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Economic Watch

US

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Economic Analysis

US
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Corporate Profits Growth to Slow in 2014

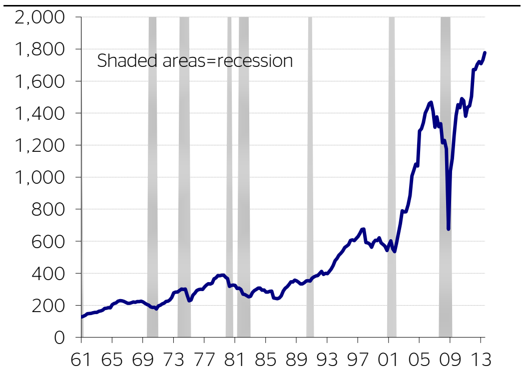
Firms Adjust to Stronger Recovery and the End to Easy Cost-Cutting

- **Real corporate profits accelerated in 3Q13 as labor costs fell sharply while demand expectations improved**
- **Corporate taxes have fallen near historical lows, around 20% of total profits, but future tax reform could reverse this trend**
- **Annual profit growth will likely peak in mid-2014 as businesses increase costs in order to shift into an expansionary mindset**

Corporate profits have been somewhat of an anomaly throughout this slow economic recovery. After dropping more than 50% during the financial crisis, real corporate profits bounced back quickly and managed to soar to new historical highs despite other struggling sectors of the economy. Businesses have been able to take advantage of extremely low borrowing and labor costs as well as favorable tax codes, allowing them to maintain consistent profits even when consumer demand was faltering. At the same time, we have seen extreme highs when it comes to equity markets as the Fed's QE3 program pumps money into the system. Now that the rest of the economy is gaining speed (the Fed has started to taper, interest rates are on the rise, and unemployment continues to decline), corporate profits growth will most likely decelerate. We expect that profit growth will hit a peak sometime in 2014 and soften thereafter as firms adjust to changes in the economic environment, both domestically and globally.

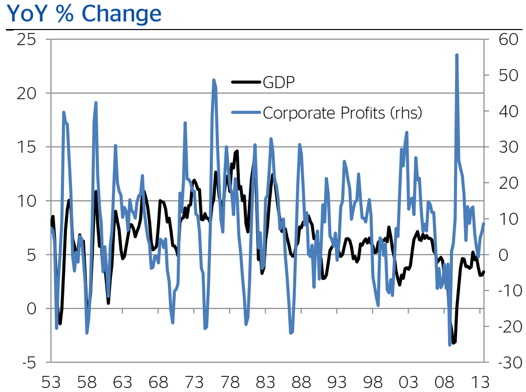
Historically, corporate profits have always been much more volatile compared to GDP growth, yet the 2008 fall and subsequent spike was one of the largest in history and sets the stage for somewhat of an unprecedented recovery. The acceleration since the crisis has been much sharper compared to previous business cycles, even though overall economic progress has been slower. Throughout 2013, profit growth remained relatively stable but accelerated in the third quarter alongside a significant jump in GDP. In 3Q13, real corporate profits increased 2.6% on a QoQ basis, the fastest pace since 1Q12, and accelerated to 4.3% on an annual basis. While this movement reflects the strongest jump in 2013, it is clear that significant acceleration is not sustainable.

Chart 1
Real Corporate Profits
SAAR, $Bn Chained



Source: BEA & BBVA Research

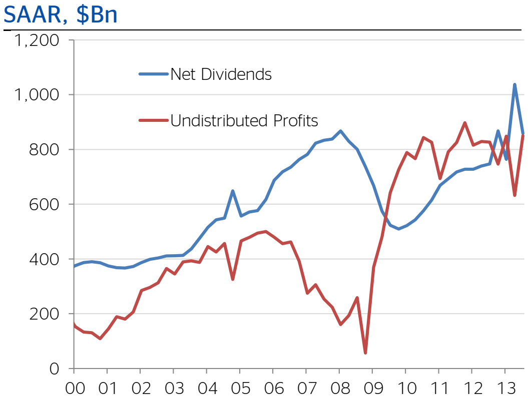
Chart 2
Nominal GDP & Corporate Profits
YoY % Change



Source: BEA & BBVA Research

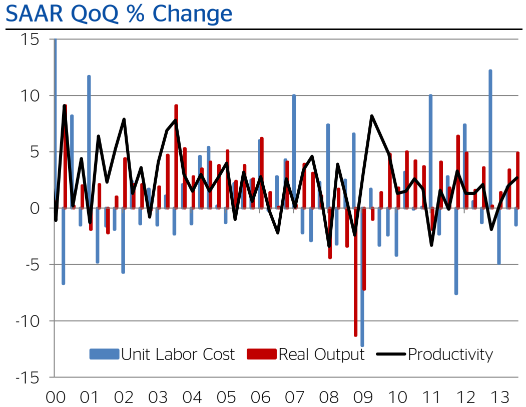
It is particularly interesting to look at the underlying details behind this growth in corporate profits. Since the recession, corporate profit growth mostly reflected a significant acceleration in undistributed profits (i.e., corporate savings) in the first year or so of the recovery, while growth in net dividends was much more gradual. However, 2013 saw an unusual change in dynamics – net dividend growth jumped in 2Q13 as undistributed profits plummeted. While this change was only temporary and almost completely reversed in 3Q13, the movement poses an interesting question for the future of corporate profits. It is quite possible that businesses have shifted their strategy: slowing reinvestment and accelerating dividend payments to keep investors happy during these uncertain times – but what does this mean for the next few years? Despite the uptick in economic activity, businesses remain hesitant regarding fragile consumer demand. Hiring has picked up in the second half of 2013 but if reinvestment plans do not materialize, we are unlikely to see significant acceleration in employment growth throughout 2014. Furthermore, the eventual end to the Fed's stimulus program may put a strain on businesses and equity markets toward the latter half of the year. In the following years, we expect that that the economic environment will return to a much more normal state as the Fed begins its monetary policy normalization process (slated for mid-2015 and beyond).

Chart 3
Net Dividends & Undistributed Profits
SAAR, $Bn



Source: BEA & BBVA Research

Chart 4
Unit Labor Cost, Output, & Productivity
SAAR QoQ % Change

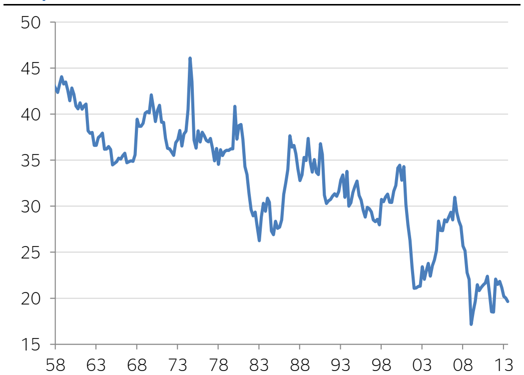


Source: BLS & BBVA Research

Another important aspect of corporate profits growth stems from labor costs and productivity, both of which have been advantageous to firms throughout this vulnerable recovery period. High levels of unemployment resulting from the crisis left employees at the mercy of businesses that were looking to cut costs wherever they could. Now, unit labor costs and compensation are back near pre-recession levels, but we are still seeing significant resource slack in the labor market. Wage pressures will be limited in 2014, although businesses may only be able to maintain (rather than continue to reduce) expenses as the cost-cutting days seem to be officially behind us. At the same time, firms have tried to get as much out of existing employees as possible without having to bring on additional workers. Consequently, worker hours continue to increase and overall productivity improves, although not necessarily at a sustainable pace. In 3Q13, unit labor costs dropped 1.5% on a QoQ SAAR basis while real output spiked 4.9%. Furthermore, the share of nominal output remitted to labor compensation dropped to near historical lows at 55.9% in 3Q13, compared to a share of more than 60% prior to the crisis. Ultimately, productivity growth was strong in the third quarter, but the data expose still-slow hiring patterns compared to the pace of output growth. This ongoing trend may be cost efficient for businesses but will certainly not last as demand continues to rise and employees feel more comfortable about job mobility and availability elsewhere. Eventually, firms will have to increase hiring to keep up with output, sacrificing a temporary hit to profit margins or passing along the higher costs to consumers. On the bright side, improving demand should boost revenues and at least partially offset increasing labor costs.

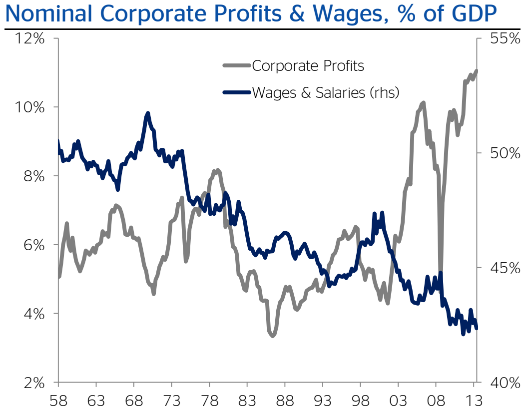
A third issue surrounding corporate profit growth has been taxes, particularly during this time when corporations appear to be reaping all the benefits of a slow growing economy. Tax reform has become a more prominent issue throughout the past few years as the "Occupy Wall Street" supporters attack wealthy individuals and corporations. Taxes on corporate income have almost recovered to pre-crisis levels, yet the share of taxes to total profits has dropped to historical lows. This partially reflects changes (or lack thereof) in the corporate tax code in addition to the other factors mentioned above that have sent profits skyrocketing throughout the past decade. Corporate profits continue to increase as a share of GDP, up to 11.0% in 3Q13 compared to less than 10% prior to 2012. At the same time, wages and salaries as a share of GDP continues to fall. Looking forward, we expect to see changes in the tax code and the closing of some loopholes that may temporarily cut into corporate profits; however, we do not expect that the corporate influence on GDP will drop back to pre-recession standards.

Chart 5
Corporate Taxes as a Share of Profits, %



Source: BEA & BBVA Research

Chart 6
Nominal Corporate Profits & Wages, % of GDP

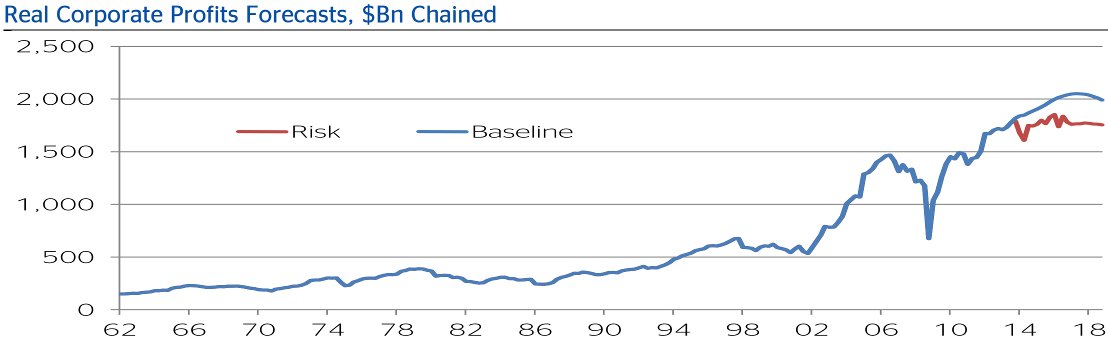


Source: BEA & BBVA Research

Bottom Line: Corporate Profits Still Growing, but at an Unsustainable Pace

Given the above factors and considering the changing dynamics of the economic recovery, we expect that corporate profits will increase at a slower pace in the coming quarters, stabilizing sometime in 2015. While it may be reasonable for us to forecast labor costs, future output, and rising interest rates, potential tax reform is difficult to account for in our models. If corporate tax loopholes are eventually addressed, we could see a change in the composition of corporate profits. In general though, our risk scenario assumes a set back from the current pace of GDP growth and subsequent slowdown in employment. Ultimately, we expect that this would have only a minor impact on profits compared to the 2008 crisis given that businesses are already mostly prepared to withstand another negative shock to the system.

Chart 7
Real Corporate Profits Forecasts, $Bn Chained



Source: BBVA Research