October 15, 2024

Corporate Profits Provide Ballast For The U.S. Economy

- A robust corporate sector should help sustain a healthy job market and rising private nonresidential fixed investment.
- Corporate profits remain strong, profit margins are high, and surveys indicate that companies are looking to hire, not fire. Job growth should remain solid.
- Capital spending is elevated relative to GDP but there has been no sign of overinvestment that will need to unwind anytime soon.
- Moreover, capex relative to corporate profits and cash flows is low by historical standards, highlighting that corporate financial conditions are favorable for ongoing investment growth.
- Continued growth in private nonresidential fixed investment will help sustain solid overall U.S. economic growth.

The latest gangbusters U.S. jobs report underscores that the U.S. economy continues to have solid momentum, which is consistent with our long-standing upbeat outlook[1]. Solid payroll gains also reflect the robust profits and balance sheet strength of the corporate sector. As we highlight in this report, corporate sector financial health bodes well for prospective U.S. employment and capital spending, and, in turn, overall economic growth[2].

The latest jobs report is consistent with our long-standing upbeat economic outlook

Corporate Profits Are Strong And Margins Are High

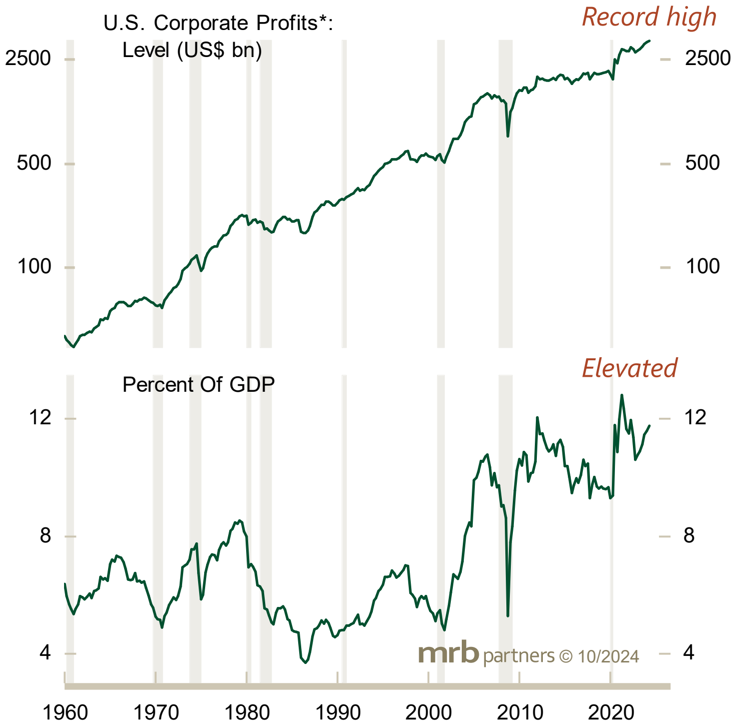
U.S. corporate profits are at record highs, and are approximately 60% above their immediate pre-pandemic level (**chart 1**).

Profits as a share of GDP (profit margins) surged in the months immediately following the start of the pandemic, boosted by fiscal support and the subsequent rapid rebound in consumer spending. That boost to margins proved temporary,

[1] **MRB***:* "***U.S. Economy: On Firmer Ground Than You Thought***", October 2, 2024

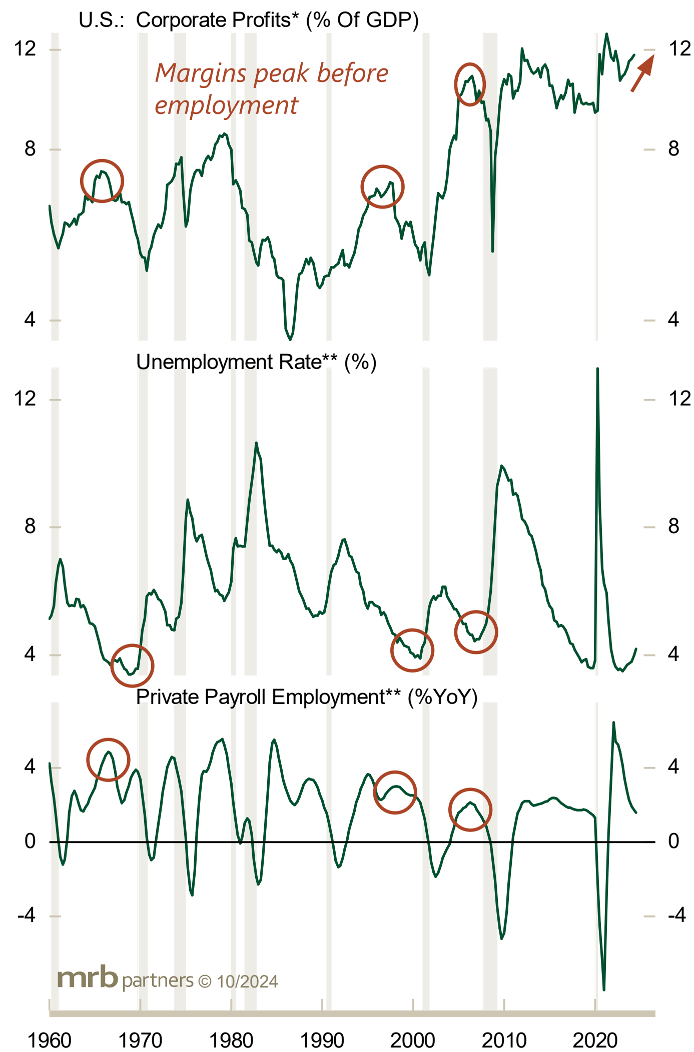
[2] For perspective, corporate business income was three times greater than that of noncorporate business in 2023, while nonfinancial corporate fixed investment was seven times greater than that of nonfinancial noncorporate business. Small businesses, i.e. those with fewer than 249 employees, accounted for 44% of total employment in 2023, according to the U.S. Bureau of Labor Statistics. **MRB***:* "***The Business Of America Is Big Business***", April 16, 2020

Chart 1 Corporate Profits Are Very Strong



* Source: U.S. Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions; panel 1 shown in log scale

Chart 2 Rising Margins Should Support Ongoing Employment Growth



* Shown in log scale; source: U.S. Bureau of Economic Analysis
** 6-month moving average of 1-month changes; source: U.S. Bureau Of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

but margins have expanded anew since the end of 2022. Margins are now very high by historical standards, in part reflecting the global reach of many U.S. corporations, but also the health of the U.S. economy.

Rising Profit Margins Will Support Payrolls

Periodic wiggles aside, rising corporate profit margins have typically corresponded with a declining unemployment rate and healthy or accelerating growth in private sector payroll employment (**chart 2**). While the unemployment rate has risen meaningfully over the past year, it reflects the extraordinary post-pandemic labor force growth driven by a surge in immigration rather than any deterioration in employment[3].

Margins are very high by historical standards

[3] See **MRB**: "[U.S. Labor Market: Less Bearish Than It Appears]", August 9, 2024. An upward revision to the labor force is likely in the coming months because of the surge in immigration in 2023. Thus, the unemployment rate is also likely to be revised higher, although, again, it will reflect the rise in the labor force rather than a deterioration in employment.

Indeed, private sector payroll growth averaged a solid 168k in 3Q2024, although it is slowing modestly. Still, it is likely running at a pace above the growth in the labor force, following the notable decline in immigration this year.

Moreover, past cycles indicate that slowing but still solidly positive private sector payroll growth is not a harbinger of a faltering job market. There were payroll growth slowdowns during the 1960s, 1980s, 1990s and 2010s economic expansions that did not herald the onset of recession. Corporate profit margins had peaked even as private sector payroll growth remained strong in the 1960s, 1990s, and 2010s. Payroll growth was surprisingly robust in the 2010s despite profit margins drifting lower for most of the period.

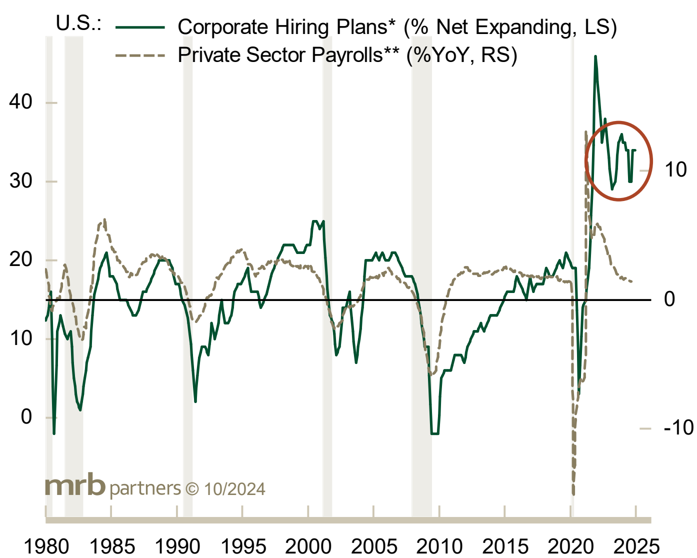
With profit margins high and rising, past cycles indicate that private sector payroll growth should be expected to stay solid in the months ahead.

Corporate hiring plans are consistent with ongoing healthy payroll growth. The latest Manpower survey indicates that an historically high proportion of U.S. companies is expecting to add to staff (**chart 3**).

Corporate Capex Is Underpinned By High Margins

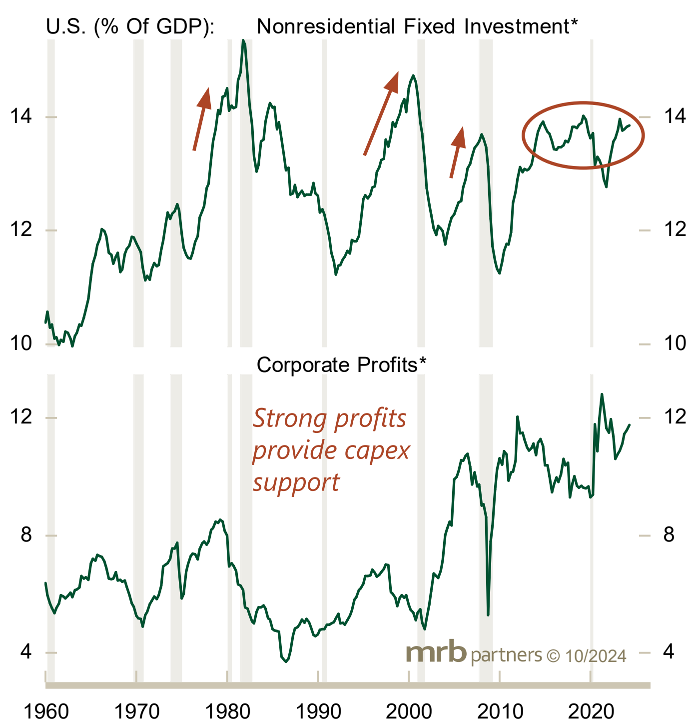
Nonresidential fixed investment (capex) is highly cyclical and thus has a significant impact on real GDP growth. Capex is historically elevated at 14% of GDP, but it has risen only modestly over the past decade and has only recently recovered its immediate pre-pandemic share (**chart 4**). The elevated level of capex relative to GDP primarily reflects strong spending on software and research & development (together 37% of private nonresidential fixed investment), while spending on equipment (37%), is historically low.

Chart 3 **Companies Still In Hiring Mode**



* Source: Manpower
** Soource: Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

Chart 4 **No Recent Capex Boom To Unwind**



* Source: U.S. Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

Capex typically lags profits over the course of the economic cycle. In part this likely reflects the fact that investment programs already underway often continue even when corporate profitability begins to wane, until recessionary pressures take hold. A similar lagging behavior occurs in the subsequent recovery.

Past capex cycles in the 1970s, 1990s and 2000s were very strong and indicated significant corporate confidence in the economic outlook. However, the capex booms extended well beyond the peak in corporate profit margins, and were followed by pronounced downturns (surprisingly capex relative to GDP declined during the strong 1980s economic expansion).

The post-Great Recession capex cycle has been unique. Capex as a share of GDP recovered very strongly from 2010 to 2014, but has largely been flat at an historically-elevated level since, apart from the temporary decline and rebound associated with the pandemic.

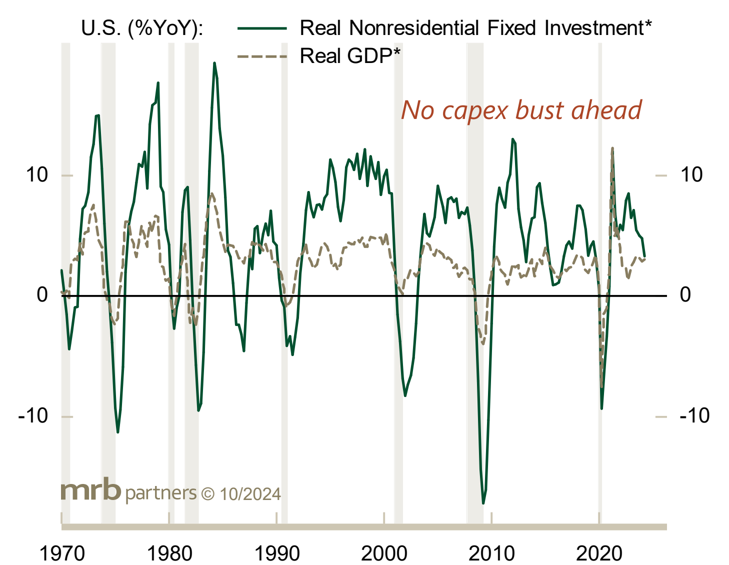
While capex is high relative to GDP, it is near historic lows relative to corporate profits and cash flow (**chart 5**). There is little indication that there has been over investment relative to corporate financial capacity that would portend a capex downturn on a 1-2 year horizon.

Every recession since 1970 has coincided with a contraction in real nonresidential fixed investment (capex) annual growth and only once has capex declined outside a recession (**chart 6**). We expect that investment spending on software and R&D will continue to grow at a steady pace and equipment spending will gradually rebound from its current depressed level, aided in part by onshoring. If capex continues to grow in the year ahead, as we expect, then it will provide important support for the broader U.S. economy.

Chart 5 **No Financing Risks To Investment**

* Source: U.S. Bureau of Economic Analysis
** Corporate profits before tax plus net interest and capital consumption
Note: Shaded for NBER-designated U.S. recessions

Chart 6 **Sturdy Capex Will Bolster U.S. Economic Growth**



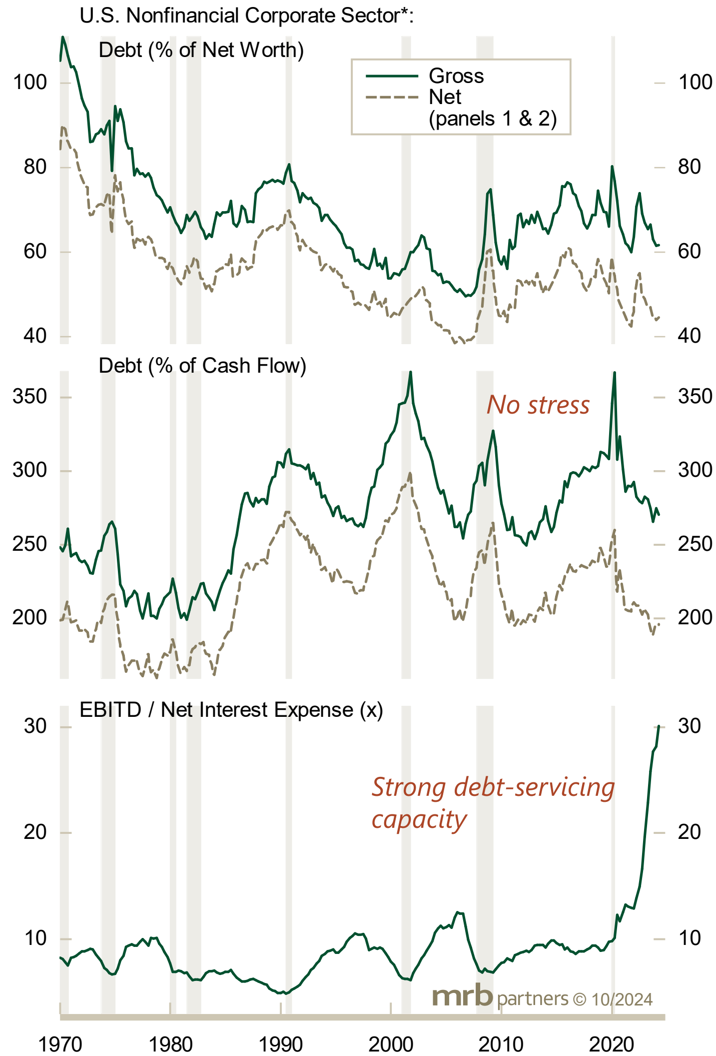
* Source: Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

Healthy Finances Will Support The Corporate Sector

The U.S. corporate sector is in fine fettle. Nonfinancial sector gross and net debt are at historically comfortable levels relative to net worth, reinforcing that the sector has not stretched its finances to undertake investments and business expansion (**chart 7**). Similarly, debt relative to cash flow (i.e. EBITD) is at the low-end of its range over the past 40 years, consistent with healthy debt-servicing capacity.

The latter is underscored by the extraordinarily high ratio of nonfinancial sector cash flows relative to net interest expenses, which has surged since the pandemic. Despite the rise in interest rates over the past few years, nonfinancial sector net interest expense has declined sharply, in part because of rising interest income for many of the large cash-rich companies. Nonetheless, net interest coverage was comfortable prior to the pandemic and has improved since, underscoring the strength of nonfinancial corporate sector finances. It also underscores that monetary policy never became restrictive for the corporate sector overall during the Fed's recent hiking cycle.

Chart 7 Strong Corporate Finances To Underpin Capital Spending



* EBITD = earnings before interest, taxes and depreciation; source: U.S. Bureau of Economic Analysis
Note: Shaded for NBER-designated U.S. recessions

Final Word: *Strong U.S. corporate sector finances point to healthy ongoing hiring and capital spending levels. Nonresidential investment (capex) is 14% of U.S. GDP, but it is highly cyclical and will provide important ongoing support to the economy if it continues to expand, as we expect. The corporate sector will remain a bulwark for the overall U.S. economy.*

Peter Perkins
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