Morgan Stanley

MORGAN STANLEY RESEARCH
ASIA/PACIFIC

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Downunder Daily

RoW Relief

It's true: the best thing the US has going for it now is the rest of the world. That's clear from the GDP data – where exports have contributed 1.1 percentage points to GDP growth over the past year – and also from the profit data:

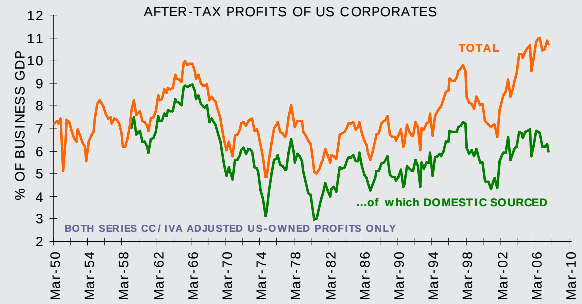
Growth in top-down profits (*aka* the NIPA data) has stalled over the past year (and fell outright in the September quarter), but it would have been far worse if not for the contribution from earnings made in the rest of the world. Exhibit 1 shows that the total profit share (relative to business-sector GDP) remains around all-time highs. However, the domestically sourced component, which never exceeded the late 1990s peak, is now in decline.

Profits have been maintained at elevated levels by foreign-sourced earnings, which now account for 31.5% of US corporate earnings (Exhibit 2). Over the four quarters to September, domestically sourced after-tax earnings fell by 8%, while foreign-sourced rose by 20%.

Foreign-sourced earnings have obviously benefited from two tail-winds: a weaker US dollar and strong growth in offshore markets. The weak US dollar does not appear to have helped America's export competitiveness – on OECD data, America has been losing market share in its foreign markets. However, it means that earnings made in, say, Europe, translate into more dollar earnings.

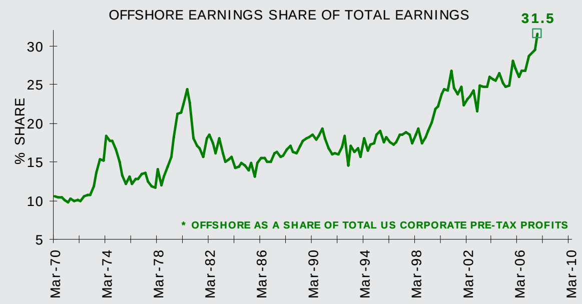
The more important benefit has been the economic strength in the rest of the world. Exhibit 3 shows the link between America's foreign-sourced profits and growth in America's trading partners.

Exhibit 1
Total Profits Peak



Source: BEA; Morgan Stanley Research

Exhibit 2
With Growing Offshore Support

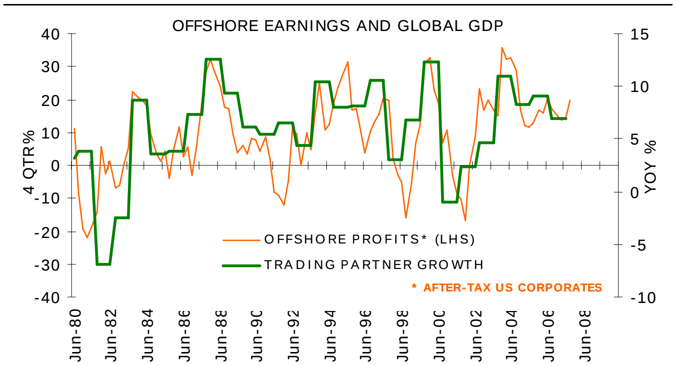


Source: BEA; Morgan Stanley Research

This highlights an important point: the support from foreign earnings would likely fade if, as I think seems increasingly likely, there is a material slowdown in global growth next year. Having said that, while I have structural concerns for the Anglo world, I expect that any slowdown elsewhere would be largely cyclical. In other words, the medium-term outlook remains more positive for offshore-based earnings than for domestically sourced earnings.

Exhibit 3

Growth Drives Earnings

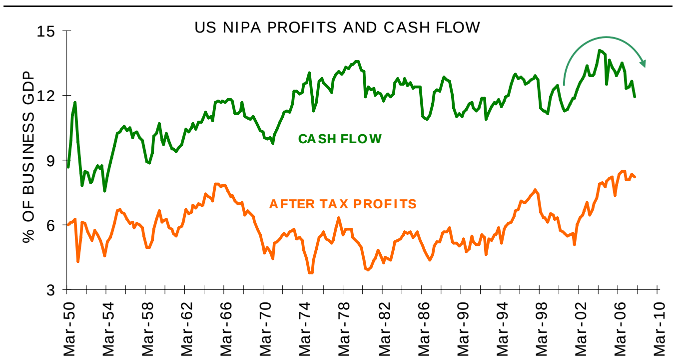


Source: BEA, OECD; Morgan Stanley

There are a couple of other points to note about the profit data. The first is that the NIPA data do not include capital gains or losses. Lately, of course, there's been more of the latter than the former, particularly in the financial sector (where consensus forecasts are for a 7% decline in S&P financial earnings this year).

Exhibit 4

Cash Flows Peak

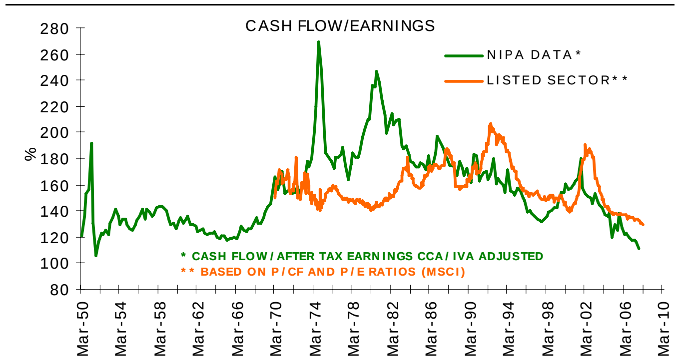


Source: BEA; Morgan Stanley Research

Second, it's notable that net cash flows peaked some time ago (Exhibit 4). This presumably reflects the shift from the early part of the recovery phase where the focus was on balance sheet repair and debt repayment. Corporates are now managing returns for equity holders, rather than debt holders, and are distributing earnings via dividends and buy-backs. The same is also apparent for the listed sector. Exhibit 5 shows the ratio of free cash flow to reported earnings. For the US MSCI index, that ratio is now at an all-time low. The decline in free cash is now a concern to our credit team (see Greg Peters, *Free Cash Fading*, 30 November).

Exhibit 5

Less Cash behind Earnings

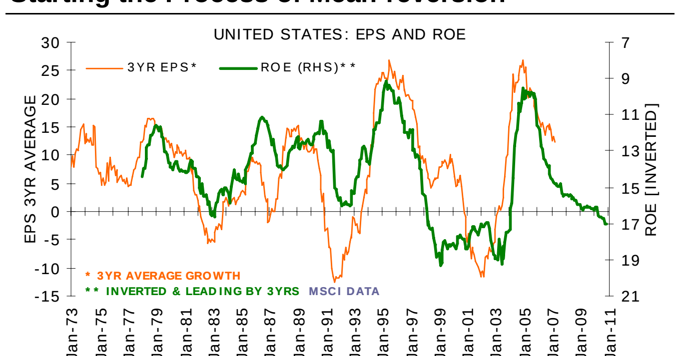


Source: BEA, MSCI; Morgan Stanley Research

The final point to note is that even with the support of strong foreign-sourced earnings, the process of return mean-reversion seems well underway. This is simple economics: high returns attract competition, which tends to erode profit growth and returns, just as low returns lead to less competition and point to rising profits. Exhibit 6 shows how trend (three-year annual average) EPS growth follows the rise and fall of returns. The high returns of the past few years point to substantially lower earnings growth. That is what now appears to be happening.

Exhibit 6

Starting the Process of Mean-reversion



Source: MSCI, Morgan Stanley Research

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(as of November 30, 2007)

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