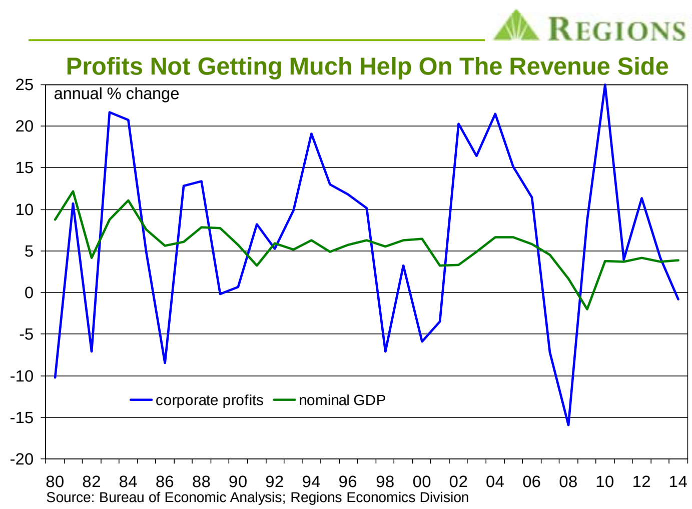
ECONOMIC OUTLOOK
REGIONS
April 2015

Corporate Profits Under Pressure

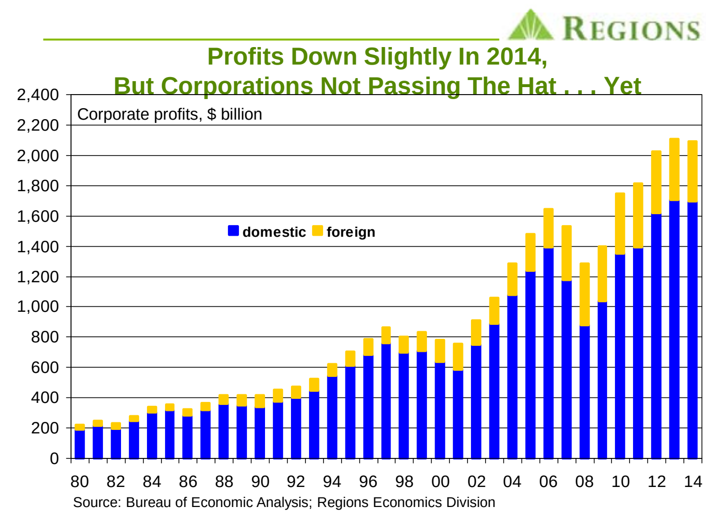
In the immortal words of the late Herbert Stein, if something cannot go on forever, it will stop. And so it goes with corporate profits, at least judging by the first look at Q4 2014 profits as published by the Bureau of Economic Analysis in the GDP data (see note at end). The first estimate shows corporate profits declined slightly for 2014 as a whole, thus ending a five-year run during which growth in profits easily outpaced growth in nominal GDP, the latter acting as a proxy for top-line revenue growth. This is something we discussed as far back as September 2012 when, in that month's *Economic Outlook*, we tabbed corporate profits as a standout in an otherwise not so great recovery from the Great Recession. At that time, we wondered how long profit growth could persist without more help from the revenue side, and it seems now our question has been answered.



The above chart helps put the five-year run of profit growth coming out of the 2007-09 recession in perspective (the recession officially ended in June 2009, profits rose for 2009 as a whole) and also helps illustrate why that run was bound to end. Nominal GDP growth has been steady but notably unspectacular, averaging just 3.8 percent per year from 2010 on, easily outpaced by profit growth, at least until 2014. Obviously there was a good deal of "payback" in the 25.0 percent profit growth logged in 2010, but the broader point here is despite paltry gains on the revenue side corporate profits still grew each year.

This growth reflects the extent to which the corporate sector managed the expense side of the ledger. Of course, "managed" may be too strong of a word in this context, as the expense side of the ledger was made far more manageable by several factors, including an extraordinary degree of slack in the labor market that kept a lid on growth in compensation costs even as hiring picked back up in March 2010, an exceptionally low rate of capital spending as firms undertook replacement investment but had little incentive to expand capital stocks in such a slow growth environment, and low interest rates that gave many firms the ability to refinance debt at much lower costs. These factors helped curb growth in expenses, thus allowing for profit growth despite less than stellar growth in top-line revenue.

Though interest rates stayed low in 2014, they offered little marginal relief while faster growth in the aggregate wage bill (thanks to solid growth in aggregate hour worked, as opposed to faster growth in hourly earnings) and stepped-up capital spending meant faster growth in expenditures. To be sure, the corporate crowd didn't exactly go crazy on the spending side, but neither did they have to, in what turned out to be another year of disappointing growth in top-line revenue. True, as declines go, the 0.81 percent decline in corporate profits in 2014 doesn't exactly qualify as "precipitous" and, as seen in the chart below, the level of profits remains exceptionally elevated.



The concerns, however, would be a matter of direction not of degree, at least at this point in time. In other words, with trends on the expense side of the ledger going in the "wrong" direction, especially if this is the year in which interest rates, you know, actually rise as certain economists (absolutely no need to name names here) have been telling you they would for some time now, the decline in profits will be more significant in 2015. At least without the long awaited acceleration in top-line revenue growth – kind of like the one that didn't materialize in 2014 despite expectations (once again, absolutely no need to name names here) to the contrary.

Another factor that will weigh on corporate profits in 2015 is the stronger U.S. dollar, even if "stronger" is very much a relative

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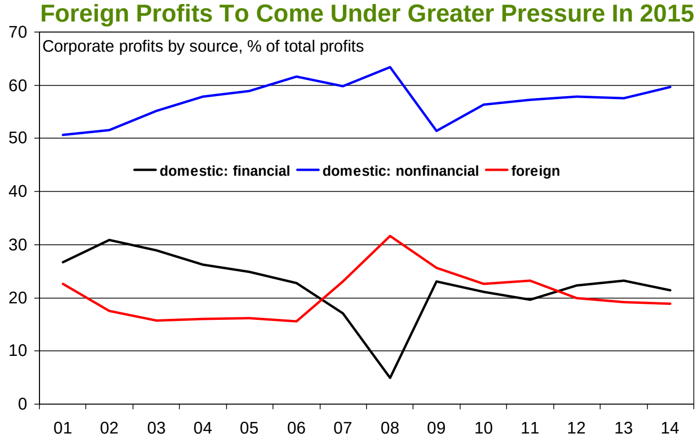
term here. To be sure, the dollar has appreciated over the past few years, but the pace of dollar appreciation has been significantly faster over recent months as the Fed and many foreign central banks are on divergent policy paths. For instance, as the Fed contemplates the beginning of the process of normalizing the Fed funds rate, aggressive policy accommodation in the form of “quantitative easing” on the part of the European Central Bank is only in the infancy stage.

There are two channels through which a stronger U.S. dollar can adversely impact corporate profits. First, for those firms who do business abroad, when foreign profits are translated back into U.S. dollars a stronger U.S. dollar means this translation is less favorable. Second, a stronger U.S. dollar makes exports of good produced here in the U.S. less competitive in global markets. While this second channel may have been one factor behind what was a sharp decline in foreign profits in Q4 2014, the reality is this “price effect” has not fully kicked in given the lag between changes in the exchange rate and the pricing of exports.

We believe this effect will become more apparent over the course of 2015 and, hence, be a larger drag on corporate profits. What is more likely the case is the first effect, foreign profits being translated back into U.S. dollars at a lower exchange rate, has to date been the primary channel through which a stronger U.S. dollar has impacted corporate profits. After all, foreign profits hit their post-recession peak in 2011 after which the dollar began to steadily appreciate, though certainly at a far milder pace than that seen of late. While the second effect, i.e., the “price effect” may have made a contribution to the 8.8 percent (quarter-on-quarter) decline in foreign profits in Q4 2014, this more likely reflects an “income effect” through which weaker foreign demand – not tied to a stronger U.S. dollar but weaker foreign economies – weighed on U.S. exports.

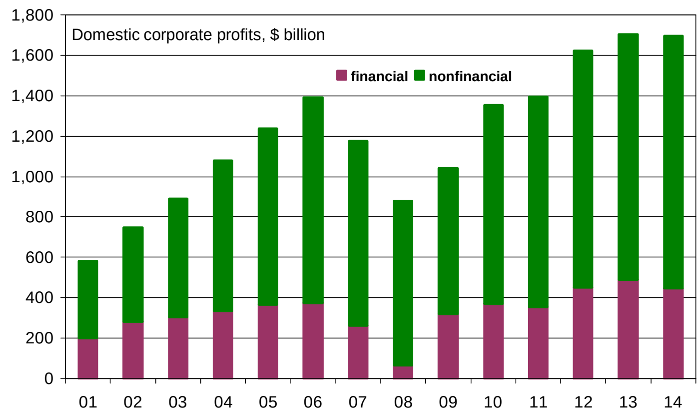
Foreign Profits To Come Under Greater Pressure In 2015



Source: Bureau of Economic Analysis; Regions Economics Division

Foreign profits accounted for 18.9 percent of total corporate profits in 2014, the lowest share since 2006, and we look for an even smaller contribution in 2015. After having posted solid increases in 2012 and 2013, domestic profits from the financial sector fell by 8.5 percent in 2014 and accounted for 21.5 percent of total profits. Far and away the largest share of total profits is accounted for by domestic profits in the nonfinancial corporate sector, which accounted for 59.7 percent of total profits in 2014. Having fallen sharply during the 2007-09 recession, profits in the domestic nonfinancial sector have more or less been plodding along, growing by 2.8 percent in 2014, not much but decidedly better than the declines logged in the domestic financial sector and by foreign profits. To a large degree, profit growth in the domestic nonfinancial sector reflects the pattern in overall nominal GDP growth since the end of the downturn – steady but slow growth in demand for goods and services in an environment with but limited pricing power.

Financial Sector Profits Fall In 2014



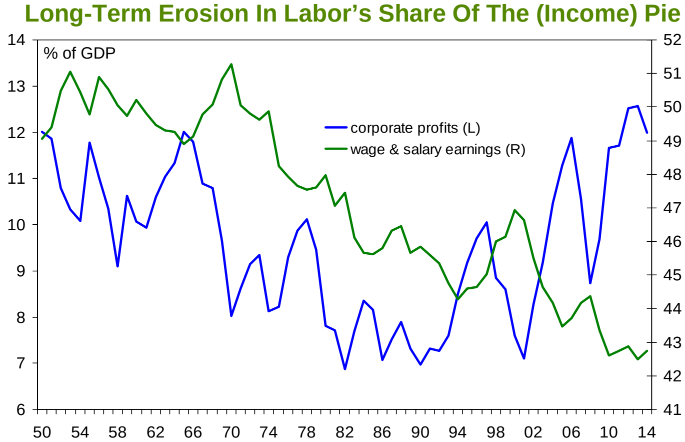
Source: Bureau of Economic Analysis; Regions Economics Division

The above chart plots domestic profits broken out by the financial and nonfinancial sectors. It is by now generally, albeit not universally (we’ll always give a nod to the “every good number is a lie, things are still horrible” crowd), accepted the domestic economy is now on much firmer footing than at any point since the end of the 2007-09 recession. Indeed, one could argue this relative health extends ever further back in to the past, given all of the imbalances that had built up in the economy prior to the 2007-09 recession. Still, the improving health of the domestic economy was not enough to prevent domestic profits from declining in 2014 (down 0.5 percent as the modest increase in profits from the nonfinancial sector was negated by the decline in profits from the financial sector), and there is of course no guarantee further improvements in the health of the domestic economy in 2015 will lead to rising profits. Indeed, as discussed above, the combination of rising labor costs and higher, though still not high, interest rates will continue to pressure domestic profits, particularly with seemingly dim prospects for increased pricing power this year.

One implication of faster growth in labor costs in 2015 is that labor’s share of aggregate income will rise further, adding to the increase seen in 2014. Still, this will do little to make up for what, over the past few decades, has been a steady decline in labor’s share of aggregate income. To be perfectly clear, no, we are not dusting off our “workers of the world unite” signs (yes, we do have such signs, we just won’t go into why we have them) and organizing a solidarity march. But, labor’s share of aggregate income has been trending lower over the past few decades and, even while labor’s share rose in 2014 while profits as a share of aggregate income fell, both remain on the extreme ends of historical values – labor's share on the low end and profits' share on the high end, as can be seen in the chart below. Moreover, it is likely that the share of aggregate income that is going to labor has become increasingly concentrated amongst a relatively small block of the highest of high earners.

With all due respect to Karl Marx, revolutions may be the locomotives of history but productivity growth is the locomotive of sustained growth in labor income. Unfortunately, this does not bode well for a significant increase in labor's share of aggregate income, at least in the near term, as aside from the typical post-recession bounce seen in 2009 productivity growth had been anemic in recent years. We have frequently discussed how weak productivity growth holds down the economy's "speed limit," or, the sustainable rate of noninflationary growth (see for instance our July 2014 *Economic Outlook*), but there is a clear and undeniable, even if often overlooked, link between productivity growth and the growth of labor earnings.

Long-Term Erosion In Labor's Share Of The (Income) Pie



Source: Bureau of Economic Analysis; Regions Economics Division

As we discussed in our July *Economic Outlook*, going back over the past several decades there are two distinct post-WWII periods of rapid productivity growth – the 1955-1968 period and the 1996-2005 period (when annual productivity growth averaged a staggering 3.0 percent). During the first of these periods, labor's share of aggregate income hovered right at 50 percent, as seen in the above chart. When productivity growth subsequently slowed, labor's share of income began what has turned out to be a steady slide. This slide was interrupted during the second period of rapid productivity growth, as labor's share of income rose for several years before the 2001 recession took hold (recall this was a mild recession but one that had lasting effects on the labor market). Over the late 1990s, there was growth in real wages across all industry groups, growth that no doubt is the envy of the current cycle. But, that productivity growth is now so anemic suggests we can expect little in the way of a sustained increase in labor's share of aggregate income.

Or, to be more precise, a sustained increase in labor's share of aggregate income that does not come at the expense of corporate profits. This is perhaps a cruel irony of what, at least in our view, has been underinvestment on the part of the corporate sector since the end of the 2007-09 recession. We have argued one factor behind anemic productivity growth is an aged capital stock, older than at almost any point in the life of the data. To be sure, in the early phases of the recovery firms had little incentive to invest given the economy was seemingly stuck in a two percent growth environment. But, as the economy began to embark on a self-sustaining expansion over the second half of 2013, firms were quickly falling behind the investment curve. While there was some catch-up in the middle quarters of 2014, when business investment in equipment and software grew at a double-digit rate, the two most recent quarters have seen investment slow dramatically. While some of this is clearly due to pullbacks in the energy sector, it remains to be seen what track business investment spending will ultimately settle on.

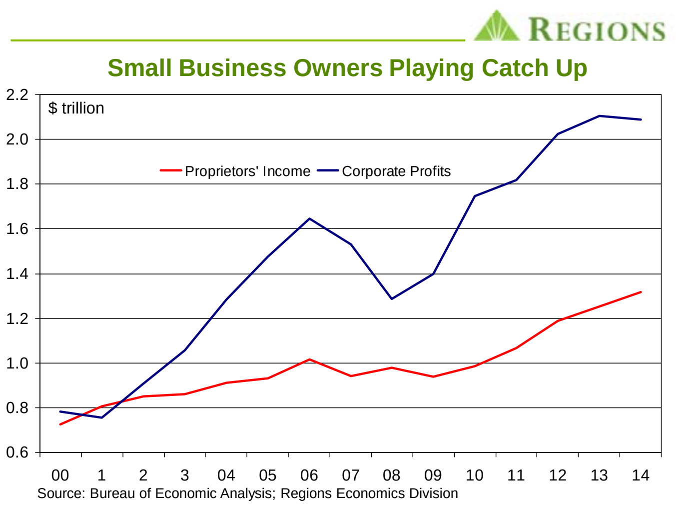
The broader point, however, is productivity growth is the means through which firms can pay higher wages without cutting into profit margins. As it now stands, however, with productivity growth so listless, wage gains will come out of profit margins, at least in the absence of a significant increase in pricing power, which simply is not in the cards any time soon. This should be a useful reminder to those who see a direct link between wage growth and inflation. In and of itself, wage growth is not inflationary. Wage growth in excess of productivity growth can be inflationary, to the extent firms have the ability to pass along higher costs in the form of higher prices.

Again, though, we see limited capacity for this in the near term, which brings us back to our point that profit margins will be squeezed by higher labor costs unless and until there is meaningful acceleration in productivity growth. This of course does not happen overnight, and it will take a prolonged period of firms catching up on investment in equipment and software to translate into meaningfully faster, and sustained, productivity growth. To be sure, the level of corporate profits will remain high relative to historical norms (and, in case you're going there, this is also true when we deflate corporate profits and look at the level of real profits) even if margins slip over coming quarters. But, to the extent gains in stock prices are tied to the growth of, not the level of, profits, erosion of margins over coming quarters may be painful on several fronts.

Don't Forget The Little Gals And Guys . . . Small Businesses, That Is

There is a perhaps underappreciated bright spot in the discussion of profits – small businesses. Yes, you read that correctly, though it is understandable if that seems a surprise given what, until recently, has been a dour outlook on the part of small business owners. The Bureau of Economic Analysis (BEA) publishes data on proprietors' income in the nonfarm business sector (it is included in the monthly personal income data), and this series is a good proxy for profits in the small business sector, as it covers sole proprietorships, partnerships, and other private nonfarm businesses organized for profit but not classified as corporations. The data series published by the BEA is income net of business expenses, so while not perfect, it nonetheless serves as a useful proxy for small business profits.

During the 2007-09 recession, proprietor's income did not decline nearly to the extent corporate profits declined – a peak-to-trough decline of 7.9 percent for proprietors' income compared to a 22.0 percent peak-to-trough decline in corporate profits. By the same token, corporate profits rebounded faster, at least coming out of the recession, as seen in the chart below. Over the past four years, however, proprietors' income has grown at an average annual rate of 7.5 percent while corporate profits have grown at an average annual rate of 4.7 percent. And, while corporate profits declined by 0.81 percent in 2014, proprietors' income grew by 5.0 percent, so that at year-end 2014 proprietors' income was further above its pre-recession peak than were corporate profits.



There are a few possible explanations for the steady growth seen in proprietors' income over recent years. Perhaps the primary factor is many, though certainly not all, small businesses are providers of services as opposed to producers of goods. As such, they are operating locally more than globally for the most part, with "locally" a relative term that can of course encompass the entire U.S. The point, though, is providers of locally traded services tend to have more pricing power than producers of globally traded goods. Indeed, the core services component of the Consumer Price Index has settled into a fairly steady rate of about 2.5 percent over the past two years. While this is shy of the longer-term historical rate of growth, it is nevertheless far ahead of the component for core goods, prices for which have declined on a year-over-year basis for 23 consecutive months, a streak not likely to end any time soon given the strength of the U.S. dollar of late.

While small business owners have clearly faced their own challenges over recent years, including weak sales growth in the early phases of the recovery and increased regulatory burdens, particularly on the health care front, they seem to have adapted and, thanks to at least some pricing power, have seen steady growth in profits. They too will face faster growth in labor costs over coming months, so it will remain to be seen just how much pricing power they have.

It is, in any event, at least worth keeping the small business sector in mind when the discussion turns to profit growth. While growth in small business profits may not do a whole lot for stock prices, small business owners would, at least in theory, be more willing to plow at least some portion of profits back into their businesses, either in the form of capital expenditures or in the form of expansion, which in turn feeds into the broader economy in a more direct way than do share buybacks and dividend payouts.

To sum up, corporations and small businesses will be faced with faster growth in labor costs over the course of 2015 and at least moderately higher interest rates later in the year. Possible offsets will come from low, though perhaps not much lower than they now are, energy costs, and for those corporations who import commodities and raw materials as inputs to production, the stronger U.S. dollar will provide some relief. But, the bottom line (pun intended) is labor costs are far and away the largest individual segment of business costs. In this sense, larger corporations unable to squeeze meaningful gains in productivity from their current workforces will feel more pressure on margins than was the case in 2014. Those corporations who produce here in the states and sell their goods in global markets will feel the downside of the stronger U.S. dollar, as their goods will be less competitive in global markets. As such, given they have at least some pricing power to fall back on, small businesses may see healthier profit trends over the course of 2015 than is the case for their large corporate counterparts.

NOTE: As indicated in the opening paragraph, the discussion herein is based on the profits data from the National Income and Product Accounts, or, NIPA. NIPA profits differ from more widely followed measures of profits, the most common being S&P 500 profits. In general the long-term trends exhibited by the two measures are similar, though quarter-on quarter and year-on-year changes can at times vary significantly. The differences between NIPA profits and S&P profits reflect differences in definitions and methodologies, and the two approaches are typically used for different purposes. One main difference between the two is that S&P 500 profits cover only 500 large publicly traded corporations while NIPA profits encompass the entire economy, from small subchapter S corporations to the largest corporations. Unlike NIPA profits, which represent a true time series, changes in the composition of the S&P 500 over time mean this profit series is not a true time series. NIPA profits are intended to capture profits from current production by corporations while S&P profits are measured on a financial accounting basis. As such, NIPA profits exclude income items such as dividends and capital gains and expense items such as capital losses and bad debt expenses, as such items do not reflect income/expenses from current production. For our purposes (not only this piece but in our day-to-day existence), NIPA profits are the preferred measure as they better reflect profit generated from current economic activity and hence offer a more clear, albeit less timely, signal of underlying economic trends.

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Q3 '14 (a)	Q4 '14 (a)	Q1 '15 (f)	Q2 '15 (f)	Q3 '15 (f)	Q4 '15 (f)	Q1 '16 (f)	Q2 '16 (f)		2013 (a)	2014 (a)	2015 (f)	2016 (f)
5.0	2.2	1.2	3.8	3.4	3.4	3.2	2.9	Real GDP[1]	2.2	2.4	3.0	3.2
3.2	4.4	1.7	4.3	3.9	3.5	3.2	2.9	Real Personal Consumption[1]	2.4	2.5	3.3	3.3
								Business Fixed Investment:				
10.2	4.3	-4.6	2.5	5.5	7.0	7.4	7.0	Equipment, Software, & IP[1]	4.1	5.8	2.9	6.6
4.8	5.9	2.3	1.6	3.2	3.9	5.9	7.1	Structures[1]	-0.5	8.2	4.0	5.3
3.3	3.8	11.2	12.3	16.0	16.5	12.3	8.0	Residential Fixed Investment[1]	11.9	1.6	9.8	11.9
4.4	-1.9	2.4	0.7	-0.5	-0.4	0.0	-0.3	Government Expenditures[1]	-2.0	-0.2	0.9	-0.2
-431.3	-471.4	-469.3	-471.3	-487.3	-496.5	-508.0	-519.1	Net Exports[2]	-420.5	-452.6	-481.1	-514.6
1.030	1.065	1.043	1.100	1.096	1.110	1.126	1.136	Housing Starts, millions of units[3]	0.930	1.001	1.087	1.151
16.7	16.7	16.6	17.0	17.1	17.0	16.9	16.8	Vehicle Sales, millions of units[3]	15.5	16.4	16.9	16.8
6.1	5.7	5.6	5.5	5.4	5.3	5.2	5.1	Unemployment Rate, %[4]	7.4	6.2	5.4	5.1
2.0	2.1	2.3	2.2	2.2	2.1	2.1	2.1	Non-Farm Employment[5]	1.7	1.9	2.2	2.1
1.6	1.3	0.9	0.9	1.0	1.4	2.0	1.9	GDP Price Index[5]	1.5	1.5	1.0	2.0
1.5	1.1	0.1	-0.2	-0.1	0.6	1.8	2.2	PCE Deflator[5]	1.2	1.3	0.1	2.1
1.8	1.2	-0.3	-0.8	-0.5	0.5	2.3	2.7	Consumer Price Index[5]	1.5	1.6	-0.3	2.6
1.5	1.4	1.4	1.3	1.4	1.5	1.6	1.7	Core PCE Deflator[5]	1.3	1.4	1.4	1.7
1.8	1.7	1.7	1.6	1.8	2.0	2.1	2.2	Core Consumer Price Index[5]	1.8	1.7	1.8	2.1
0.13	0.13	0.13	0.13	0.29	0.54	0.93	1.17	Fed Funds Target Rate, %[4]	0.13	0.13	0.27	1.30
2.50	2.28	2.02	1.90	2.15	2.40	2.60	2.75	10-Year Treasury Note Yield, %[4]	2.35	2.54	2.12	2.81
4.14	3.97	3.71	3.56	3.70	3.93	4.14	4.31	30-Year Fixed Mortgage, %[4]	3.98	4.17	3.73	4.38
-2.3	-2.6	-2.3	-2.2	-2.3	-2.3	-2.4	-2.4	Current Account, % of GDP	-2.4	-2.3	-2.3	-2.4

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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