ECONOMIC OUTLOOK

REGIONS

June 2023

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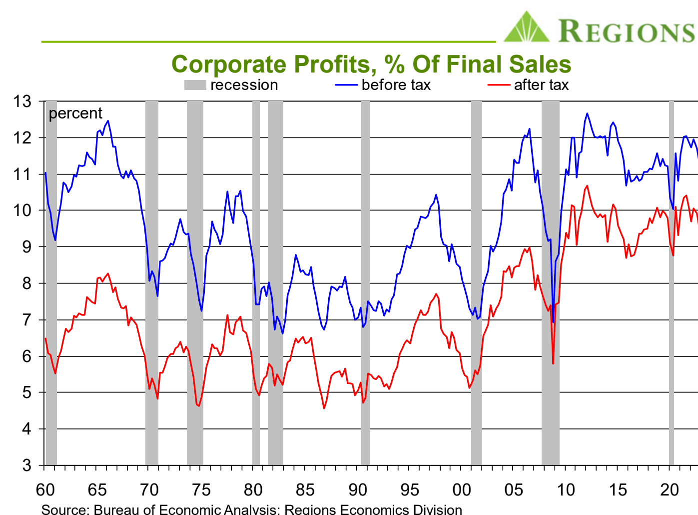
The Sky May Or May Not Be Fallling, But Margins Clearly Are

In conjunction with the recent release of the second estimate of Q1 2023 GDP, the Bureau of Economic Analysis (BEA) offered their first estimate of Q1 corporate profits, showing a third straight quarterly decline in before-tax profits and a second straight quarterly decline in after-tax profits. If nothing else, the data on corporate profits over the past few quarters show that price gouging on the part of greedy corporations isn't actually the cause of elevated inflation. Okay, either that or that greedy corporations aren't all that good at price gouging. In any event, corporate profit margins had been compressing even before profits began their recent slide, and that compression has become more intense over the past few quarters. Absent meaningful relief on the cost side of the ledger, profit margins figure to remain under pressure over coming quarters as further slowing in demand growth and waning pricing power weigh on the revenue side of the ledger. Our view is that mounting pressures on profits over recent quarters have been a key factor in weakening in business investment, particularly spending on equipment and machinery. If we are correct in expecting continued pressure on corporate profits, the weakness in business spending on equipment and machinery seen over recent quarters will persist, acting as a drag on real GDP growth.

Recall that the measure of corporate profits from the National Income and Product Accounts (NIPA), from which GDP is derived, is much broader than the more familiar S&P 500 measure of corporate profits, as the NIPA measure includes smaller corporations, privately held corporations and S corporations. The two measures are produced with different methodologies, so that while the longer-term trends in profits in the dual measures tend to be broadly similar, short-term patterns can, and often do, differ sharply. Our focus here is on the NIPA measure of profits.

As reported in the BEA's initial estimate, total corporate profits fell by 5.1 percent in Q1 2023, leaving them down 2.8 percent year-on-year. Both domestic and foreign profits declined in Q1, as did profits in both the financial and non-financial sectors which, barring Q1 2020, is the first instance of this inglorious grand slam since Q4 2008. Financial sector profits have had a rough go of it since Q1 2022, logging five consecutive quarterly declines, which left them down 25.9 percent year-on-year as of Q1 2023. Though "only" the second straight quarterly decline, the decline in profits in the nonfinancial sector picked up pace in Q1, with a decline of 5.3 percent compared to the 1.1 percent decline logged in Q4 2022. Still, profits in the nonfinancial sector were still up by 1.9 percent year-on-year as of Q1 2023, though it is reasonable to wonder how much longer over-the-year comparisons will remain favorable. Despite having declined by 3.5 percent in Q1, foreign profits were still up 3.4 percent year-on-year. These figures refer to before-tax profits; on an after-tax basis, corporate profits were down by 6.8 percent in Q1, following a 2.7 percent decline in Q4 2022, leaving after-tax profits down 2.9 percent on an over-the-year basis as of Q1 2023.



The chart above puts the NIPA measure of corporate profits into a more familiar context, showing profit margins on a before-tax and an after-tax basis. Note that rather than using nominal GDP as our revenue base, as many do when citing profit margins based on the NIPA data, we use nominal final sales, or, nominal GDP minus the change in business inventories. While the change in business inventories enters into the calculation of the level of GDP, it does not represent revenue to firms, so final sales are a truer measure of actual sales revenue. While over time the patterns in profit margins based on the two approaches will look similar, there can be divergences in any given quarter, which was the case in Q1 2023 when a much slower rate of inventory accumulation was a meaningful deduction from top-line GDP.

The real story in the above chart is the sharp compression in profit margins over the past several quarters. Both before-tax and after-tax margins have fallen in five of the past six quarters, the exception being a modest increase in Q2 2022. Barring Q1 2020, after-tax tax profit margins are now at their lowest point since Q4 2015 while before-tax profit margins are at their lowest point since Q3 2009. Our baseline forecast anticipates further compression in margins over coming quarters, in part reflecting our expectation of a marked deceleration in the growth of final sales. To be sure, we do not expect the listless pace of growth we expect over the next few quarters to represent a new "run rate" that will hold over the longer-term. That's the good news, but the bad news is that nothing we've seen over the last three-plus years leads us to think the economy's longer-term trend rate of real GDP growth is any different than it was prior to the pandemic. Indeed, without a rally

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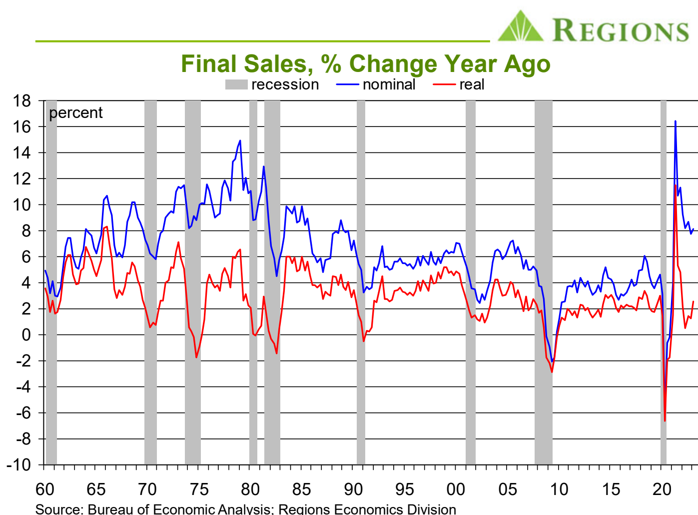
in the trend rate of productivity growth, the longer-term trend rate of real GDP growth rate could fall below the rate seen prior to the pandemic. This is relevant in that the longer-term trend rate of real GDP growth will shape expectations for revenue growth.



If you think, as we do, that going forward two percent is an unrealistically low target rate of inflation, that would suggest at least modestly faster trend growth in top-line revenue, but whether that would be a meaningful support for profit margins would be a function of growth in costs for labor and other inputs. For instance, though we expect the pace of wage growth to slow further, we nonetheless expect wage growth to ultimately settle into a range above that which prevailed prior to the pandemic. If so, a faster trend rate of growth in labor costs could negate a similarly faster trend rate of revenue growth. Obviously, we're dealing with aggregates here, and revenue/cost profiles will vary across industry groups. That said, it isn't clear how much more capacity there is for discipline on the cost side of the ledger to support profit margins as was the case in the years prior to the pandemic, though we think there to be ample room for efficiency gains, in the form of stronger productivity growth, to be more supportive of margins than has been the case in recent years.

Those are questions that will be answered over time, but in the near term we expect further pressures on profits, and profit margins. Continued pressure on profits in turn helps account for our expecting business investment to soften further over coming quarters, particularly outlays on equipment and machinery. It has become rather common of late to blame tightening bank lending standards for any and every soft data point, and faltering business investment in equipment and machinery has been no exception. In reality, however, this weakening began several months before the March bank failures, which is when many seem to have noticed the tightening in bank lending standards on commercial and industrial (C&I) loans that had been underway for some time prior.

For instance, commercial banks began raising lending standards on C&I loans in Q2 2022. As the year wore on, firms began scaling back planned capital expenditures, which was a not uncommon element of Q3 earnings calls and which became evident in the data on orders for core capital goods, a leading indicator of business investment in equipment and machinery as reported in the GDP data, over the final months of 2022. That weakness carried into 2023, and although the surprising 1.4 percent increase reported in the preliminary April data may seem at odds with the trend, it helps to note that April increase simply reflects a smaller decline (11.8 percent) in not seasonally adjusted orders than is typical for the month, hence the increase reported in the seasonally adjusted data. As such, the April data do not lead us to alter our view of the path of business investment, particularly in equipment and machinery, over coming quarters. Adjusted for inflation, business investment in equipment and machinery has contracted in three of the past four quarters and we look for contractions on both a nominal basis and a real basis over the next few quarters.

Our view is that a dimming growth outlook, and in turn a dimming profit outlook, are the primary culprits. Many are quick to cite higher interest rates as having dampened business investment, and that would seem a fairly obvious link. Empirically, however, there is little support for a link between business investment and interest rates, but there is ample evidence supporting a link between business investment and profits. Moreover, the argument that higher interest rates have dampened business investment takes a further hit from the Federal Reserve's "*Flow of Funds*" data which show firms more than able to completely fund capital spending from internal cash over the past four quarters. Again, we're dealing with aggregate measures here and obviously it isn't the case that every firm has more than enough internal cash to fund capital outlays. This does, however, suggest that higher interest rates have had less of an adverse impact on business investment over recent quarters than is commonly assumed.

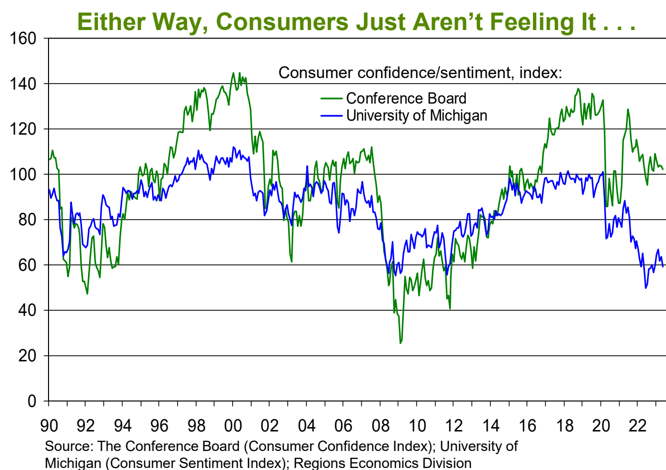
We could make the same point about elevated internal cash balances and tighter lending standards for C&I loans, i.e., more stringent C&I lending standards have had less of an adverse impact on business investment over recent quarters than is often implied to be the case. After all, more stringent lending standards would not have been a deterrent for firms with enough cash to self-fund capital spending or, for that matter, larger firms with access to alternative financing sources. Where unfavorable shifts in the cost and availability of credit will have been higher hurdles for business investment are firms with less cash and heavier debt loads and smaller firms for whom bank financing is typically the most, if not only, viable option. We find it unlikely, however, that firms in these two groups are the sole, or even the primary, source of the weakening capital spending seen over recent quarters.

It could be that firms in these two groups pull back on capital outlays to an increasing degree over coming quarters, thus adding to the deterioration already apparent in the data. One reason we pay so much attention to trends in business investment is that in addition to impacting current GDP growth, business investment also lays the foundation for future GDP growth. We had long argued that businesses were underinvesting over much of the expansion that endured for over a decade prior to the pandemic. We also argued stepped-up business investment would be needed to offset deteriorating demographic trends in order to keep an already anemic trend rate of real GDP growth from sinking even lower. It is fair to point out that over time outlays on equipment and machinery have accounted for an increasingly smaller share of total business investment, with outlays on intellectual property products, primary consisting of research and development and software, capturing an increasingly larger share. That does not,

however, mean investment in equipment and machinery is no longer relevant, which would make the recent weakness much less of a concern. The reality is that much of the physical capital stock remains dated and, by extension, less efficient than would have been the case had there been greater investment in the decade-plus prior to the pandemic. Unless and until the outlook for profit margins improves, however, there seems little chance of a meaningful and sustained rebound in business investment.

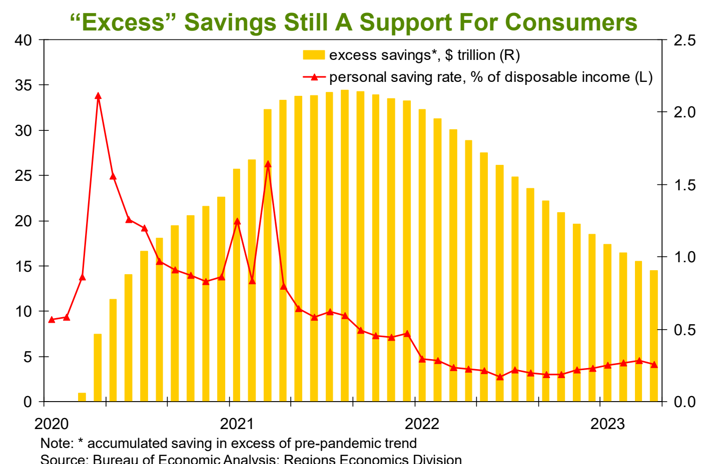
U.S. Consumers: Getting Squeezed, Or Willingly Pulling Back?

The recent batch of disappointing earnings results from a group of retailers was generally attributed to consumers being "squeezed" by high inflation, with "challenging macroeconomic conditions" taking a toll on spending in categories of consumer goods ranging from necessities all the way up to luxury goods. An increasingly common narrative is that U.S. consumers are "tapped out," with pandemic-related excess savings either already or soon to be "run dry" and credit cards being "maxed out," barely leaving room in household budgets for necessities and no room for discretionary purchases. Crafting a narrative around these themes is not too difficult, and while such narratives sound plausible, whether or not they are accurate portrayals is another question entirely.



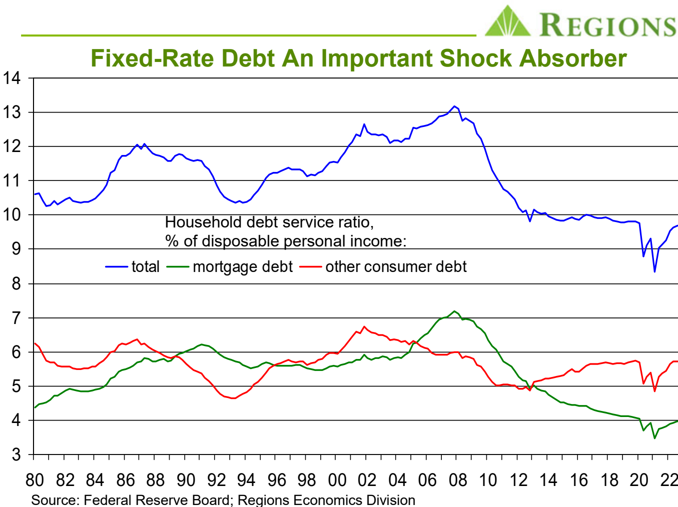
Perhaps one reason such narratives are so common and so readily accepted is that they fit nicely with measures of consumer moods, the two most common being the Conference Board's measure of consumer confidence and the University of Michigan's measure of consumer sentiment. As seen in the chart above, both measures fell sharply with the onset of the pandemic but rebounded as the economy began to reopen with the worst of the pandemic behind us. Those rebounds, however, proved to be, well, only transitory in the face of rapidly rising inflation and the spikes in market interest rates that followed as the FOMC began pushing the Fed funds rate higher at an aggressive pace. Still, after bottoming in mid-2022, with the University of Michigan measure sinking to an all-time low in June 2022, sentiment measures began to improve before bank failures and debt ceiling drama again soured moods. Whether it was the actual events themselves or the constant barrage of doomsday-ish media coverage that took a toll on consumers is a question for another day but, either way, sagging consumer confidence seems to support generalized narratives attributing weak retail earnings reports to tapped out consumers.

What often goes unsaid, however, is how at odds such narratives are with a range of indicators of household financial conditions and with a labor market that, while cooling a bit, remains tight. Our assessment is that consumers are not lacking the wherewithal to spend even if, as suggested by measures of consumer sentiment, they are lacking the will. Right off the bat, the various indicators of household financial conditions we cite are aggregate measures, which is a function of how the data are reported and thus out of our control. Obviously, households across different household income buckets face varying degrees of financial stress, but even within a given household income bucket there will be differences in financial conditions and the degree of financial stress being felt across households. In one sense, as our main focus is analyzing and forecasting aggregate measures, such as personal income and spending, the composites gauges of household financial conditions are what matter to us. That does not, however, mean we are not mindful of variances across income groups and even across households in the same income groups. We are. What is less clear, however, is whether those offering these generalized narratives are aware of such variances, or whether they simply choose to not let them get in the way of their generalized narratives.



In any event, despite being down from a peak of over $2 trillion in mid-2021, the level of excess savings on household balance sheets nonetheless remains substantial. Our estimate puts it at just over $900 billion as of April, the latest available data point, which is in line with most other estimates we've seen. It is reasonable to assume that lower income households would by now have run down more of any savings buffers built up during 2020 and 2021 than would be the case for higher income households. It is, however, clear that excess savings are in the aggregate nowhere near having been "run dry," which is one explanation we've seen for recent retail sector earnings misses. It is worth noting that the rate at which excess savings were being pared down accelerated over the course of 2022, lending some support to the premise that the cumulative effects of higher inflation were stressing household budgets. Still, even with the faster pace at which they have been draw down, excess savings would still be a considerable support

for household finances well into 2024. It could be that, to the extent consumer sentiment is sagging and there is at least some unease about the state of the labor market, households will look to preserve more of this savings buffer, rather than using it as a support for spending, than would have otherwise been the case, which would be consistent with the listless pace of growth in real consumer spending our baseline forecast anticipates.

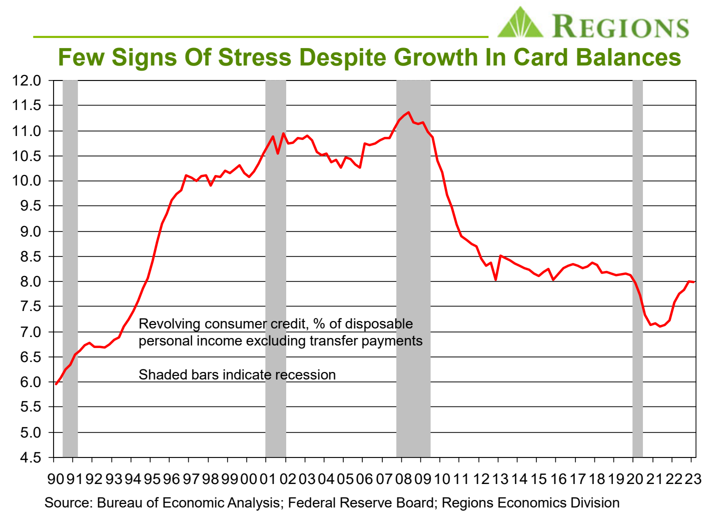


Though the data for Q1 2023 are not yet available, we think it worth pointing out that, while up from the all-time lows registered in 2021, the overall household debt service ratio remains below the pre-pandemic norm, as seen in the above chart. While low interest rates played a role, the bigger factor in the debt service ratio (monthly principal and interest payments as a percentage of disposable personal income) hitting that all-time low in 2021 was the magnitude of financial transfers to the households in the name of pandemic relief efforts, particularly the final two rounds of Economic Impact Payments (EIP) which hit in Q1 2021. As the EIP ran their course, debt service ratios began moving higher though as of year-end 2022 were still below pre-pandemic reads despite rapidly rising interest rates over the course of 2022.

A key reason there was not a more pronounced increase in debt service ratios over the course of 2022 is the preponderance of fixed rate debt on household balance sheets. As did corporations, households took advantage of extraordinarily low interest rates in 2020 and 2021 by refinancing into fixed rate debt where possible. This of course was more prominent with mortgage debt, and a key exception is credit card debt, with these differences apparent in the above chart (credit card debt is included with "other consumer debt"). That said, despite notably rapid growth in credit card debt over the final three quarters of 2022, the debt service ratio for non-mortgage debt did not budge, which in part reflects the faster growth in disposable personal income seen over that same span.

It also helps to note that a significant share of credit card accounts is paid in full in each period, over one-third of all accounts according to data from the Federal Reserve Bank of Philadelphia. As such, differences in the timing of reporting mean that the amount of credit card debt reported as outstanding in any given period is to some degree overstated. Again, one could make the argument that lower-income households are more likely to carry credit card balances and hence labor under heavier monthly debt service burdens than do higher income households.

In the aggregate, however, debt service burdens remain more manageable than was the case prior to the pandemic, and a higher share of fixed rate debt on household balance sheets has, on the whole, acted as a more powerful shock absorber against higher interest rates in the current cycle than has been the case in past cycles. When the data for Q1 2023 are available, they could show a decline in the debt service ratio given the much slower growth in household debt seen in Q1 coupled with faster growth in disposable personal income. Even should the Q1 data show them ticking slightly higher, that would not change our view that debt service burdens remain manageable and are not, on the whole, acting as a constraint on the growth of consumer spending.



The above chart shows revolving consumer credit, the vast majority of which is credit card debt, as a percentage of disposable personal income excluding transfer payments, which we see as the best gauge of funds available for meeting monthly debt service obligations. As with overall debt service ratios, this narrower measure is below pre-pandemic norms, and despite rapid growth in credit card debt has been flat over the past two quarters. This is a reflection of what has also been faster income growth. While the importance of income growth seems obvious, one seldom, if ever, sees it mentioned in the steady barrage of ominous stories about new record-high levels of household debt, of which there is one pretty much every quarter. The reality, which apparently doesn't make for all that good of a story, is that income growth has outpaced debt growth over the past several years.

Even with the caveat that there will be differences across individual households, any number of indicators suggest that consumers are not lacking the wherewithal to spend, even if they are lacking the will. That too is in question, at least to some degree, given that thus far discretionary services spending has held its own, in part a reflection of the shift in consumer spending patterns, away from goods, toward services, that we've been discussing for quite some time now. While the cumulative effects of elevated inflation are stressing budgets, particularly those of lower income households, generalized narratives of stressed out, tapped out consumers are not exactly reflective of overall household financial conditions.

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June 2023

Q4 '22 (a)	Q1 '23 (p)	Q2 '23 (f)	Q3 '23 (f)	Q4 '23 (f)	Q1 '24 (f)	Q2 '24 (f)	Q3 '24 (f)		2020 (a)	2021 (a)	2022 (a)	2023 (f)	2024 (f)
2.6	1.3	1.2	0.9	0.9	1.2	1.1	1.2	Real GDP[1]	-2.8	5.9	2.1	1.5	1.1
1.0	3.8	1.3	1.0	1.0	1.0	0.9	0.9	Real Personal Consumption[1]	-3.0	8.3	2.7	2.0	1.0
4.0	1.4	1.4	1.1	0.8	1.9	2.9	3.1	Real Business Fixed Investment[1]	-4.9	6.4	3.9	2.3	2.0
-3.5	-7.0	-4.7	-3.3	-3.0	-1.1	0.8	1.7	Equipment[1]	-10.5	10.3	4.3	-2.8	-1.0
6.2	5.2	4.5	4.0	3.5	4.1	4.8	4.8	Intellectual Property and Software[1]	4.8	9.7	8.8	5.4	4.2
15.8	11.0	10.0	5.1	3.3	3.4	2.7	1.6	Structures[1]	-10.1	-6.4	-6.6	6.9	3.5
-25.1	-5.4	-1.0	2.9	5.5	4.6	3.7	4.3	Real Residential Fixed Investment[1]	7.2	10.7	-10.6	-11.1	3.9
3.8	5.2	2.2	1.6	1.8	1.5	0.8	0.6	Real Government Expenditures[1]	2.6	0.6	-0.6	3.1	1.3
-1,238.6	-1,243.5	-1,272.3	-1,289.1	-1,306.0	-1,315.0	-1,328.6	-1,337.8	Real Net Exports[2]	-922.6	-1,233.4	-1,356.7	-1,277.7	-1,334.0
850	830	859	876	887	901	914	928	Single Family Housing Starts, ths. of units[3]	1,003	1,132	1,004	863	921
556	552	531	501	479	445	433	423	Multi-Family Housing Starts, ths. of units[3]	394	474	547	516	431
7.0	3.1	-1.1	-3.1	-4.1	-4.8	-3.1	0.3	CoreLogic House Price Index[5]	6.7	15.6	13.5	-1.3	-1.4
14.3	15.3	15.4	15.3	15.2	15.4	15.4	15.6	Vehicle Sales, millions of units[3]	14.5	14.9	13.8	15.3	15.5
3.6	3.5	3.5	3.6	3.8	3.9	4.1	4.2	Unemployment Rate, %[4]	8.1	5.4	3.6	3.6	4.1
3.4	2.9	2.6	2.1	1.6	1.0	0.6	0.4	Non-Farm Employment[5]	-5.8	2.9	4.3	2.3	0.6
2.5	7.8	2.8	2.5	1.6	2.8	1.7	2.1	Real Disposable Personal Income[1]	6.2	1.9	-6.2	3.6	2.2
6.4	5.4	3.8	3.4	3.1	2.7	2.5	2.4	GDP Price Deflator[5]	1.3	4.5	7.0	3.9	2.4
5.7	4.9	3.8	3.5	3.2	2.8	2.7	2.4	PCE Deflator[5]	1.1	4.0	6.3	3.8	2.5
7.1	5.8	4.0	3.4	3.1	2.8	2.7	2.5	Consumer Price Index[5]	1.3	4.7	8.0	4.1	2.5
4.8	4.7	4.5	4.2	3.8	3.2	2.7	2.3	Core PCE Deflator[5]	1.3	3.5	5.0	4.3	2.6
6.0	5.6	5.2	4.5	4.0	3.4	2.9	2.6	Core Consumer Price Index[5]	1.7	3.6	6.1	4.8	2.8
3.71	4.56	5.04	5.13	5.13	5.13	4.82	4.44	Fed Funds Target Rate Range Mid-Point, %[4]	0.42	0.13	1.73	4.96	4.63
3.83	3.65	3.56	3.59	3.56	3.45	3.33	3.32	10-Year Treasury Note Yield, %[4]	0.89	1.44	2.95	3.59	3.34
6.66	6.37	6.43	6.46	6.42	6.21	5.96	5.79	30-Year Fixed Mortgage, %[4]	3.12	2.96	5.34	6.42	5.89
-3.2	-3.4	-3.6	-3.4	-3.4	-3.3	-3.2	-3.2	Current Account, % of GDP	-2.9	-3.6	-3.7	-3.5	-3.2

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2012 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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