Is Employment Growth at Risk to Waning Profits?

Executive Summary
The financial position of the U.S. corporate sector has been deteriorating over the past few years, making it more vulnerable to any shock that would reduce earnings. Efforts to contain the new coronavirus represent one such potential shock. Could a decline in corporate profits at this stage of the economic cycle spillover into the labor market and trigger a recession?

In times of stress, one way for businesses to shore up finances is to reduce labor costs, i.e., cut jobs. We estimate that a 10% decline in before-tax profits has historically corresponded to a 1% decline in employment. That said, employment has fallen and the economy has slipped into a recession following more modest drops in profits, particularly when profits declined over a series of quarters. Timing also matters. A decline in profits is more perilous later in the economic cycle, when margins are falling and monetary policy is slow to become more accommodative.

Profit growth has been rather anemic, as economy-wide corporate profits have moved more or less sideways over the past five years. Therefore with margins already falling and Fed efforts to ease financial conditions up in the air, the coronavirus and its potential hit to profits could yet lead to trouble for the jobs market.

Corporate Sector’s Financial Health Makes It Vulnerable to a Shock
For more than a year now, we have been highlighting the deteriorating financial position of the U.S. corporate sector. Amid a record amount of debt in the non-financial corporate sector, interest coverage has eroded and net debt relative to earnings has climbed. Our own measure of corporate financial health, which captures eight financial metrics reflecting corporate balance sheets and income statements, is near its lowest levels since the past recession (Figure 1).1 At the same time, corporate profits growth remains rather anemic, as economy-wide corporate profits have moved more or less sideways over the past five years (Figure 2).2 While corporate finances do not appear so weak at present as to be the catalyst for the next recession, the more fragile financial position in recent years certainly makes the business sector more vulnerable to any economic shock that would reduce earnings.

Such a shock might be upon us. While currently our working assumption is that COVID-19 does not become a full-blown pandemic, it is hard to say with any certainty how events unfold from here. But measures being taken to stem the virus’ spread come with an economic cost. Corporate earnings are already in some degree of jeopardy as travel is curtailed, supply chains are disrupted and stores are closed. Could a deterioration in U.S. corporate profits spill over into key segments of the economy, like the labor market, and trigger a recession?

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1 See “U.S. Corporate Sector Health: Should We Worry?” (September 27, 2018), for more detail.
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Figure 1
Corporate Financial Health Index

Figure 2
U.S. Profits

Source: Federal Reserve Board, U.S. Dept. of Com., S&P Dow Jones Indices and Wells Fargo Securities

How Big of a Drop in Profits Could Derail Hiring?

Businesses in financial peril are apt to cut costs where they can. Major expenditures like capital investments and labor are often on the chopping block. As we have seen in a number of recent periods, such as 2015-16 and the last three quarters of 2019, a decline in real business investment does not always translate to a recession. However, given the commanding share of economic activity driven by the consumer and households’ reliance on jobs for income, a decline in nonfarm payrolls has always corresponded to recession.

To determine the extent to which a decline in profits would affect employment, we employ a statistical technique to “shock” earnings. We then calculate an impulse response function between corporate profits and nonfarm payrolls. Specifically, we find that a 10% decline in corporate profits over a single quarter would lead to roughly a 1% decline in employment the following quarter. Such a shock can be long lasting, with the full effect not completely dissipating for about three years.

A 10% decline in profits over a single quarter is exceptionally rare. Indeed, such a drop has occurred once since the 1980s, when the financial crisis was at its height in the third quarter of 2008. However, employment has fallen and the economy has slipped into a recession following more modest quarterly drops in profits, particularly when profits declined over a series of quarters. By the time the past three recessions rolled around, corporate profits were down an average of 6% year-over-year.

Profits & Employment: Timing Matters

It is worth noting that wide-scale job cuts do not always follow periods of declining profits. For example, before-tax profits fell from late 1985 to the end of 1986 (Figure 3). That episode, however, was only shortly after the double-dip recessions of the early 1980s, so there had been little time for the economy to build up major imbalances. Moreover, the FOMC was still cutting interest rates from the marked levels that had been used to tame inflation early in the decade, while corporate profit margins were still expanding. Similarly, declining profits from mid-2014 to 2015 were not enough to stop job growth from strengthening over the period (Figure 3 again). There too, however, the economy was still emerging from the prior downturn, corporate margins were expanding and monetary policy was still highly accommodative.

If a profit decline derails hiring, the U.S. economy could fall into recession.

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3 We estimated a three-equation vector autoregression (VAR) that contained quarterly growth rates in before-tax corporate profits, nonfarm payrolls and real GDP. The data set spans Q1-1983 to Q4-2007 and we used the first lag in each sector as the independent variables in each equation. We exclude the Great Recession due to the severity of that downward on profits and employment. The econometric results are available upon request to interested readers.
Nonetheless, as we have highlighted, a deteriorating profit picture has preceded each of the past three downturns in employment. Profits stalled out ahead of the 1990 recession, and underwent more than a yearlong slide ahead of the 2001 and 2008-09 recessions. Moreover, each episode bears a number of conditions in common.

First, margins were no longer expanding. As shown in Figure 4, corporate earnings as a share of all income in the economy—a proxy for corporate profit margins—tend to decline late in the economic cycle; easy cost-cutting has been done and labor costs rise as the jobs market tightens, shifting more income to the household sector. More generally, the financial health of the corporate sector as measured by our index shown in Figure 1 had already been deteriorating when earnings weakness eventually translated to a drop in employment. The reduced financial cushion inhibits corporations’ willingness and ability to hire.

Second, the Fed was slow to become more accommodative. The FOMC raised rates to new cycle highs after profits peaked in the lead up to the 1990-91 and 2001 recessions (Figure 5). Ahead of the 2008-09 recession, the FOMC did not begin cutting rates until a full year after profits peaked. Relatedly, overall financial conditions were no longer easing, making it harder and/or more expensive for companies to borrow or refinance debt. Together, the more fragile financial state of the corporate sector alongside cycle-high policy rates made the economy more vulnerable to a shock, whether that was the oil price shock of 1990 when the U.S. invaded Kuwait, the tech bubble bursting in early 2000s, or the collapse of the housing market in the mid-2000s.
Profit Hit Could Spell Trouble for Jobs Market

How vulnerable is the labor market to a downturn in profits today? As we have already shown, the financial health of the U.S. corporate sector has been deteriorating on net since 2014. The corporate sector’s share of income has similarly been on the decline. While both metrics are at levels that do not suggest financial stress in the corporate sector is imminent, the erosion of the past few years suggests that hiring could be poised for a pullback if profits were to fall.

Fortunately, the Fed seems quite unlikely to increase interest rates anytime soon. Our base case at present remains that the FOMC will stay on hold through 2021, but there is growing risk to that call; as more economic activity has been disrupted with the virus spreading beyond China, at least one cut looks increasingly likely over the next few months.\(^4\) Currently, markets have priced in a cut to the fed funds rate as soon as its next meeting. The degree to which that would decrease the recent tightening in financial conditions remains to be seen, however. Therefore, the exogenous shock of the coronavirus and its potential hit to profits could yet lead to trouble for the jobs market.

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