

U.S. Corporate Profit Outlook: Nothing Gold Can Stay

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- The sharp resurgence in U.S. corporate profitability faces mounting cyclical headwinds, such as a tight labor market and a strengthening dollar, as well as structural obstacles, including the threat of de-globalization.
- We project corporate profits by incorporating the likely path of the cyclical and long-term drivers into a range of economic scenarios from a soft landing to stagflation.
- Our results indicate profits are likely to come under pressure even in our most optimistic economic scenarios. With this result in hand, we examine the strength of the relationship between U.S. corporate profits and credit spreads before concluding with an assessment of the investment implications.

FACING THE CYCLICAL AND STRUCTURAL

Despite widespread recession concerns, U.S. corporate profits remain remarkably strong. In Q2 2022, corporate profits as a share of GDP not only reached a fresh post-pandemic high, but they also registered a new high since records began in the 1940s (Figure 1). Looking ahead, corporate analysts expect this strength to continue over the next year or so: their estimates for earnings growth over the next 12 months stand in the low double-digit percentages. In our view, these expectations appear too optimistic considering the plethora of cyclical and structural headwinds described in the following section. We then incorporate these current headwinds into an outlook for corporate profits, which is based on a range of economic scenarios from a soft landing to stagflation.

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Figure 1: U.S. corporate profits surge to a record despite rising risks of an economic downturn

(U.S. corporate profit share*, percent of GDP)



*Earnings before interest, taxes, and depreciation. Economy-wide profits before interest, depreciation, and taxes as percentage of GDP. The analysis is based on economy-wide profits which differ from S&P earnings in a number of ways: 1. S&P EPS is based on net income while our measure is closer to EBITDA; 2. S&P earnings are expressed on a per share basis unlike NIPA profits; S&P earnings focus on the largest corporations while the NIPA include all corporations.

Our analysis of economy-wide corporate earnings suggests that the profit *share* of GDP will likely fall even in our favorable economic scenarios, with the *level* of profits expanding at an anemic, low single-digit pace. This does not bode well for credit markets as our study of credit spreads' historical behavior highlights that the profit cycle is perhaps more important to the market outlook than gyrations in GDP.

CYCLICAL HEADWINDS FOR CORPORATE PROFITS

1. Late Cycle Factors

Our analysis of economy-wide corporate earnings suggests that the profit share of GDP will likely fall even in our favorable economic scenarios, with the level of profits expanding at an anemic, low single-digit pace.

- a. **The labor market:** A stringent labor market is often a harbinger of profit margin compression. The labor market appears incredibly tight on multiple metrics and employment costs are rising at a pace not seen since the early 1980s.
 - b. **Wages are the largest component of the cost base.** Rapid wage gains likely result in downward pressure on margins unless companies have the power to commensurately increase product prices. Yet, lack of labor market slack also sets the stage for a macro-policy thrust aimed at curbing the ability of businesses to increase prices of their wares.
 - c. **Fed policy restraint:** When workers are scarce, the Fed is often tightening policy for the fear of a wage-price spiral. As demand slackens due to tightening financial conditions, companies find it hard to pass-on higher costs to their customers.
 - d. **Inflation:** Extremely high and broadening inflation is supercharging this late-cycle dynamic of margin compression driven by the combination of cost pressures and countercyclical Fed hikes. To bring rapidly escalating price pressures under control, the Fed may need to tighten policy well beyond the neutral threshold, risking a hard landing in the process. Policy tightening will likely reduce wage and price pressures over time, but inflation relief may come at the cost of weakening corporate sales and profits.
2. **Dollar strength:** Dollar strength is negative for earnings via multiple channels. First, an appreciating dollar hurts overseas earnings via the translation effect. Second, currency strength makes exports more expensive and imports cheaper—a loss of competitiveness hurts exporters and domestically oriented companies as consumers shift to cheaper

alternatives. Importers certainly benefit from cheaper inputs and, for multi-national corporations, the impact is unclear due to their globally diversified operations, but empirically, the net effect of currency appreciation is a negative for the non-financial corporate sector.

In addition to the dollar's rapid ascent in recent quarters, of which the full effects are still likely to be felt, relative monetary policy/interest rate differentials will likely favor the greenback for the foreseeable future. The U.S. labor market appears stronger and should provide relative resilience to growth as the Fed tightens policy. In contrast, the European economy faces the prospect of a sharp recession from a potential energy shutoff. China's weak property sector means that authorities remain focused on rejuvenating growth. Their unwillingness to stimulate excessively via increasing the availability of credit indicates that interest rates will likely remain low, making CNY less attractive relative to the dollar. Furthermore, China's efforts to stimulate external demand likely plays an important role in its current countercyclical efforts, requiring a weaker exchange rate. Elsewhere, well advanced EM hiking cycles should provide a cushion as the Fed continues to withdraw liquidity, but riskier EM currencies may yet remain under pressure if the global growth backdrop remains weak.

SECULAR, STRUCTURAL HEADWINDS FOR CORPORATE PROFITS

1. **Exhaustion of the Chinese surplus labor:** Inexpensive imported goods from China, which suppressed labor compensation in the developed world, were one of the important contributors to the trend increase in U.S. profit margins. China's demographic challenges going forward are well known, and the surplus labor stands largely exhausted.¹ This development will likely result in greater bargaining power for workers in the U.S. and help the labor share of GDP to normalize higher. Wage gains in excess of productivity improvement may result in robust consumption, but this growth may be less profitable for firms compared to the past 20-years.
2. **De-globalization threat:** Continued friction between the U.S. as the incumbent global power and China as the challenger will likely be the norm going forward. In addition, the pandemic and the geopolitical shock emanating from Ukraine have led to talk of greater onshoring of strategically important industries. Thus, offshoring and outsourcing, which helped to control costs, may lend less of a helping hand going forward.

Other long-term challenges to profits include outright declines in U.S. immigration, lack of a full recovery in U.S. labor force participation despite higher nominal wages and a reduction of COVID risk as well as the potential for structurally higher energy prices over the next decade amid the transition from fossil fuels to renewables.

We simulate the effect of these factors on earnings by conducting an analysis of the scenarios in Figure 2 using a cyclically reinforced version of our profits model.²

¹ Das and Papa; "Chronicle of a Decline Foretold: Has China Reached the Lewis Turning Point?"; IMF WP/13/26

² "The Evolution of U.S. Corporate Profits: Dissecting 70 Years' of Performance," PGIM Fixed Income, April 2021. See Appendix for additional information.

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Figure 2: PGIM Fixed Income’s economic scenarios

Scenario	Attributes
Soft landing/moderation	<ul style="list-style-type: none"> Growth and inflation show clear convergence towards 2% PCE target and trend growth (1.8% real GDP). Fiscal policy support wanes and the labor market softens but remains robust. Fed tightens broadly in line with market expectations and achieves a soft landing.
Mature cycle	<ul style="list-style-type: none"> U.S. growth rebounds strongly, and inflation stops converging towards target. Fed tightening continues and exceeds current market expectations, although growth remains firm. Overall, a strong and rates-insensitive US economy.
Recession	<ul style="list-style-type: none"> Front-loaded and aggressive Fed hiking leads to a reduction of demand and a contraction in economic activity. Unemployment rises and inflation eventually falls, leading to a Fed easing cycle by mid-2023.
Stagflation	<ul style="list-style-type: none"> Repeated supply shocks keep growth below trend, while inflation remains at levels that are significantly higher than 2%, despite more rapid and aggressive Fed rate hikes than currently priced into the market. Lower real incomes and higher interest rates tip the economy into recession.

Source: PGIM Fixed Income.

SCENARIO ANALYSIS USING PGIM FIXED INCOME’S PROFIT MODEL

In our scenario analysis, economy-wide earnings before taxes, interest, and depreciation is our preferred measure of corporate profits. This measure represents a proxy for cashflow, which is the most relevant variable for credit investors. The model has both long-term (10-year real yield, excess bond premium, real broad dollar, and trade share of GDP) and short-term (real GDP growth, real broad dollar, policy stance, and unemployment rate) explanatory variables.

We use the long-term variables for the following reasons: real yields and credit risk premia capture funding conditions and are negatively related to the profit share of GDP; the exchange rate has an inverse relationship with corporate earnings; and the trade share of GDP captures the benefits from globalization, such as lower labor/input costs as well as access to new markets.

The short-term variables were selected for the following reasons: solid real GDP growth lifts sales and earnings. A low unemployment rate is a harbinger of wage/cost pressures hurting profits. The Fed’s policy stance, measured by the level of the real Fed Funds rate relative to the natural rate, determines the future course of economic growth by impacting broader financial conditions—if the policy rate is higher than its equilibrium value, future growth is likely to decelerate.³

Figure 3 shows that profit falls as a share of GDP in each of our scenarios. A declining business earnings trend in the bad scenarios—recession and stagflation—should not be a surprise. The

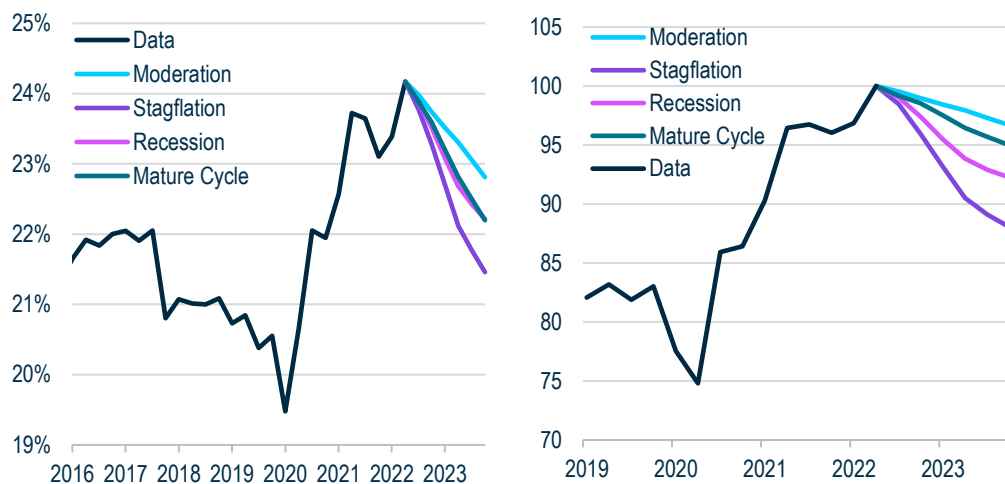
³ The assumptions for these variables in each of our scenarios is laid out in the appendix.

The eye-catching aspect of the simulations is that our measure of economy-wide corporate profits descends relative to GDP and EBITDA may expand at a low single digit pace even in the relatively good, but low probability, economic outcome such as mature cycle.

eye-catching aspect of the simulations is that our measure of economy-wide corporate profits descends relative to GDP, and EBITDA may expand by merely 1-2% even in the relatively good, but unexpected, economic outcomes of a mature cycle and moderation.

Figure 3: Corporate profits look set to decline in a range of economic scenarios

3A (left): Profit share of GDP (%); 3B (right): Real corporate profits (index, 2022Q2=100)



Source: PGIM Fixed Income and BEA.

DRIVERS OF THE POOR PROFIT PROJECTIONS IN THE FAVORABLE GDP GROWTH SCENARIOS

The common long-term drivers of the declining profit share of GDP in each scenario are the lagged, deleterious effects of dollar strength, higher 10-year real rates, and excess bond premia—all of which are already in train.

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In the **soft-landing/moderation** scenario, the unemployment rate rises slightly as the economy cools, but the still-tight labor market detracts from earnings via higher wages. Additionally, the continued normalization of Fed policy compounds the problem by limiting the ability of businesses to pass on cost increases to customers.

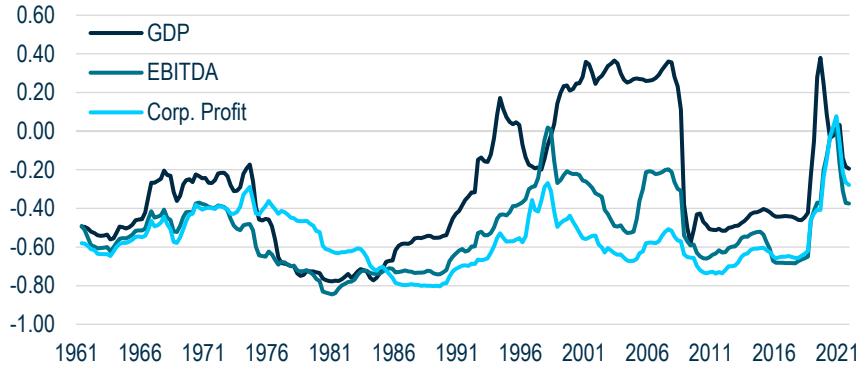
In the **mature** scenario, above trend real GDP growth helps, but the unemployment rate declines further, partly offsets this strong growth due to higher labor costs. Moreover, high inflation forces a more rapid normalization by the Fed leading to still higher interest rates and a stronger dollar. Both of these factors lead to a further contraction in the profit share of GDP.

SPREAD CO-MOVEMENT WITH PROFIT AND GDP GROWTH

Figure 4 shows the generally inverse relationship between credit spreads vs. GDP and profits. Spreads tend to respectively tighten/widen when profits and GDP growth are positive/negative. Notably, this negative covariation of spreads with corporate earnings appears more consistent and robust.

Figure 4: Spreads have a stronger correlation with profits than GDP

10-year rolling correlation of Moody's BAA spreads with profit³ and GDP growth (% y/y; 1950-2021)



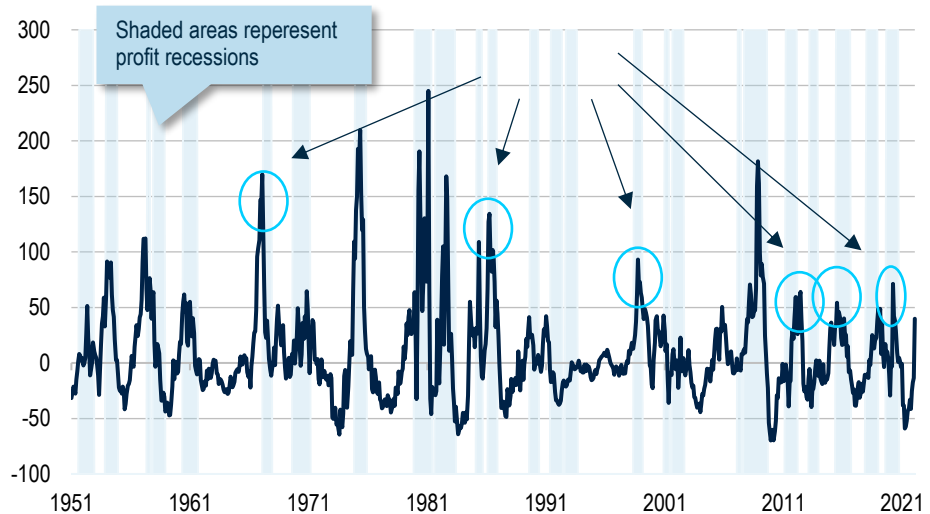
Source: PGIM Fixed Income, Bloomberg, Moody's and Haver Analytics. Corp. Profit: Real US Corporate profits before tax without IVA and CCA; 2. EBITDA: Real US Corporate profits before interest, depreciation, and tax without IVA and CCA.

Figure 5 shows 1-year rolling spread changes with shaded areas representing periods of year/year profit declines, and nearly all of the widenings of 50% or more occur during periods of earnings contractions. The chart also delineates major credit market corrections (1966-67, mid-1980s, late-1990s, 2011, 2015, and 2018) that occurred outside economic recessions, but coincided with corporate profit distress.

The centrality of profits for credit market behavior should not be surprising considering that companies pay debt holders out of their cashflows. Generally, GDP declines are a subset of profit declines, yet corporate earnings can even wither during periods of solid growth because the distribution of the cashflow pie matters. If the gains of the economic expansion accrue more to workers than capital owners, they may consequently erode the returns on corporate securities.

Figure 5: Periods of significant spread widening can occur outside of GDP recessions

1-year rolling Moody's BAA spread change vs. profit (% y/y) recessions²: 1950-2021



Source: PGIM Fixed Income, Bloomberg, Moody's and Haver Analytics. Profit recessions: Decline in y/y real EBITDA

Corporate earnings can even wither during periods of solid growth because the distribution of the cashflow pie matters. If the gains of the economic expansion accrue more to workers than capital owners, they may consequently erode the returns on corporate securities.

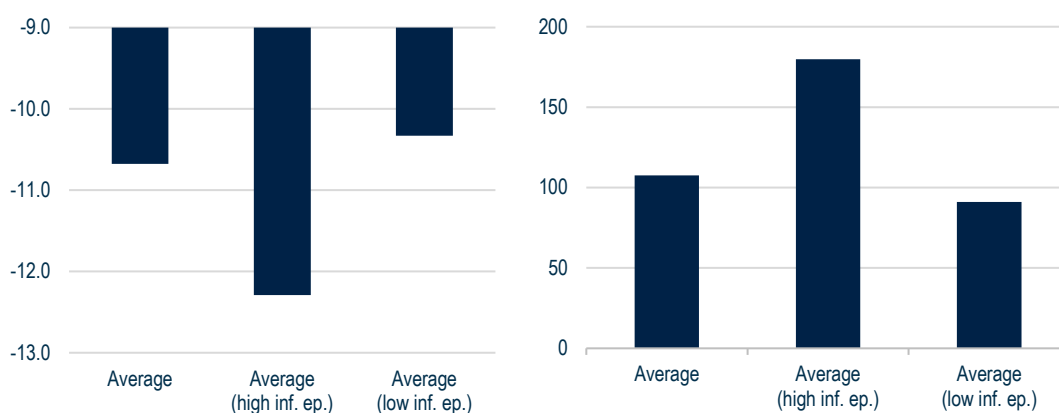
INVESTMENT IMPLICATIONS: CORPORATE SPREADS' BEHAVIOR AROUND TURNS IN PROFIT CYCLES

In the previous section, we showed that corporate credit spreads are correlated with profit cycles, but we didn't assess: (i) how much spreads typically widen in profit recessions, (ii) whether spread widening is more pronounced when inflation is high, and (iii) how much of that widening occurs before and after profits start to decline.

Figures 6A and 6B suggest that spreads (defined as Moody's Baa minus Aaa spread levels) widen on average by about 110% during profits recessions. Furthermore, both the profit recessions and the associated widening are larger when inflation is high. Spreads in those periods widen by 180% on average, compared with a widening of about 100% in low inflation periods. The contrast is even more stark when we look at the medians as spreads widen around 200% in high inflation episodes, while they widen about 50% in low inflation episodes.

Figure 6A & 6B: Real profit recessions are deeper and spreads are wider when inflation is high

6A (left): Real profit change (%); 6B (right): Spread widening (%)



Source: PGIM Fixed Income and Haver Analytics.

In terms of the timing of such spread widening, Figure 7 shows the behaviour of spreads (defined as Moody's Baa minus Aaa spread levels) during profit recessions. We observe that about 20% of the spread widening on average takes place before real profits decline, meaning that on average, 80% of the decline takes place after profits have past their peak. Spread widening, on average begins, about two quarters before profits peak and typically continues widening throughout the profit recession, peaking only after profits have troughed. So far this cycle, we have seen spreads widen 72% since their tights. But given that spreads in high inflationary episodes widen by about 200% and that most spread widening happens after the peak, further spread widening could take place over the next few months.

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We find that industries with a higher labor share underperform when the labor market is tight and real wage pressures are significant. This is because labor costs grow disproportionately for industries with high labor shares, especially if these costs cannot be passed on to the consumer. Such margin compression usually results in relative underperformance.

Figure 7: Spreads widen materially *after* U.S. profit recessions start

Episode (real profit peak)	Real profit change	Spread widening (trough to peak) (%)	Share of widening before profit decline	Share of widening after start of profit decline	Widening before	Widening after (quarters)	Spread peak relative to profit trough
6/30/1948	16.5	5.3	6.2	3.8	.0	.0	.0
12/31/1950	21.2	5.3	.0	.0	1.0	.0	4.0
6/30/1953	15.7	8.5	.0	.0	.0	.0	.0
12/31/1955	3.9	7.7	8.4	1.6	.0	.0	.0
3/31/1957	16.4	41.0	5.9	4.1	.0	.0	.0
6/30/1959	11.9	2.2	.0	.0	.0	.0	.0
6/30/1966	2.9	15.1	2.8	7.2	.0	.0	.0
6/30/1969	8.1	2.5	.0	.0	.0	.0	.0
9/30/1974	13.9	.0	3.7	6.3	.0	.0	.0
9/30/1979	14.8	36.6	0.2	9.8	.0	3.0	1.0
3/31/1989	2.9	—	—	—	—	—	—
9/30/1990	2.2	4.3	7.5	2.5	.0	.0	7.0
6/30/2001	5.4	6.9	6.1	3.9	.0	.0	.0
9/30/2006	26.2	69.6	1.2	8.8	.0	.0	.0
3/31/2012	2.6	4.2	1.2	8.8	.0	.0	3.0
9/30/2014	6.8	36.5	.4	7.6	.0	.0	.0
12/31/2019	9.8	5.7	.0	.0	.0	.0	1.0
Average	10.7	7.6	8.5	1.5	.9	.3	0.8
Average (high inf. ep.)	12.3	79.7	1.3	8.7	.0	.3	0.3
Average (low inf. ep.)	10.3	0.9	0.1	9.9	.8	.6	0.8
Median	9.8	0.5	4.9	5.1	.5	.5	.0
Median (high inf. ep.)	13.9	.0	3.7	6.3	.0	.0	.0
Median (low inf. ep.)	8.3	8.5	6.1	3.9	.0	.0	.0

Source: PGIM Fixed Income. Note: Shaded indicates a profit recession without NBER recession; inflationary episodes, 1969, 1974, and 1979.

RELATIVE INDUSTRY PERFORMANCE IN A TIGHT LABOR MARKET

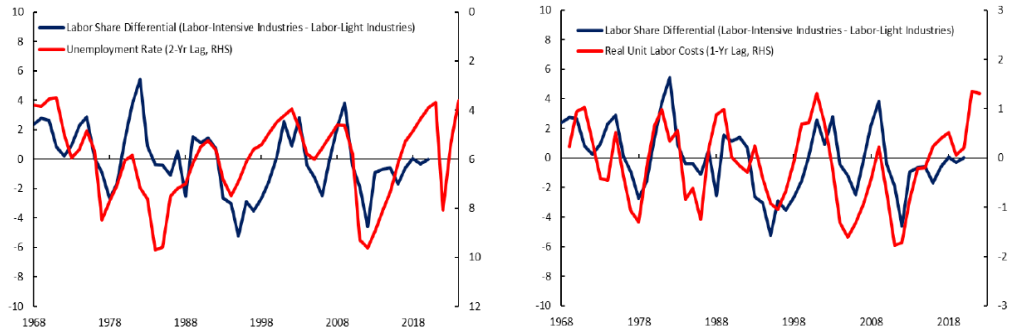
While we remain cautious on spreads directionally, we see potential relative-value opportunities across industry sectors. In particular, we find that industries with a higher labor share underperform when the labor market is tight and real wage pressures are significant. This is because labor costs grow disproportionately for industries with high labor shares, especially if these costs cannot be passed on to the consumer. Such margin compression usually results in relative underperformance.

Our analysis shows that the labor share rises *more* in high-labor intensity industries when the labor market is tight and real wages are rising (Figures 8A and 8B). Further, we find evidence that the equity prices of labor-light firms outperform during periods of strong real wage growth

(Figure 9).^{4,5} This suggests that risk assets of companies in high-labor sectors could widen relative those of companies in labor-light sectors.

Figure 8A & 8B: The labor share rises more when the labor market is tight and real wages are rising

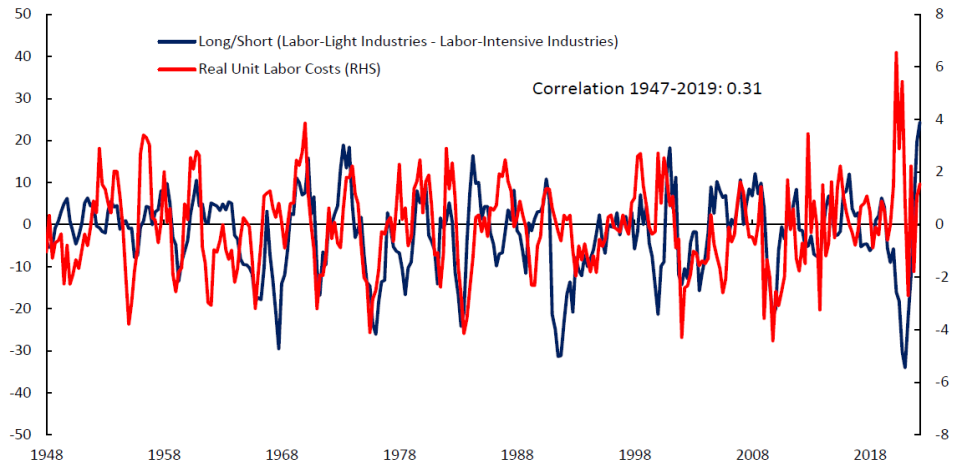
8A (left): Labor share and unemployment rate (LHS: 3-year change, percentage points; RHS: %);
 8B (right): Labor share and real unit labor costs (LHS: 3-year change, percentage points; RHS: 3-year % change, AR)



Source: PGIM Fixed Income and Haver Analytics.

Figure 9: Risk assets of high-labor companies tend to underperform those of labor-light companies

Relative stock returns and labor costs (LHS: relative return, 4Q%; RHS: 4Q, % change)



Source: PGIM Fixed Income and Haver Analytics.

CONCLUSION

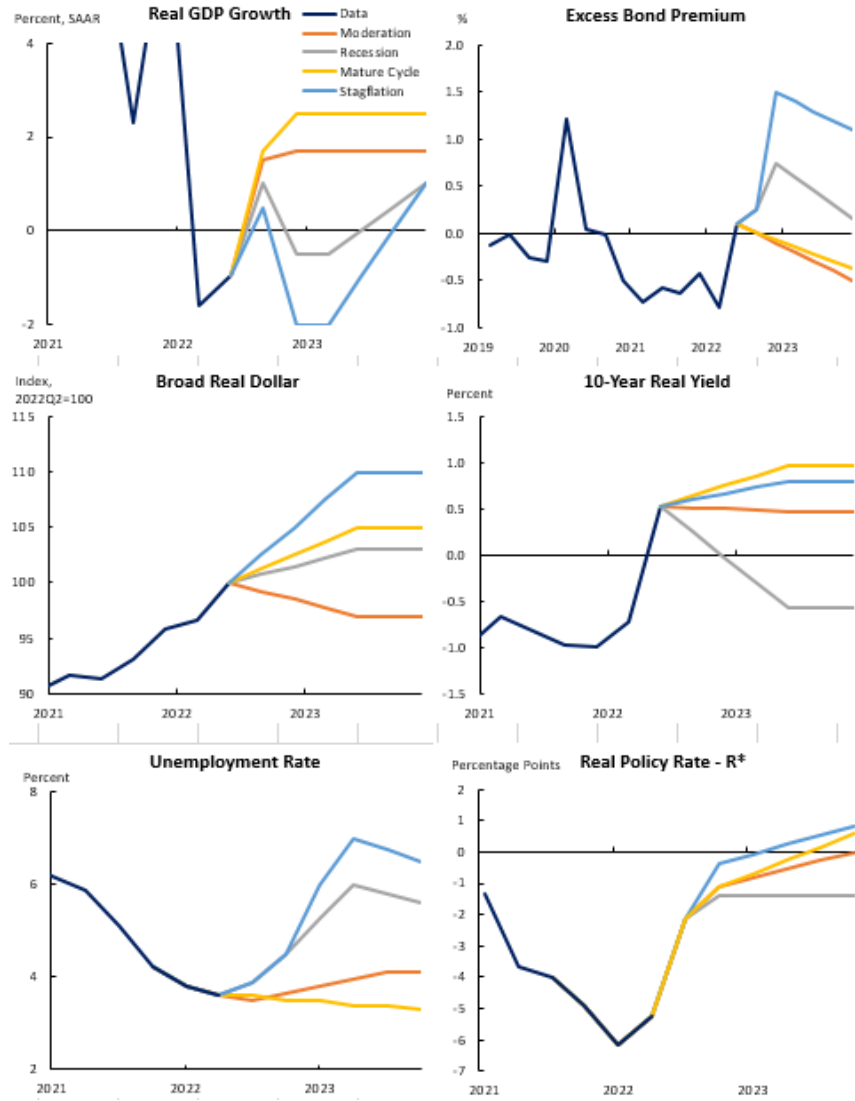
The profit outlook the year ahead appears plagued by Fed policy tightening, rising wage pressures due to a tight labor market, dollar strength, and lack of tailwinds from globalization. This informs our cautious outlook on spread markets over the next 12-months. In the longer-term, fading structural drivers of corporate earnings may result in a bumpier ride for spread markets compared to their behavior during the economic expansions of the past two decades. So far in 2022, credit spreads have widened materially from cyclical tightness. This reflects various negative shocks, such as the uncertainty instigated by the Russia-Ukraine conflict, its impact on

⁴ We find a similar relationship for credit spreads, but historical data only go back to the late 1990s. We show performance of equities here to show the relationship remains robust with over 70 years of data.

⁵ Labor-intensive industries include for example, education, hospitals, nursing/social assistance, warehousing and storage, computer system design and apparel/textiles.

energy markets and the rise in global inflation as well as the associated tightening in monetary policy. If one considers a weakening profits outlook, especially when inflation is high, historical evidence suggests that further spread widening is likely.

APPENDIX: SCENARIO ASSUMPTIONS



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Source(s) of data (unless otherwise noted): PGIM Fixed Income as of September 2021.

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