Economics

Macro news

BERENBERG CAPITAL MARKETS

US CORPORATE PROFITS ROSE MODESTLY IN 2016Q4

US corporate profits rose modestly in 2016 Q4 capping a strong year with a moderation in momentum. Before taxes and adjusted for inventory valuation adjustment (IVA) and capital consumption allowance (CCA) adjustments, operating profits rose an annualized 2.1% in Q4, following a more robust rise of annualized 25.4% q/q in Q3. Yr/yr, operating profits rose a strong 8.8%. Quarterly shifts in IVA--the estimated value of inventories companies hold in stock--added significantly to Q3 operating profits and subtracted from Q4 (see Chart 1). A reduction in Q4 taxes boosted after tax NIPA profits, so that after tax profits adjusted for IVA and CCA rose by an annualized 9.5% in Q4 and 15.7% yr/yr.

Rest of world profit growth (profits earned by US entities in overseas activities net of profits earned by overseas entities in US activities) continued to outpace domestic profit growth on a yr/yr basis, rising by 14.5% yr/yr, despite the strengthening of the dollar in Q4 2016 (see Chart 2). This provides further evidence that the global economy has improved from its fragile state and is good news for export-dependent sectors.

Profit trends were uneven by sector, with half of major industries recording declines, as shown in Table 1. Profits rose in the financial sector, which benefited from the rise in interest rates and the stock market. Profits also rose in most basic industries such as electrical equipment and appliances, fabricated metals and machinery, but fell in the motor vehicle and parts industry, presumably reflecting downward pressure on prices (in part due to pricing strategy by the auto industry to reduce inventories) that had squeezed margins all year. Profits fell in the petroleum and coal sector, an ongoing adjustment from the earlier decline in oil prices.

Corporate profits remained relatively high as a share of GDP, but have receded in recent years, as shown in Chart 3. Margins have been squeezed modestly, as wages and unit labor costs have increased moderately, while relatively slow growth in product demand continues to constrain business pricing power. The recent pickup in nominal GDP growth, if sustained, will enhance business pricing power and stabilize margins.

The stock market rally since the US elections reflects, in part, expectations of a more favorable business environment with lower tax rates and other pro-business reform that boost product demand, capital spending and after-tax profits. To date, data point to sizable improvements in both residential investment and business investment (albeit from a low base), but a temporary slump in private consumption in Q1 that likely will be followed by a rebound in Q2. Measures of confidence point toward overall strengthening in coming quarters. Global demand remains robust and may be enough to outweigh the effect of the strong US dollar, which will help export-related manufacturing sectors. The Fed is expected to continue raising rates gradually which in addition to financial regulatory reforms should increase the efficiencies in the financial industry. Increased investment in energy-related sectors and expected ongoing technological advances are expected to increase profits. Overall, the outlook for profits is favorable.

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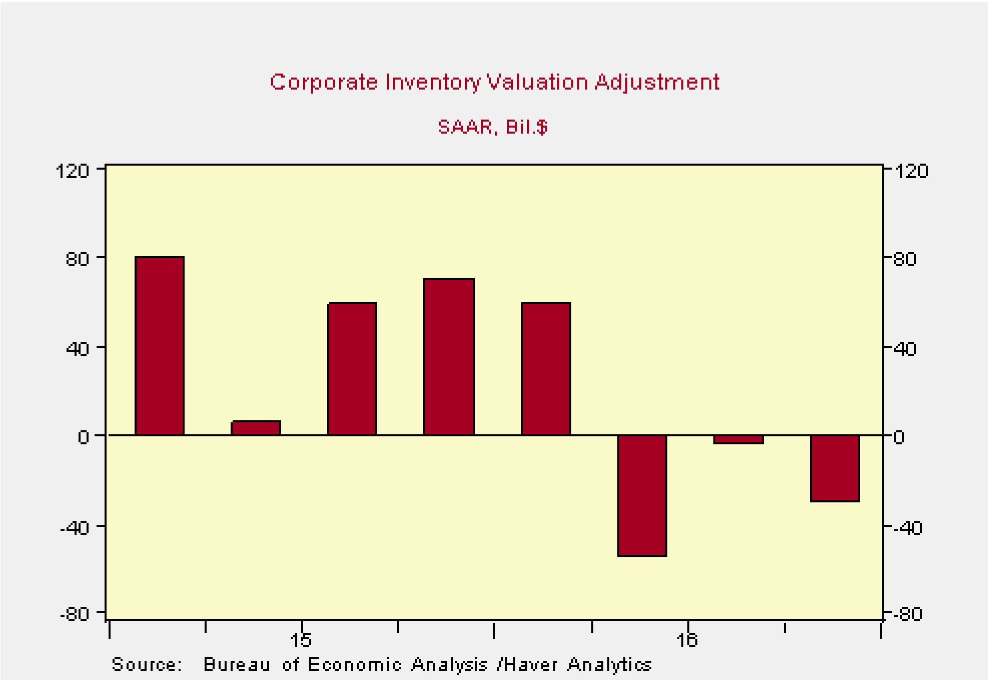
Table 1: Corporate profits before tax with inventory valuation adjustment by industry

Industry	Year ending 2016Q4 (% change)	2016Q4/2016Q3 (% change)	2016Q3/2016Q2 (% change)
Financial	+18.8	+5	+10.2
Financial excluding Federal Reserve	+21.8	+6.7	+13.6
Utilities*	+19.2	+0.5	+5
Durable goods:			
Electrical equipment, appliance and components	+19.4	+8.6	+8.8
Computer and electronic products	+0.9	+2	-0.4
Motor vehicles and parts	-22.7	-13.8	-26.8
Fabricated metal products	-11.9	+3.1	+11.5
Machinery	-43.6	+1.4	-21
Other durable goods	+15.3	+0.7	+14.4
Nondurable goods			
Foods and beverage and tobacco products	+13.6	-4.1	+3.9
Chemical products	-5.7	-11.6	+5.9
Petroleum and coal*	+57.8	-11.5	+0.4
Transportation and warehousing	-17.9	-14	+1.9
Information	+6.3	-4.8	+8.6
Wholesale trade	-29.8	-22.9	+24.4
Retail trade	+7.4	-2.4	+6.3
Other nonfinancial	-0.2	+3.6	+0.7
Rest of World	+14.5	+11	+0.3

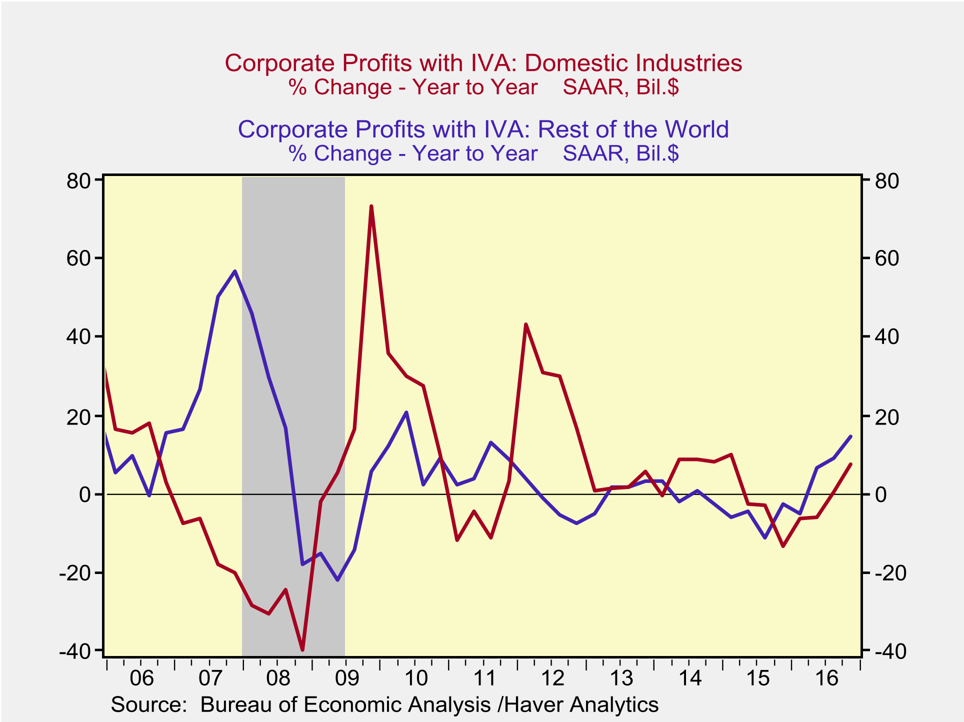
*Note: *Measured in $ billions. Source: US Department of Commerce and Bureau of Economic Analysis*

Chart 1: Corporate inventory valuation adjustment



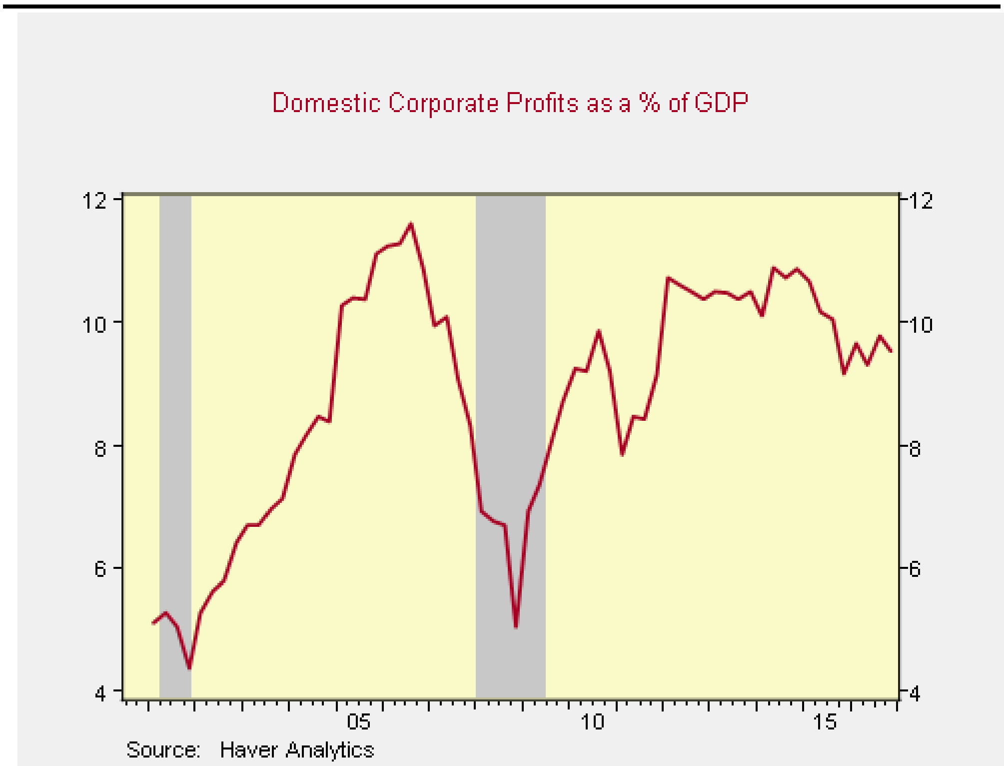
Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 2: Corporate profits with inventory valuation adjustment: domestic vs rest of the world



Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 3: Corporate profits with inventory valuation adjustment in domestic industries as a % of GDP



Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics

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