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Economic Watch

US

16 November 2011
Economic Analysis

US
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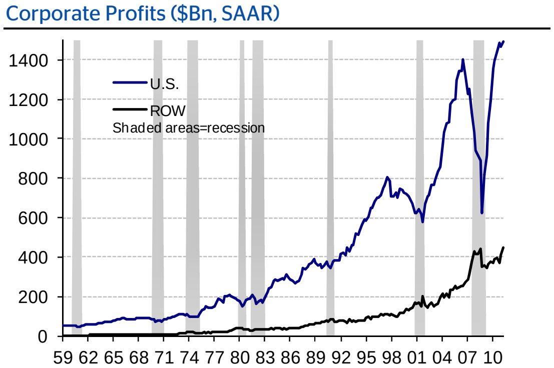
Corporate Profits on the Rise Again

Improving the bottom line via labor efficiency

- **Corporate profits increased again in 2Q11, although downward data revisions have deflated short-term estimates**
- **As a percentage of GDP, corporate profits have jumped to almost 10% from a low of 4.6% during the financial crisis**
- **Demand and investment uncertainties stemming from Europe are likely to dampen profits in 4Q11, however, the long-term outlook remains stable**

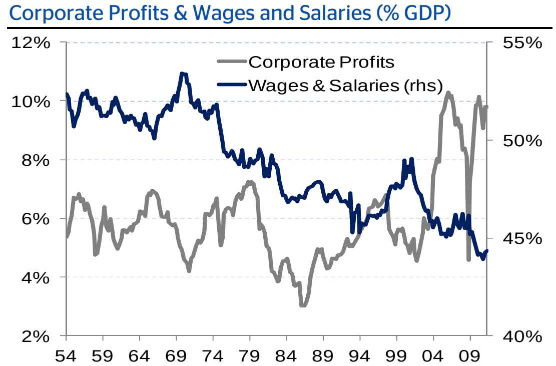
Manageable capital expenditures combined with lower labor and borrowing costs have enabled businesses to maintain high profits despite weak economic data. As expected, corporate profits increased in 2Q11 for the second consecutive quarter, although at only a fraction of the pace as in 1Q11 and to a level less than the year-ago figure. Growth was lower than initially predicted in part due to the Bureau of Economic Analysis (BEA) annual revisions to the National Income and Product Accounts. Although data for 4Q09 was revised up almost 13% as a result of new IRS tabulations, downward revisions to 2H10 data ultimately skewed the short-term estimate due to level effects. As corporate profits continue to grow, businesses may be more inclined to reinvest domestically if global trade dynamics foster the cost advantages of investing at home. Domestic expansion could contribute to much-needed growth in the labor market, addressing the primary concerns of high unemployment and subdued labor costs. However, recent CEO confidence reports and the Federal Reserve's Senior Loan Officer Survey suggest a deteriorating short-term business outlook and reduced borrowing for expansionary purposes. Historically, wages and salaries have always accounted for a strong proportion of US GDP, however, this trend is significantly declining. Since early 1970, when wages and salaries hit a high of nearly 54% of GDP, the fraction has declined to the lowest ever at only 44% of GDP. While this is similar to the post-1980 historical average of 46%, it is much lower than the pre-1980 average of 51%. Corporate profits, on the other hand, fell sharply to 4.6% of GDP during the financial crisis but have rebounded to the highest level near 10% of GDP. This is a significant jump from the historical average of 6.0% and suggests a more lasting change to the structure of economic growth. Globalization has allowed for corporations to take advantage of an abundance of cheaper labor outside of the US, ultimately helping their bottom lines but lowering the contribution of domestic wages and salaries to GDP.

Chart 1
Corporate Profits ($Bn, SAAR)



Source: Bureau of Economic Analysis & Haver Analytics

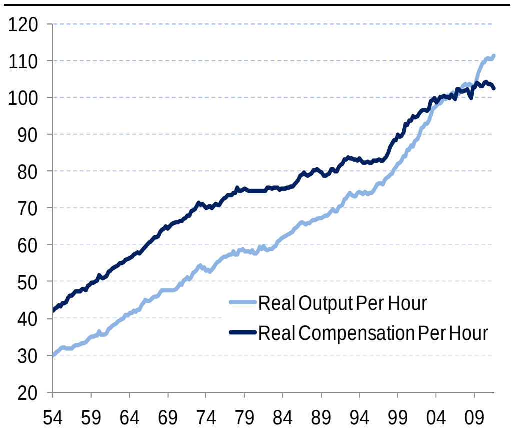
Chart 2
Corporate Profits & Wages and Salaries (% GDP)



Source: Bureau of Economic Analysis & Haver Analytics

Aside from reduced labor and borrowing costs, businesses can improve their bottom line via inventory management. Inventory growth has slowed throughout the past few months and stalled at the end of 3Q11, which is positive for corporate profits. While sluggish demand conditions have resulted in only incremental sales growth, companies have managed to maintain a relatively stable inventory-sales ratio. Although declining inventories may be a negative sign for GDP growth, businesses are likely to boost production again once the outlook for future sales improves. Corporate profits will adjust accordingly as domestic growth opportunities expand.

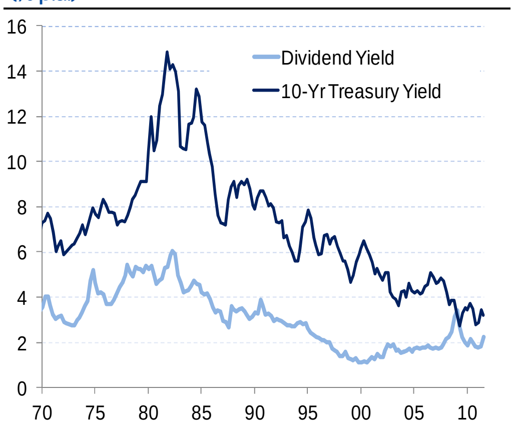
Chart 3
Real Output Per Hour & Real Compensation Per Hour (SA, 2005=100)



Source: Haver Analytics

Productivity declined slightly throughout 1H11 but surged in Q3 despite weakness in most aspects of the economy. This may play an important factor in corporate profit growth for the second half of 2011 and onward, particularly because labor costs have declined for most of the past year. From the corporate perspective, increased output per hour at a lower cost suggests that labor efficiency has improved, ultimately lifting the bottom line. However, this trend is unlikely to continue once the employment situation recovers. Furthermore, if structural employment worsens, firms may find themselves paying more for qualified workers or to retain employees that have already been trained on the job.

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



Source: Haver Analytics

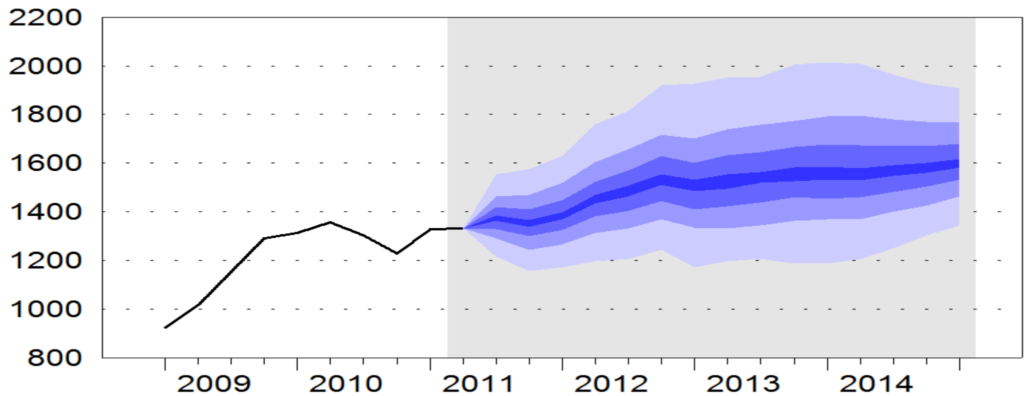
Dividend and nominal bond yields reacted as expected to stock market declines in 2Q11. Many shareholders enjoyed the benefits of rising corporate profits as signaled by the increasing dividend yield, although payouts remain modest when considering the amount of cash firms' have on-hand. Interest rates are at all-time lows as risk averse investors look to safety in Treasuries. Fed interventions that have flattened the yield curve should keep rates low for the next few years. While we continue to experience turbulent macroeconomic conditions, yields are less likely to move alongside each other as suggested by historical trends. However, we could see dividend yields decline with Treasuries if conservative corporations pull back on payouts.

Corporate Profits Forecasts

The outlook for corporate profits has changed slightly from our prior estimates. Although yields moved in line with our presupposition, real output per hour has increased more than expected. Furthermore, downward revisions to corporate profits data for the latter part of 2010 have deflated the short-term levels of our forecasts. However, long-term projections are slightly stronger than previously expected. For 3Q11, we expect that increased productivity will lift corporate profits to the highest level for 2011. Increased uncertainties related to the sovereign debt crisis in Europe may hit profits in the fourth quarter, but the decline should be minimal. Growth is expected to pick up again in 2012 and continue through 2014, with possible speed bumps in 2013. Aside from the YoY decline seen in 2Q11, corporate profits should continue growing on a YoY basis, though at a slower pace in the near term than in our previous forecasts. As the economy recovers, businesses will continue to see high profits as stronger demand helps to offset increasing labor and borrowing costs. While we do not include tax policy in our estimates, these forecasts could see some adjustments depending on whether the government agrees to changes in the corporate tax code.

Chart 5

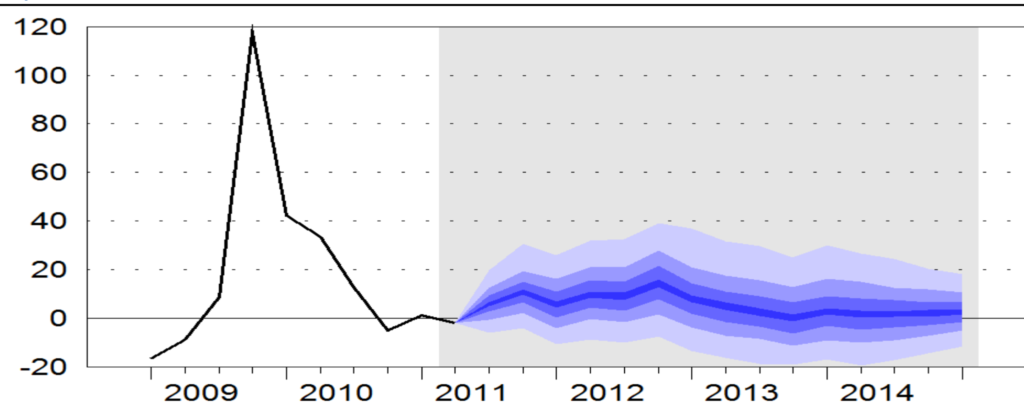
Corporate Profits, Real $bn



Source: BBVA Research

Chart 6

Corporate Profits, YoY%



Source: BBVA Research