Investing Beyond the Profit Squeeze

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Over the years, my standard approach to analyzing corporate profits has been to think of them as the last slice taken from a big national income pie. The growth of the pie itself is important. But so is the size of the other slices, such as labor costs, interest costs and corporate taxes. Once every one else has had their slice, what's left over is corporate profits.

It's a useful model for analytical purposes. However, it has one glaring flaw, namely that it assigns to corporations a purely passive role, meekly accepting the slice left after all the other factors of production have taken theirs'. In reality, American corporations are muscular and sharp-elbowed, growing profits by enhancing productivity but also by beating back the demands of labor, lobbying for a more favorable tax and regulatory environment and seducing customers into buying more goods and services than they really should, based on sober calculation.

These attributes, rather than benign economic trends, have allowed profits to grow more quickly than the economy for many decades. And while the difficult transitional economy of 2023 will likely yield a decline in profits, the economic landscape that should emerge in the years thereafter should allow for rising profitability. While not all companies will participate in this renaissance, most should, providing opportunity for long-term investors in U.S. stocks, despite this year's challenges.

The Earnings Slump

As the fourth-quarter earnings season wraps up, it's clear that profits are slumping relative to a spectacular 2021. As of last Thursday, with almost 95% of market cap reporting, S&P500 operating earnings per share were tracking $49.37, down 13% from a year earlier. For all of 2022, it now appears that S&P500 operating EPS will fall by roughly 6%, following a spectacular 70% gain the year before.

We don't, as yet, have fourth quarter numbers for the government's broader measure of adjusted after-tax corporate profits. However, they also look likely to be down year-over-year, with the potential for a steeper decline in 2023.

A Slower-Growing Pie

On the overall size of the pie, 2023 is still shaping up to be a tough year relative to recent years. We estimate that nominal GDP will grow by 5.6% this year compared to 9.2% in 2022.

This slowdown partly reflects a further decline in real GDP growth from 2.1% last year to 1.2% this year and a sharper fall in inflation, with the GDP deflator rising by 4.3% compared to 7.0% in 2022. As we have noted in recent weeks, January data on employment, retail sales and inflation have all been stronger than expected. However, this does not negate the general trend towards slower growth due to fiscal drag, a housing slump and a too-high dollar. Moreover, even if the "demand" side of the economy were not pointing to lower growth, the "supply" side makes lower growth inevitable, given very slow growth in the working age population, only moderate productivity gains and a starting point of the lowest unemployment rate in over 50 years.

Nor does it alter a general trend towards lower inflation. The reality is that while the pandemic, the policy response and the invasion of Ukraine combined to produce the highest U.S. inflation since the 1980s last year, inflation is now on a steady downward track, as the global economy adapts to supply-side disruptions and demand fades.

It should be noted that, even without a recession, nominal GDP growth will likely fall again in 2024 before stabilizing and then improving in 2025 and beyond.

The Margin Squeeze

While nominal GDP growth should slow in both 2023 and 2024, the maximum squeeze on corporate profits could be this year rather than next, as corporations struggle to control costs in a slowing economic environment.

The first problem will be compensation in the tightest labor market since the 1960s. Businesses are continuing to award pay increases to at least partially compensate their workforce for inflation in 2022.

It should, however, be noted that firms have been generally successful in restraining wage growth. The average hourly earnings of all private sector workers grew by 4.4% year-over-year in January, well below the 6.3% increase in CPI, marking the 22nd consecutive month in which workers have failed to keep up with consumer inflation.

In this regard, it's notable that just 6% of private sector workers belonged to a trade union in 2022, far below the almost 17% of 1983 and much higher levels of unionization in the 1970s when workers last faced significant consumer inflation. It is also likely relevant that, according to a mid-January Morning

Consult poll, 46% of respondents thought the economy was already in recession with a further 25% expecting a recession in the next year. It's hard to fight for pay increases if you're worried about the security of your job.

Wage growth has already eased substantially since peaking at 5.9% year-over-year in March of 2022. It could, quite possibly, ease further over the next two years and continue to run below inflation in goods and services, thereby boosting corporate margins.

Other issues may be less of a drag on profits after this year. Corporate interest costs will likely continue to rise in 2023 as companies are forced to make higher interest payments on bank loans and corporate bonds. However, if, as markets expect and the Federal Reserve itself projects, short-term interest rates fall in 2024, corporate profits should benefit from cheaper financing.

Tax increases should also hurt profit growth in 2023 but not in 2024. According to the Joint Committee on Taxation, the imposition of a minimum corporate tax on large corporations and the tax on stock buybacks should raise roughly $40 billion in the current fiscal year, $42 billion in fiscal 2024 and lower amounts in fiscal 2025 and beyond. If this is accurate, it implies a roughly 3% hit to S&P500 earnings growth in calendar 2023 but no further hit to earnings growth thereafter. Divided government suggests that there will be no further increase in corporate taxes before 2025 at the earliest.

Finally, a higher dollar cut U.S. profits from abroad in 2022 and, even if the dollar were to drift down from current levels for the rest of the year, 2023 corporate taxes will be handicapped by a high exchange rate. However, a slow fall in the dollar from here should boost earnings from abroad in 2024 and beyond.

Getting Back to Profit Growth

Adding it up, even if the economy avoids recession, 2023 will be a difficult year for corporate profits. If there is a recession, profits will likely fall sharply. However, as the economy stabilizes and settles into what we believe should be a slow-growth, low-inflation and low-to-moderate interest rate environment, profits should recover and likely outpace economic growth overall.

Since the mid-1980s, adjusted after-tax profits have risen from roughly 5% of GDP to over 10% of GDP. This doesn't reflect fast economic growth, extraordinary productivity gains or a tailwind from a falling exchange rate boosting overseas earnings. Rather it is testament to the success of corporations in growing their share of the pie by squeezing labor costs and boosting sales. Profits have also received an assist from Washington in the guise of generally falling corporate tax rates and low real interest rates. While these trends have stalled, to some extent, in the current post-pandemic economy, they should re-emerge in the years ahead, providing strong support to U.S. equities.

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