GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

Thank You, Uncle Sam: Understanding the Amazing Resilience of U.S. Profits

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Highlights

- U.S. corporate profits have been amazingly resilient during the most severe recession since the 1930s, with profits in the third quarter posting a new all-time high level.
- The largest driver of the quick profits recovery was the massive fiscal stimulus implemented by the U.S. Congress, as we show with national income accounting data.
- Efforts to rein in U.S. government budget deficits will need to be calibrated carefully since they could weigh heavily on profit growth. Other nations face more modest challenges of this type.

Despite the Pandemic, U.S. Corporate Profits Posted an All-Time High in Q3

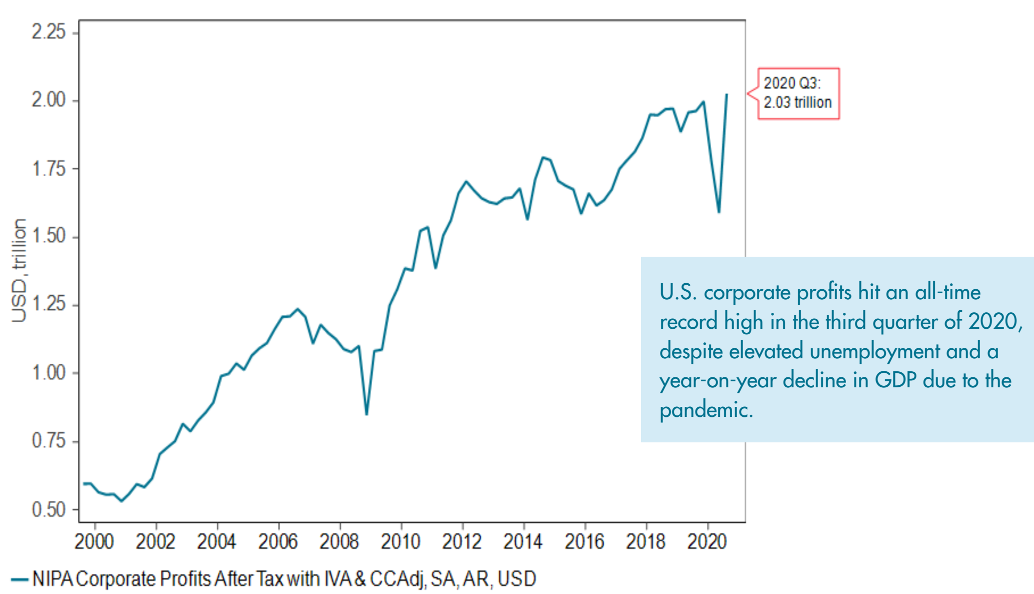
According to data from the National Income and Product Accounts (NIPA), U.S. corporate profits rose by 27.5% in the third quarter to reach an annual rate of $2.0 trillion. That is an all-time record which puts profits 1.2% higher than their pre-pandemic level of the fourth quarter of 2019 (see Chart 1).

That is remarkable resilience in the face of the most severe economic downturn since the 1930s. To be sure, corporate management teams and their employees deserve a great deal of credit for flexibility and grit in the face of extremely trying circumstances.

That said, a careful look at the NIPA data makes it clear that Uncle Sam, and specifically the U.S. Congress, played a starring role in the resilience of corporate profits.

This observation is rooted in a national income accounting identity that is true by definition. It is a fact, not a theory. Investors may benefit from understanding this fact since it also is likely to exert outsized influence on the outlook for future profits.

Chart 1: Despite the Pandemic, U.S. Corporate Profits Hit a Record High in the Third Quarter



Source: GW&K Investment Management, BEA, and Macrobond

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Massive Government Red Ink, Record Private Sector Black Ink

The relevant national income accounting identity defines corporate profits as follows:[1]

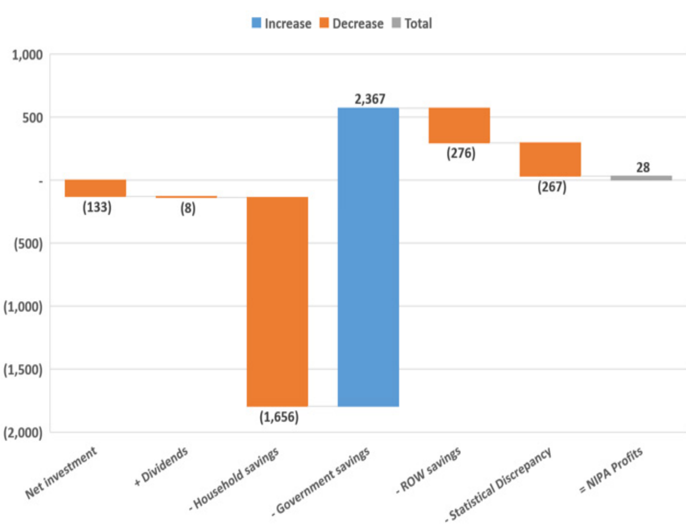
Corporate profits = Investment + Dividends/buybacks - Household savings - Government savings - Rest of world (ROW) savings

Table 1 shows recent NIPA quarterly data that breaks down U.S. corporate profits into each of these components.[2] A key conclusion from this data is that the *only* key factor which drove profits higher in 2020 was a huge expansion of the federal budget deficit, which recorded an annualized expansion of the $2.4 trillion (11% of GDP) since the fourth quarter of 2019. In the absence of such aggressive fiscal policy, there almost certainly would have been a wipeout of corporate profits this year. As shown in Chart 2's "waterfall" presentation, changes in all other key components would have reduced corporate profits. The largest negative contribution to profits by far was the $1.7 trillion rise in household savings.

In short, massive government red ink created record black ink in the private sector, which more than offset the negative effects of the pandemic on business and household spending. That is the logic of the "sectoral balance framework" used in the NIPA data. When the government provided trillions of dollars of critical aid to households and businesses, profits rose as those sectors spent much of the money with both large and small corporations.[3]

Moreover, government aid that was not spent immediately created ample cushions of corporate cash and household savings that are likely to boost future profits. That dynamic was evident in a comparison of the components of third-quarter profits to their second-quarter levels. For example, the government deficit declined in the third quarter by an annual rate of $1.5 trillion,

Chart 2: Decomposition of Change in U.S. NIPA Corporate Profits 2019:Q4 to 2020:Q3 ($B, SAAR)



Source: GW&K Investment Management and Bureau of Economic Analysis

A $2.4 trillion annualized decrease in government savings from 2019:Q4 to 2020:Q3 (i.e., an increase in the budget deficit) was the key macro factor that saved U.S. profits from a wipeout in 2020.

Table 1: Components of U.S. NIPA Corporate Profits 2019:Q3 to 2020:Q3 ($B) (Based on Levy-Kalecki Profits Identity)

	US$ Billions, Seasonally Adjusted Annual Rate						
Year	Net investment	+ Dividends	- Household savings	- Government savings	- ROW savings	- Statistical Discrepancy	= NIPA Profits
2019:Q3	1,074	1,348	1,181	(1,304)	508	75	1,963
2019:Q4	1,031	1,356	1,204	(1,277)	436	26	1,999
2020:Q1	955	1,380	1,595	(1,354)	423	(110)	1,779
2020:Q2	380	1,364	4,771	(5,168)	566	(13)	1,589
2020:Q3	898	1,348	2,859	(3,644)	711	293	2,027

	US$ Billions, Change from Previous Quarter						
Year	Net investment	+ Dividends	- Household savings	- Government savings	- ROW savings	- Statistical Discrepancy	= NIPA Profits
2019:Q3	(11)	(21)	(6)	(96)	(28)	92	5
2019:Q4	(43)	8	23	27	(72)	(49)	36
2020:Q1	(76)	23	392	(76)	(12)	(136)	(219)
2020:Q2	(575)	(15)	3,176	(3,814)	143	97	(190)
2020:Q3	518	(16)	(1,912)	1,524	145	307	438

	US$ Billions, Change from 2019:Q4						
Year	Net investment	+ Dividends	- Household savings	- Government savings	- ROW savings	- Statistical Discrepancy	= NIPA Profits
2020:Q1	(76)	23	392	(76)	(12)	(136)	(219)
2020:Q2	(651)	8	3,567	(3,891)	131	(40)	(410)
2020:Q3	(133)	(8)	1,656	(2,367)	276	267	28

	Percent of GDP, 2020 vs 2025 Projected						
Year	Net investment	+ Dividends	- Household savings	- Government savings	- ROW savings	- Statistical Discrepancy	= NIPA Profits
2020*	4.2	6.4	13.5	(17.2)	3.4	1.4	9.6
2025*	5.4	5.5	5.0	(5.3)	3.3	(0.2)	8.1
2020-25 Change	1.2	(0.9)	8.5	(11.9)	0.0	1.6	(1.4)

Source: Bureau of Economic Analysis, National Income and Product Accounts, Tables 4.1, 5.1 and 1.12.

*2020 percent of GDP calculated as of 2020:Q3; 2025 projections use 2000-2019 average percent of GDP as targets, with the exception of government savings, which uses the IMF's projection from its October 2020 World Economic Outlook.

which implied a substantial drag on profits. But it was more than offset by a decline in household savings of $1.9 trillion during the quarter, which turbo-charged consumer spending and profit growth. The sharp rise in third-quarter profits can thus be attributed to the giant cash injections the government provided to the private sector in the previous quarter.

Widespread optimism about U.S. growth in 2021 is supported by the prospect that this kind of dynamic will continue as mass immunization lets consumers and businesses normalize activity. The expected normalization will be supported by ample cash reserves in the private sector which are legacies of expansive fiscal policy in 2020. For example, corporate cash has risen by 16% so far in 2020 to $2.0 trillion. Even more impressively, household savings rose by 142% to $2.9 trillion and the broad money supply (M2) rose 25% to $19 trillion.

What Does It Mean for Profits When Congress Pivots to Fiscal Consolidation?

Against this backdrop, we concur with the widespread optimism for U.S. corporate profits in 2021. According to Bloomberg's consensus survey, S&P 500 earnings per share (EPS) are expected to rise by 30% this year to $164. It is easy to envision even better numbers as cash reserves and excess savings are deployed by businesses and households. Moreover, the recently passed $900 billion U.S. stimulus package should further boost the outlook for 2021 profits, as did the earlier rounds of stimulus.

That said, understanding the critical role of government deficits in the recovery of corporate profits raises an important question: if and when the U.S. Congress pivots toward fiscal consolidation as the pandemic fades, how will that affect profits? At time of writing, based on the results from the runoff Senate elections in Georgia, it now appears that Democrats will control all three branches of government, albeit with a slim margin. That suggests minimal near-term pressure for fiscal consolidation compared to a divided government scenario. But eventually such pressures are likely, especially if mid-term elections in 2022 result in divided government.

The International Monetary Fund (IMF) recently modeled a plausible path of fiscal consolidation that assumes the government deficit as a percent of GDP is brought down to 5.5% by 2025. In the final panel of Table 1, we illustrate how that degree of fiscal consolidation could impact NIPA profits as a percent of GDP.

Using the same NIPA profits identity as above, we assume that other key drivers of profits revert to their 2000-2019 average levels relative to GDP. In other words, suppose that investment, dividends, household savings, and rest-of-world savings revert to normal levels relative to GDP. Those are strong assumptions, of course, but highlight that the two largest swing factors in corporate profitability are likely to be declining household savings (a big positive) and declining government deficits (an even bigger negative).

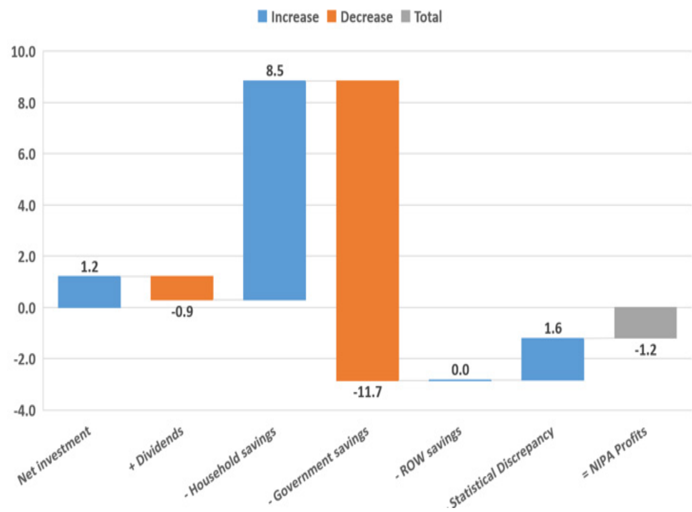
The net result of these assumptions is a decline in NIPA profits as a percent of GDP from 9.6% currently to 8.3% in 2025 (see Chart 3). Even though that may sound modest, it would mean that the level of profits five years from now would potentially be only 6% higher, giving a 5-year annual growth rate of just 1.2%. This profits illustration – and it is only that - assumes that the IMF's forecast for a 22% increase in nominal GDP from 2020 to 2025 could be offset by a 13% compression in profit margins due to fiscal consolidation.

To be sure, any number of factors could result in faster growth in profits, including better organic growth in capital investment or a more significant decline in household savings – both of which could be promoted by a "lower for longer" Fed policy on interest rates. Likewise, further U.S. dollar weakness associated with low rates could help improve profits by reducing the trade deficit. Finally, fiscal policy could turn out to be more supportive than this simple illustration assumes.

The main point of this exercise is to show that fiscal policy can have a more direct and powerful influence on corporate profits than is commonly understood. In short, with deficit spending essentially placed on wartime footing in 2020, the impact on profits was hugely positive. But a move back toward "peacetime" norms over the next few years potentially could work in the opposite direction.

Other nations will face similar challenges, although generally of a more modest size. Using recent IMF projections, only two nations are expected to increase government savings ratios (i.e., reduce budget deficits relative to GDP) more than the United States: Canada and Singapore (See Chart 4). At the other end of

Chart 3: Potential Impact of Fiscal Consolidation on U.S. NIPA Profit/GDP Margin
Projected Change from 2020 to 2025 (%)



Note: These estimates are based on the U.S. deficit to GDP ratio shrinking from 17.2% in 2020:Q3 to the IMF's projection of 5.5% by 2025, while assuming that all other macro drivers of margins revert to their 2000-2019 mean levels.
Source: GW&K Investment Management, Bureau of Economic Analysis, and International Monetary Fund

A reduction in the U.S. deficit to GDP ratio to 5.5% by 2025 would put downward pressure on U.S. profit margins and could easily offset the probable positive contribution from declining household savings.

the scale, Emerging Market (EM) economies overall and China are projected to have much small increases in government savings ratios, on the order of 4% of GDP over five years. That should translate into less pressure on profit margins than in most advanced nations. The key exceptions in EM are Brazil, South Africa, and Ecuador, which face similar pressure for fiscal consolidation as the advanced economies.

In short, efforts to rein in budget deficits will need to be carefully calibrated since they could weigh heavily on profit growth. That could dampen investment spending and raise the risks of "Japanification" – an extended period of very low inflation and near-zero interest rates.

For investors in U.S. equities, an awareness of the critical role recently played by the U.S. Congress in boosting corporate profits can usefully highlight two issues: (1) the potential challenge to U.S. profit growth from a pivot toward fiscal consolidation, and (2) why equity investors may benefit from exposure to selected non-U.S. markets, most notably China and EM, whose corporations face more modest fiscal headwinds.

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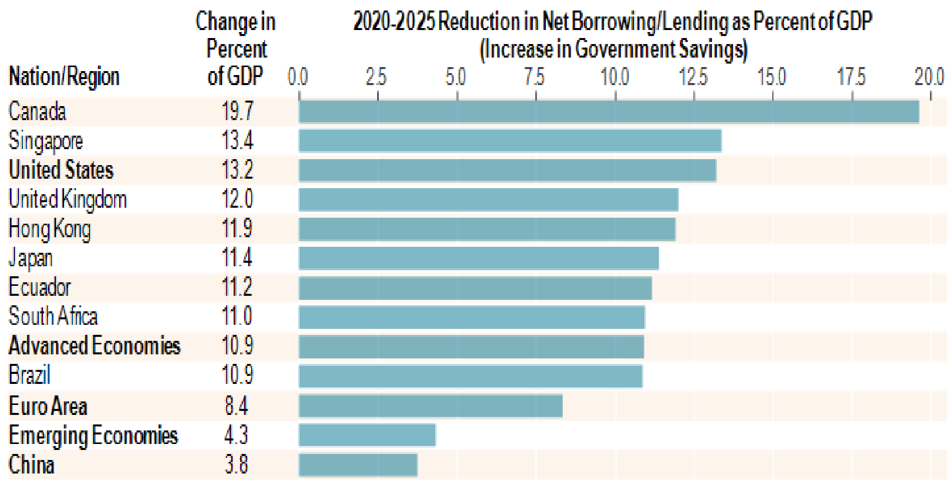
Chart 4: Which Nations/Regions Are Projected by the IMF to Have the Most Significant Fiscal Consolidation from 2020-2025?



Countries that borrowed most aggressively during the pandemic are projected to face the largest pressures for fiscal consolidation. China and EM face only modest pressures vs Advanced Economies.

The greater the fiscal consolidation, the greater the potential downward pressure on profit margins.

Source: GW&K Investment Management, IMF and Macrobond

Endnotes:

[1] This identity is known as the Levy-Kalecki profits equation. For an excellent derivation and explanation see David A. Levy, Martin P. Farnham, and Samira Rajan, "Where Do Profits Come From?" The Jerome Levy Forecasting Center LLC, 2008.

[2] As with other NIPA identities, the components add up exactly to the overall level of corporate profits once a "statistical discrepancy" term is added to the mix (as computed by the Bureau of Economic Analysis).

[3] NIPA corporate profits include both large and small businesses, including profits of private corporations and S corporations. For that reason, after-tax NIPA profits are typically about twice as high as S&P 500 operating earnings during expansions. For further details see Andrew Hodge, "Comparing NIPA Profits with S&P 500 Profits, BEA Brief, March 2011.

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