GLOBAL MACRO RESEARCH
CORPORATE PROFITS AND
THE GROWTH CYCLE

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EXECUTIVE SUMMARY

WHY MARGINS MATTER

- High and expanding margins provide a backdrop where corporates are able to plan investment decisions with a higher level of confidence. Conversely, periods of margin contraction make corporate behaviour more defensive which, in aggregate, makes the economy more vulnerable to shocks.

- In all of the post-war recessions experienced by the US, it is a fall in investment spending that has consistently been the largest contributor during contraction phases.

ANALYSING THE CURRENT CYCLE VERSUS HISTORY

- The initial acceleration in margins at the beginning of this cycle was one of the sharpest from our dataset, in part thanks to the severe decline seen in the global financial crisis. Today, margins remain above their cycle low but have showed a declining trend in recent years.

- Cost control, rather than revenue growth, has been a key driver of margins in this cycle. This is part of the reason why the labour share of US growth has declined significantly.

MARGINS ARE LIKELY TO DECLINE, BUT IT SHOULD BE MANAGEABLE

- A fall in margin growth seems likely in coming years, the pace and extent of this decline is unlikely to prompt a sharp change in corporate behaviour. Indeed the current strength of US growth and supportive base affects in the cost component means that a corporate led recession seems unlikely before the US election in 2020.

- Insight bottom-up industry analysis shows early signs of margin pressure, however this mostly stems from the cost component rather than the demand component. When viewed through the lens of corporate financing balances, US corporates are in a strong place to absorb modest margin squeeze.
WHY MARGINS MATTER

In our recent publication 'Asset Allocation and Growth Cycles', we discussed the reasons for, and the consequences of, lengthening business cycles. Our conclusion was that a combination of structural economic change and developments in the policymaking framework has made economies less susceptible to recessions. The cause of recessions in more recent decades has changed, with financial sector forces more dominant than traditional causes such as monetary mismanagement or industrial/oil price shocks.

However, all cycles must eventually end, and they don’t simply die of old age. As the taming of inflation has given policymakers more flexibility to use the tools at their disposal to sustain economic expansion, we believe that an end to the current cycle due to policy error (i.e. central banks overtightening to counter rising inflation) seems unlikely.

This note will explore an alternative risk to the current cycle – falling profit margins. We view profit margins as an important driver of the economic cycle. We can demonstrate that profit margins impact corporate behaviour with falling margins leading to a reduction in investment and hiring which ultimately impacts growth.

There is a large body of investment research highlighting the link between profit margins and return on equity. When viewed through a return on equity (RoE) lens (margins x efficiency x leverage) the changes in net margin component explains the vast majority of changes in RoE. It follows that changes in margins also have a strong link with stock price performance and as a consequence tend to be an important driver of corporate management behaviour.

High and expanding margins provide a backdrop where corporates are able to plan investment decisions with a higher level of confidence. Conversely, periods of margin contraction make the economy more vulnerable to shocks. This is because low or falling margins force companies to be more cautious when making both hiring and investment decisions. A breakdown of the growth dynamics within recessionary periods (Chart 1) highlights the key role of investment as a driver of down-turns. In all of the post-war recessions experienced by the US, it is a fall in investment spending that has consistently been the largest negative contributor during contraction phases. So changes in corporate profitability that affect companies’ investment intentions are a key factor to watch.

THE US ECONOMY HAS ENJOYED ITS LONGEST PERIOD OF ECONOMIC EXPANSION IN 165 YEARS. WE BELIEVE THAT AN END TO THE CURRENT CYCLE DUE TO POLICY ERROR (I.E. CENTRAL BANKS OVERTIGHTENING TO COUNTER RISING INFLATION) SEEMS UNLIKELY. THIS NOTE WILL EXPLORE AN ALTERNATIVE RISK TO THE CURRENT CYCLE – FALLING PROFIT MARGINS.

US CORPORATE MARGINS OVER HISTORICAL BUSINESS CYCLES

CHART 1: FALLING INVESTMENT HAS BEEN THE KEY DRIVER IN EVERY POST-WAR RECESSION

We can also illustrate how corporate profits lead the labour market. When profits decline, this subsequently leads to a deterioration in employment. A fall in hiring then ultimately leads a decline in GDP growth. Chart 2 shows the leading nature of profits in the past nine economic cycles (i.e. since 1953).

The rest of the note explores the historical relationships between margins and the business cycle and how current margin dynamics may evolve. This is particularly relevant given growing evidence that the current Trump administration’s use of tariffs is already having a detrimental impact on US corporate profit margins. In short, the impacts of tariffs are a cost that needs to be borne somewhere. China may be bearing some of the pain, either directly or via currency depreciation but a substantial part of the burden is falling on US companies absorbing costs that they are unable to pass onto their end consumers.

Chart 2: Profit cycle also leads employment

![Chart 2: Profit cycle also leads employment](image)

To illustrate the point, Chart 3 shows the percentage of small business in the US making capital expenditures has been drifting down since early 2018, which coincides with the start of trade tensions. This data is provided by the National Federation of Independent Business (NFIB) from their monthly small business survey.

Chart 3: US corporate behaviour starting to turn down. NFIB survey – % of businesses making capital expenditure during last 6 months

![Chart 3: US corporate behaviour starting to turn down. NFIB survey – % of businesses making capital expenditure during last 6 months](image)

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MAPPING MARGIN CYCLES

To examine the typical relationship with margins and the business cycle, we begin by splitting our margin series into discrete periods coinciding with each US business cycle (as defined by the NBER). Chart 4 shows that margin growth accelerates in the recovery phase of the cycle, peaks some time during mid-cycle and that falling margins tend to be a precursor for recession. Another observation is that margins also appear to have a ‘mean reverting’ quality. An intuitive fundamental explanation for this is that higher margins will be eroded either through competition or increased labour costs (as employees demand a greater share of profits).

Chart 4: US corporate margins generally peak before recessions^5

We can then illustrate the typical pattern for US profit margins along the business cycle by taking a simple average of margins for each cycle above and normalising cycle length (i.e. each cycle normalised over time period 0-100%). The result is a ‘stylised’ path for margins which shows that margins typically peak before the end of the business cycle and fall during recessions.

Chart 5: A stylised view of the US corporate margin cycle^6

Clearly this stylised margin cycle ignores cycle length (i.e. time), which is an important consideration, particularly given the longevity of the current cycle. This is the issue to which we turn next.


^6 Source: BEA, Bloomberg, NBER. Data as at 31 December 2019.
HOW DOES THE CURRENT MARGIN CYCLE COMPARE?

In Chart 6, we compare the path of the current expansion phase with other historical margin cycles. This includes some recessions caused by shocks stemming from oil spikes or financial crises, as there are very few recent recessions where such events weren’t a contributing factor.

Chart 6: Sharp post global financial crisis bounce led to a strong, and now long, margin cycle

Each line above represents the ‘cumulative change’ in margins over each cycle and this is plotted against cycle length in months. There are a few conclusions we can draw from this:

- The current cycle has now been the longest on record
- The initial rebound from the crisis was one of the sharpest from our dataset
- Margins remain above their cycle lows but have showed declining trend in recent years

There are notable differences in this cycle when we look into the drivers of profit growth. In simple terms, profit margins represent the difference between revenue and cost. Whilst the longevity of this economic cycle is without precedent, its strength has been sub-par compared to those of recent decades. In that regard, cost control, rather than revenue growth, has been a key driver of margins in this cycle (see Chart 7). This is part of the reason why the labour share of US growth has declined significantly since the GFC (see Chart 8).

WHERE DO MARGINS GO FROM HERE?

What is clear from Chart 6 is that margins have now been declining for multiple years. The key concern is at which point this decline could start to signal a significant deterioration in fundamentals. Therefore forward expectations for margins and how we can monitor these for signs of deterioration become the key concern. The next sections explore this in more detail from both a top-down and bottom-up perspective.

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7 Source: BEA, Bloomberg, NBER. Data as at 31 December 2019. US profit margins rebased to the low point of the economic cycle. 8 Source: Bloomberg. Data as at 31 December 2019.
US MARGIN DATA SERIES: NIPA profits versus S&P GAAP

In order to properly analyse the relationship between profits and the business cycle, we need a dataset that is both consistent over time and has a history spanning multiple cycles. The two most frequently used sources for US profit data are the national income and product accounts (NIPA) and reported profits on the S&P 500, which follow generally accepted accounting principles (GAAP). These two series tend to exhibit similar trends over multi-year time periods but on shorter time horizons they can diverge significantly. There are a myriad of reasons for why the two time series can diverge but it can broadly be broken down into two factors; coverage and accounting principles.

Coverage
NIPA data is produced by the US Bureau of Economic Analysis (BEA) using corporate income tax returns. This means that the data covers all companies in the US, both publicly traded and private. The S&P 500 data set covers the largest 500 publicly traded firms at any given time and so the composition shifts frequently. Thus the NIPA series has a much more comprehensive coverage of firms and the sector composition more accurately reflects that of the US economy.

The difference in sector makeup is particularly interesting given the increasing dominance of the technology sector on S&P profits.

Accounting principles
As the primary source for NIPA data is tax returns, the series is produced using tax accounting principles, whereas GAAP profits use financial accounting principles. The differences between these two practices is more nuanced than merits the scope of this note, but can be summarised as follows: firstly, there are differences in the timing of when certain revenue and expense items are recognised (e.g. depreciation treatment) and secondly, there are some accounting items that are included in one set of standards and not the other (e.g. employee stock options).

We use NIPA data for our analysis due to the fact it has a longer history, much broader coverage and consistency in methodology. To generate a margin time series we use NIPA reported profits as a percentage of nominal GDP and we have found this provides a reasonable proxy when compared to S&P 500 reported net margins (which are only available from 1990). We do acknowledge that one limitation for using NIPA is that it is subject to large revisions (caused by newly available tax information).

Chart 9: NIPA versus GAAP profit margins

9 Source: Subject to a number of requirements including profitability and public float. 10 Source: BEA, Bloomberg. Data as at 31 December 2019.
**RECENT DIVERGENCE: NIPA margin versus S&P GAAP**

If we zoom into Chart 10, it is notable there has been recent divergence between the NIPA series versus S&P. NIPA profits have been trending down since 2014 while S&P reported margins increased from early 2016 through 2018. This divergence became a particularly pronounced in July 2019, when the BEA revised down NIPA profits $93 billion (4%) for 2017 and $188 billion (8%) for 2018.

**Coverage and company size**

As explained above, the sector composition of the two data series is different. Recently we have observed profit margins have been falling for smaller companies faster than large firms. This is shown in chart 11 below comparing S&P 500 profit margins versus the Russell 2000 Index.

**Tax policy**

In 2018, the Trump administration reduced corporate tax from 35% to 21%. This has been reflected in higher after-tax profits for S&P firms, where firms report quarterly. However, the impact has been less noticeable in NIPA profits which use annual tax return data. There is potential for NIPA profit margins to be revised as more tax return information becomes available to the BEA.

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**THE IMPACT OF BUYBACKS:** It is also worth noting that the majority of market commentary on S&P profit growth will refer to EPS growth. While EPS growth is a fair measure of earnings available to shareholders, the growth rate is often much larger than actual profits growth. This is due to the denominator impact of buybacks reducing the float of available shares. In fact, over the past five years, corporate share repurchases have boosted EPS growth in the US by 1.7% per annum.

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THE FUTURE PATH OF US CORPORATE PROFIT MARGINS

TOP-DOWN: THE INSIGHT MARGIN INDICATOR

We use a simple margin indicator which uses a top-down approach to model the near-term path for corporate margins across scenarios for cost and demand.

The margin indicator has the following inputs:

\[ \text{MARGIN INDICATOR} = \text{PRICES} - \text{UNIT LABOUR COSTS} \]

Where:

- **Prices** = Implicit Price Deflator (Non-Farm Business)
- **Unit Labour Costs** = Compensation per hour / Implied productivity per hour
- **Implied Productivity** = Business output / hours worked

It’s not intended to be an accurate forecast – more a stylistic illustration of what could happen. We deem this useful in light of the conclusions of section one, not least that changes in margins might warn of a change in the underlying economy.

Although simple, the margin numbers produced in this way correlate well with actual margin growth numbers. Chart 13 shows this relationship using the same NIPA data in section one, here shown in year-on-year terms.

In order to construct our top-down view we have looked at three potential scenarios and analysed the margin implications for each. This included building forecasts for both output and hours worked for each scenario, enabling us to develop productivity projections that ultimately feed into our unit wage cost numbers.

1. **Central view**: Moderate growth slowdown with a modest pickup in wages. This scenario modelled the central view of our bottom-up analysis discussed later in this section and fits with our broader economic view.

2. **Slow growth and high wage inflation**: Here we modelled a more severe slowdown in growth combined with a pickup in wage growth.

3. **Trade war induced stagflation**: Here we modelled the only scenario where margin pressures really start to bite in the near term. This requires both a significant decrease in business output and prices and a large increase in unit labour costs.

Our conclusion from a top-down perspective, is that while a fall in margin growth seems likely in coming years, the pace and extent of this decline in our first two scenarios would be unlikely to prompt a sharp change in corporate behaviour. Indeed the current strength of US growth and supportive base affects in the cost component means that a corporate-led recession seems unlikely before the US election in 2020.

By contrast, the margin decline in scenario three caused by further escalation in trade tensions would lead to significant reduction in investment and hiring. In this scenario a self-inflicted recession within the next 18 months seems more probable than not.

Chart 13: Insight margin indicator maps closely with realised margin growth\(^{14}\)

![Chart 13: Insight margin indicator maps closely with realised margin growth](image1.png)

Chart 14: Insight margin indicator shows margin decline only a near-term worry in most extreme scenario\(^ {15}\)

![Chart 14: Insight margin indicator shows margin decline only a near-term worry in most extreme scenario](image2.png)

\(^{14}\)BEA, Thomson Reuters. Data as at 31 December 2019. Insight margin indicator year-on-year versus actual NIPA profit margins growth of the economic cycle. \(^{15}\)Source: BEA, Datastream, Insight Investment. Data as at 31 December 2019.
BOTTOM-UP: THE INSIGHT ANALYST PERSPECTIVE

To obtain a bottom-up perspective we asked members of the Insight investment analyst team to examine three factors within their sector: revenue, costs and future margin growth.

In aggregate, the analyst view is that slower global growth in 2018/2019 has increased margin pressure for US corporates. However, this was viewed as manageable given the expectation of slower, but still positive, top-line growth and healthy free cash flow generation.

A positive corporate financing gap (operating cashflow less dividends and cap-ex, but not share repurchases), means that the corporate sector is retaining a healthy proportion of the cash that it is generating. Prior to previous recessions, the corporate financing gap has generally become negative, meaning that the corporate sector was reliant on borrowing to fund capital expenditure. With corporates funding capital expenditure with cash from operations rather than debt, this should provide some insulation from small shifts in corporate margins.

The risk to this view would be that the corporate sector has increased financial leverage, not due to business investment, but due to share repurchases. So while retained cashflow is quite strong, debt levels are elevated. It is also unclear if businesses under margin pressure would choose to cut buybacks or capital expenditure first.
ANALYST
KEY THOUGHTS

REVENUE
Slower global trade and manufacturing activity have increased top-line risks for the transportation sector.
Slower growth in Asia and the deferral of business investment due to trade uncertainty has increased the risk in the technology sector.
Sluggish auto sales with US sales likely to decline somewhat next year and China sales continuing to contract pose a risk to the auto sector. The weaker auto market has already weighed on the chemical sector.

COSTS
Increases to input costs appear manageable, leaving us comfortable that a meaningful erosion of margins over the near term is not expected.
Ultimately, the analyst team sees more pressure on costs than revenues.
In order for there to be a severe contraction in margins, we would likely need to see pressure on revenues in addition to rising costs.

CASHFLOW
After tax cashflow has been robust in recent years built on a strong economy, and further buoyed by lower corporate taxes and changes to repatriation rules.
Many companies have invested this cashflow back into their existing business for expansion and productivity gains, acquisitions, and to increase shareholder returns.
The current environment is one in which the likelihood of a traditional policy mistake (i.e. that of central banks overtightening) is unlikely to bring an end to this record expansion, and thus margin trends are high on our watch list of risk factors which could tip the economy into recession. Margins remain above the lows seen at the beginning of this cycle, and this partly reflects the sheer scale of the rebound following the deep pain felt by corporates during the global financial crisis.

Our analysis on the future outlook for margins shows that while a decline in margins seems likely in coming years, the pace and extent of this decline is unlikely to prompt a sharp change in corporate behaviour. Indeed the current strength of US growth and supportive base affects in the cost component means that a corporate-led recession seems unlikely before the US election in 2020. That being said, a renewed escalation in trade tensions could lead to a significant reduction in investment and hiring. In this scenario a self-inflicted recession within the next 18 months seems more probable than not.

While margin levels remain relatively healthy in the near term, we continue to remain vigilant for any signs that increased cost pressures are leading to a change in corporate behaviour. One such watch factor is the reported cash use for S&P listed companies, which is revealed in quarterly earnings reports. Chart 15 looks at the growth rate in three categories of cash use: capex, dividends and buybacks. The impact of the 2018 tax cut is particularly striking, with a lot of the excess cash provided by this boost used for share repurchases. More important for us will be to monitor the more stable dividend and capex lines, which for now remain in positive growth territory, however the rate of growth has started to decline.

Chart 15: Growth rate of cash use for S&P companies. S&P firms boosted share repurchases with excess cash provided by 2018 tax cut16

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16 Source: Bloomberg. Data as at 31 December 2019.
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