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Economic Watch

US

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Economic Analysis

US
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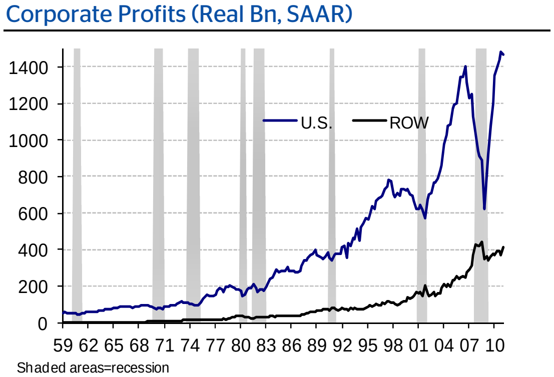
Can Corporate Profit Growth Continue?

Assessing strength in an otherwise weak economy

- **Corporate profits have rebounded from the Great Recession despite weak economic activity**
- **Growth of corporate profits is likely to continue in the short term as dividend yields remain high, nominal bond yields low, and output per hour flat**
- **Long-term outlook for corporate profits is relatively stable, with expectations for a flatter growth trajectory after 3Q12**

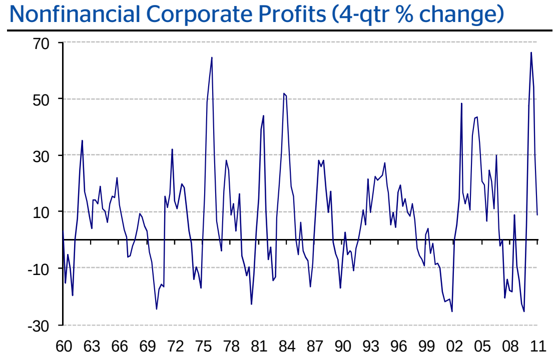
Corporate profits have historically been a volatile indicator of growth in the U.S., yet volatility has increased dramatically in recent years. In the midst of the financial crisis, corporate profits in the U.S. fell sharply to approximately $600bn (4.6% of GDP), the lowest since early in the decade. Despite this significant decline, corporate profits have rebounded more than double, surpassing historical highs while the rest of the economy struggled to maintain a strong recovery. Weak labor market conditions have negatively impacted most economic activity, yet corporations have retained strong profit margins as a result of reduced labor and borrowing costs. Furthermore, U.S. firms have strived to increase productivity and expand overseas to capitalize on growing international markets rather than succumb to sluggish domestic sales. However, now that fiscal uncertainties regarding budget reform and weak economic activity have swept across the U.S. and Europe, concerns have arisen over whether corporate profits will start to thin. The recent debt ceiling debate and unprecedented downgrade of the U.S. credit rating, along with downward revisions to GDP and proposed cuts to spending and business investment, have brought forth the possibility of a double-dip recession. Rising commodity prices and economic slowdowns in the rest of the world will further challenge corporations to retain their profit margins. Given that these are unique macroeconomic times, it is likely that corporate profit trends could play a role in whether the economy recovers or dips back down into a recession. If corporations decide to hoard less cash and expand domestically, this could contribute to much-needed growth in the labor market and ultimately spark consumer activity.

Chart 1
Corporate Profits (Real Bn, SAAR)



Source: Bloomberg and Haver Analytics

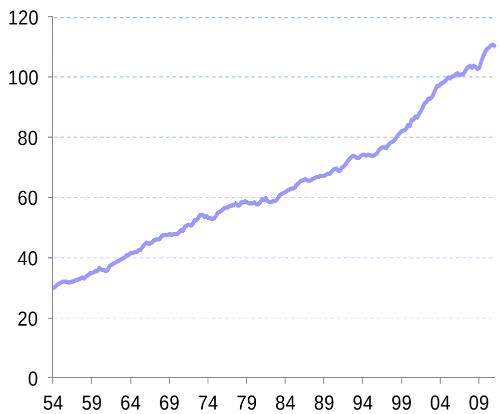
Chart 2
Nonfinancial Corporate Profits (4-qtr % change)



Source: Bloomberg

Forecasting corporate profits is typically difficult given the volatility of the indicator and many factors can come into play. Prior publications utilized a variety of methodologies to predict how corporate profits will react to changes in macroeconomic data. There exists an extended collection of earnings forecasts and in general most of these include measures of economic growth, dividend payouts, and non-corporate investment. For this particular model we included output per hour as a proxy for growth as well as yields for dividends and nominal bonds. We calculated corporate profits forecasts via co-integrated vector autoregression models, conditioned appropriately for expected changes in the economy.

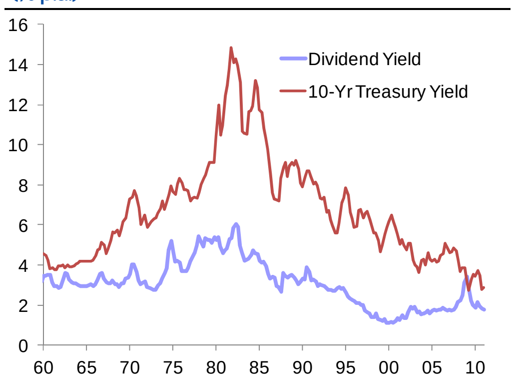
Chart 3
Real Output Per Hour (SA, 2005=100)



Source: Haver Analytics

Despite volatility in corporate profits, real output per hour has historically been a relatively stable measure of output and productivity growth and it can be a clear indicator of slowdowns in economic activity. Increased productivity can directly improve profit margins, particularly if it involves lower labor costs. Given the weak employment situation, it is no surprise that corporations have been able to take advantage of lower labor costs and maintain high profit margins. However, output per hour has slowed in recent months, indicating that labor efficiency has slipped. If structural unemployment worsens, corporations may see a negative impact on their bottom line. Ultimately, we expect real output per hour to remain flat through 2H11 and then return to growth as the economic recovery strengthens.

Chart 4
S&P 500 Composite Dividend Yield (%) and 10-Year Treasury Note Yield at Constant Maturity (% p.a.)



Source: Haver Analytics

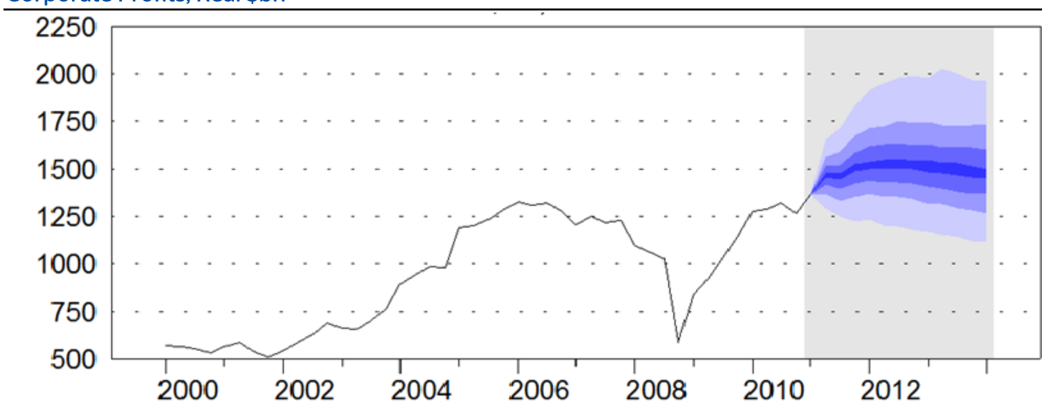
Dividend and nominal bond yields point to risk aversion among investors and, in general, the two tend to move alongside one another. However, the recession in 2008 created the opposite reaction as the stock market fell and investors turned to less risky assets. Given the expected short-term declines in the stock market, we expect a similar reaction: it is likely that dividend yields will increase while nominal bond yields decrease. Dividend yields can only remain high as long as corporations are comfortable with their profit margins. Thus, as the economic recovery strengthens in the longer-term, we expect yields to revert back to normal trends.

Corporate Profits Forecasts

In the short-term, with expectations for flat output per hour, high dividend yields, and low nominal bond yields, we expect corporate profits to continue growing through 3Q12. Weak economic activity are unlikely to have an immediate negative impact on profit margins as corporations continue to hoard cash and take advantage of low labor and borrowing costs. However, we expect profits to fall in the longer-term. As economic growth recovers, corporations may find it harder to hold on to cash as labor and borrowing costs increase and business competition strengthens. Although the growth trajectory of corporate profits is likely to flatten, levels will remain above 1H11 averages. On a YoY basis, growth will remain positive through 4Q12, after which corporations will see small YoY declines in profits.

It is important to note that tax policy and global issues are not incorporated in the model and could be significant contributing factors in terms of future corporate profit volatility and trends. Fiscal uncertainties remain a concern for corporations as governments look to balance budgets and the potential for changes in corporate tax rates would impact bottom lines. Essentially, corporations have been very efficient in maintaining high profit margins during this sluggish economic recovery, mostly benefiting from reduced employment costs and refinanced long-term borrowing. Despite projections for slowing corporate profit growth in the near future, businesses will continue to see high margins as stronger demand helps to offset increasing labor and borrowing costs.

Chart 5
Corporate Profits, Real $bn



Source: BBVA Research

Chart 6
Corporate Profits, YoY%

Source: BBVA Research