ECONOMIC OUTLOOK

REGIONS

April 2016

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Corporate Profit(s) Of Doom?

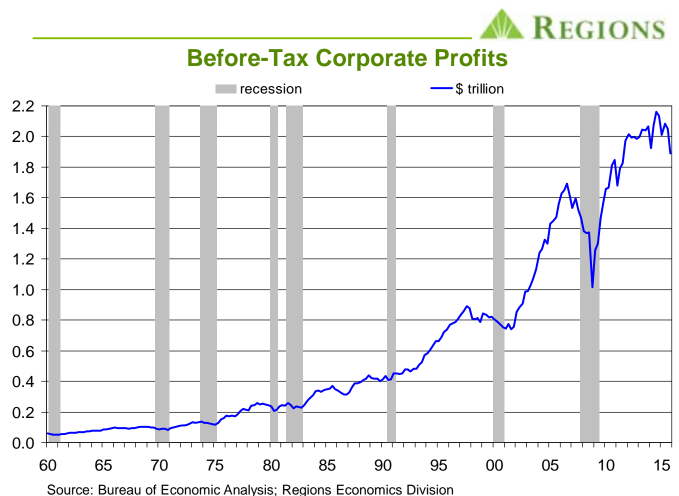
What a difference a year makes. Or two. Or three. Or, in this case, three-and-a-half. The late-March release of the third estimate of Q4 2015 GDP included the first look at the data on Q4 2015 and full-year 2015 corporate profits as measured in the National Income and Product Accounts (NIPA), from which the data on GDP flow. In the case of corporate profits, one look may be all anyone wants to take, as before-tax corporate profits were down 11.5 percent year-on-year in Q4 2015, the largest such decline since Q4 2008. For 2015 as a whole, before-tax profits were down 3.1 percent after having risen by 1.7 percent in 2014.

These numbers touched off quite a mix of reactions, bounded on the two extremes by "it's all energy, nothing to worry about here" and "the corporate sector is going down and taking the rest of the economy with it." Well, we did say the two extremes. Amidst all of the discussion, we couldn't help but think back to our September 2012 *Monthly Economic Outlook*. Okay, sure, we often think back to that particular edition, as it was the very first we produced after taking this post. This time, though, there was a reason aside from sentiment to think back to that September 2012 edition, the title of which was "One Standout In The Not So Great Recovery" and the topic of which was corporate profits.

Back then, of course, the discussion was somewhat different. In the midst of what was a lackluster recovery from the Great Recession (okay, that part hasn't changed), corporate profits were hitting what, at the time, were record levels and growing at a considerably above-average pace compared to profit growth in prior cycles at the same point in the recovery. Our discussion focused on how profits were growing so rapidly despite anemic growth in top-line revenue and how long this could be expected to continue. We pointed out that a still considerable degree of labor market slack was holding down growth in unit labor costs of production, and our conclusion was that while we expected revenue growth to remain middling, it would be some time before rising input costs began to pressure profit margins.

Jump forward three-and-a-half years and the discussion has changed, with the focus now on how much further corporate profits will fall and what are the implications for the broader economy. So, as we did back then, in what follows we'll discuss some of the main factors behind the behavior of corporate profits and our outlook for the path of profits over coming quarters. As to the two extreme reactions to the 2015 profits data noted above, well, as with most things in life, reality lies somewhere in between. Sure, the view of corporate profits is being clouded by the energy sector, but anyone not seeing cause for concern outside of energy just isn't looking all that hard.

Before proceeding, we'll note the measures of profits reported in the NIPA data are economic profits, which will vary from what can be thought of as "accounting" profits that are the basis of most corporate earnings announcements and are more widely reported. The variances between the two measures mostly stem from differences in accounting for inventory valuation and capital consumption. For instance, the accounting treatment of capital consumption (or, depreciation) can vary with tax laws, such as the accelerated depreciation allowances that have often been in place over the past several years, whereas in the calculation of economic profits depreciation is taken on a straight-line basis over the economic life of the asset. This discussion is based on before-tax profits with adjustments for inventory valuation and capital consumption, the measure of economic profits which most closely corresponds to changes in GDP.



The above chart shows before-tax corporate profits (again, with adjustments for inventory valuation and capital consumption) and, if nothing else, should at least lend some perspective to the recent spate of stories about declining profits. In Q4 2015 profits were $1.89 trillion (as with the GDP data, the profits data are reported on a seasonally adjusted annualized basis), which marks a 12.5 percent decline from the peak of $2.16 trillion in Q3 2014. For all of 2015, pre-tax profits were $2.009 trillion which, while down 3.1 percent from 2014, doesn't exactly suggest corporate chieftains are about to take to the streets, hats in hands, hitting up passersby for their spare change.

But, one cause for concern at present is that historically, declines in profits have tended to precede recessions, though as can be seen not every downturn in profits has been followed by a recession. Aside from changes in direction, however, looking at the level of profits in isolation does not necessarily convey much meaningful information. For instance, the data are reported in nominal terms so the effects of inflation over time are not accounted for. It is even more useful to look at profits in the context of top-line revenue, or, in terms of profit margins. Using

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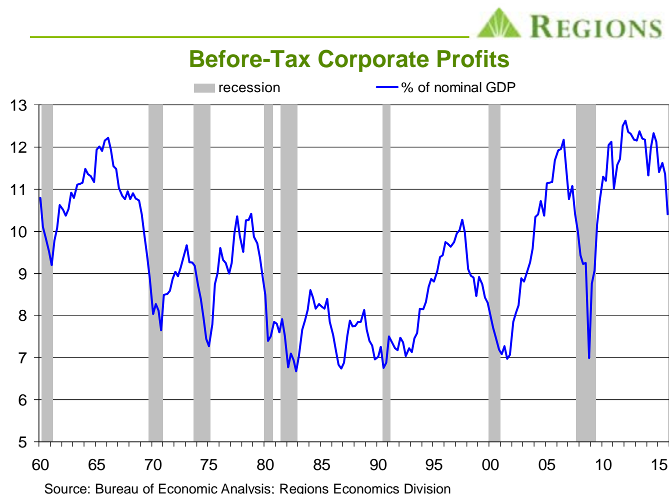
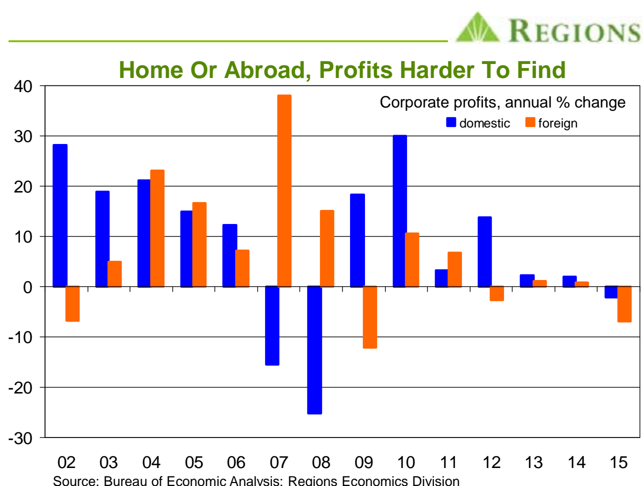


nominal GDP as a proxy for top-line revenue, the chart above shows how profit margins have been trending lower since hitting an all-time high of 12.6 percent in Q1 2012 (when we did our analysis in 2012 the data at that point ran through Q2 2012), falling to 10.4 percent in Q4 2015. This is the narrowest margin since Q3 2009, which of course marked the start of the recovery from the 2007-09 recession. This chart may help better illustrate the concerns over profits, the $2.009 trillion level in 2015 notwithstanding. While there is no profit margin version of the "Mendoza Line", i.e., a point below which a recession is sure to follow, the concern is the downtrend in profit margins since mid-2012 could be a signal that a recession is on the horizon. Keep in mind these concerns are being raised in the context of several years of sluggish domestic growth and what, more recently, has been a string of uneven domestic data and soft economic growth across much of the globe.



While a stronger U.S. dollar has been a convenient scapegoat for fading profits/profit margins, the data don't exactly cooperate on this point. The NIPA data provide a split between domestic and foreign profits – though the foreign profits data have a limited history going back only to 2001. As seen in the above chart, profits earned abroad fell by 7.0 percent in 2015 after posting only modest increases in the prior two years. But, as can be seen, domestic profits also declined in 2015, falling 2.1 percent after average growth of 2.1 percent over the prior two years.

Still, some brush off declining domestic profits on the grounds that this reflects nothing more than the turmoil in the energy sector having an undue impact on overall corporate profits. Yes, it is true that of the $64.0 billion decline in total before-tax profits in 2015, $40.6 billion of that came from the energy sector (which includes coal), and of that roughly half reflected a one-off charge by one large firm to settle a legal judgment. But, we'd counter with simple math – excluding energy, pre-tax corporate profits fell from $2.019 trillion in 2014 to $1.996 trillion in 2015, a decline of 1.2 percent (compared to the 3.1 percent decline in total profits). This comes after an increase of just 1.5 percent in 2014 (compared to the 1.7 percent increase in total profits).

It is worth looking at the industry detail in the NIPA data on corporate profits. For instance, on an industry-wide basis manufacturers of motor vehicles, metals, and chemicals turned in solid gains in profits in 2015, reflecting lower input costs and growth in demand. Providers of transportation and warehousing services also saw healthy profit growth, particularly truck transportation which saw rising freight volumes and lower fuel costs. Conversely, producers of industrial machinery and utilities providers saw profits fall in 2015. In other words, the data on corporate profits, at least once one goes beyond the headline numbers, are pretty much consistent with what we know to have been the broader themes of the U.S. economy in 2015.

While this would seem to imply the corporate profit picture is not as bleak as the headlines suggest, there are indeed legitimate reasons for concern. For instance, focusing on the full-year data can easily cause one to overlook the marked deterioration in profit performance over the course of the year. Indeed, information services is the only industry group in which profit growth over the second half of 2015 was stronger than it was over the first half of 2015. In every other industry group, one of three things occurred – profit growth was slower over the second half of the year than over the first half, profit growth over the first half of the year gave way to profit declines over the second half of the year, or profit declines over the first half of the year intensified over the second half of the year.

These same patterns are true across the broader splits in the data – domestic vs. foreign profits, financial vs. nonfinancial sectors. Clearly, profit growth lost considerable momentum over the course of 2015 and it is hard to see how that momentum will be regained over the course of 2016. Our forecast is for a further decline in corporate profits in 2016, reflecting our expectations for both the revenue side and the cost side of the ledger, which cannot be dismissed as simply an energy story and/or a U.S. dollar story. Instead, another year of middling growth in top-line revenue, further increases in labor costs, and at least moderately higher interest rates figure to put further downward pressure on corporate profit margins in 2016.

In our 2012 piece we pointed to unusually slow (relative to historical cycles) growth in labor costs as the main explanation for the seeming disconnect between earth bound revenue growth and soaring corporate profits. We noted that, given the elevated degree of labor market slack, profits could continue to grow even

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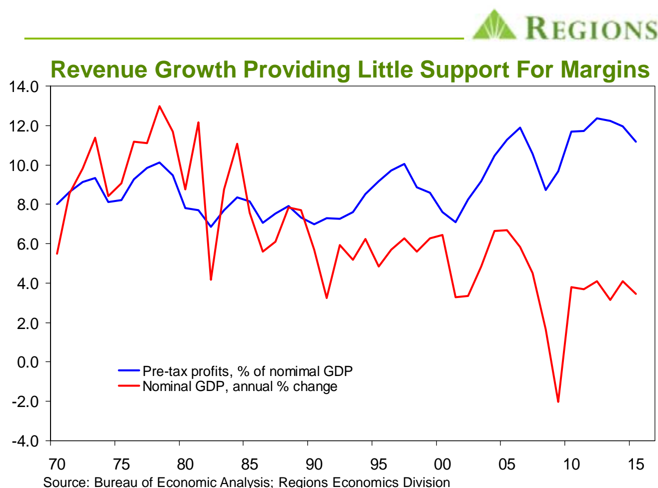
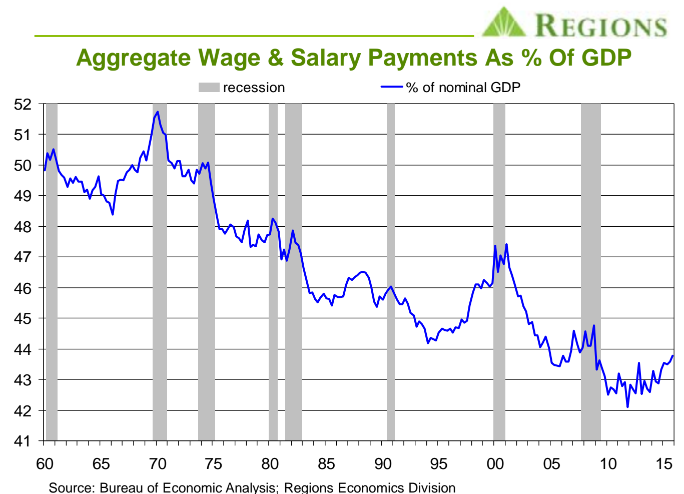
in what we figured would remain a challenging revenue environment. But, at some point there figured to be a "day of reckoning" for corporate profits and that day seems to have arrived. In some ways, what we've seen over the course of the current cycle is no different than what we've seen in past cycles. For instance, in the early stages of recoveries profit growth has historically been quick to accelerate but ultimately gives way to rising labor costs and margins begin to compress. As with many other aspects of the economy, that process has taken longer in the current cycle, which is simply a reflection of how severe the 2007-09 recession was and the depth of the hole the economy had to dig itself out of.



Still, there are some critical differences between the current cycle and past cycles. One such difference is the fact that, despite the current expansion now being one of the longest on record, top-line revenue growth remains middling. This can be seen in the above chart which, using annual data, shows corporate profit margins plotted against growth in nominal GDP (again, a proxy for growth in total revenue). Since the end of the 2007-09 recession nominal GDP growth has settled into what is the slowest sustained growth rate on record in the NIPA data. To be sure, this reflects persistently low rates of inflation, here and abroad, but the flip side of that is firms have very little pricing power, particularly producers of goods.

As we've discussed, this is not an impediment to growth in profits as long as costs remain contained but, as is now happening, when costs – particularly labor costs – begin to rise at a faster rate, profit margins will suffer. In the aftermath of the 2007-09 recession wage & salary payments as a share of GDP fell to the lowest point in the life of the data. This is another way of illustrating our point about the degree of slack in the labor market. Even as the level of nonfarm employment began to rise steadily beginning in early 2010, there was such a high degree of slack in the labor market (i.e., unemployed and underemployed individuals plus those who wanted jobs but had given up and left the labor force) that firms could take on additional workers without facing upward pressure on wages.

From the trough of total nonfarm employment in December 2009 through December 2014, the level of nonfarm employment rose by over 10 million jobs yet the wage share of GDP barely budged. As seen below, however, this began to change in 2015. If the wage share of GDP still looks low by historical standards, that doesn't mean the increase in 2015 was insignificant to firms, as this is where anemic revenue growth comes into play. For instance, the increase in the wage share of GDP in 2015 was the largest of any year since 2000 which, aside from the recession years of 2007 and 2008, was the last year in which corporate profit margins narrowed by as much as they did in 2015.

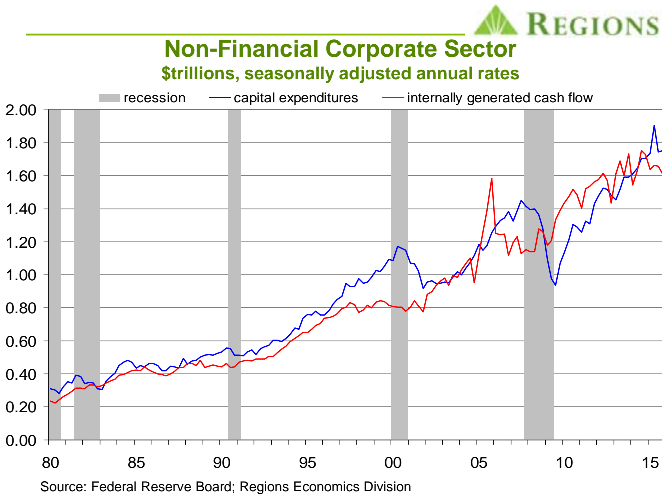


As we've discussed in other forums, in order to be able to properly assess their impact on inflation and on corporate profit margins, wage increases must be looked at in relation to productivity growth. This of course highlights another critical difference between the current cycle and past cycles, which is that, in the current cycle, we have seen only anemic growth in labor productivity. The underlying trend rate of productivity growth is at present less than one-half of one percent, well below historical averages. So, even though wage growth has itself been slow, it is nonetheless running ahead of productivity growth. What this means is that the per-unit labor costs of producing each unit of output are rising, and with firms unable to simply pass these higher costs along in the form of higher output prices, the result is narrower profit margins. To the extent labor costs rise at a faster rate in 2016 than they did in 2015 in a world in which revenue growth remains constrained, the negative implications for corporate profit margins are painfully clear.

The prospect of further declines in profit margins due to higher wage bills could of course lead firms to push for faster growth in worker productivity, but this is not something which happens overnight. Productivity growth, or, the lack thereof, has been a frequent topic of discussion for us, and one argument we've made is that underinvestment in equipment and software on the part of firms over the course of the current cycle is a primary culprit behind anemic productivity growth. The age of the capital stock remains near a record-high, and reversing this is something that happens only gradually over time.

To the extent firms do wish to step up spending to bring capital stocks more up to date and enhance worker productivity, declining profit margins complicate this task, particularly to the extent interest rates move higher as margins are compressing. One consequence of compressing margins over the past several

quarters is that firms are retaining less cash, thereby leaving them less able to internally finance capital outlays. One measure of the need for external financing on the part of firms in the nonfinancial corporate sector is the "financing gap" or, the difference between capital expenditures and internally generated cash. In the chart below, we show the two individual components of the financing gap, and what is noteworthy is the drop-off in internally generated cash over recent quarters.



First and foremost, that capital expenditures have been rising since the end of the 2007-09 recession is not inconsistent with our contention that there has been underinvestment – we base our view on cap ex's contribution to GDP growth which has been and remains below historical averages. This can also be seen by the fact that for most of the post-recession period the financing gap was negative, i.e., firms were generating more than enough internal cash to finance all capital spending, which has never been the case for such a prolonged period of time. While the level of internally generated cash remains high, as with profits it's all about momentum, and the reality is cash flows have been diminishing and figure to slow further as profit margins compress further, particularly as firms have been loath to cut dividend payouts. So, with even the modest growth we've seen in capital spending, firms will become more reliant on external financing, which will become more costly to the extent interest rates rise and equity prices log further declines.

What Does It All Mean?

Over six-and-a-half years into an expansion, it should come as no surprise to see profit margins compressing. At the same time, cyclical peaks in profits have historically been a precursor to recessions, though the lag time has tended to vary greatly, which is why it would be foolish to ignore the signal being sent by profits over the past several quarters. Still, there are those who insist it's all about energy and not a commentary on trends in the broader economy. On top of the evidence to the contrary we presented earlier, we'll simply add that back in 2000 there were plenty of people using the "it's only tech, don't worry about it" argument and, remind us again, how did that turn out?

There are also those who argue that firms will simply be able to pass along higher costs, particularly wage costs, along to consumers in the form of higher output prices. We'll raise two points here. First, we'd argue goods price deflation is not going away any time soon given how much slack remains in the global economy. This makes it far more likely goods producers will see even further pressure on profit margins in the absence of the ability to pass along higher input costs to consumers.

Second, while it is true services providers, being largely immune to global competition, have much greater latitude to pass along higher labor costs in the form of higher output prices, to the extent they do so and this is reflected in faster measured inflation, this would simply mean the FOMC would raise the Fed funds rate at a faster pace than is now being anticipated. This in turn would touch off a number of reactions, none of them good for corporate profits. In addition to making it more costly for firms to finance capital spending, it would also ignite further appreciation of the U.S. dollar, which in turn would depress foreign profits. More broadly, to the extent higher interest rates would choke off economic activity, this would simply put even more downward pressure on profits.

It is of course possible that there will be relief on the revenue side of the ledger. After all, the world is awash with monetary stimulus which, at least according to practitioners of the art, will lead to a revival in demand. This in turn would enable firms to exercise a greater degree of pricing power and negate some, if not all, of rising costs for labor and other inputs, thus either maintaining profit margins or at least slowing down the rate of margin compression. Anyone who read our March 2016 *Outlook*, in which we discussed the limits on the effectiveness of monetary policy, even if policy itself is unlimited, will know our thoughts on the likelihood of this outcome. Then again, we've been wrong before so we'll at least throw out a monetary stimulus induced respite for declining profit margins as a possibility. But, if such a scenario were to play out, it seems more and more likely it would be a 2017 story, not a 2016 story, leaving our forecast of another year of declining profits largely intact.

Unfortunately, what seems more likely is that profit margins will compress even further in 2016 than we had anticipated. There are downside risks to profits on both the revenue side and the cost side of the ledger. Though our baseline forecast incorporates slower growth in labor costs and less appreciation in the U.S dollar than do the forecasts of many other analysts, it seems unlikely these pressures on profit margins will abate over coming quarters. Instead, it seems more a matter of the degree to which they will further intensify, particularly since any relief from faster growth in labor costs in the form of enhanced worker productivity is likely several quarters away. At the same time, with global growth still on shaky ground and the prevailing two-percent or so trend rate of growth in the U.S. economy, there is little capacity to absorb an adverse economic or financial shock, which in our view tilts the risks to our forecast for top-line GDP growth – or, top-line revenue growth – to the downside.

With margins already under pressure, slow top-line revenue growth, rising labor costs, and dividend preservation still seen as a priority, it would seem as though something has to give. While each individual can look at the same data and draw their own conclusions, our view is that it is hard to come up with a plausible scenario in which profit margins start expanding again as opposed to compressing further in 2016.

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Q3 '15 (a)	Q4 '15 (a)	Q1 '16 (f)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
2.0	1.4	0.7	2.1	2.3	2.2	2.1	2.3	Real GDP[1]	2.4	2.4	1.7	2.2
3.0	2.4	1.6	2.6	2.9	2.3	2.2	2.1	Real Personal Consumption[1]	2.7	3.1	2.4	2.3
								Business Fixed Investment:				
5.5	-1.3	0.1	2.5	2.2	2.3	3.1	3.2	Equipment, Software, & IP[1]	5.6	4.1	1.6	2.9
-7.2	-5.1	3.2	2.4	0.9	1.5	2.1	4.8	Structures[1]	8.1	-1.5	-0.1	2.7
8.2	10.1	9.0	8.0	8.3	9.6	11.8	10.6	Residential Fixed Investment[1]	1.8	8.9	8.9	10.1
1.8	0.1	1.0	1.1	0.8	1.0	0.4	0.7	Government Expenditures[1]	-0.6	0.7	1.0	0.7
-546.1	-551.9	-571.4	-581.8	-594.0	-596.6	-600.7	-606.5	Net Exports[2]	-442.5	-543.4	-585.9	-610.4
1.158	1.135	1.142	1.141	1.174	1.213	1.249	1.278	Housing Starts, millions of units[3]	1.001	1.107	1.167	1.302
17.8	17.8	17.1	16.8	16.8	16.5	16.2	16.2	Vehicle Sales, millions of units[3]	16.4	17.3	16.8	16.1
5.2	5.0	4.9	4.8	4.8	4.7	4.7	4.7	Unemployment Rate, %[4]	6.2	5.3	4.8	4.6
2.0	2.0	1.9	1.8	1.7	1.5	1.4	1.3	Non-Farm Employment[5]	1.9	2.1	1.8	1.3
0.9	1.1	1.6	1.6	1.7	1.9	1.9	1.8	GDP Price Index[5]	1.6	1.0	1.7	1.7
0.3	0.5	1.1	1.0	1.2	1.7	2.1	2.2	PCE Deflator[5]	1.4	0.3	1.2	2.2
0.1	0.4	1.1	0.9	1.2	1.6	2.2	2.3	Consumer Price Index[5]	1.6	0.1	1.2	2.3
1.3	1.4	1.6	1.6	1.6	1.7	1.7	1.8	Core PCE Deflator[5]	1.5	1.3	1.6	1.8
1.8	2.0	2.2	2.1	2.2	2.2	1.9	1.9	Core Consumer Price Index[5]	1.7	1.8	2.2	1.9
0.13	0.17	0.38	0.38	0.55	0.67	0.88	0.91	Fed Funds Target Rate, %[4]	0.13	0.14	0.49	1.08
2.22	2.19	1.88	1.87	1.93	2.02	2.23	2.33	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.93	2.44
3.95	3.90	3.66	3.57	3.60	3.68	3.85	3.97	30-Year Fixed Mortgage, %[4]	4.17	3.85	3.63	4.06
-2.8	-2.8	-3.0	-2.9	-2.8	-2.9	-3.0	-3.0	Current Account, % of GDP	-2.3	-2.7	-2.9	-3.1

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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