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Economics Group

Special Commentary

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Corporate Profits: A Problem in 2019?

Executive Summary

Corporate profits surged in 2018 thanks to faster growth in real GDP and a reduction in the corporate tax rate. Profit growth is unlikely to be as strong in 2019, however. Slower GDP growth and higher costs as the labor market tightens further and interest costs rise suggest profit growth is likely to have already peaked. Stronger productivity growth should mitigate some of these late-cycle strains on profits, as businesses get more out of their existing workforce. Nevertheless, we forecast that before-tax corporate profits for the broad economy will increase only 5% in 2019 after increasing nearly 8% this year. While there are technical differences with our economy-wide measure and more market-oriented measures of profits, the slowdown could be troubling to investors as well as a headwind to new investment and hiring in the year ahead.

Has Profit Growth Peaked?

In our recently released 2019 Annual Economic Outlook, we forecast that growth in before-tax profits will downshift from nearly 8% in 2018 to about 5% in 2019 before flattening out in 2020 (Figure 1). We look for growth in after-tax profits, which we project jumped 16% in 2018 because of the corporate tax cuts earlier this year, will decelerate meaningfully as well. A natural concern for many investors would be the potential implications of slower profit growth for the stock market.

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Figure 1

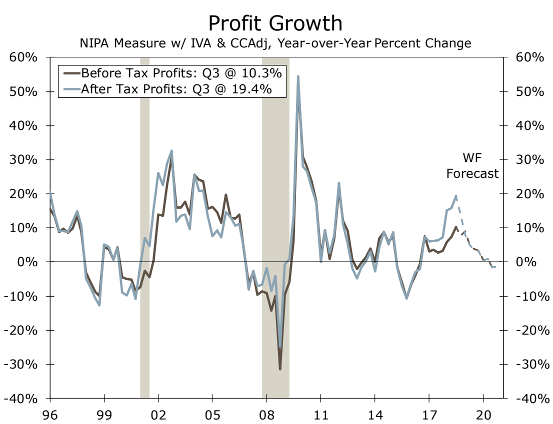
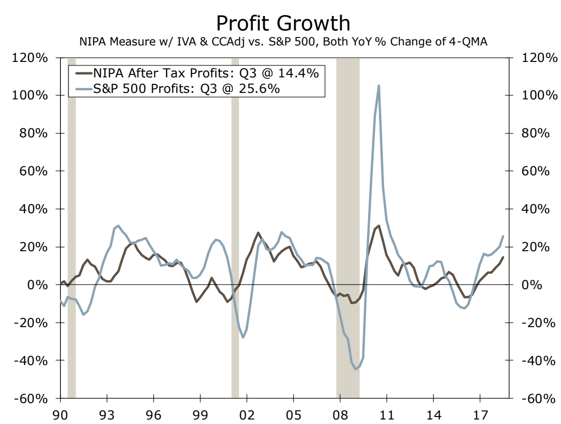


Figure 2



Source: Standard and Poor's, U.S. Department of Commerce and Wells Fargo Securities

We are not stock market strategists, so we will not opine on valuations and the direction of the stock market. Moreover, there are some technical differences between our measure of profits, which come from the quarterly National Income and Product Accounts (NIPA, commonly referred to as the GDP accounts), and measures of profits that readily spring to the mind of most investors, such as the profits of the S&P 500 companies. For starters, the NIPA measure includes profits from current production only. S&P profits include changes in asset valuations such as pension plans. The NIPA measures include profits for all of the corporations in the U.S. economy, while the

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S&P 500 measure is limited to publically traded corporations. In short, NIPA and S&P 500 profit measures differ in both coverage and accounting methodologies.[1]

That said, the year-over-year growth rate in NIPA profits has a fair degree of correlation with growth in S&P profits (Figure 2). So slower growth in the former in coming quarters implies that growth in the latter probably will downshift as well. In addition to troubling investors, slower profit growth points to more difficulty for firms to finance new investment or hire workers.

Look Out Below?

We see a number of factors weighing on profit growth in the coming year. First, slower GDP growth in the upcoming year points to a more moderate pace of revenue growth. While after-tax profits received a significant boost in 2018 from the reduction in corporate tax rates, before-tax profit growth also looks to have had the best year since 2012 as sales accelerated alongside GDP. As overall GDP growth reverts back to its trend, the weaker sales environment should weigh on revenue growth.

At the same time that sales growth is slowing, costs at corporations are rising. First, as interest rates head higher, the cost of servicing the record amount of corporate debt is expected to climb. Input costs are also increasing amid strained resource availability. Higher material costs are unlikely to dent the economy's aggregate profit picture, because one company's costs are, in many cases, another company's revenue, but labor availability is another story. In that regard, compensation costs are rising now that there is little, if any, slack in the labor market. We forecast that the Employment Cost index will rise more than 3% in 2019, which would be the fastest pace in 12 years.

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Although we look for a moderation in profit growth, we do not anticipate an acute squeeze on profits. For one, more companies report raising prices than at any point in the current expansion, although that may only be a temporary salve, as presumably workers would begin to push for even higher wages if inflation picked up broadly (Figure 3). Second, and more favorable for the medium-term profit picture, is a pickup in productivity growth. Up to this point in the cycle, muted wage gains have kept a rein on unit labor costs. More recently, however, a rebound in productivity growth has kept unit labor costs in check even as compensation costs have grown (Figure 4). We expect to see some further improvement in productivity growth in the year ahead as the tight state of the labor market encourages companies to invest more in labor-saving technology.

Figure 3

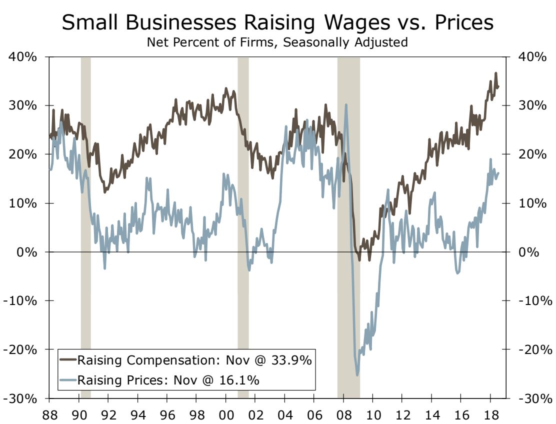
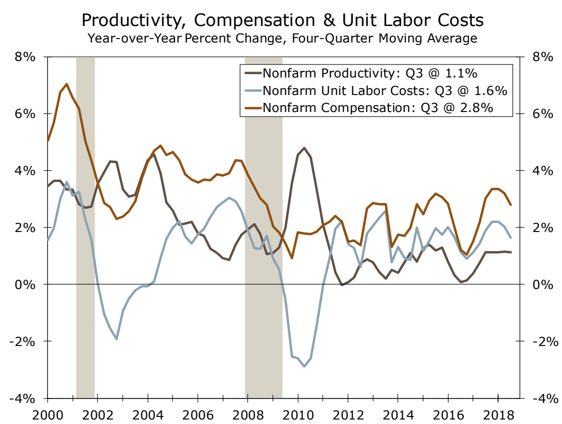


Figure 4



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

[1] **United States. Bureau of Economic Analysis. "BEA Briefing: Comparing NIPA Profits With S&P 500 Profits," in United States. Bureau of Economic Analysis. "March 2011,"Survey of Current Business (March 2011): 28-33.**

Should We Worry About Profits in 2019?

Nevertheless, we see the level of corporate profits in this cycle peaking late in 2019, which generates some valid macroeconomic concerns. As a quick glance at Figure 1 indicates, the year-over-year rate of profit growth usually turns negative before the economy falls into recession.[2] Figure 5, which shows the average dynamics in NIPA profits over past cycles, reinforces this point. On average over the past eight cycles, NIPA profits have peaked four quarters before the economy has entered into a recession. Profits remain more or less flat for the next three quarters before declining one quarter before the peak in real GDP. Looking at the three most recent cycles, however, profits have peaked earlier, leading a broad downturn in the economy by seven quarters. Investment spending follows profits lower, which then weighs on employment as the economy slides into recession.

We see the level of corporate profits in this cycle peaking late in 2019.

Figure 5

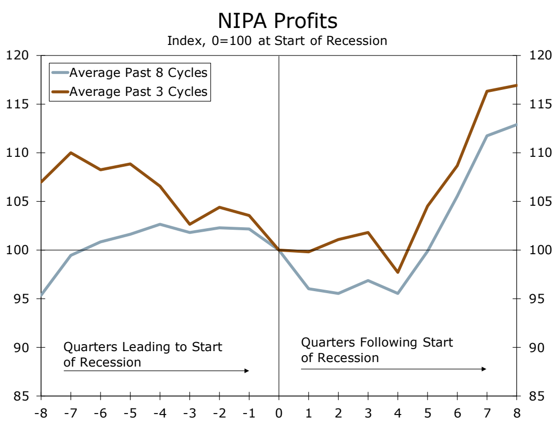
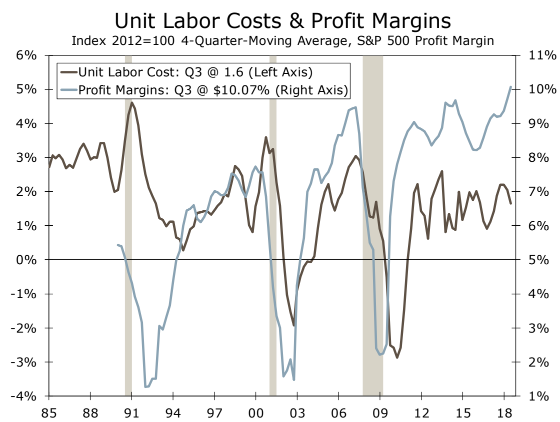


Figure 6



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

The good news is that although we forecast that profit growth will turn modestly negative at the end of 2020, it will not weaken to the same degree as it has prior to past recessions. The bad news is that errors are associated with all models, so model-based forecasts of profits are not always precise. In short, there are some developments that could cause profit growth to turn negative earlier and more deeply than our forecast.

Profit growth will turn modestly negative, but not weaken to the same degree as it has prior to past recessions.

For example, if growth was to slow faster than we currently expect, profits would deteriorate more quickly. There are no shortages of risks on the horizon at present. Excessive interest rate hikes by the FOMC or abrupt tightening in financial conditions more broadly could lead to a sharp slowdown in real GDP growth. An escalation in trade tensions or other exogenous shocks could also slow GDP growth more than we expect. In addition to slowing growth, higher tariffs on additional goods are also likely to weigh on profits since companies may have difficulty passing the entire increase in input costs onto buyers.

Furthermore, a pickup in unit labor costs could erode profit margins (Figure 6). With a slew of measures pointing to the tightest labor market in decades, wage costs could accelerate more quickly. Unless productivity growth picks up in a commensurate fashion, unit labor costs would rise and put pressure on profits. We anticipate productivity will advance about 2% this year, close to its average over the past 20 years, as difficulty finding labor leads firms to lean more on capital. That pace of productivity growth is a meaningful increase, however, from the 1.1% average of the current expansion. If productivity continues to grow at a historically slow pace, the tight state of the labor market could lead to a sharper decline in profits.

[2] **Profit growth turned negative in 2015-16 when the collapse in oil prices sharply reduced profits in the energy sector. The economy did not slip into recession, but the year-over-year rate of real GDP growth slowed to only 1.3% in Q2-2016.**

Conclusion

The deceleration in before-tax profits should be fairly modest.

Corporate profit growth is set to slow in 2019, although the deceleration in before-tax profits should be fairly modest. Slower sales growth and rising costs—particularly for labor—are set to weigh on profits, but, at 2.7%, GDP growth is anticipated to remain fairly solid, while stronger productivity growth is keeping a lid on unit labor costs. Should productivity growth and/or GDP growth weaken materially, however, the slowdown in profit growth would likely be more acute. We see the level of corporate profits peaking late in 2019 before edging lower in 2020. Given that profits tend to peak a year or two before a recession, that could be troubling to investors as well as a headwind to investment and hiring in the year ahead.

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