Economic Watch

US

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Economic Analysis

U.S.
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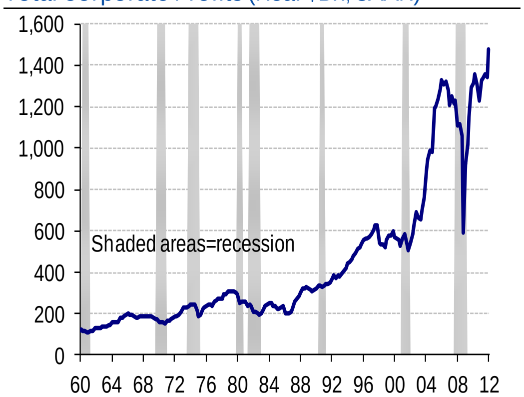
Real Profits Rise by Leaps & Bounds

Will Slowing Productivity Pose a Problem for Future Growth?

- Corporate profits accelerated in 1Q12 to 11.0% YoY growth, the fastest pace in almost two years, with domestic figures offsetting foreign weakness
- Recent slowdowns in productivity suggest that businesses may have to cut into profit margins in order to maintain steady output levels
- Despite global weaknesses, we expect that domestic profits will continue to drive profit growth in the coming years, though at a slowing pace

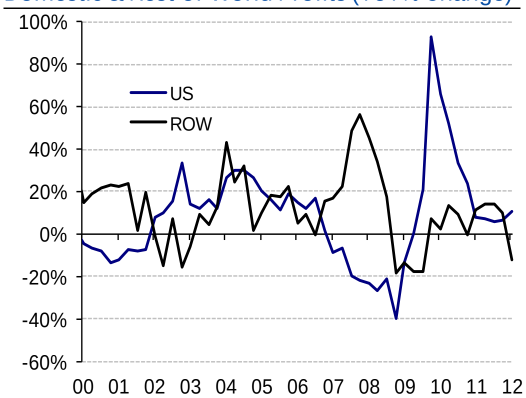
The latest data from the Bureau of Economic Analysis suggest that real corporate profits jumped significantly in 1Q12, rising 9.9% from the fourth quarter to $1.474tr and surpassing the historical peak reached in mid-2010 (Chart 1). Throughout the past 12 months, total profit growth has increased nearly 11.0%, accelerating from the 3.8% and 9.3% YoY rates seen in 3Q11 and 4Q11, respectively. Toward the end of 2011, profit growth was dragged down on account of foreign slowdowns, with the domestic side unable to offset this weakness. Rest-of-world (ROW) profits continued to decline in 1Q12, down 11.8% on a QoQ basis after falling 9.2% in 4Q11 (in nominal terms). Comparatively, profits in the U.S. were surprisingly strong to start 2012. On an annual basis, domestic profits increased 10.5% while ROW profits declined 12.1% (Chart 2). Still, the rationale behind the dramatic profit gains in the U.S. is much less obvious than its foreign counterpart. Economic activity has been modest at best since the crisis, with many bumps along the road, yet corporate profits have recovered at an extraordinary and unprecedented pace. The drastic increase in real profits suggests that businesses may still have some incentives to expand production and add new equipment and workers. A typical assumption for this scenario is that businesses have become much more productive and cost-efficient and are thus able to squeeze out more on their margins. However, this does not appear to be the case today. Slowing productivity gains pose a serious risk to future profit growth if demand conditions are not strong enough to compensate for increased production levels.

Chart 1
Total Corporate Profits (Real $Bn, SAAR)



Source: Bureau of Economic Analysis & BBVA Research

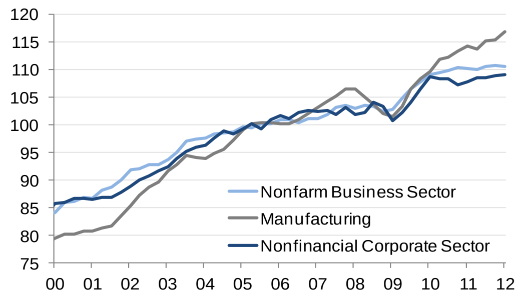
Chart 2
Domestic & Rest-of-World Profits (YoY% Change)



Source: Bureau of Economic Analysis & BBVA Research

Productivity in the first quarter of 2012 declined 1.0% QoQ annualized, mostly on account of slower output growth, suggesting that many businesses may have maxed out on their current capacity in terms of productivity and worker hours. Balancing this, however, is the simultaneous slowing in unit labor costs. This implies that businesses won't necessarily have to dip too far into profits if they need to hire more workers in order to increase output or at least maintain similar levels. If output increases in the coming quarters and labor costs remain subdued, we will continue to see strong profit growth. On the downside, though, is the fact that we have seen significant slowing in job growth thus far in 2Q12. Rather than sacrifice profits, businesses may be at the point where they are uncomfortable hiring additional employees given increasing uncertainties regarding short-term demand conditions.

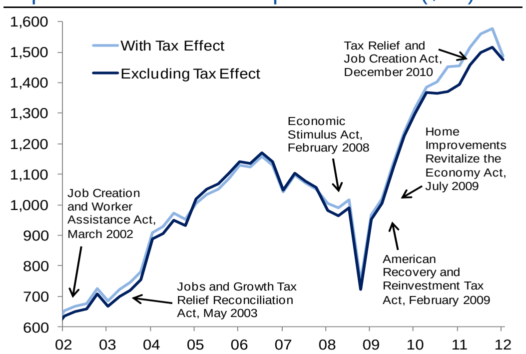
Chart 3
Real Output Per Hour (SA, 2005=100)



Source: Bureau of Labor Statistics & BBVA Research

The nonfarm business sector has experienced relatively flat productivity levels throughout the past few years after recovering quickly from the 2008 recession. Weakness primarily stems from nonfinancial corporations, which accounted for nearly 48% of GDP in 2011. Not surprisingly, the manufacturing sector is performing extremely well, with productivity gains reflecting both increased output and hours worked. In particular, durable goods manufacturing has been a key driver of total production, with productivity having surpassed the nondurable component back in 2Q10.

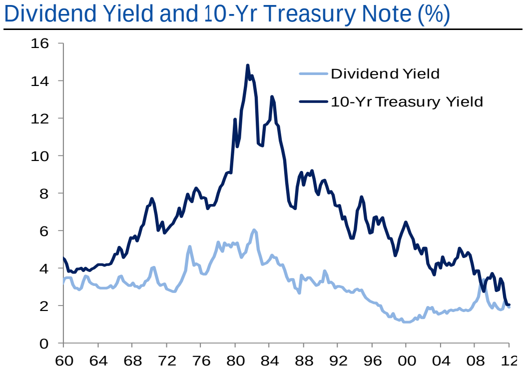
Chart 4
Impact of Tax Acts on Corporate Profits ($Bn)



Source: Bureau of Economic Analysis & BBVA Research

Taxes actually had a significant impact on corporate profits in 1Q12. Throughout the past decade, before-tax and after-tax profits have generally followed the same growth trend. However, after-tax profits dropped significantly in 1Q12, down 5.7% from 4Q11 and marking the first quarterly decline since 4Q08. On the other hand, before-tax profits declined only 0.3% on a QoQ basis. Both data series continue to show YoY growth but at a slightly slower pace compared to the previous quarter. If the Bush tax cuts expire as scheduled at the end of 2012, corporations will struggle to maintain similarly high profit levels in the following years.

Chart 5
Dividend Yield and 10-Yr Treasury Note (%)



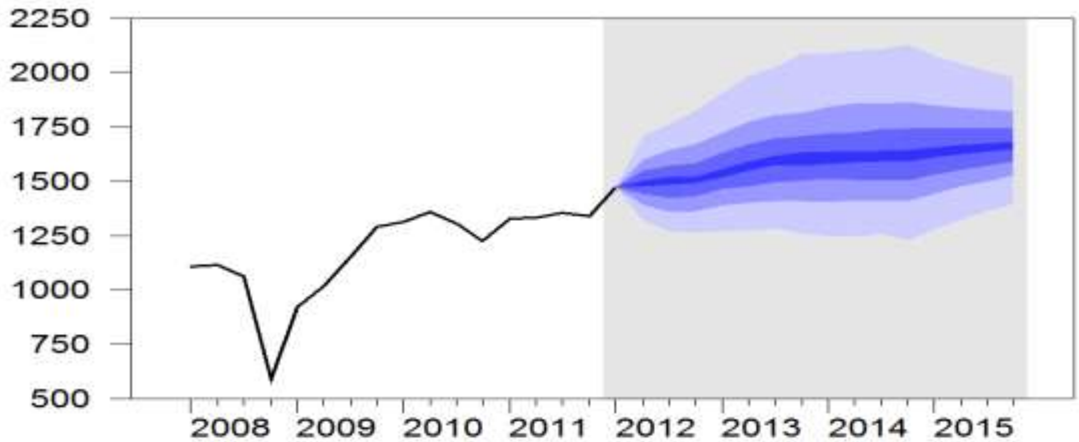
Source: S&P, Federal Reserve, & BBVA Research

The dividend yield has gradually increased since the introduction of the Bush tax cuts in 2003 as a result of the lower payout cost to businesses. However, the end of this tax policy and the resulting increase in dividend taxes could discourage further payouts and significantly reduce the yield closer to 1%, particularly with the added stress of a weak economy. On the other hand, flight to safety has caused the 10-year Treasury yield to drop near all-time lows. Lingering global uncertainties on top of the approaching fiscal cliff in the U.S. will limit a major recovery in both yields.

Corporate Profits Forecasts

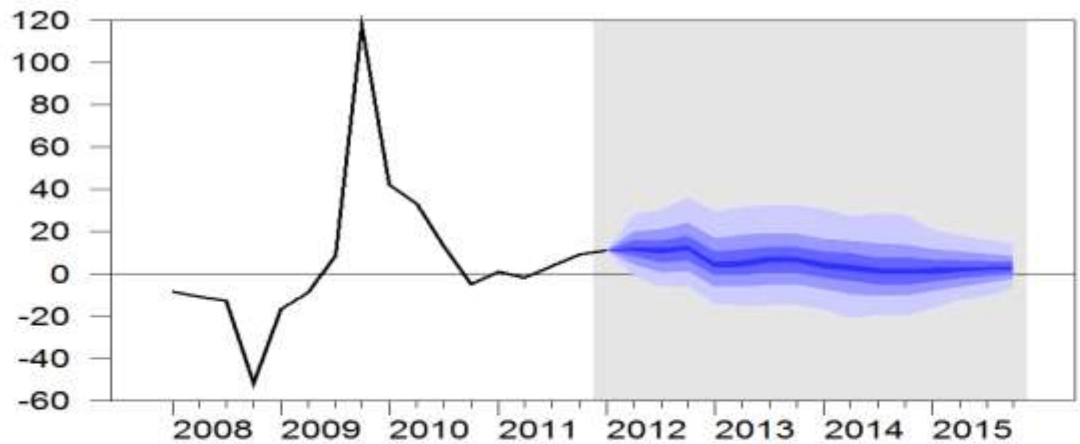
Corporate profits have been growing at an extremely fast pace since the recession, outpacing that of the rest of the economy. Despite the recent slowing in productivity that would, in normal times, cause businesses' labor costs to increase, we expect that subdued hiring in 2Q12 will keep profits growing at a steady pace. Uncertainties in global finances will continue to result in market volatility, but we expect that firms will be able to manage their finances enough to prevent a major hit to their bottom lines. In the short-term, we expect that annual growth rates will be slightly higher than previously predicted given that domestic profits have held strong. Looking ahead to the longer-term, our forecast remains relatively unchanged from the prior report.

Chart 6
Corporate Profits (Real $Bn)



Source: BBVA Research

Chart 8
Corporate Profits (YoY % Change)



Source: BBVA Research