RESEARCH

Economic Watch

US

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Economic Analysis

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

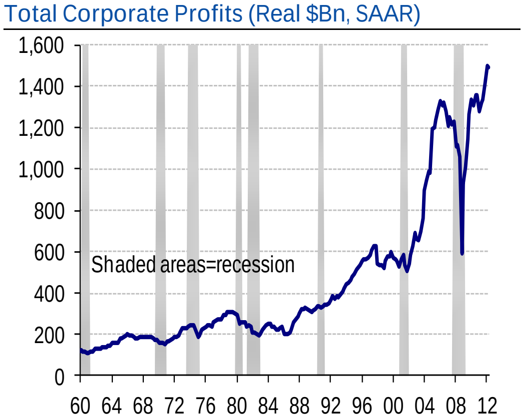
Weak Hiring Supporting Profit Growth

Risk Scenario Poses Little Threat to Corporate Earnings

- Despite a modest decline in 2Q12, real corporate profits are still extraordinarily high compared to historical trends
- Meager job growth is indicative of a stubbornly slow recovery but ultimately translates into higher profit margins for businesses
- Even under our risk scenario, we see only a small downward shift in corporate profits' share in GDP

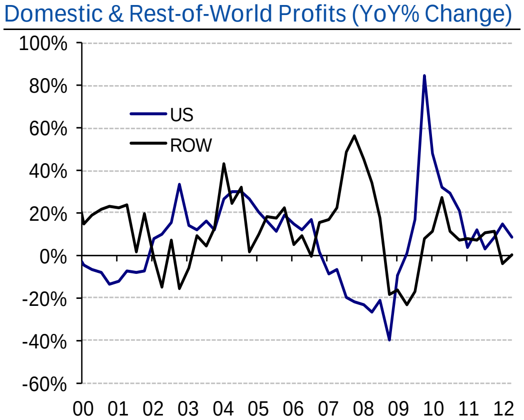
The economic recovery has been modest at best throughout the past few years, yet corporations continue to reap the benefits of subdued labor and borrowing costs. According to the latest data from the Bureau of Economic Analysis, real corporate profits declined on a quarterly basis for the first time in more than a year, although levels dropped only 0.67% from the historical high of $1.5tr reached in 1Q12 (Chart 1). On an annual basis, corporate profits increased more than 12% in 2Q12, slightly slower than the pace seen in 1Q12 but much faster than in the previous 5 quarters. In nominal terms, corporate profits in the U.S. declined for the second consecutive quarter to $1.485tr, while profits from the rest of the world (ROW) rebounded from a sharp QoQ decline in the beginning of 2012, settling near $437bn in 2Q12 (Chart 2). Aside from the drop in 1Q12, ROW profits have increased on a YoY basis for nearly 3 years. Although the European sovereign debt crisis has caused significant volatility through global markets, the worst of it appears to be past us for now. Still, with most of the region in recession for the next year, we expect that the ROW component will not be a significant contributor to total corporate profits. The global slowdown has also taken a toll on business confidence in the U.S., with various surveys noting a slight decline for the second quarter. However, firms have remained very conservative since the recession, and confidence levels have been nothing to write home about. Although the most recent data for the third quarter suggest slowing demand and a downturn in industrial production, it is likely that business were prepared for such a shift and will be able to manage costs so as to preserve the bottom line.

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



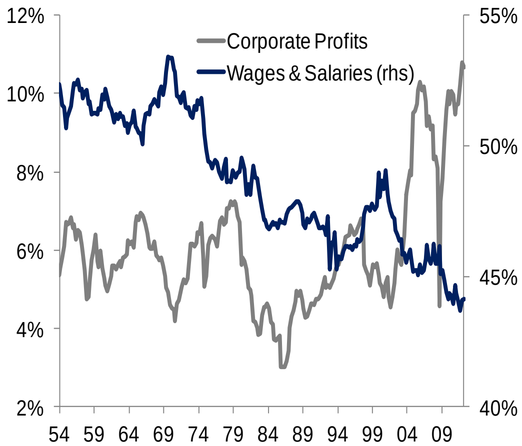
Source: Bureau of Economic Analysis & BBVA Research

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



Source: Bureau of Economic Analysis & BBVA Research

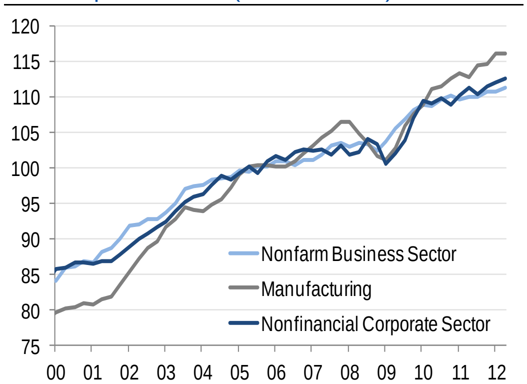
Chart 3
Nominal Corporate Profits and Wages (% of GDP)



Source: Bureau of Economic Analysis & BBVA Research

Despite slowing economic activity and the resulting weakness in internal and external demand, businesses have been able to squeeze out as much as they can from existing employees without having to add to the workforce. Even when confidence rises and firms feel the need to hire more workers, extremely low labor costs help to maintain profit margins. As a percentage of GDP, wages and salaries expenditures have fallen drastically over the past few decades to just over 44% from a high of 53% in the late 60s and early 70s. Corporate profits, on the other hand, have jumped to nearly 11% of GDP from a low of just 3%. Ultimately, we are seeing somewhat of a structural shift in the composition of GDP, which could help support the economic recovery as long as corporate profits continue to grow.

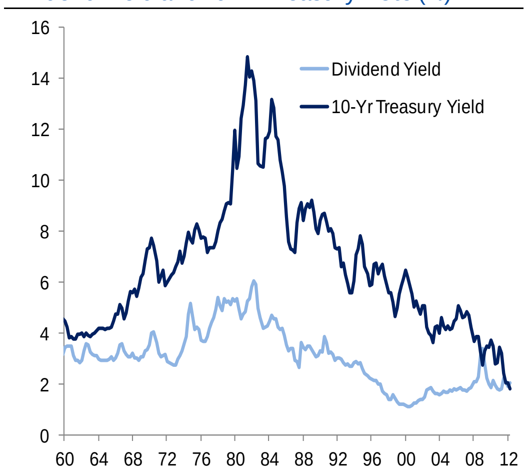
Chart 4
Real Output Per Hour (SA, 2005=100)



Source: Bureau of Labor Statistics & BBVA Research

In 2Q12, the nonfinancial corporate sector saw the largest increase in productivity, though manufacturing remains the strongest in terms of the ratio of total output and worker hours. As long as the pace of output growth remains higher than the rate of hiring in absolute terms (even if both are negative), corporations will continue to see gains in productivity. The underlying factors may not be so encouraging for sustainability in the long-run, but businesses are much more focused on their margins in the short-term. Thus, they will continue to adjust in order to maintain a productive environment that benefits the bottom line.

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



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

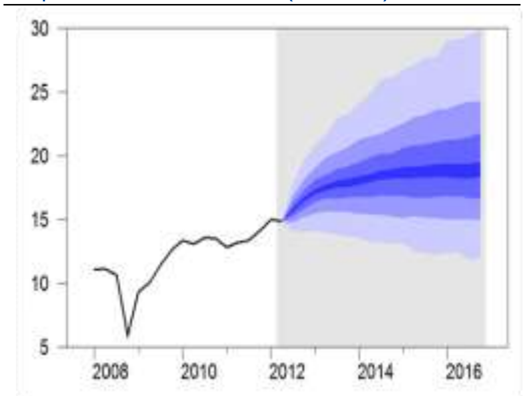
Dividend yields and 10-year Treasury rates have reverted back to movements seen during the crisis in 2008, when the two moved in unprecedented, opposite directions rather than together. In 2Q12, dividend yields increased only slightly but remained relatively low compared to late 2011 levels. On the other hand, flight to safety dragged down the Treasury yield to a new historical low. In the third quarter thus far, we have seen even further declines in interest rates along with steady gains in dividend yields. Given the latest announcement from the Fed in which they extended the policy guidance to mid-2015, we expect that the 10-year yield will bottom out and then increase very gradually over the next few years. Of course, downward pressure on yields increases in our risk scenario for 2013.

Outlook for Corporate Profits

The outlook for corporate profits is much more optimistic than for overall economic growth. Our baseline scenario, which assumes slow but consistent growth in productivity, stable inflation, and steady gains in 10-year Treasury rates up above 3.5% by the end of 2016, suggests that corporate profit growth will be positive but decelerate in the long term. Projections show a much sharper increase in the short-term but deceleration in the long run as the cost of employment rises in line with a stronger economy.

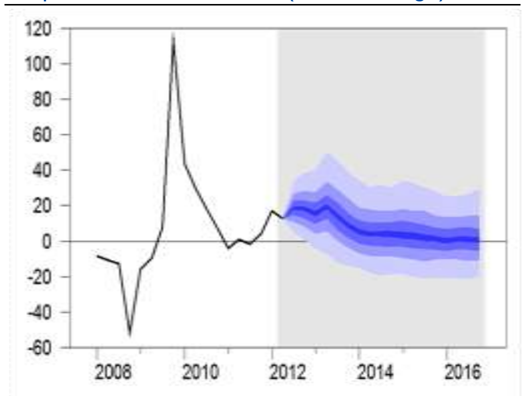
While there are significant downside risks to economic growth in the next year (with the fiscal cliff and the European sovereign debt crisis being the most prominent), the risk to corporate profit growth is minimal. In the case of our risk scenario (which assumes that employment remains extremely low or even declines) business productivity will remain positive as long as the value of output does not decline at a faster pace than employment. Given that most of the risk is targeted for 2013, we see only a small shift in corporate profits' share of GDP – from approximately 12% to near 10% -- but the rebound in the following years would be much stronger. As was the case after the latest crisis, businesses were able to aggressively cut costs while simultaneously seeing a recovery in demand, translating into a more drastic profit gain than in normal times. Ultimately, the risk scenario impacts corporate profit growth in the short-term but results in a more resilient recovery compared to other aspects of economic activity.

Chart 6
Corporate Profit Forecasts (Real $Bn)



Source: BBVA Research

Chart 7
Corporate Profit Forecasts (YoY% Change)



Source: BBVA Research