


Have Lofty US Corporate Profit Margins Finally Turned a Corner?

Profit margins are regarded by many as one of the most reliably mean-reverting time series in finance. In a global economy, high margin businesses should, in theory, attract competition that will gradually erode the ability of those companies to sustain significantly higher margins. Following the global financial crisis, US corporate profit margins expanded to new all-time highs. However, recent data seem to suggest weakness in this trend. Are US companies (in aggregate) finally experiencing an overdue contraction in margins or can profit margins continue to levitate?

This brief looks at how elevated US corporate profit margins are, outlines the various factors that have contributed to their rise, and evaluates how sustainable high margins are going forward.

Where Do Profit Margins Stand Today?

The Bureau of Economic Analysis provides an extensive history of economy-wide US profit margin data dating back to the 1950s. Over the past 60 years, domestic corporate profit margins[1] in the United States have averaged just under 9%. After reaching an all-time high of 13.5% in third quarter 2013, margins (along with GDP) contracted sharply at the start of 2014, dropping over 3 ppts. After a slight rebound in the second quarter profit margins stood at 11.1%, about 23% above the long-term historical average.

Turning to profit margins on an index level, the S&P 500 has enjoyed a steady and robust rebound in corporate earnings since the depths of the global financial crisis. From their trough in 2009 through the end of 2013, 12-month

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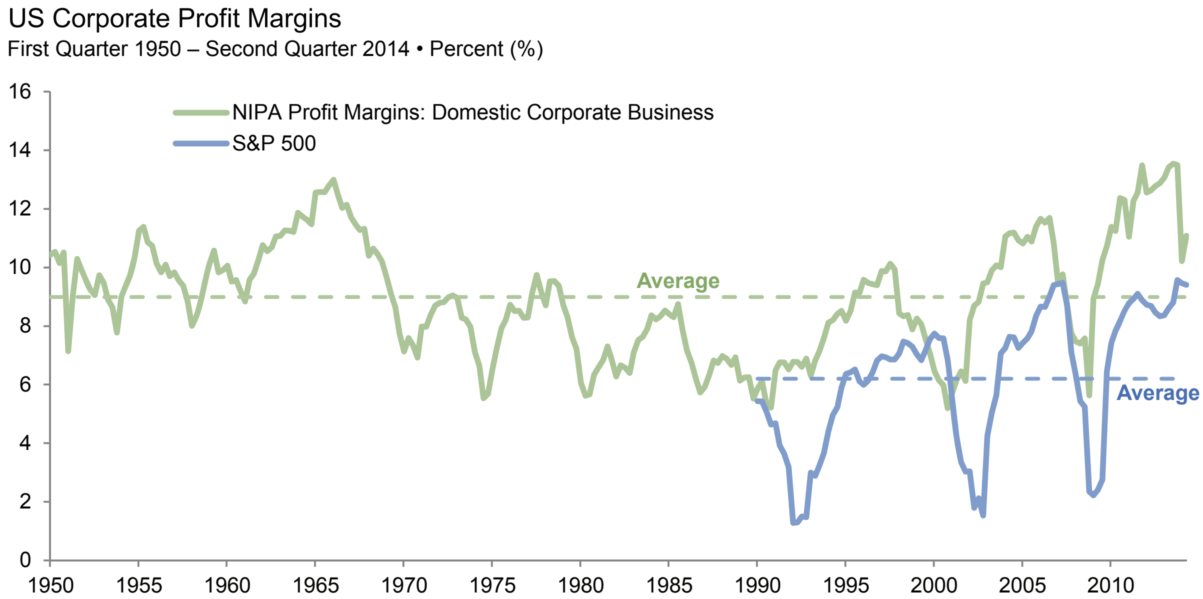
[1] As measured by profits after tax over the gross value added by corporate businesses.

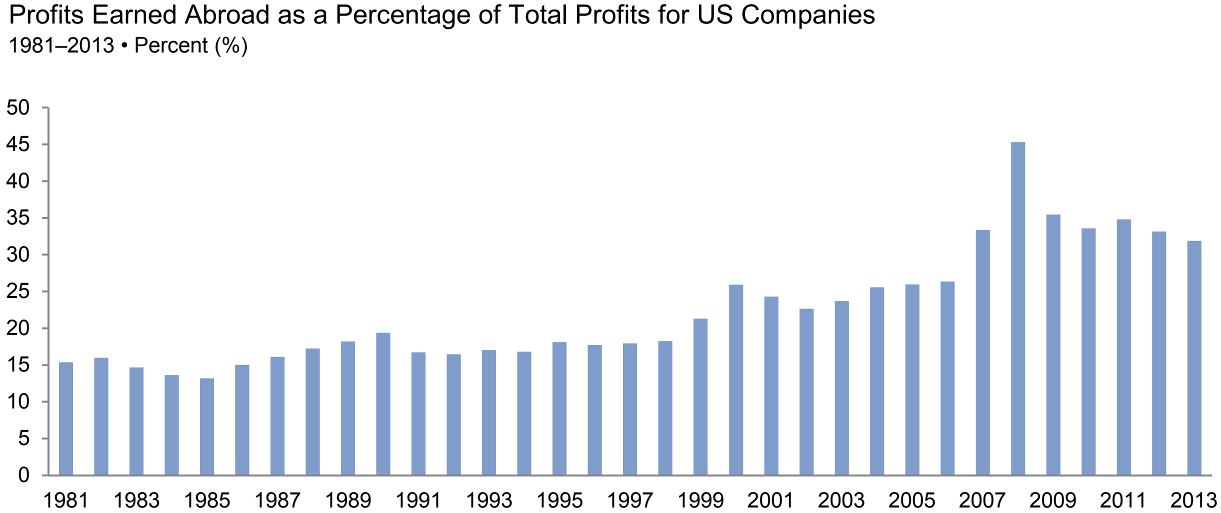


operating earnings per share of the S&P 500 have increased from $39.61 to $107.30 on the back of rapid profit margin expansion (from 2.2% to 9.6%). Despite a lackluster US economic recovery, profit margins (defined as net income divided by sales) of S&P 500 companies have hovered above 8% for nearly four years.

Drivers of Margins

Revenue. The increased reliance of US companies on foreign revenue is one explanation for the high level of corporate profit margins in recent years. Prior to 1999, foreign revenue as a percentage of total revenue remained below 20% for US-domiciled companies. This ratio skyrocketed to 45% in 2008 and today, US companies still generate about one-third of their income overseas. Foreign revenue is typically earned at a higher margin than domestic revenue for several reasons, the largest of which may be the lower effective corporate tax rates incurred overseas. The increased reliance of US companies on foreign revenue is a trend that is likely here to stay.

Labor Costs. Long-term trends in the US labor market and the reduced bargaining power of employees have resulted in slow wage growth that has contributed substantially to the rise in US corporate profit margins. This is not a recent phenomenon, as technological advances have improved productivity and reduced demand for unskilled labor, while offshoring has also limited opportunities in the manufacturing sector. However, the financial crisis and the resulting drop in economic activity further exacerbated these stresses, as over two million jobs were shed in the construction and manufacturing sectors between 2008 and 2011. Partially as a result, real annual wage

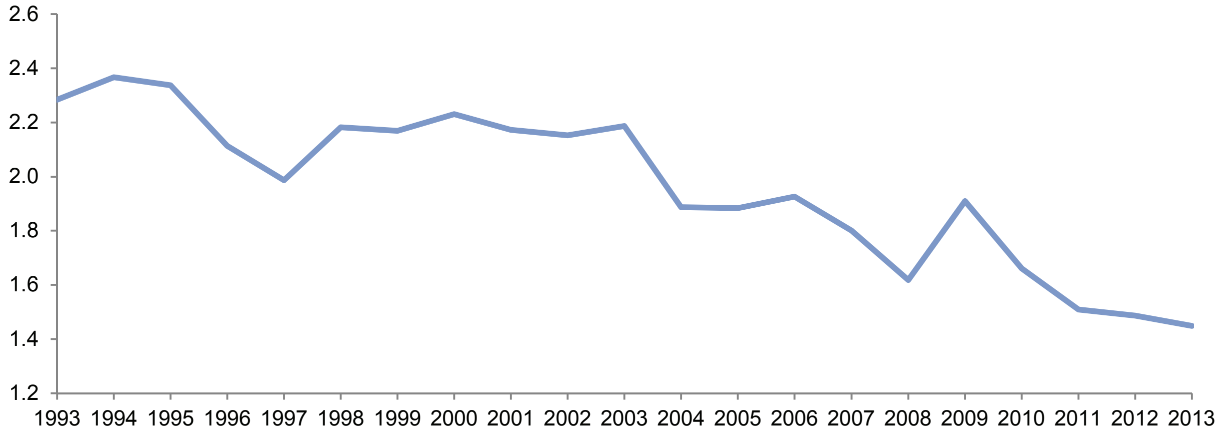


growth in the United States has averaged just 1.2% since the global financial crisis, less than half the historical rate.

Interest Rates. An extended period of low interest rates has also buoyed corporate profit margins. Historically, most periods of declining interest rates have been associated with rising profit margins as debt servicing costs for companies are reduced. This has clearly been the case in recent years, as interest expenses as a percentage of sales have plummeted to 1.45% for non-financial companies within the S&P 500. Companies have an even greater incentive to finance operations by issuing debt as interest expenses are deductible on federal taxes. Looking ahead, the favorable interest rate environment will not last forever, and the Federal Reserve has signaled its intention to raise short-term rates as soon as the middle of 2015. However, the impact could be muted in the short term as many companies have pushed out debt maturities, locking in today's low rates for several years to come.

Taxes. A lower *effective* corporate tax rate has exerted a favorable influence on profit margins in recent years. While the statutory corporate income tax rate in the United States has been 39% since the early 1990s, Goldman Sachs estimates that over the past ten years fewer than 10% of S&P 500 firms have paid the statutory rate or higher and that the median effective rate is nearly 10 ppts lower. The Government Accountability Office arrived at an even lower figure, estimating that US companies with over $10 million in assets paid US federal income taxes amounting to just 12.6% of worldwide income (16.9% when factoring in total foreign, state, and local corporate income taxes). Much of the discrepancy between the statutory income tax rate and the effective rate can be directly attributed to the accumulation of untaxed offshore international profits, which

S&P 500 ex Financials Net Interest Expense as a Percentage of Sales
1993–2013 • Percent (%)



are associated with high margins thanks to lower offshore tax liabilities.[2] President Obama has made it clear that reform measures are on his agenda but in the interim, the low effective rate continues to help support elevated profit margins.

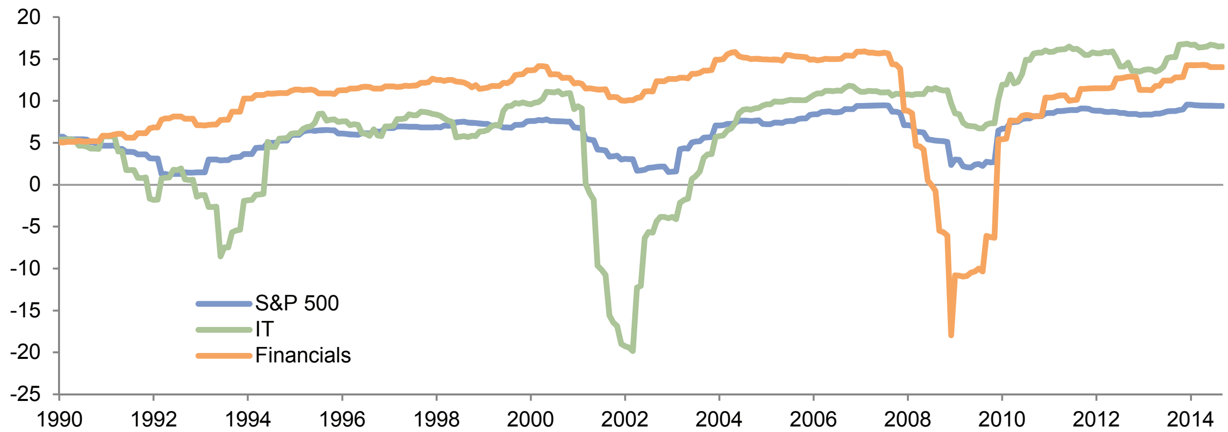
Revert to the Mean? Which Mean Do You Mean?

While profit margins recently contracted at the economy-wide level, S&P 500 margins remain within a fraction of their all-time high. This is because the changing composition of an index like the S&P 500 can have a profound impact on index-wide margins, making comparisons to the past less meaningful. As we have previously written, "it is not necessary for individual companies to increase their margins for index margins to rise. Rather, index margins can rise when higher margin firms grow their sales more quickly than less profitable index members."[3] Consider the two sectors with the highest profit margins: financials and information technology. Since 1990, the trailing 12-month operating margins of these sectors have grown at a compound annual rate of 4.8% and 2.6%, respectively, compared to the index average compound annual rate of 1.5%. Over this same time period these two sectors also expanded their market capitalization weightings from 8.2% and 6.6% to 16.1% and 18.8%, respectively, and they now represent the two most heavily weighted sectors within the S&P 500. It should, perhaps, come as no surprise that the profit margins of these two sectors are significantly higher than that of the overall index.

[2] See Alex Jones et al., "Combing Through the Cash Pile," Cambridge Associates Research Brief, July 24, 2014.
[3] See Wade O'Brien et al., "Can US Profit Margins Continue to Defy Gravity?," Cambridge Associates US Market Commentary, August 2011.

S&P 500 Profit Margins by Sector
January 31, 1990 – September 30, 2014 • Percent (%)



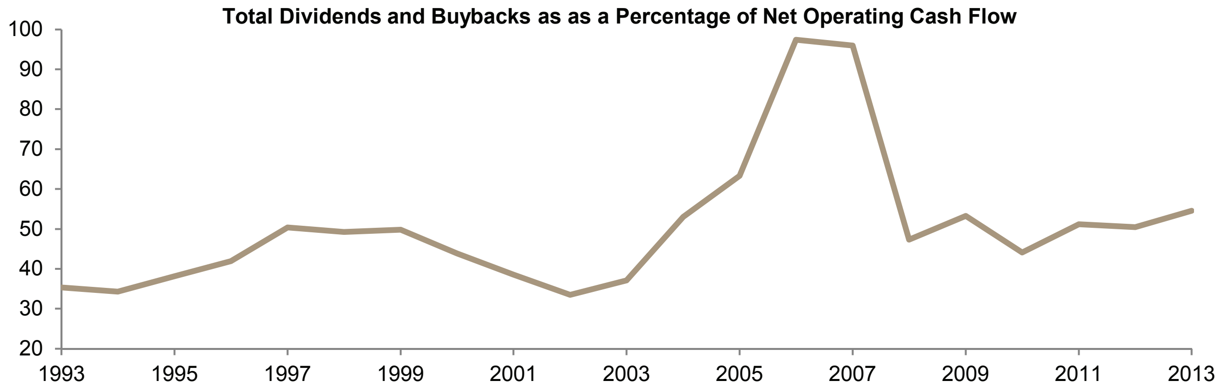
According to Goldman Sachs, the IT sector has had such a significant impact on index margins that excluding these companies from the index puts the peak in S&P 500 margins at 7.9% in third quarter 2011. IT margins have outpaced the broader index since early 2004 for many reasons including the lower fixed cost structures of tech companies, the relatively lower amounts of leverage than that employed in other sectors, and the fact that, generally speaking, companies within the tech sector have become quite adept at acquiring other companies that might become competitors. As recent months have shown, however, the technology sector is highly cyclical, so it would be shortsighted to expect elevated margins to persist indefinitely.

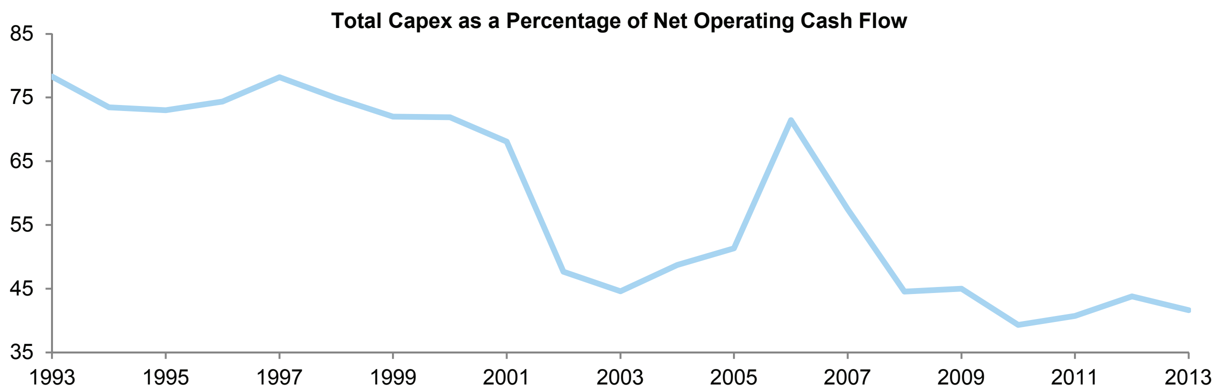
Considerations Going Forward

As noted earlier, some recent indications suggest that the sustained trend in profit margin growth could be slowing or perhaps even reversing course. Slack in the economy is diminishing and the gap between the number of unemployed and number of job openings is narrowing, which should eventually put upward pressures on wages. Corporate capital allocation in recent years will also likely impact the future course of profit margins. Total buybacks and dividends as a percentage of sales have increased since the early 1990s, but capital expenditure (excluding resource companies) has decreased. Capex tends to boost profit margins because it is usually geared toward higher margin products, and investing in assets such as property, plant, and equipment can enhance the future productivity of a company. The notable lack of capex during this cycle could impair the ability of companies to maintain their current level of profitability.

The Fed has dramatically scaled back its quantitative easing efforts and is expected to embark on a series of rate hikes as early as next summer. Partially as a result, the US

Dividends, Buybacks, and Capital Expenditure of S&P 500 Companies
1993–2013 • Percent (%)





dollar has risen (in some cases dramatically) against most developed and emerging markets peers. If the dollar's strength persists given the ultra-loose monetary policies of other central banks around the globe, this could pressure margins by making US exports less competitive with those of countries whose currencies have seen relative depreciation. US$ strength also reduces the value of sales abroad when translated back into US dollars.

The Bottom Line

A multitude of structural changes have driven US profit margins higher in recent years, which could impact the mean to which they revert and the time they take to get there. When the current cycle does turn, margins and profits could fall faster than GDP as mean reverting series tend to overshoot their averages. A contraction in profit margins would likely be negative for US equities. If companies react to falling margins by further delaying necessary hiring and capital expenditure, this could trigger a vicious cycle of slower economic growth. ■

Contributors

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Exhibit Notes

US Corporate Profit Margins
Sources: Bloomberg L.P., Standard & Poor's, Thomson Reuters Datastream, and US Bureau of Economic Analysis (NIPA).
Notes: S&P 500 data start first quarter 1990. All data are quarterly. NIPA profit margins are measured by profits after tax over the gross value added by corporate businesses.

Profits Earned Abroad as a Percentage of Total Profits for US Companies
Sources: Thomson Reuters Datastream and US Bureau of Economic Analysis (NIPA).
Notes: Data are annual and seasonally adjusted. Corporate profit margins include inventory valuation adjustments and capital consumption adjustments.

S&P 500 ex Financials Net Interest Expense as a Percentage of Sales
Sources: FactSet Research Systems, Standard & Poor's, and Standard & Poor's Compustat.
Note: Data are annual.

S&P 500 Profit Margins by Sector
Sources: Bloomberg L.P and Standard & Poor's.
Note: Data are monthly.

Dividends, Buybacks, and Capital Expenditure of S&P 500 Companies
Sources: FactSet Research Systems and Standard & Poor's.
Note: Data are annual.