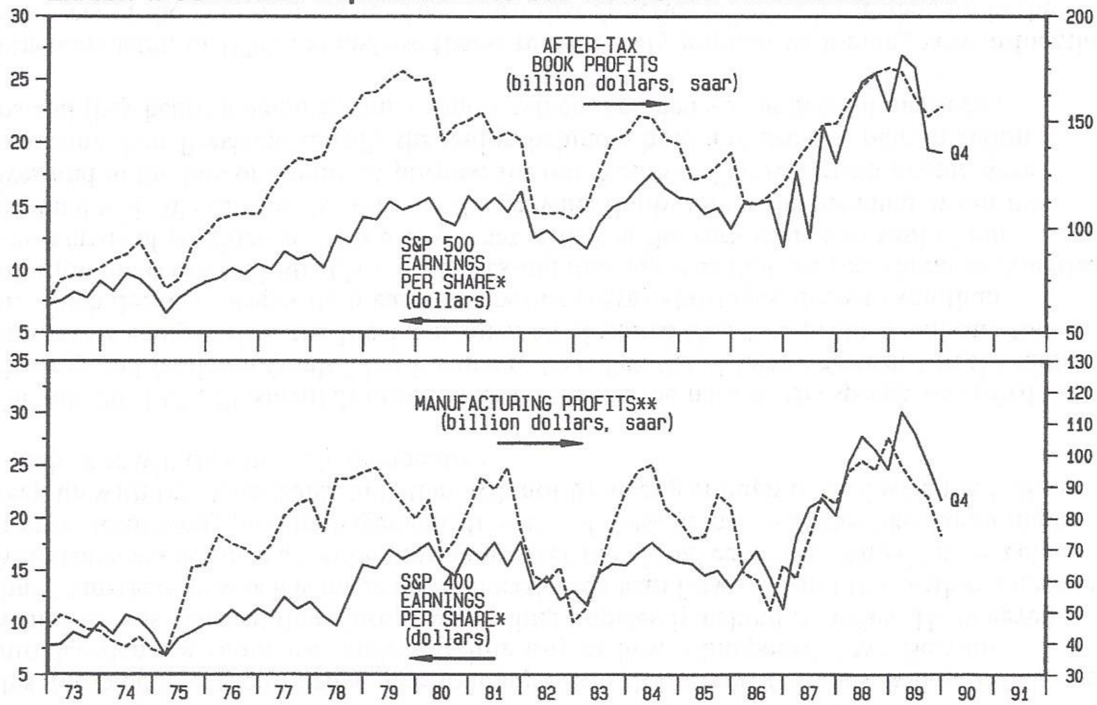
* End of quarter closing price.

Exhibit 3: S&P 400 Earnings Rose 80% From 1985 To 1989.



* End of quarter closing price.

Exhibit 4: Commerce Department And S&P Data Show Profits Recession.



* Annualized current quarter earnings.
** Book profits before tax including IVA.

II. Corporate Profits And Cash Flow

We still expect that the profits recession which started in the second quarter of last year will end by the middle of the year. After-tax profits, as measured by the Commerce Department, fell 10.8% during the fourth quarter compared to a year ago (see following table). That is a slight improvement from the 12% drop during the third quarter, which should be the trough of the profits recession. We were pleasantly surprised: We had expected the fourth quarter to be the trough because profits peaked during the fourth quarter of 1988.

In the March 1990 *Survey Of Current Business,* the Commerce Department's economists report that profits of domestic nonfinancial corporations have recently been "squeezed by a substantial increase in unit costs (especially labor costs)." Profit margins should widen as costs are cut. Indeed, wage inflation—i.e., the yearly percent change in average hourly earnings, fell to 3.5% in April, the lowest in 17 months.

Book profits are often artificially boosted by inventory gains that occur when prices are rising. Such gains don't add to cash, or "operating" profits. The Inventory Valuation Adjustment (IVA) is an estimate of inventory profits with sign reversed. Last year, inventory profits totaled $18.7 billion, or 11.6% of after-tax book profits. If inflation remains moderate as we expect, then book profits are less likely to be inflated by inventory gains. So the quality of earnings ratio (book-to-operating profits) should remain close to 1.0 (Exhibit 7).

The quality of earnings ratio is also affected by the Capital Consumption Adjustment (CCAdj), which is the difference between the predominantly tax-based depreciation measure (Capital Consumption Allowance) and economic depreciation (Capital Consumption Allowance *less* the CCAdj). To derive cash flow, inventory profits must be subtracted from retained earnings and tax-based depreciation must be added back (see following table).

Tax law changes in the 1980s allowed companies to depreciate their plant and equipment at a faster pace. So tax-based depreciation expenses rose sharply relative to economic depreciation (Exhibits 8 & 9). The CCAdj remains positive but it has been declining primarily because of the Tax Reform Act of 1986, which lengthened the service lives used in calculating most depreciation allowances for tax purposes.

The gap between tax-based depreciation and economic depreciation is likely to narrow further. The CCAdj peaked at $63.6 billion during the third quarter of 1985. By the first quarter of 1990, it was down to $18.0 billion.

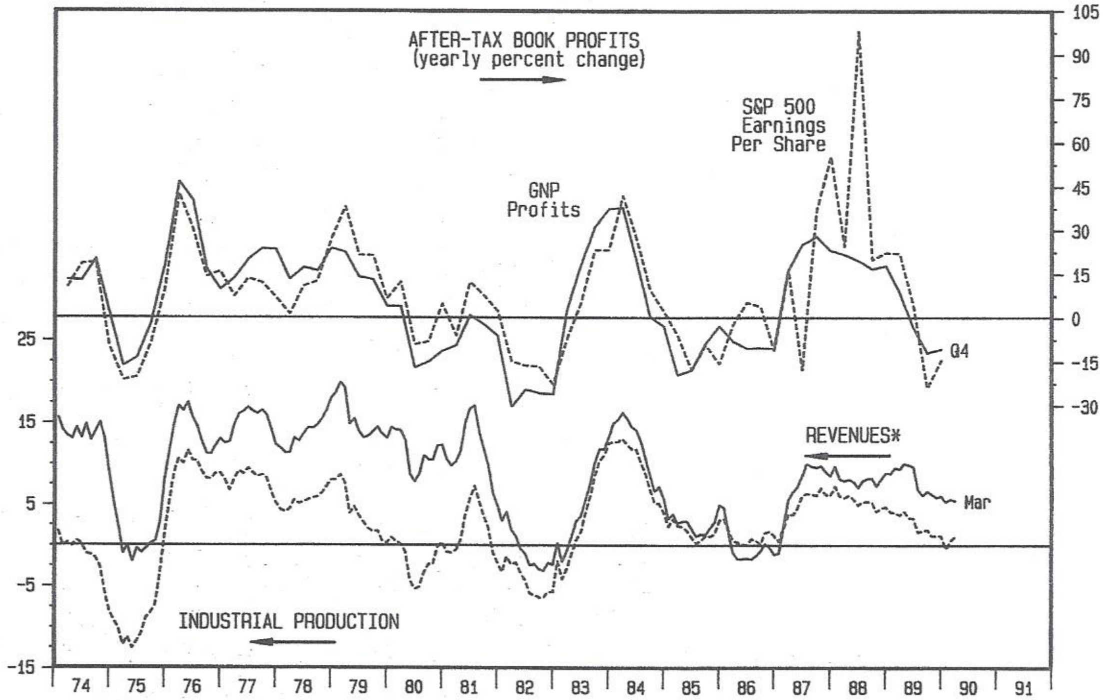
If both the IVA and CCAdj move closer to zero, then there will be less divergence between book and operating profits. (If both the IVA and CCAdj are zero, then book and operating profits would be identical.)

Corporate cash flow, i.e., retained earnings excluding inventory profits plus tax-based depreciation, rose 82% from 1979 through 1989 (Exhibit 9). A similar gain is likely in the 1990s, and would put corporate cash flow at $727 billion by 1999—an increase of $329 billion from 1989.

Exhibit 5: Corporate Profits And Cash Flow.

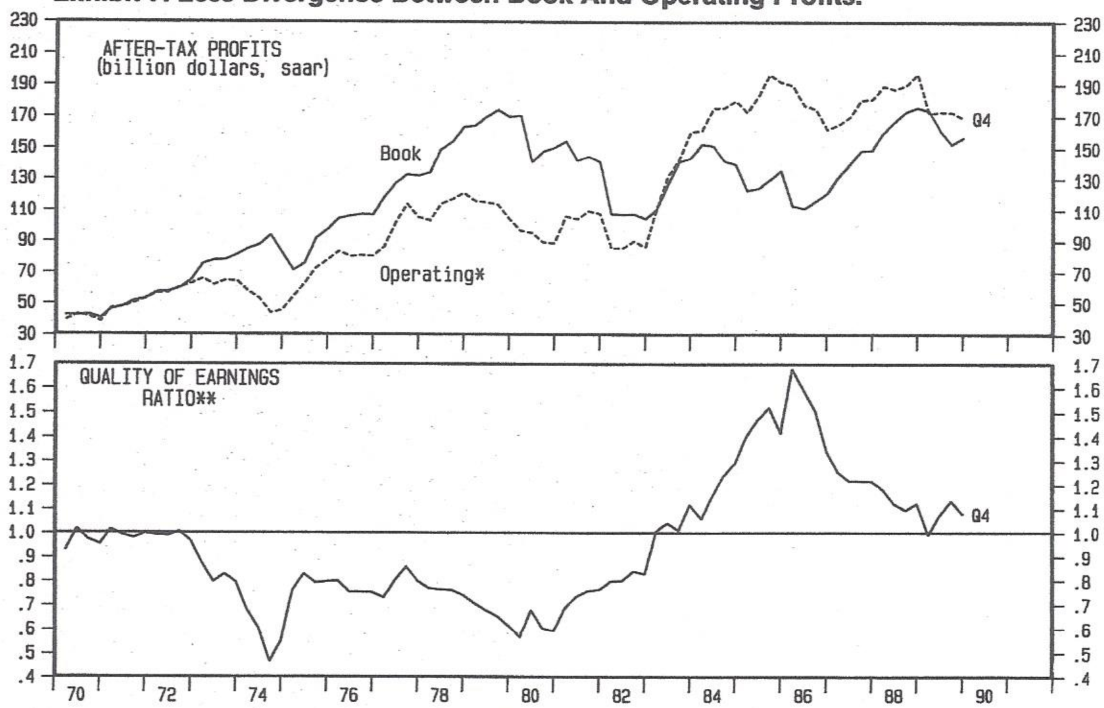
	1989				1988			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
	Billion Dollars, saar							
Book Profits Before Tax	273.7	275.0	296.0	318.0	318.8	314.4	305.3	288.8
Tax Rate (%)	42.7	44.6	45.6	45.4	44.9	44.9	45.3	44.6
Book Profits After Tax	156.7	152.4	161.1	173.6	175.6	173.2	166.9	159.9
(-) Dividends	125.6	123.3	120.9	118.5	115.2	112.2	108.6	105.7
(=) Retained Earnings	31.1	29.1	40.2	55.1	60.4	61.0	58.3	54.2
(+) Inventory Valuation Adjustment	-9.7	-6.3	-20.5	-38.3	-20.1	-30.4	-28.8	-20.7
(+) Capital Consumption Allowance w/Adj	354.9	349.9	339.7	335.2	329.7	323.1	319.0	314.9
(+) Capital Consumption Adjustment	21.9	26.5	32.3	36.6	41.5	46.9	48.9	49.9
(=) **Net Cash Flow**	398.2	399.2	391.7	388.6	411.5	400.6	397.4	398.3
Operating Profits								
Before Tax	285.9	295.2	307.8	316.3	340.2	330.9	325.4	318.0
After Tax	168.9	172.6	172.9	171.9	197.0	189.7	187.0	189.1
	Yearly Percent Change							
Book Profits Before Tax	-14.1	-12.5	-3.0	10.1	15.4	11.9	15.9	17.2
Book Profits After Tax	-10.8	-12.0	-3.5	8.6	17.9	16.8	19.7	21.7
Dividends	9.0	9.9	11.3	12.1	12.1	12.2	12.1	11.3
Retained Earnings	-48.5	-52.3	-31.0	1.7	31.0	26.3	37.2	48.9
Capital Consumption Allowance w/Adj	7.6	8.3	6.5	6.4	6.9	6.0	5.9	5.8
Net Cash Flow	-3.2	-0.3	-1.4	-2.4	6.4	4.0	6.2	8.4
Operating Profits								
Before Tax	-16.0	-10.8	-5.4	-0.5	10.4	5.7	10.8	13.7
After Tax	-14.3	-9.0	-7.5	-9.1	8.9	5.2	10.2	14.7

Exhibit 6: As Production Growth Revives, So Should Profits.



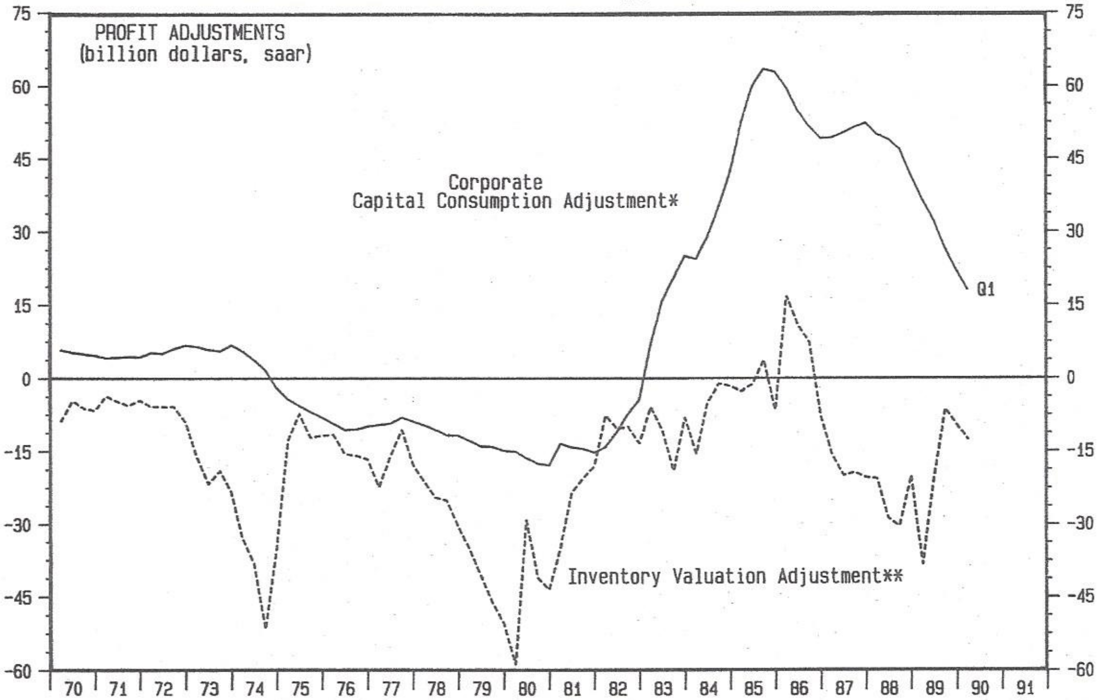
* Producer price index times industrial production index. Yearly percent change.

Exhibit 7: Less Divergence Between Book And Operating Profits.



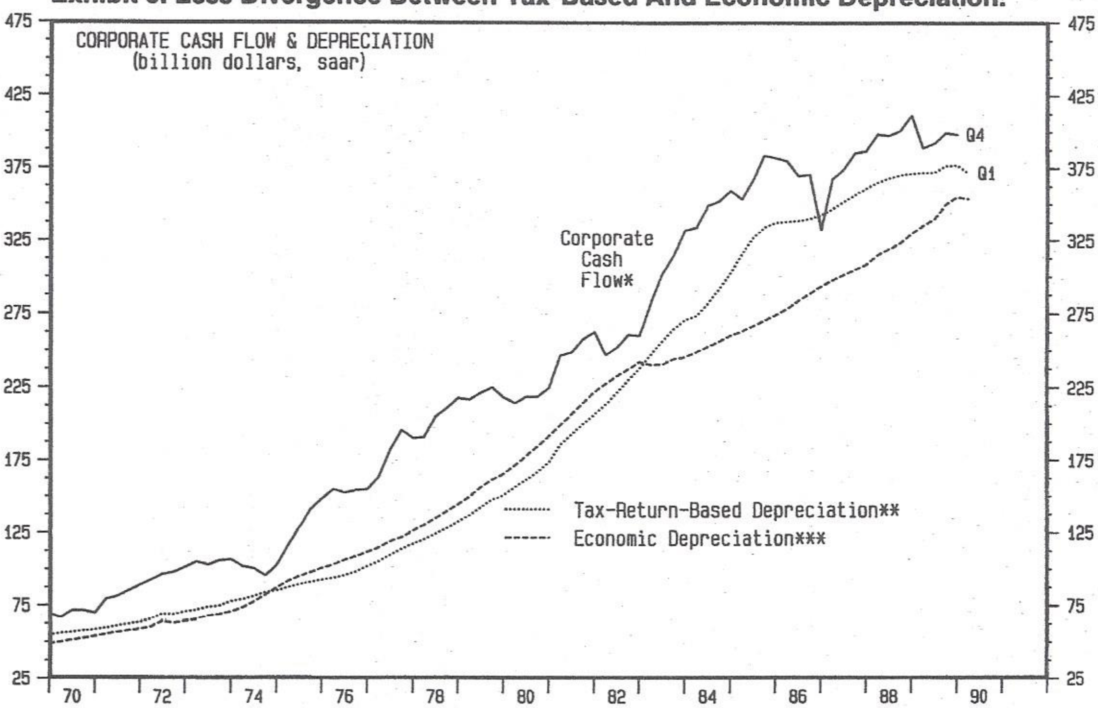
* Book profits after tax including IVA and CCAdj.
** Operating profits divided by after-tax book profits.

Exhibit 8: If Inflation Moderates, IVA Should Approach Zero.



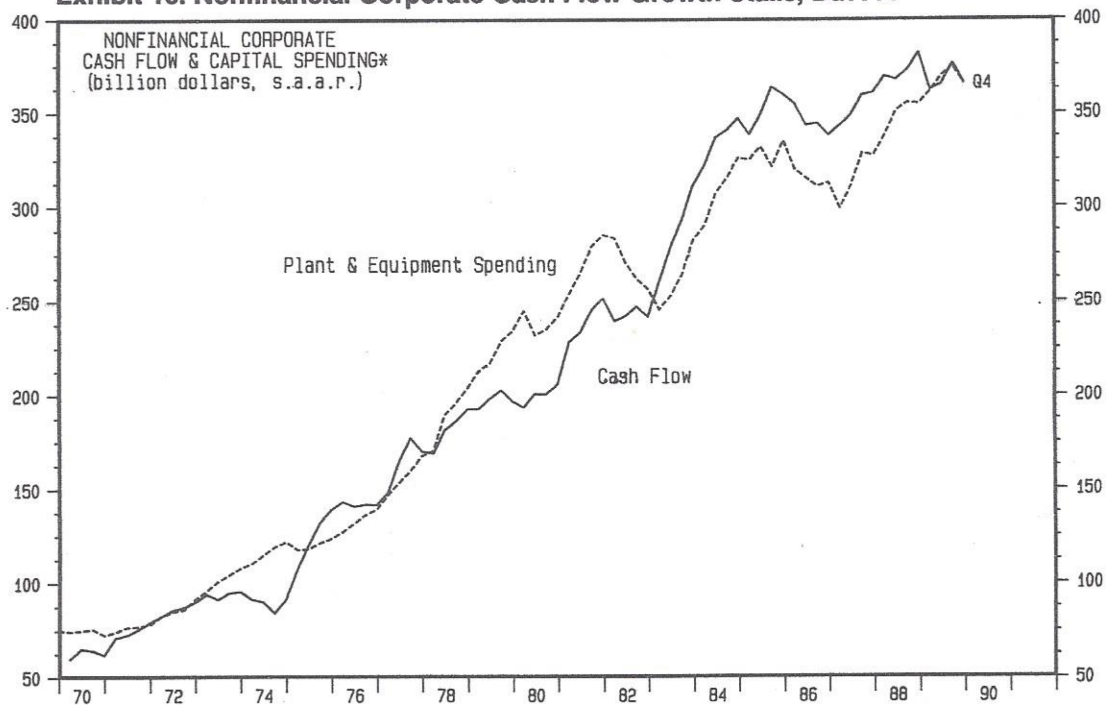
* Gap between tax-return-based depreciation and economic depreciation.
** Inventory profits attributable to inflation.

Exhibit 9: Less Divergence Between Tax-Based And Economic Depreciation.



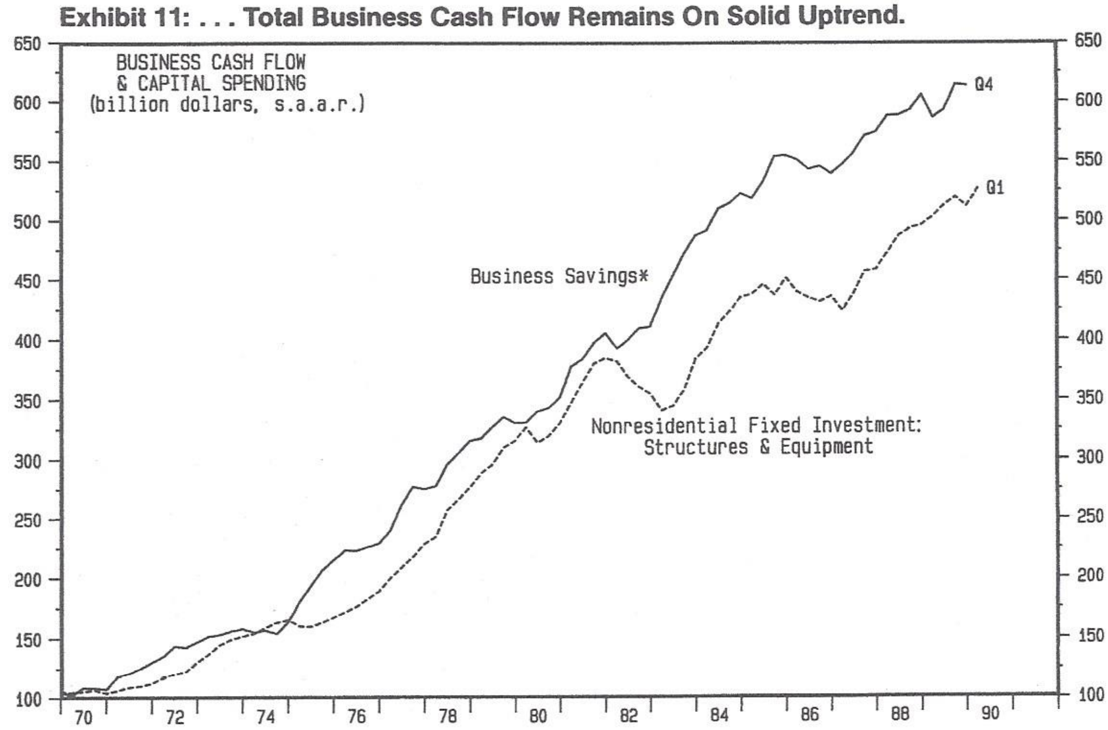
* After-tax operating retained earnings plus tax-return-based depreciation.
** Corporate capital consumption allowances.
*** Corporate capital consumption allowances with capital consumption adjustment.

Exhibit 10: Nonfinancial Corporate Cash Flow Growth Stalls, But . . .



* Flow of Funds Accounts.

Exhibit 11: . . . Total Business Cash Flow Remains On Solid Uptrend.



* Undistributed corporate profits with IVA and CCAdj plus corporate and noncorporate capital consumption allowances with CCAdj.

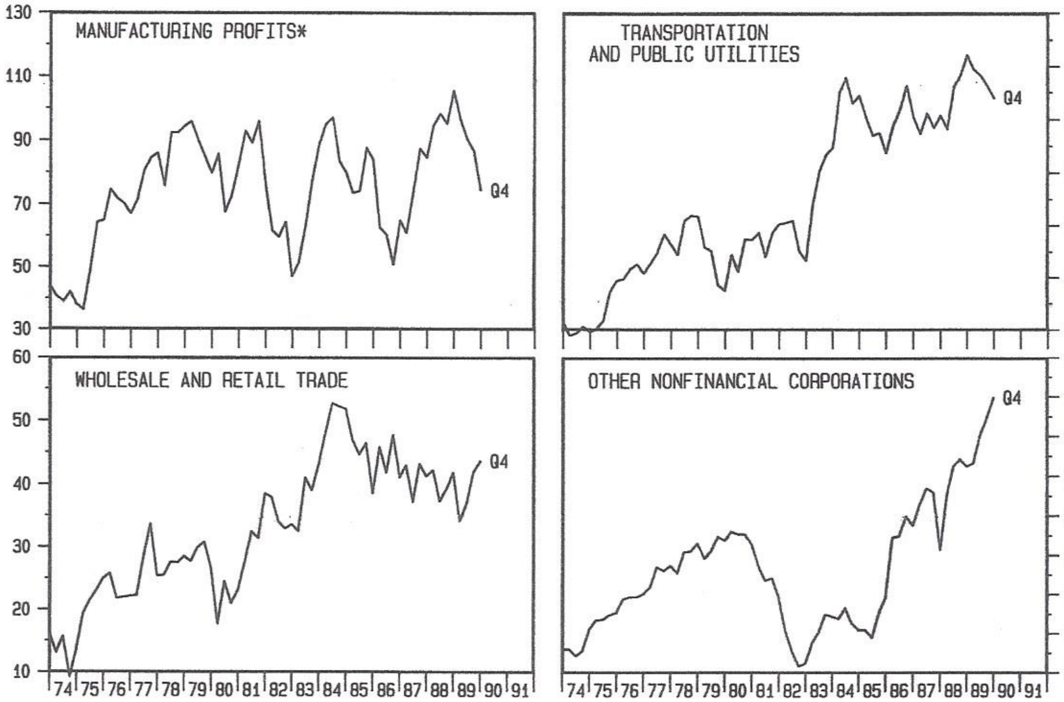
III. Industry Profits

Profits have been very weak in manufacturing. In this sector, profits fell 29.5% from the fourth quarter of 1988 through the fourth quarter of 1989 (Exhibit 13). Manufacturers have responded by operating with fewer workers. Over the past 12 months through April, factory employment dropped 272,000. Such cuts are likely to boost productivity and profits. Profits of financial corporations were depressed recently by an unusually high level of loan write-offs (Exhibit 17). And profits of savings and loan associations also dropped sharply, reflecting continued turmoil in the industry. Losses in the financial sector are likely to be a drag on overall profits for the remainder of the year. Profits from the rest of the world increased sharply at the end of last year as U.S. affiliates enjoyed boom times in several overseas markets, particularly in Europe. Such profits accounted for 19% of total profits from current production during the fourth quarter (Exhibit 17).

Exhibit 12: Nonfinancial Corporate Profits.

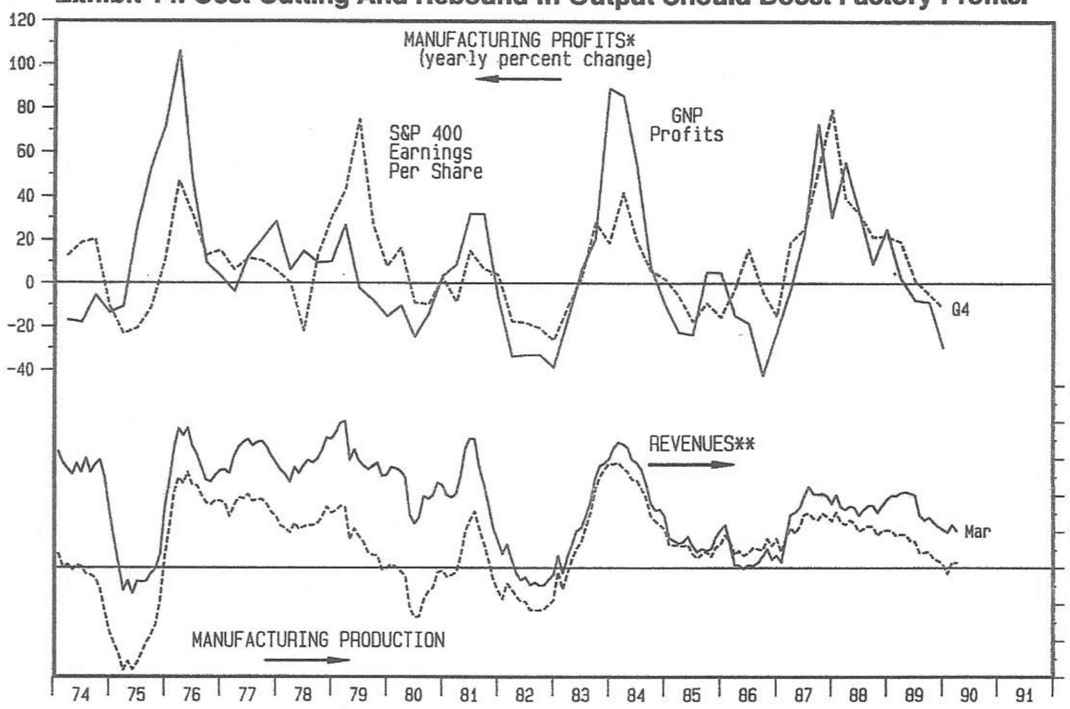
	1989				1988			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
	Billion Dollars, saar							
Nonfinancial Corporate Profits	195.7	205.3	203.2	203.9	222.1	207.3	206.0	198.1
Manufacturing	74.4	86.6	90.3	96.5	105.5	95.1	98.2	94.6
Wholesale And Retail Trade	43.6	41.9	36.9	34.1	41.8	39.2	37.3	42.2
Transportation And Public Utilities	37.8	39.4	40.8	41.6	43.5	40.8	39.2	33.7
Other	39.9	37.4	35.2	31.7	31.3	32.2	31.3	27.6
Manufacturing	74.4	86.6	90.3	96.5	105.5	95.1	98.2	94.6
Durable Goods	23.0	28.6	31.5	35.6	39.8	38.3	41.3	32.8
Primary Metals	4.5	6.7	6.6	6.5	7.4	6.8	6.6	4.7
Fabricated Metals	3.8	6.2	6.7	7.2	5.9	4.8	6.5	7.4
Nonelectrical Machinery	2.7	2.3	2.8	2.0	2.1	6.0	6.7	4.3
Electrical Machinery	6.2	3.0	5.1	4.4	6.6	5.8	4.8	1.1
Motor Vehicles And Equipment	-4.7	-2.0	-1.9	3.0	4.5	3.2	1.0	0.9
Other Durable Goods	10.6	12.3	12.2	12.4	13.4	11.8	15.6	14.4
Nondurable Goods	51.4	58.0	58.8	60.9	65.7	56.8	57.0	61.8
Food And Kindred Products	13.4	14.8	14.8	17.4	17.2	14.9	15.5	15.3
Chemical And Allied Products	14.8	15.9	18.1	18.5	22.0	15.6	15.9	16.0
Petroleum And Coal Products	2.7	3.9	1.0	1.2	5.3	3.8	1.6	4.2
Other Nondurable Goods	20.4	23.4	24.9	23.8	21.2	22.5	24.0	26.2
	Yearly Percent Change							
Nonfinancial Corporate Profits	-11.9	-1.0	-1.4	2.9	22.1	7.7	17.6	21.2
Manufacturing	-29.5	-8.9	-8.0	2.0	24.9	8.9	33.2	55.6
Wholesale And Retail Trade	4.3	6.9	-1.1	-19.2	1.5	-9.3	0.3	-1.9
Transportation And Public Utilities	-13.1	-3.4	4.1	23.4	22.5	20.4	9.5	1.8
Other	27.5	16.1	12.5	14.9	51.2	15.0	9.8	4.2
Manufacturing	-29.5	-8.9	-8.0	2.0	24.9	8.9	33.2	55.6
Durable Goods	-42.2	-25.3	-23.7	8.5	53.1	1.1	14.7	-12.8
Primary Metals	-39.2	-1.5	0.0	38.3	80.5	94.3	164.0	11.9
Fabricated Metals	-35.6	29.2	3.1	-2.7	0.0	-26.2	75.7	100.0
Nonelectrical Machinery	28.6	-61.7	-58.2	-53.5	10.5	33.3	123.3	7.5
Electrical Machinery	-6.1	-48.3	6.2	*	*	7.4	-14.3	-63.3
Motor Vehicles And Equipment	*	*	*	*	*	68.4	-82.5	-81.3
Other Durable Goods	-20.9	4.2	-21.8	-13.9	-2.9	-26.7	1.3	-19.6
Nondurable Goods	-21.8	2.1	3.2	-1.5	12.3	15.0	50.8	166.4
Food And Kindred Products	-22.1	-0.7	-4.5	13.7	11.7	8.0	37.2	86.6
Chemical And Allied Products	-32.7	1.9	13.8	15.6	77.4	33.3	69.1	88.2
Petroleum And Coal Products	-49.1	2.6	-37.5	-71.4	-25.4	171.4	-157.1	-132.1
Other Nondurable Goods	-3.8	4.0	3.7	-9.2	-10.2	0.0	20.6	33.7

Exhibit 13: Big Drop In Factory Profits Offset By Jump In "Other."



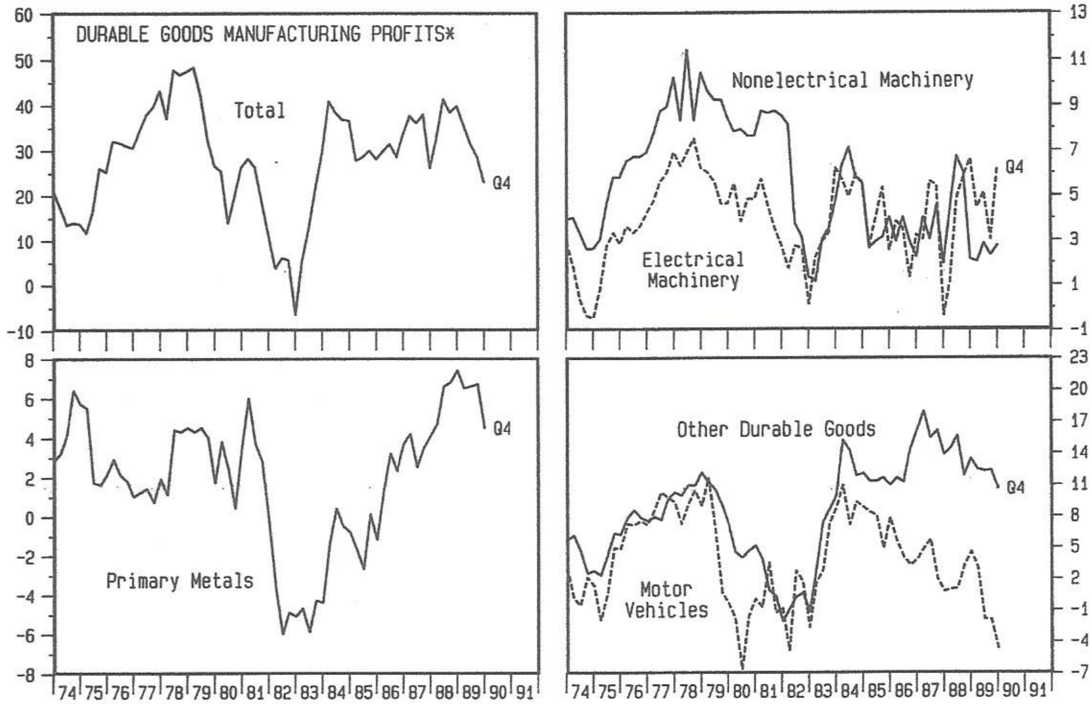
* Book profits before tax excluding inventory profits, billion dollars, saar.

Exhibit 14: Cost Cutting And Rebound In Output Should Boost Factory Profits.



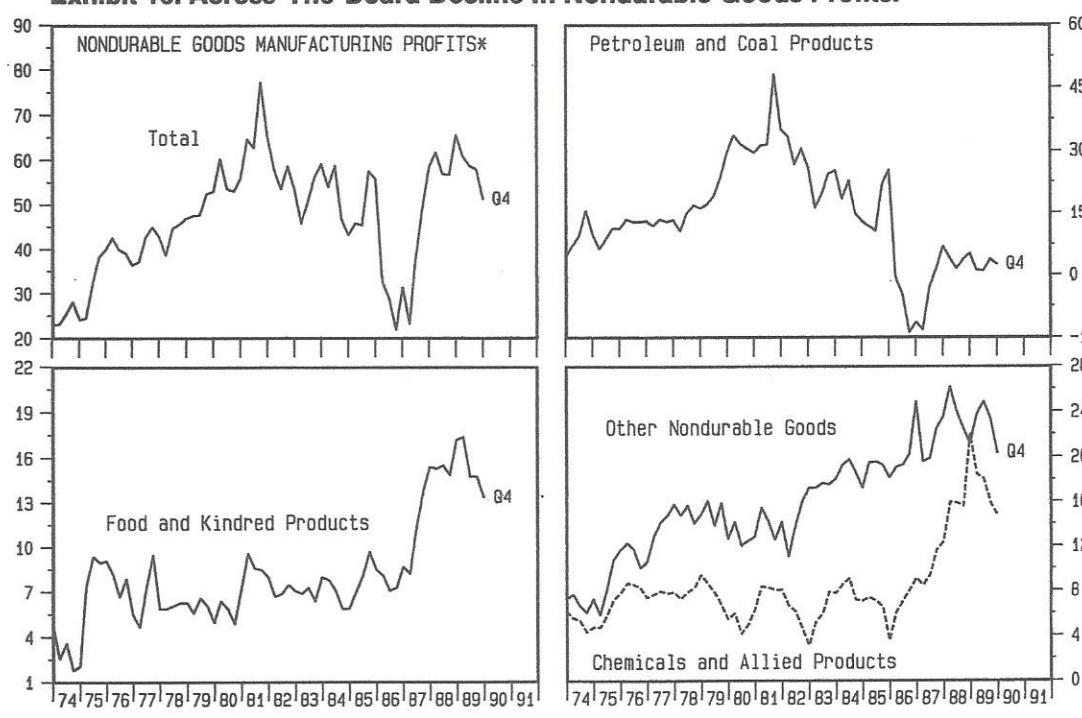
* Book profits before tax excluding inventory profits.
** Producer price index times manufacturing production.

Exhibit 15: Autos Lead Downturn In Durable Goods Profits.



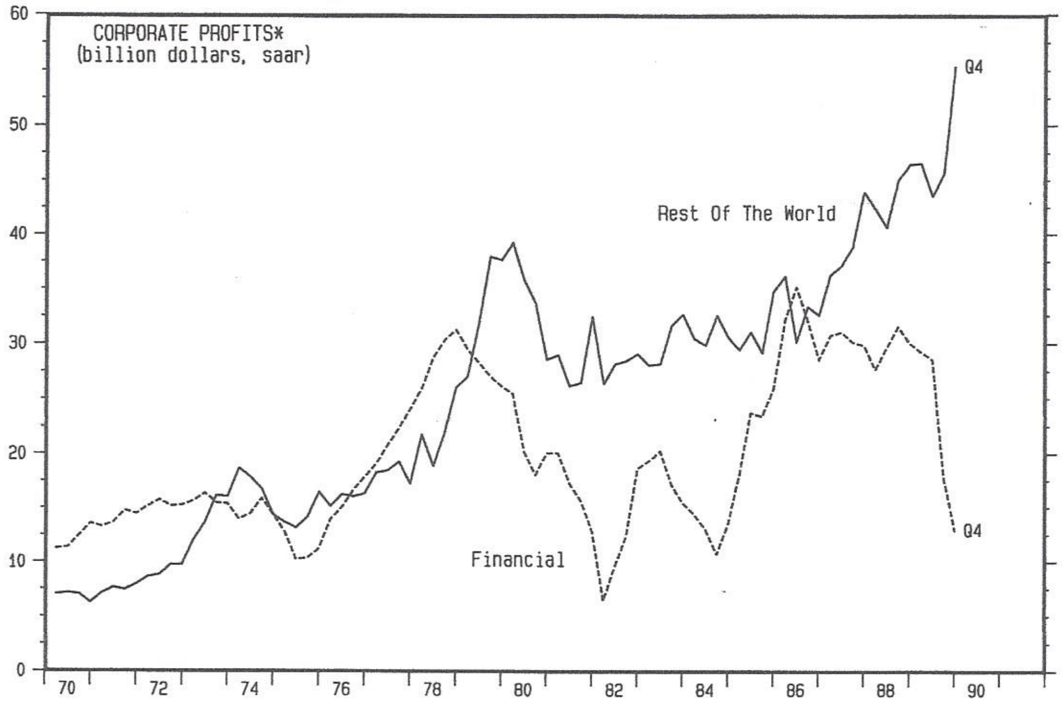
* Book profits before tax excluding inventory profits, billion dollars, saar.

Exhibit 16: Across-The-Board Decline In Nondurable Goods Profits.



* Book profits before tax excluding inventory profits, billion dollars, saar.

Exhibit 17: Big Drop In Financial Corporations' Profits Offset By Big Jump In Profits From Overseas.



* Book profits before tax excluding inventory profits.

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