Jeremy Grantham on Profit Margins and American Prosperity
January 8, 2018
by Robert Huebscher

Have profit margins risen to a permanently higher plateau? Are average Americans better off than they were a generation ago? I had the opportunity to discuss those questions, which are centrally important to investing and economic policy, with Jeremy Grantham a couple of weeks ago.

The discussion took place as part of a larger interview about climate-change investing. Grantham is the co-founder and chief investment strategist of Boston-based Grantham Mayo Van Otterloo (GMO).

It’s been widely reported that over the last 20 years the number of publicly traded companies has decreased by about 50%. The common explanations center on the fact that the number of de-listings, mergers, acquisitions and bankruptcies have outstripped the initial public offerings (IPOs).

But I wanted to know if there was a deeper explanation related to the fact that corporate profit margins are at historical highs. Over the last dozen years, with the exception of the financial crisis, profit margins have been between 9% and 11% of GDP. Prior to that, the last time they were above 9% was in 1951.

The U.S. economy has become more concentrated in the service and technology sectors, which are inherently more profitable than the manufacturing businesses that dominated 50 years ago. Those business, like Amazon, Apple and Google have built incredibly strong, near-monopolistic franchises that should translate to higher margins.

If the market has become dominated with highly profitable, monopolistic franchises, then maybe that is why there are fewer companies and profit margins are no longer “the most mean-reverting series in finance,” as Grantham once claimed.

GMO has looked at this issue extensively. As Grantham noted, “profit margins and return on sales will vary much depending on whether you are in the supermarket business or whether you are in some software company. There is no average to which it moves.”

But that doesn’t necessarily mean that returns for equities will be greater going forward. As Grantham explained, higher margins will attract more capital and reduce the returns relative to other asset classes. “If your capital is returning more in this area than the other area then capital will flow and balance it out,” he said.

Higher margins have been offered as an explanation, by Grantham and others, for why the cyclically adjusted price-earnings (CAPE) ratio is higher than its historical average. But CAPE ratios depend on other factors, such as real interest rates, so margins only tell part of the story.

Grantham said that the monopoly factor has increased margins “a bit.” “Corporate power as exercised through Congress, particularly in the U.S., has clearly increased the total domination of regulatory boards by the industries. Regulations have gone from being concerning to laughable, and totally run by those guys for their own interests,” he said.

Grantham is far more concerned about the societal impacts of unchecked capitalism than he is with its effect on margins. “We are seeing a flowering of corporatism where government is designed to maximize the opportunities of giant influential companies and industries that spend a lot of money lobbying,” he said. “We continue down that primrose path today with yet another cycle of deregulating designed to help corporations.”

Grantham spoke about the “punishing consequences” that tax cuts and deregulation will have on the general public. He said that “maximizing the returns and the share of the pie going to corporations and the superrich is deplorable and has terrible effects on the economy in the long run. The average person in the street doesn’t have the buying power increments that they used to have.”

American prosperity
But is the average American really losing buying power? On this point, Grantham and I disagreed. Whether you go back 10, 20 or 40 years, I contend the standard of living for Americans has increased enormously.

Grantham, however, said that in terms of general well-being and happiness, Americans are worse off. “If you do your best to control for everything and measure happiness, this is not a particularly happy country,” Grantham said. “It is not entirely dependent on income by any means, and we have not improved.”

He acknowledged a couple areas where Americans are better off – entertainment, such as high-tech computer games, and medicine, where he said progress in drugs and technology are keeping people alive longer. To those I would add food, in light of the advances in the quality and variety of choices in cuisine, and transportation, considering the speed and safety at which we can travel by car, plane and other means.

But Grantham said that the average worker has not been paid more since 1974 for an hour’s work. “Does he feel more content, or does he feel extremely frustrated by his relative lack of progress compared to others?” he asked, rhetorically. “There is no doubt that he is more frustrated. The suicide rate in that group has gone way up. The drug addiction has gone way up.”

Indeed, he said there are all the indications of a “thoroughly miserable middle America.”

That is obvious from the suicide rate and the addiction rate, according to Grantham. He sympathizes with those who came from a world where one’s parents increased their annual wages by 3% or 4% real per year. Inflation-adjusted salaries have gone “dead flat” since the early 1970s, he said.

“This has been a bitter disappointment,” Grantham said.

I asked whether this could be the result of rhetoric from politicians and commentators who seek to amplify the fears of disadvantaged Americans. Grantham agreed that there has been a political background that encouraged – or even whipped up – disappointment.

“But it is also clear that the reasons for being frustrated have not come out of thin air,” he said. “This is not the postwar boom where blue-collar workers make enough money to feel very pleased with themselves, and have their kids one way or the other go to college. This is not by any means as successful a society.”

He pointed to some statistics that illustrate the lack of progress among Americans relative to other developed countries – more children are born to 16-year old girls, a higher murder rate, more people in prison (by a factor of three or four, he said), a higher rate of gun violence and lower life expectancies.

But the data on life expectancy is not conclusive. Life expectancy at birth is less for Americans than for most developed countries, but after approximately age 35, U.S. life expectancy is indistinguishable from the others. The reason is that the murder rate in the U.S. is so high and most victims are younger than 35.

Grantham countered that our infant mortality is 19th or 20th out of 20 developed counties and mothers who die in childbirth are very high compared to the others. He said that those rates have improved steadily, but that America pays the most for health care as a percentage of GDP, and we have worse outcomes than everyone except a couple of countries.

But you can’t use life expectancy to claim that medical outcomes in the U.S. are worse than for other countries, unless you carefully adjust for our murder rate.

I acknowledged that Americans pay more for medical care, but I contended that a better question to ask is whether all health-related government spending, including social services, is greater in the U.S. than for other developed countries. Those social services, including welfare, food stamps, and subsidized housing, contribute to better health outcomes in the same way as does healthcare. When you look at all health-related spending, the data for the U.S. is not that different than our peers (The major OECD countries on average spend about $1.70 on social services for each $1 on health services. But the US spends just 56 cents per health dollar – see here).

The question of whether Americans get better outcomes for our healthcare dollars is significant, yet for most of us its relevance will be limited to cocktail-party conversations. But the larger question of how fast our standard of living is advancing has profound implications for economic policymakers. If our standard of living is improving faster than the published data indicates, then it means that inflation has been overstated. If inflation is overstated, then real growth rates and productivity are understated.
Most importantly, this runs contrary to the claims by politicians and others about stagnating real wages.

This is where Grantham and I had the sharpest difference. He said, “There is no question that GDP growth has slowed way down. Productivity has slowed way down and we have entered a low-growth world.” In his view, this has led to extreme income inequality and favoring of corporations.

“Where it goes and how long it lasts, nobody knows. You would hope for a swinging back of the pendulum, and I would certainly hope, and to some extent I expect that that will occur in the not too distant future.”

I agree that that income inequality has risen and corporations are more favored by government policy. But I am not persuaded that real growth rates in the U.S. are as low as Grantham fears, nor am I convinced that Americans are as bad off as he claims.