U.S. CORPORATE PROFITS RISE TO NEW HIGH IN Q2 2018

In our prior research where we found that, in economic expansions since the mid-1970s, the S&P 500 and real GDP rose for 21 months and 23 months, respectively, on average following corporate profit peaks, we were hesitant to declare Q1 2018 as the peak in corporate profits, given strong underlying economic momentum and elevated consumer and business optimism that we observed at that time (US stock market and economy: room to rise, June 22, 2018). Today, the Bureau of Economic Analysis (BEA) reported that U.S. corporate profits from current production rose to a cycle-high in Q2 — surpassing the previous high in Q3 2014 — as nominal GDP grew by 5.4% yoy in Q2, also the best in this expansion (“US nominal GDP acceleration: pay more attention to it”, August 6, 2018). See Chart 1.

Corporate profits before taxes with inventory valuation adjustment (IVA) and capital consumption allowance adjustments (CCAdj) increased by an annualized 14% q/q, lifting its yr/yr gain to 7.7% from 5.9% previously. Quarterly changes in IVA — the estimated value of inventories that companies hold in stock — subtracted from Q2’s profits (Chart 2). Of course, because of the Tax Cuts and Jobs Act, after tax profits with IVA and CCAdj rose by 10% q/q annualized and a strong 16.1% yr/yr in Q2, slightly better than the 15.1% yr/yr gain in Q1 (Chart 3).

Rest of world profits (profits earned by U.S. entities in overseas activities net of profits earned by overseas entities in U.S. activities) fell by 6.5% q/q annualized, bested by domestic profits growth (-20.4% q/q annualized), reflecting slower H1 growth in key trading partners and U.S. dollar strengthening. If GDP growth in other advanced nations rebound as we expect in H2, corporate profits will benefit.

Corporate profits after tax with IVA and CCAdj as a percent of GDP has picked up sizably due to the tax legislation returning to prior elevated levels, suggesting that, although higher input costs are weighing on companies’ margins, the Tax Cuts and Jobs Act is giving companies more than enough room to counter the higher costs and maintain margins (Chart 4). Moreover, unit labor cost growth remains contained with better productivity gains mitigating increases in labor compensation (Chart 5). Note that the recent declines in commodity spot prices are a welcome reprieve for businesses after the acceleration in input price pressures earlier this year (Chart 6). At the same time, the declines in commodity prices stem from concerns about demand from emerging market economies, which, if materialized, would spell trouble for broader global growth and profits.

Economic activity is off to a solid start again in Q3, especially for consumers and businesses as the housing sector lags behind. July’s retail sales point to healthy real consumption growth around 3% in Q3 — a moderation from 3.8% in Q2, with the surge in consumer confidence in August providing upside risks, and solid increases in core durable goods orders and shipments indicate continued healthy demand for manufactured goods and strong business equipment investment gains in Q3. Financial conditions remain very supportive — low long-term interest rates, tight corporate credit spreads, and higher equity prices — of investment, and business sentiment remains elevated. Higher oil prices will continue to boost investment and hiring in oil and gas, and supporting sectors. Overall, conditions are favorable for further profit growth.

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Chart 1: U.S. Corporate Profits Before Tax with Inventory Valuation Adjustment and Capital Consumption Adjustments

Source: Bureau of Economic Analysis/Haver Analytics

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

Chart 2: Corporate Inventory Valuation Adjustment

Source: Bureau of Economic Analysis/Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics
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Chart 3: Corporate Profits After Tax with Inventory Valuation Adjustment and Capital Consumption Adjustments

Source: Bureau of Economic Analysis/Haver Analytics

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

Chart 4: Corporate Profits After Tax with Inventory Valuation Adjustment and Capital Consumption Adjustments as Percent of GDP

Source: Haver Analytics

Source: Quarterly data. Source: Bureau of Economic Analysis and Haver Analytics
Chart 5: Unit Labor Cost (year-over-year, %)

Source: Bureau of Labor Statistics/Haver Analytics

Source: Quarterly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 6: Spot Commodity Price Indexes of Metals, Raw Industrial and Foodstuffs

Source: Commodity Research Bureau/Haver Analytics

Source: Daily data. Source: Commodity Research Bureau and Haver Analytics
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