Economic Watch

US

Houston, April 2, 2012
Economic Analysis

U.S.
Kim Fraser
kim.fraser@bbvacompass.com

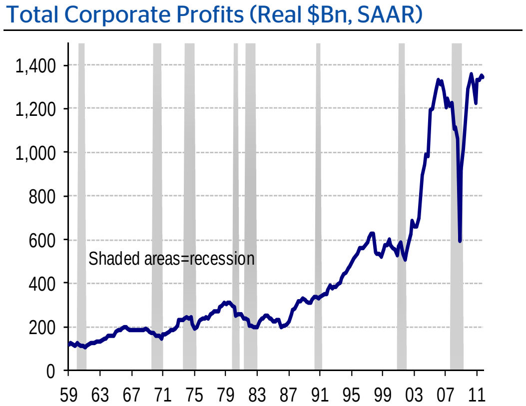
Corporate Profits Tackle European Crisis

A Temporary Bump in an Otherwise Uphill Path

- **Total corporate profits declined in 4Q11 on account of demand and investment uncertainties stemming from the European crisis**
- **Declining corporate tax rates and a reduction in employee compensation have contributed to the large corporate profits gains since the 1990s**
- **Domestic profits show no signs of slowing, particularly as economic activity gains momentum, yet ROW profits may be limited in the short term**

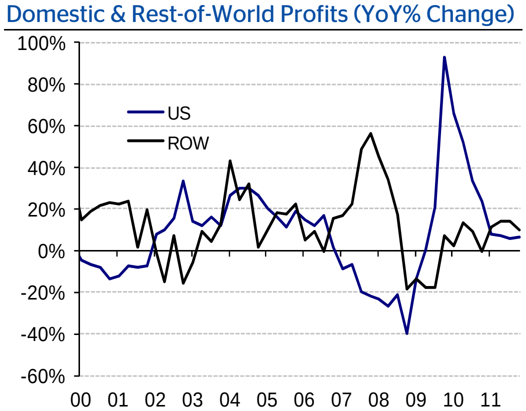
The fourth quarter of 2011 was dominated primarily by fiscal woes stemming from the crisis in Europe, yet economic activity in the U.S. gained significant momentum. As expected, total corporate profits in 4Q11 were dragged down slightly by slowdowns in the rest of the world (ROW), falling 0.9% to $1,342bn (in real terms) but remaining above early 2011 levels (Chart 1). On a nominal basis, ROW corporate profits dropped to the lowest level of the year, falling 9.2% QoQ and marking the largest decline since 4Q08 when profits fell more than 20%. Domestic growth was led primarily by the manufacturing sector, with profits from durable goods up nearly 25%, not surprising given the positive coincident data regarding the industry. On a YoY basis, profit growth accelerated slightly in the U.S., while ROW profits decelerated significantly (Chart 2). Still, positive YoY growth supports the notion that profits will remain inflated for the next few years, assuming that progress in Europe continues to move in the right direction. For the most part, Europe's impact on activity in the U.S. has mostly subsided throughout 1Q12, and developments in Europe to resolve sovereign issues have slightly brightened the region's outlook. However, we expect that corporate profits from the rest of the world will be limited at least in the short-term given that many European nations will be in, or close to, an economic recession. Although risk aversion has subsided in the U.S., it is likely that investors will steer clear of risky corporate assets with any vulnerability to Europe, minimizing the potential for ROW profits. For the year, total corporate profits increased 9.3% from the recovery's low point in 4Q10.

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



Source: Bureau of Economic Analysis & BBVA Research

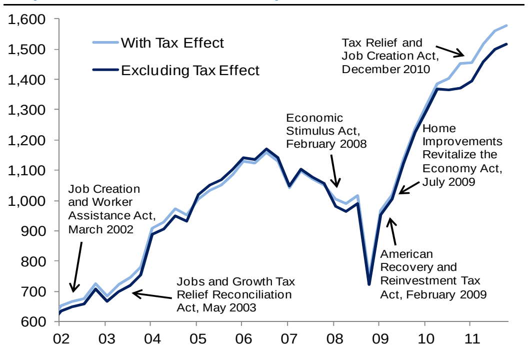
Chart 2
Domestic & Rest-of-World Profits (YoY% Change)



Source: Bureau of Economic Analysis & BBVA Research

Throughout the past decade, fiscal and monetary policy in the U.S has supported an extreme and unprecedented jump in corporate profits. Prior to 2000, the largest gain occurred between late 1989 and 1997, when profits increased 125% due in large part to a decline in the effective corporate tax rate that helped to boost margins. Between 4Q01 and 3Q06, profits jumped nearly 200% as the share of corporate taxes to profits continued to decline and employee compensation costs dropped. Of course, much of this increase was temporarily erased by the 2008 financial crisis, but profits recovered extremely quickly and surpassed the pre-recession peak in less than two years.

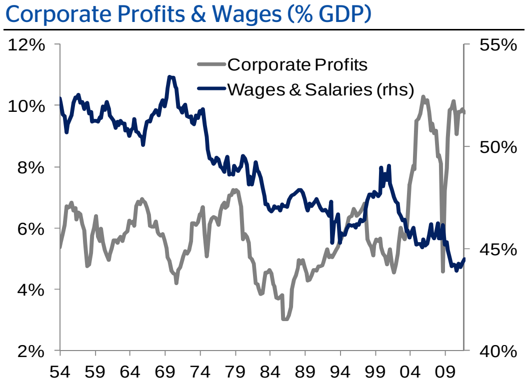
Chart 3
Impact of Tax Acts on Corporate Profits ($Bn)



Source: Bureau of Economic Analysis & BBVA Research

Tax reform has become a pressing issue as we approach the presidential election, particularly in regards to closing corporate tax loopholes. Various policies have attempted to stimulate economic activity via corporate tax credits, most of which businesses have learned to fully exploit. Compared to other tax acts earlier in the decade, Obama's Tax Relief and Job Creation Act, passed in late 2010, appears to have had the biggest impact on profits. While we have not specifically incorporated corporate taxes into our profit model, it is something to consider as we approach a possible policy change after the 2012 election.

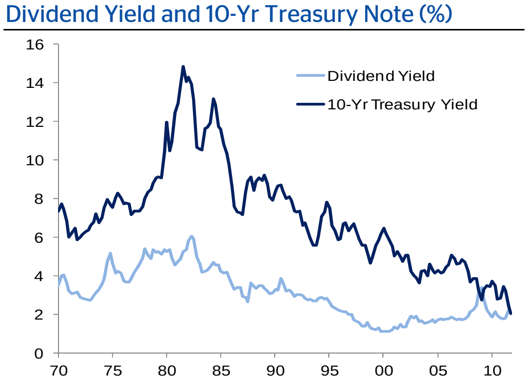
Chart 4
Corporate Profits & Wages (% GDP)



Source: Bureau of Economic Analysis & BBVA Research

Employment levels have struggled to recover since the recession, yet corporate profits have never been stronger. As a percentage of GDP, wages and salaries increased slightly in 4Q11 but remain near historical lows. Corporate profits' share hovers near 10% and may increase throughout 2012 as job market conditions improve only gradually. While the business outlook has improved throughout 1Q12, demand conditions have not proven stable enough for corporations to expand and increase their hiring plans. Throughout the recovery, wages and salaries have contributed to only 26% of national income growth, while corporate profits have accounted for more than half.

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



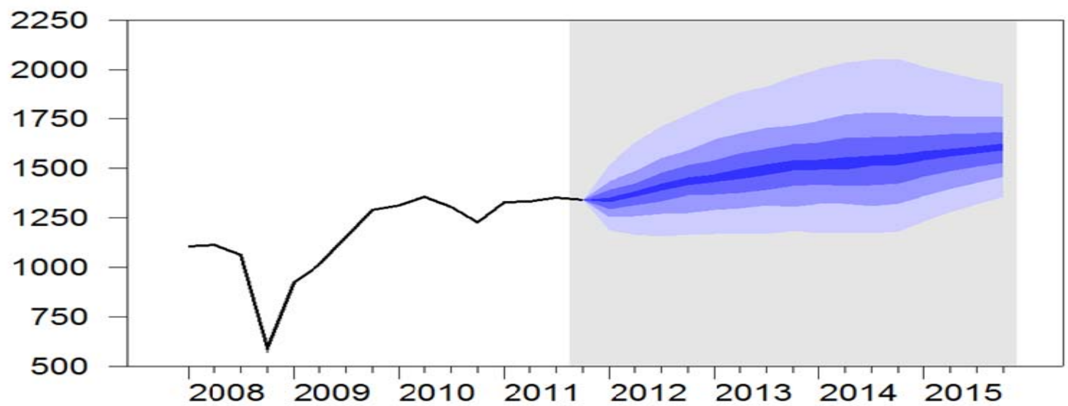
Source: S&P, Federal Reserve, & BBVA Research

History has shown us that the dividend and 10-year Treasury yields tend to move in tandem with one another. However, trends have been somewhat off since the recession and it can be assumed that this will continue for as long as the Federal Reserve maintains downward pressure on long-term yields. With so much cash on hand, corporations may soon feel compelled to pay out dividends at a yield surpassing that of treasury notes. Still, we expect that payouts will remain small relative to the amount of cash corporations have on hand until economic confidence is fully restored.

Corporate Profits Forecasts

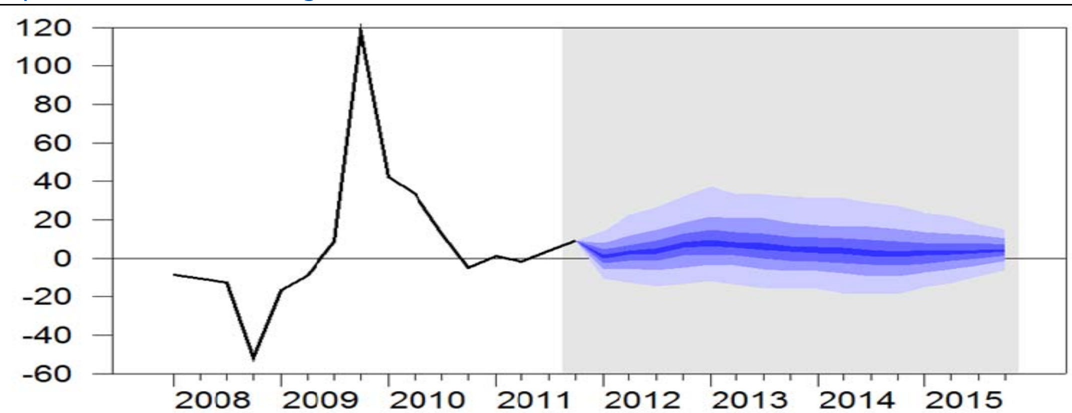
Our forecast for corporate profits is relatively unchanged from last quarter given that we expected the brief impact from the European crisis. Dividend and Treasury yields have moved in line with our projections. Productivity growth decelerated throughout 2H11, and our model assumes that this trend will continue in the near term. Businesses appear to have maximized productivity with their employee base and therefore have added more workers merely to keep up with current production levels (rather than expansion). Moving forward, this assumption will limit significant growth in profits, driving a flatter trajectory compared to the post-recession jump in 2009. In real terms, profits will likely experience a similar impact from the European slowdown in 1Q12, although at this time we do not foresee any major dips in the road across the forecast horizon. After 1Q12, YoY profit growth should hover near 5% on average throughout the next few years.

Chart 6
Corporate Profits (Real $Bn)



Source: BBVA Research

Chart 8
Corporate Profits (YoY % Change)



Source: BBVA Research