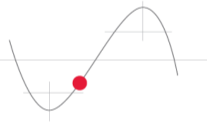

Applied Insights

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Feature Insight

Are Profits Peaking?

Earnings growth, along with multiple expansion, has driven the stock market higher for a number of years. Business profits have greatly outpaced economic growth in that time. As such, profit margins have increased and are near all-time highs and nearly twice their historical average. Should investors be concerned that this earnings support may falter? We think not. Profits and margins are poised to remain high.

The Surge in Profits

Business after-tax profits, as reported in the NIPA accounts (National Income and Product Accounting), were $1.5 trillion for the year ending September 2014, up from a low of $0.9 trillion in the year ending September 2009 and well above the peak $1.2 trillion reported in 2006, prior to the "Great Recession".

Correspondingly, for the year ending September 2014, S&P 500 earnings per share of $105 are 110% higher compared to the recession 12-month low of $50.00 (September 2009) and 31% higher versus the pre-recession peak earnings of about $80.00.

As noted, relative to business revenues, earnings are near all-time highs.

An Incomplete Explanation

This surge in profits has occurred despite a deep recession and a slow recovery and expansion, which seems counterintuitive. The commonly accepted explanations include cost cutting, higher productivity, foreign exposure, and lower interest rates.

While true for many individual companies, at the macro level these factors are about a wash because lower costs at one company reduce revenues for other companies (e.g. cost cutting in the form of travel budget reductions result in lower revenues for transportation and hotel industries; lower interest rates result in lower interest expense for borrowers, but also result in lower interest income for lenders and savers). As such, these explanations fail to explain what is taking place for the economy as whole.

The Complete Story

At the overall level, business profits can be determined by aggregating the sources of business revenues and then aggregating and subtracting the sources of business costs. The "Kalecki equation" summarizes this calculation. This equation, known as the profits identity in economics, combines the four sources of profits where revenues are received without corresponding costs (at the overall macro level). Specifically, after-tax business profits are equal to:

- Net investment, plus
- Consumer spending > wages (negative savings), plus
- Government spending > taxes (government deficits), plus
- Foreign spending in the U.S. > U.S. spending abroad (net exports)

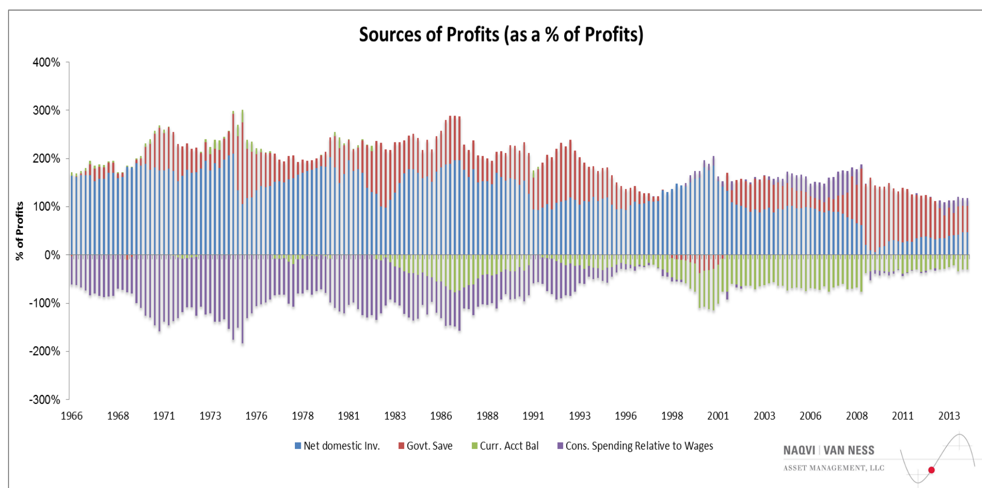
In each case, the private business sector is receiving additional revenues without an increase in overall business costs (meaning without an off-setting revenue reduction to other participants in the economy as in our prior examples).

In terms of recent experience, massive deficits incurred in the wake of the "crisis" resulted in strong profit growth during the 2009-11 period. Since then, reflecting economic improvement, deficits have declined. Offsetting the deficit decline's negative impact on profits has been stronger levels of investment as well as higher consumer spending relative to wages.

The Profits Outlook

Where do we go from here? As noted, profit margins are near all-time highs. Will they begin to revert to their "norm"? To answer this question, we need to review the current status of the components of the framework above and their outlook for 2015.

Net investment: At about 3.5% of GDP, investment net of depreciation (which includes housing) is still well below its historical norm of 6.5%. Hence, as the economy continues to grow, we expect continued gradual improvement in the level of private sector investment. While the sharp decline in oil prices will have a negative impact on capital spending in the energy industry, its share of total investment is equal to only 6%. Consequently, even a contraction of, say, 40%, in such spending in this sector will not forestall a continuation of the favorable trend in investment overall.



Consumer spending (relative to wages): After years of deleveraging, consumers are now increasing their level of borrowing. In addition, dividend growth is strong. (Dividends, when spent, increase business revenues but not business costs). Hence, profits should benefit from both of these trends. (Note that the benefit from lower energy prices is sourced in the reduction of the trade deficit. Consumer spending relative to wages is not impacted. Consumers do not have more money to spend. Instead they have more money to spend on "other things" but this increase is equal to the dollar decrease in imported oil. Indeed, to the extent consumers save any of this "windfall", consumer spending will decline relative to what it otherwise would have been).

Government deficits: Government deficits, especially at the Federal level, have fallen sharply relative to earlier in the cycle. Further reductions will likely occur if the economy is strong and the other sources of profits are thus improving. That is, stronger business activity will increase tax revenues and decrease income stabilization spending. In such a scenario, the other sources of profits should more than offset the negative impact of lower deficits. Beyond cyclical considerations, the baby boomers are retiring at a prodigious rate, increasing spending on Social Security, Medicare, etc. These additional public sector payments will create higher deficits, all else equal, thus providing a boost to corporate profits.

Trade (net exports): Economic weakness in other parts of the world and a stronger USD may reduce exports and profits of the foreign operations of US-based companies. However, if the recent levels of oil prices are maintained, the overall impact of changes in trade on profits should be a net positive, given that the US is still a significant net oil importer.

Thus, reflecting these expected trends in the sources of profits, we estimate that total earnings will grow by 5% in 2015 over 2014 earnings of an estimated $1.52 trillion. Because of buybacks and other factors, S&P 500 earnings per share could grow modestly stronger at, say, 7%.

The Bottom Line

Profit margins are near record highs. However, an analysis of the underlying determinant of profits concludes that margins are likely to stay very high in a historical context, with moderate profit growth likely to continue. Thus we don't think that concerns about "peak profits" at this time are justified.