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Economics Group

Interest Rate Weekly

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Optimism on Profits: A Late Cycle Recovery?

Profits serve a dual purpose—a return for risk-taking and an incentive for further investment. Profits are pervasive drivers in economics, and feed into the cost of capital, credit quality, personal income and pensions.

Profits: Incentive and Reward

Along with expectations for faster economic growth comes the prospect of potential profit rewards for those who serve that future growth. Current policy proposals for lower taxes and reduced business regulation provide the basis for faster growth expectations and thereby expectations for future profits to be earned by satisfying that growth. However, we are beyond the midpoint of this economic cycle and the case for optimism on profits depends on better revenue growth and modest input cost growth.

Aiming to Boost Profits

Economic policy is currently aimed at improving economic growth which, if achieved, would improve nonfinancial corporate profits. The history of profits follows a cyclical pattern, as illustrated in the top graph. A reduction in taxes on the profits from higher sales would reduce the cost of capital and lead to greater business investment and employment, all else equal.

We temper our optimism here, however, simply because gains in after-tax profits may not directly and exclusively lead to more investment and employment. There is no guarantee firms will use the additional funds to hire more workers or buy more equipment.

Tension on the Profit Margin Front: Current Policy Proposals

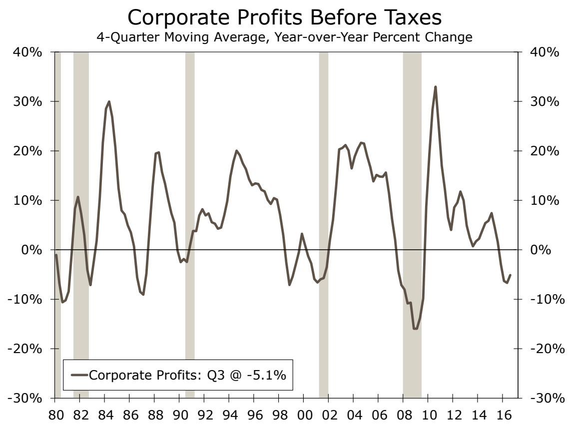
Profit margins tend to peak mid-cycle and then gradually decline until the next recession (middle graph). In the early phase of the business expansion, productivity growth tends to be fairly high and labor cost growth modest.

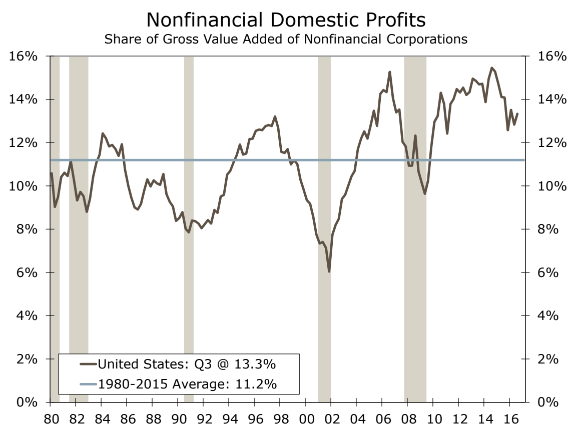
Three policy proposals would help improve profit margins. First, policy proposals to stimulate aggregate demand would improve the top-line and allow an increase in margins following increased sales. Second, a lower corporate tax rate would increase after-tax tax earnings. Finally, reductions in business regulation would reduce operating costs, increasing margins.

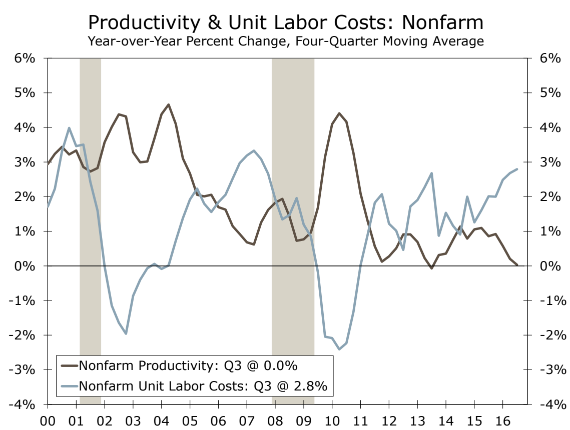
Unit Labor Costs and the Bottom-Up Issue

Success via expansionary fiscal policy to stimulate aggregate demand and thereby profits faces a constraint from the supply-side on costs. The optimistic case for higher profits, business investment and employment rests on input costs remaining tame enough to maintain margins amid stronger revenue growth. Productivity is key to limiting rising labor costs.

However, at this stage of the economic cycle, unit labor costs are rising, as illustrated in the bottom graph. Productivity gains have remained sluggish and the search for labor talent is increasingly expensive. In addition, in the current cycle, the low in energy prices has passed, adding another input cost challenge. One final caution: import and export prices will be sensitive to policy initiatives such as tariffs and border taxes. What these tariffs/taxes are and the ability of business to work around them remains to be seen, as does the impact on the bottom line.







Source: U.S. Department of Commerce, U.S. Department of Labor and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual 2016				Forecast 2017				Forecast 2018			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.75	2.00
3 Month LIBOR	0.63	0.65	0.85	1.00	1.05	1.25	1.25	1.50	1.50	1.75	2.00	2.25
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25	4.25	4.50	4.75	5.00
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.22	4.24	4.26	4.29	4.31	4.38	4.43	4.49
3 Month Bill	0.21	0.26	0.29	0.51	0.57	0.78	0.84	1.02	1.10	1.30	1.50	1.75
6 Month Bill	0.39	0.36	0.45	0.62	0.69	0.88	0.94	1.12	1.20	1.40	1.60	1.85
1 Year Bill	0.59	0.45	0.59	0.85	0.88	1.03	1.08	1.38	1.46	1.65	1.82	2.02
2 Year Note	0.73	0.58	0.77	1.20	1.23	1.35	1.42	1.66	1.73	1.91	2.08	2.22
5 Year Note	1.21	1.01	1.14	1.93	1.95	1.99	2.06	2.21	2.27	2.38	2.49	2.62
10 Year Note	1.78	1.49	1.60	2.45	2.47	2.50	2.53	2.57	2.60	2.68	2.74	2.81
30 Year Bond	2.61	2.30	2.32	3.06	3.10	3.18	3.21	3.29	3.32	3.40	3.48	3.56

Forecast as of: January 20, 2017

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2016	2017	2018
Change in Real Gross Domestic Product			
Wells Fargo	1.9	2.3	2.2
FOMC	1.8 to 1.9	1.9 to 2.3	1.8 to 2.2
Unemployment Rate			
Wells Fargo	4.7	4.6	4.5
FOMC	4.7 to 4.8	4.5 to 4.6	4.3 to 4.7
PCE Inflation			
Wells Fargo	1.5	2.0	2.3
FOMC	1.5	1.7 to 2.0	1.9 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.7	1.9	2.1
FOMC	1.7 to 1.8	1.8 to 1.9	1.9 to 2.0

Forecast as of: January 20, 2017

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: December 14, 2016

Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities

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