[Market Math]

BIG PROFITS=DANGER AHEAD!

Corporations are riding a **wave of record earnings,** but they can't sustain the current pace. BY SHAWN TULLY

THE FINAL FIGURES are in, and 2006 was another bang-up year for corporate profits, with the stocks of the S&P 500 showing earnings growth of 16%. That may be cause for celebration at annual meetings, but it's one of several signals flashing danger for investors. Here's a rundown.

First, profits stand at 12% of gross domestic product, the highest level since the 1960s and 33% above the historical average of 9%. That makes it extremely unlikely that profits can keep growing at the recent pace. In fact, the best research finds that profits for publicly traded companies grow at less than 2% a year on average, adjusted for inflation. So the best bet is that profit growth will decline sharply in the next few years.

Second, stocks are extremely expensive right now. The S&P is selling at a price/earnings ratio of about 18, based on the past four quarters' earnings. But remember, those earnings stand at a record level. "That makes stocks look cheaper than they really are," says Cliff Asness of AQR Capital Management, a highly successful hedge fund.

To gauge how much you're really paying for a dollar of profits, it's more revealing to compare today's prices with average earnings over the past ten years. That formula takes out the big swings in earnings that can make stocks look artificially undervalued or overvalued. By smoothing earnings, Asness gets an adjusted P/E of around 25 for the S&P 500. That's well above the historical average of 14 or 15. That's expensive, and buying in at high prices has always been the ticket to low future returns.

Third, dividend yields are extremely low, frequently a signal that stocks are overpriced. They stand at 1.8%, less than half the average over the past century. One reason is that P/Es are so high; another is that companies are retaining a higher portion of their earnings. If they were reinvesting those earnings for huge returns, today's high prices might be justified. But research by Asness and Robert Arnott shows that retaining more earnings leads to lower profit growth, not higher. One reason: Managements have a tendency to squander retained earnings by overpaying for acquisitions.

So what kind of returns can you expect from stocks today? Take the 1.8% dividend yield and 4.5% profit growth, including inflation, and you can expect to earn 6.3% or so on your portfolio. That's assuming that P/Es stay where they are. But it's highly possible that P/Es—and stock prices—will drop, raising dividend yields and giving investors a window to buy in at lower prices. It's only from far lower prices that stocks have a prayer of posting more double-digit gains over the next several years. F

FEEDBACK *stully@fortunemail.com*

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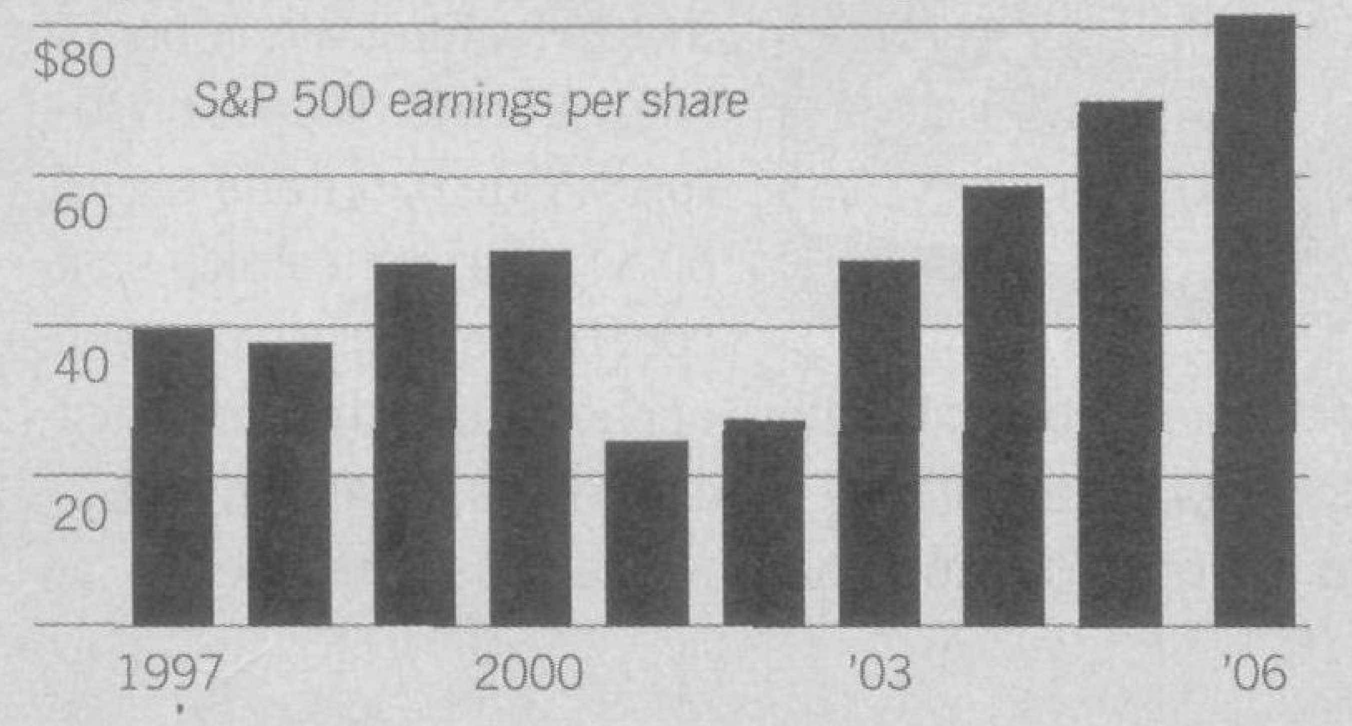
On a Roll

Corporate profits have been soaring.

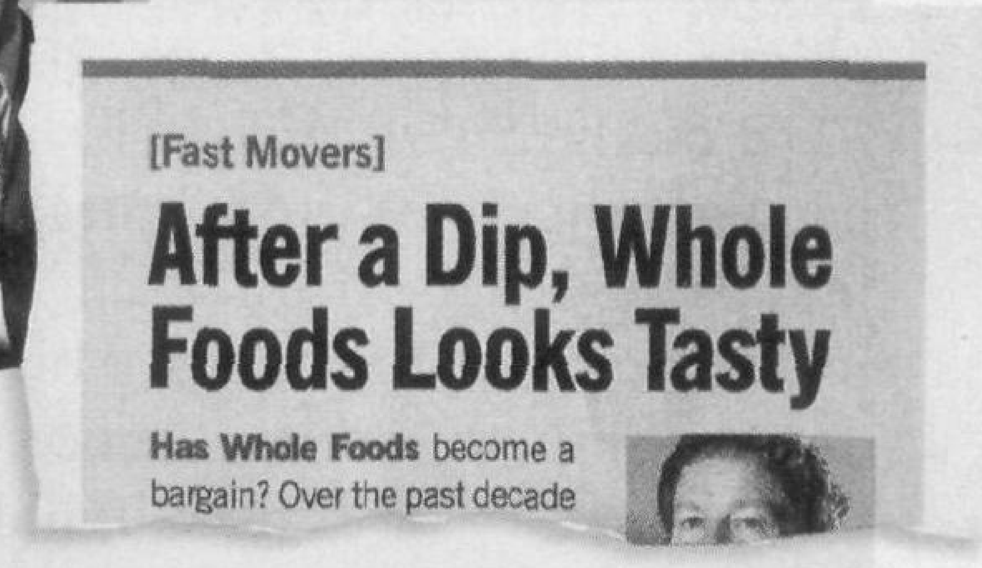


FORTUNE CHART / SOURCE: S&P

UPDATE

WHAT WE SAID

Last spring we argued that **Whole Foods (WFMI),** the organic-food retailer, looked like a bargain after its fast-climbing shares dropped 17% to $63 on two consecutive earnings misses (April 3, 2006). We were concerned about the stock's high multiple of 45 times estimated 2006 earnings. But we cited Banc of America Securities analyst Scott Mushkin's view that the stock could hit $82.50.


[Fast Movers]

After a Dip, Whole Foods Looks Tasty

Has Whole Foods become a bargain? Over the past decade

WHAT HAPPENED

Turns out that Whole Foods was headed for a tough year. The stock rose to $72 in May, but on Nov. 3 it plunged 23%, to $46, on news of slowing same-store sales growth and higher-than-expected costs for opening new stores. The ground shifted again last month, when the retailer announced a deal to acquire rival Wild Oats. Investors loved the idea and sent the stock up 14%, to $52. Some of last spring's bulls are still cautious. Mushkin rates the stock neutral, with a 12-month target of $45. On the other hand, Morgan Stanley's Mark Wiltamuth, who points to Whole Foods' history of successful acquisitions, has stuck to his overweight rating. "This transaction is a big shot in the arm in terms of fuel for future earnings growth," says Wiltamuth, who raised his one-year target to $66 and the two-year to $83. —*Eugenia Levenson*