

# The Week

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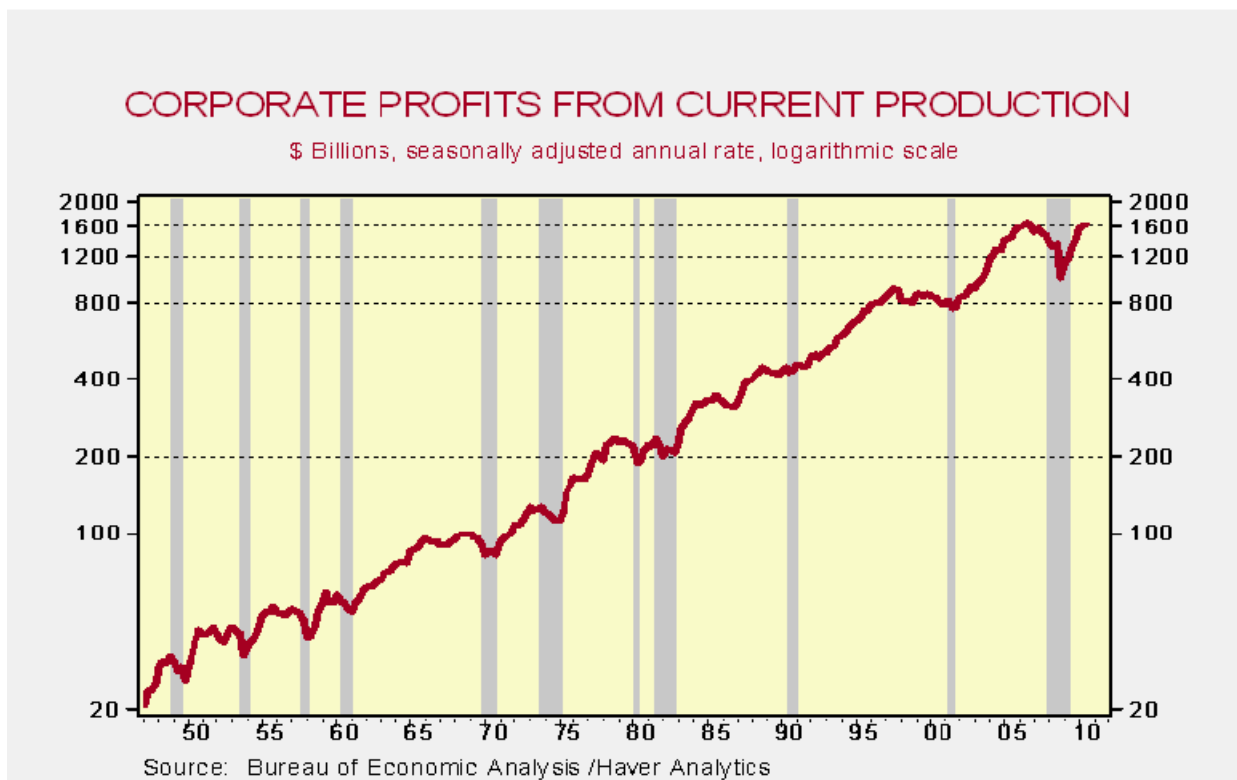
## Profits grow as economy recovers

The U.S. government released its estimate of third-quarter corporate profits last week, and the data shows that profits from current production of all corporations, not just the 500 largest, continue to increase. This is an encouraging sign that the economic recovery remains on track. This report will look at two important trends, the long-term upward trend in total corporate profits and the declining trend of domestic profits as a percent of total profits.

Investors know that the economy goes through ups and downs during an economic cycle. Sometimes, the downturns can be very severe as occurred during the most recent recession in 2008 and early 2009. Fortunately, the downturns have been shorter than the upturns, and the economy has trended higher over the long run.

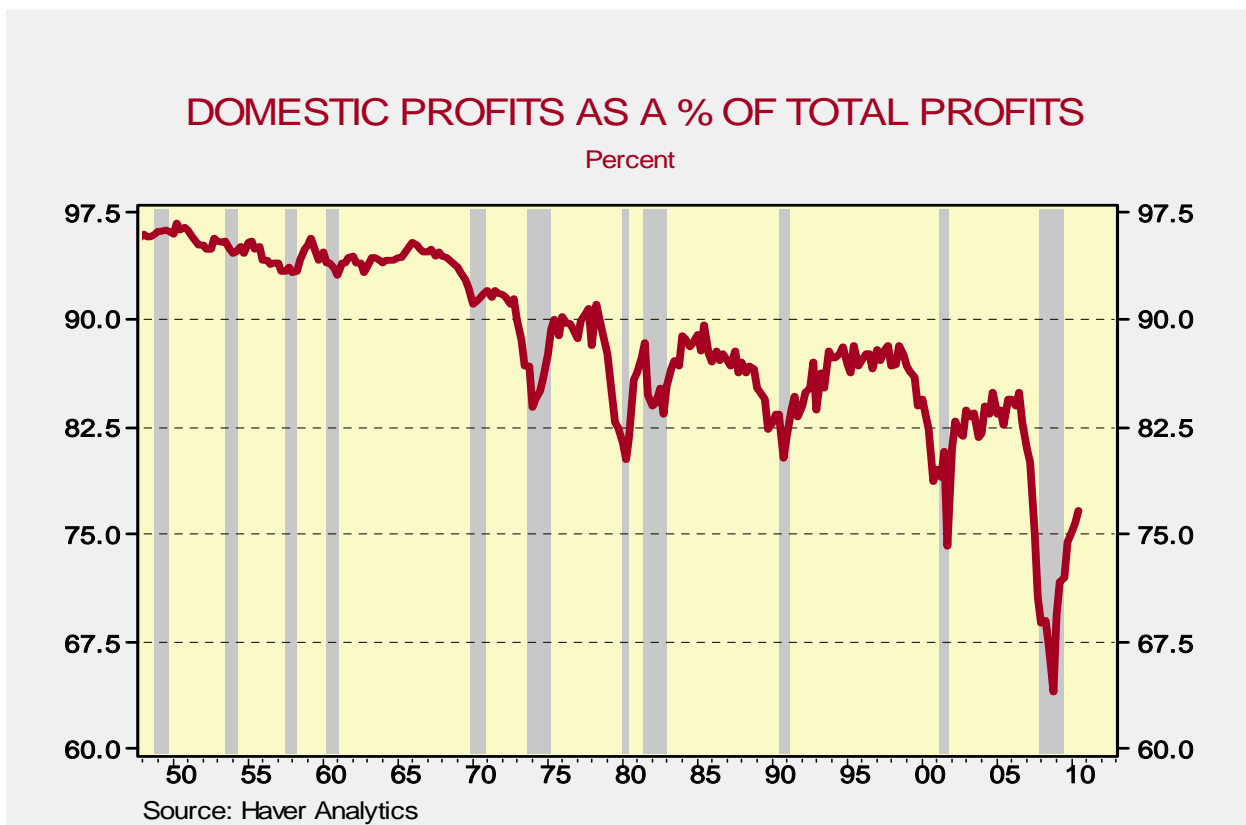
decline, the economy usually falls into recession. That is when companies cut costs, reduce spending and trim payrolls in order to restore profitability. Once profitability turns up, companies often invest in their businesses and hire more workers, causing the economy to expand again. In other words, corporate profits decline during recessions but trend up over time as the economy grows.

This can be seen in the accompanying graph on total corporate profits. When corporate profits



The latest data shows that during the third quarter of this year, corporate profits from current production increased to just under the record high set in the third quarter of 2006. The latest increase in profits was not as strong as the increase at the start of the economic recovery last year. Nevertheless, the government's measure of total corporate profits was still 26.4%, ahead of its year-ago level. This is a positive sign that the economy is likely to expand in the year ahead. Many investors are still worried that the economy could relapse into another recession. But history suggests that recessions usually occur when corporate profits start to contract, not when profits are growing as they are now.

Our second chart this week looks at the percent of total corporate profits contributed by domestic industries. As the world economy becomes more integrated, an increasing percentage of U.S. corporate profits come from global operations and a decreasing percentage comes from domestic industries. As a result, there is a downward trend in the graph showing the share of domestic profits. However, the line does not go straight down. When the economy is recovering from recession, as it is now, domestic profits as a percent of total profits usually increase.



The share of profits from domestic industries is a good indicator of when the U.S. economy is heading into recession or expansion. In particular, when domestic profits as a percent of total profits drops sharply as it did several years ago, the U.S. economy is often suffering from many problems and potentially heading into recession. However, when domestic profits as a share of total profits are increasing, as they have during the past year, the U.S. economy is usually recovering from recession and headed toward further growth.

The good news is the stock market also has trended up over time as corporate profits have increased. Of course, past performance does not guarantee similar results. The big question is how much are investors willing to pay for a dollar's worth of corporate profits? In other words, sometimes investors are optimistic, and the stock

market increases more than profits. When that happens, the market can become overpriced compared to the level of corporate profits. Other times, investors are pessimistic, and the stock market is underpriced compared to the level of corporate profits. Our analysis suggests that the stock market, as measured by the S&P 500, is currently modestly undervalued relative to the government's measure of total corporate profits. This suggests that investors are cautious but not overly pessimistic.

History suggests that two of the biggest risks to the stock market are when stocks are overpriced relative to corporate profits and when profits are decreasing. Fortunately, neither condition appears to exist at this time. That is why we remain longer-term positive on the economy and the market as we move into 2011.

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