The Remarkable Resilience of Corporate Margins

David Kelly

Chief Global Strategist at J.P. Morgan Asset Management
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Last Wednesday, the University of Michigan released its final reading on consumer sentiment for November, with the index coming in at 61.3, up from its flash reading but down from October and worse than 92% of monthly sentiment readings since 1978. Meanwhile, the "misery index" for October, calculated as the sum of the unemployment rate and the year-over-year CPI inflation rate, came in at 7.1%, better (or that is to say, lower) that it has been 79% of the time over the same period. We continue to have a bottom decile attitude about a top quartile economy.

This general gloom may account for part of the recent buildup in retail money-market funds which have risen by almost 50% over the past year to over $2.2 trillion. While some of this is the result of outflows from bank deposits, much of it represents long-term savings that investors are unwilling to commit to long-term investments.

One reason for investor caution is concern about corporate margins. In particular, many fear that, in 2024, margins will be squeezed by rising wages, rising interest rates and slower revenue growth. The concern is not unreasonable. However, before

surrendering to the idea of a margin slump, it is worth examining the current extraordinary strength of U.S. corporate margins.

This strength was on full display during the third-quarter earnings season, which is just wrapping up. As of November 20th and with almost 95% of S&P500 companies reporting, 79.9% had beaten estimates on earnings, the best reading in six quarters. This was despite the fact that only 62.5% beat estimates on sales, the worst reading in fourteen quarters. Operating earnings per share were up 4.3% year-over-year according to Standard and Poor's and 5.3% year-over-year using the pro-forma earnings estimates compiled by FactSet.

An alternative measure of earnings, the adjusted after-tax profits of all U.S. corporations, will be released on Wednesday as part of the revised 3rd quarter GDP report. We expect this measure to show a small year-over-year loss. However, this measure of earnings held up much better in 2022 than S&P500 earnings per share and is still at historically very high levels.

More to the point, these modest recent gains in profits tend to obscure the big picture. Since 2016, overall S&P500 profit margins, defined as earnings as a percent of sales, have risen from 9.2% to 11.6%. Total S&P500 EPS for 2016 was $106.26 – this year we expect it to be $214.33 or 101.7% higher. We expect the government's measure of the adjusted after-tax profits for all U.S. corporations to rise by a more modest, but still impressive, 50% between 2016 and 2023. Even allowing for CPI inflation of 27% over the same period, the growth in earnings has been remarkable.

More broadly, between 1950 and 1995, the adjusted after-tax profits share of GDP averaged 6.0% - since 2012 it has averaged 10.1%. The bottom line is that U.S. corporations have been extraordinarily successful at building and maintaining profit margins. So how have they done this and can they maintain or even grow margins in the years ahead?

The Sources of Higher Margins

One useful way of looking at the rise in the profit share of GDP is to consider the shares of GDP that have fallen. As noted above, the adjusted after-tax corporate profit share of GDP rose from an average of 6.0% between 1950 and 1995 to an average of 10.1% between 2012 and today – an increase of 4.1 percentage points. Over the same period, the compensation share of GDP fell by 2.7 percentage points (from 55.7% to 52.9%), the net interest share fell by 1.8 percentage points

(from 4.2% to 2.4%), and the corporate tax share fell by 1.5 percentage points, (from 3.3% to 1.9%).

The declining compensation share of GDP essentially reflects a reduction in the bargaining power of workers relative to employers. One aspect of this decline is falling union membership.

In the 1950s, more than 30% of U.S. workers were members of a trade union.[1] However, since then, this percentage has fallen very steadily and by last year, union membership was 10.1%, overall, and just 6.0% in the private sector.[2] This may well have inhibited the growth in wages. One stark reflection of this is that year-over-year wage growth has now fallen steadily for almost two years, despite an unemployment rate that has been below 4.0% since December 2021. Overall wage growth, at 4.1% year-over-year in October, remains higher than the Federal Reserve would like. However, with productivity growth of 2.2% year-over-year in the third quarter, it is, in fact, entirely compatible with the Fed's 2% consumption deflator inflation target.

A second, important point is that businesses are having some success in holding the line on benefits. Between 2001 and 2015, hourly benefit costs grew at a 1.1% faster annual rate than wages. Since 2015, businesses have held the growth in benefits to a 0.4% slower annual rate than wages.

Net interest costs have also fallen sharply in the long run. This mostly reflects a historic decline in long-term interest rates from the early 1980s, when Baa corporate bond yields peaked at over 17%, to the pandemic recession when they fell to nearly 3%. Since then, they have backed up sharply with other interest rates and currently yield over 6%.

However, importantly, large U.S. corporations took advantage of the lower-rate environment of recent years to lock in lower interest rates. Currently, almost half of the outstanding debt of S&P500 companies ex-financials matures after 2030, with no more than 7% maturing in any year between now and then and only 7% of this debt is floating rate[3]. This suggests that a very prolonged period of higher long-term rates could begin to erode profit margins. However, more likely, corporations can largely play for time until the next recession and bout of Fed easing gives them another opportunity to lock in low interest costs.

And finally, there is the issue of taxes. Various federal and state tax breaks have reduced the corporate tax share of GDP in the second half of the 20th Century. Since 2000, corporate taxes were fairly steady as a share of GDP until the passage of the 2017 Tax Cuts and Jobs Act which permanently reduced the federal corporate income tax rate from 35% to 21%. The 2022 Inflation Reduction Act marginally increased corporate tax revenue by assessing a 15% alternative minimum tax on book income.

We do not expect any major change in tax policy between now and the 2024 presidential election. However, in 2025, Washington will have to address the expiration of many tax breaks for individuals from the 2017 tax law. While the 21% corporate tax rate is not one of these provisions, it is, of course, possible that a new Congress and Administration would try to pay for the extension of personal income tax breaks by raising corporate taxes. However, it is more likely that deficit financing or dubious future spending cuts will be invoked to fund the extension. Low corporate taxes look set to stay.

Of course, margins are threatened by recession. Corporate profits are always more cyclical than the economy as a whole because companies can't cut costs as fast as revenues fall in a downturn. However, for as long as the economy continues to expand slowly, corporations should be able to maintain high margins. When recession hits, margins will fall, but companies will be able to take advantage of lower interest rates and are very likely to exploit weaker labor markets by taking a harder line on compensation. Moreover, when recession hits, Congress has historically provided corporate tax breaks to spur investment rather than tax hikes to refill empty federal tax coffers. This should allow margins to rebound to today's high levels in an economic recovery.

As we enter the last month of 2023, investors have much to be thankful for. The economy has avoided recession so far, inflation is falling, some geopolitical risks are easing and long-term interest rates have fallen from their peaks. All of this has allowed an equity rally to resume after a slump in the fall, with the S&P500 now up almost 19% year-to-date. Even with this performance, U.S. stocks do not look particularly expensive, outside of a few mega-cap names, under two conditions, namely that lower inflation allows long-term interest rates slowly drift down and U.S. corporations can defend their margins. Looking forward into 2024, and barring some major shock, both of these conditions seem very attainable.

[1] See “A Brief Examination of Union Membership Data”, Congressional Research Service, June 16th, 2023

[2] See “Union Members – 2022”, Bureau of Labor Statistics, January 19th, 2023.

[3] It should be noted that 38% of the debt of small caps, i.e. the Russell 2000 ex-financials is floating rate – small caps are more vulnerable to rising rates than large caps.

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