ECONOMIC OUTLOOK

REGIONS

June 2018

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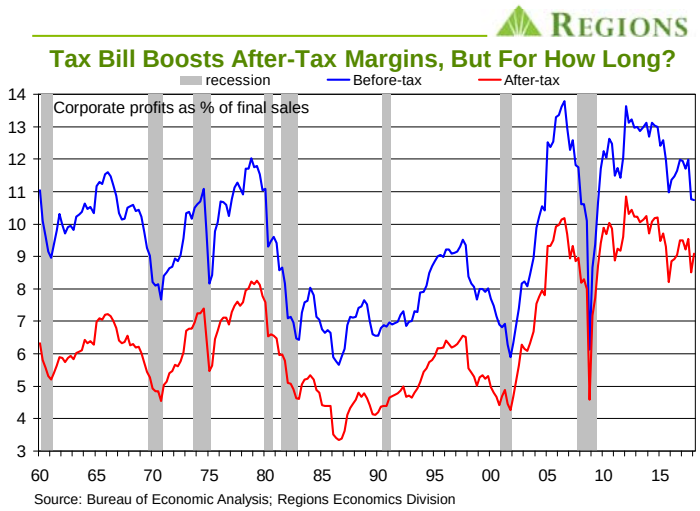
Before And After: Tax Bill Pumps Up Q1 Corporate Profits.

The 2017 tax bill is the financial equivalent of one of those magic muscle building potions that turns what in the "before" picture is a scrawny, nerdy looking guy having sand kicked all over him into what in the "after" picture is the confident muscle bound envy of every other guy on the beach. In the case of the 2017 tax bill, it is corporate profits that are being bulked up. Okay, maybe not a perfect analogy, mainly because none of those magic muscle building potions actually works (umm, or so we've heard . . .). And, sure, corporate profits were hardly scrawny prior to the tax bill, but neither were they as big and brawny as they had been earlier in this cycle. But, as the BEA's newly released data on Q1 2018 corporate profits show, the after (tax) picture of corporate profits looks decidedly more muscular than the before (tax) picture. And, for the record, no, they do not hire economists to pose for the "before" pictures in those ads for the magic muscle building potions; those guys are clearly accountants.

In any event, the 2017 tax bill reduced the statutory corporate income tax rate from 35 percent to 21 percent. It is important to specify the bill lowered the statutory tax rate which, prior to the 2017 tax bill, was in many cases was significantly higher than the effective tax rate. As the 2017 tax bill reduced/eliminated many of the deductions that led to differences between statutory and effective tax rates, the two should be much closer now. On balance, however, the 2017 tax bill resulted in significantly lower corporate income tax payments in Q1 2018, with the BEA data showing a $117.4 billion (annualized rate) decline in corporate income tax payments between Q4 2017 and Q1 2018.

That decline is reflected in the paths of before-tax and after-tax corporate profits as reported in the BEA data. Before-tax corporate profits increased by 0.67 percent between Q4 2017 and Q1 2018 but after-tax profits increased by 7.83 percent. On a year-on-year basis, however, this left before-tax profits down by 6.0 percent and after-tax profits up by just 0.1 percent. To be clear, we are using the BEA's series on unadjusted profits, i.e., without adjusting for depreciation or changes in inventory valuations. This is the BEA series that is most comparable to the more widely publicized measure of profits amongst the S&P 500. There are, however, some key differences between the two measures. First, the BEA data capture all U.S. headquartered companies as opposed to capturing only the largest publicly traded companies. Also, the BEA's measure of profits includes the various one-off charges which tend to lower reported profits and which are generally excluded from the S&P 500 profit measure.

Despite these differences, the BEA and S&P measures of profits have tended to track each other fairly well over time. That is until the Q1 data. The S&P 500 measure shows profits up roughly 25 percent year-on-year in Q1, just a tad different than the 0.1 percent increase reported in the BEA profits data. To be sure, what was a record volume of share buybacks in Q1 biased growth in S&P profits higher, as S&P profit figures are generally reported on an earnings per share basis. This, however, can't fully account for the sharp divergence in reported year-on-year growth between the two measures of profits. This difference is worth pondering given that reports of stellar S&P earnings were greeted somewhat less than enthusiastically by market participants. While this could simply mean expectations of stellar profits had already been priced in to the market, an alternative interpretation is that market participants had already begun to worry that accelerating growth in input costs, both labor and non-labor, coupled with what remains limited pricing power means that profits will come under further pressure over coming quarters, tax bill or not.



Source: Bureau of Economic Analysis; Regions Economics Division

Before-tax profits fell sharply in Q4 2017 even though final sales of domestic product (final sales are GDP excluding inventories, making final sales a good proxy for total revenue) posted their largest quarterly increase since Q3 2014 and corporate tax payments fell. As shown in the above chart, before-tax profit margins (or, before-tax profits as a percentage of final sales) fell from 11.99 percent in Q3 2017 to 10.77 percent in Q4 2017, the lowest since Q3 2009 (i.e., the first quarter of the current expansion). The pressure on before-tax profits in Q4 despite solid growth in top-line revenue reflects the sharp acceleration in non-labor input costs and faster growth in total labor compensation costs. Growth in input costs, both labor and non-labor, picked up further in Q1 2018 but another solid increase in final sales meant before-tax profit margins were basically flat.

While having compressed in Q4 2017 along with before-tax profit margins, after-tax margins jumped in Q1 2018, standing at 9.09 percent of final sales, which simply reflects the extent to which the 2017 tax bill lowered corporate tax payments. As seen in the chart

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above, after-tax margins are down from the cycle high but remain elevated relative to historical norms. The questions to be answered going forward are where do profit margins go from here and how do firms respond.

There seems little question that increasingly tight labor market conditions will lead to further acceleration in the growth of total labor compensation costs over coming quarters. At the same time, there are few signs that the rapid growth in costs of non-labor inputs seen over the past few quarters will ease any time soon, particularly to the extent global economic growth emerges from its Q1 slumber, as we expect it will. All in all, there is little to suggest corporate profit margins will get any relief from the cost side of the ledger over coming quarters.

There should, however, be some relief from the revenue side of the ledger, as growth in final sales should accelerate in line with the anticipated pick-up in real GDP growth. We look for final sales to increase by 4.8 percent in 2018 after growth of 4.2 percent in 2017 and 2.8 percent in 2016. Still, even if our forecast for growth in final sales is on or close to the mark, it seems likely there will be at least some compression in profit margins, both before-tax and after-tax, in 2018 and 2019.

This will leave firms facing a dilemma – they can either sit back and accept slimmer profit margins, or stand up and exercise their pricing power, or at least find out just how much pricing power they actually have, in an attempt to preserve profit margins. Don't dismiss the first possibility out of hand – as noted above, profit margins remain elevated relative to historical norms and, in an effort to preserve market share, firms may willingly accept at least some further margin compression over coming quarters, though equity investors would likely be none too pleased with this choice.

But, should firms opt to test their pricing power (and, for the record, no, we do not believe that Amazon has forever sapped pricing power from the entire corporate sector), faster retail (or, consumer) level inflation could at some point push the FOMC past their stated tolerance for allowing inflation to run ahead of their 2.0 percent target. This in turn would bring about a faster pace of Fed funds rate hikes than the FOMC and market participants are now anticipating.

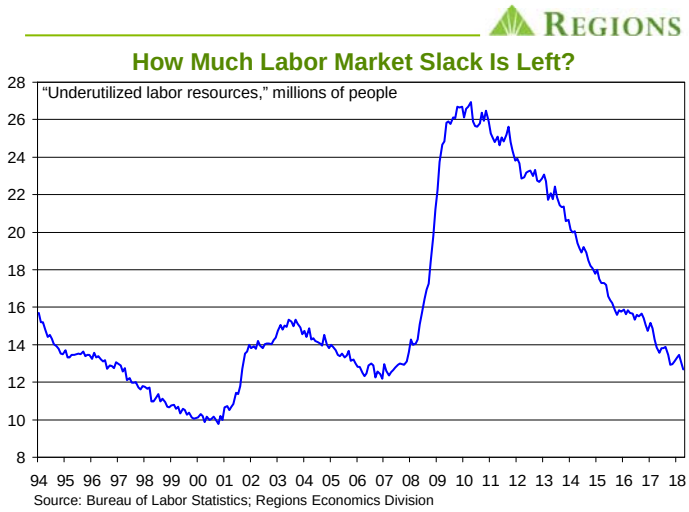
It is important to remember there is a third alternative available to firms – take steps to enhance labor productivity growth, which serves as a buffer between labor costs and output prices, thus helping preserve profit margins. Our premise has long been that underinvestment on the part of firms during the current expansion, leaving us with an aged, inefficient, and undersized capital stock, is the primary culprit behind what has been an anemic trend rate of productivity growth over the past several years.

We have also argued, however, that the provision in the 2017 tax bill allowing for the immediate expensing of capital investment would, in tandem with increasingly tight labor market conditions, lead to faster growth in capital spending this year than we have seen over the course of the current expansion. We have already seen this, even before the effects of the 2017 tax bill kicked in, in the form of faster growth in spending on equipment and machinery, computer software, business structures, and research and development. All of these will ultimately contribute to a faster rate of growth in labor productivity, but the problem is this tends to take time. In the interim, that leaves firms faced with further downward pressure on profit margins and having to choose between accepting slimmer margins or attempting to raise prices.

It will be fascinating to see how this dynamic plays out. Well, fascinating as an economist, as an investor or a central banker, maybe not so much. But, clearly the manner in which firms respond to further downward pressure on profit margins has implications for equity prices and for monetary policy, hence for the broader economy as well.

Is There Any Slack Left In The Labor Market?

Part of the increased pressure on corporate profit margins has come from faster growth in wages and other forms of labor compensation. Still, with the "headline" (or, U3) unemployment rate having fallen to 3.8 percent in May (3.755 percent, unrounded), many find it puzzling, not to mention more than a little frustrating, that wages are not growing at an even faster pace. We don't find it all that puzzling, in the sense that there a number of factors that are contributing to wage growth lagging past episodes in which the unemployment has been near or below 4.0 percent. For instance, what has been an anemic trend rate of labor productivity growth has acted as a drag on wage growth. And, as we have frequently noted, for much of the current expansion there has been much more slack in the labor market than has been implied by the headline unemployment rate.

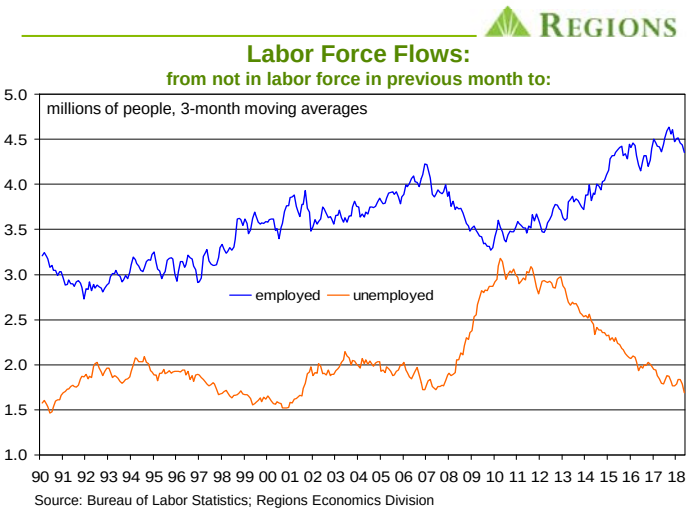


As the above chart shows, however, the degree of slack in the labor market has been significantly pared down, and some would even argue it has been totally eliminated. The above chart shows the number of, to borrow a term from former Federal Reserve Chairwoman Janet Yellen, underutilized labor resources. This is the total number of people either unemployed, working part-time for economic reasons (i.e., underemployed), or marginally attached to the labor force (i.e., not actively looking for but would accept a job). This total, which is the numerator in the calculation of the broader U6 measure of unemployment/underemployment, stood at 12.468 million persons as of May, significantly below the cyclical peak of 26.934 million seen in April 2010.

As an illustration of how the headline unemployment rate has masked labor market slack, consider those working part-time for economic reasons, or, those who would prefer full-time work but are only able to find part-time work. As of May, the number of those working part-time for economic reasons stood at 4.948 million persons, down from the cyclical peak of 9.246 million in September 2010. As they have a job, even if part-time, people in this group are classified as employed, so they do not appear in the U3 measure of unemployment but do appear in the broader U6 measure (the same is true for those marginally attached to the labor force). As they transition to full-time work, however, there can be little, if any, effect on measured wage growth, particularly if they stay in the same job but simply transition to full-time hours. Note, however, that transitioning from part-time to full-time often means workers gain access to benefits, thus, even if growth in hourly earnings does not change, firms' total labor costs go up.

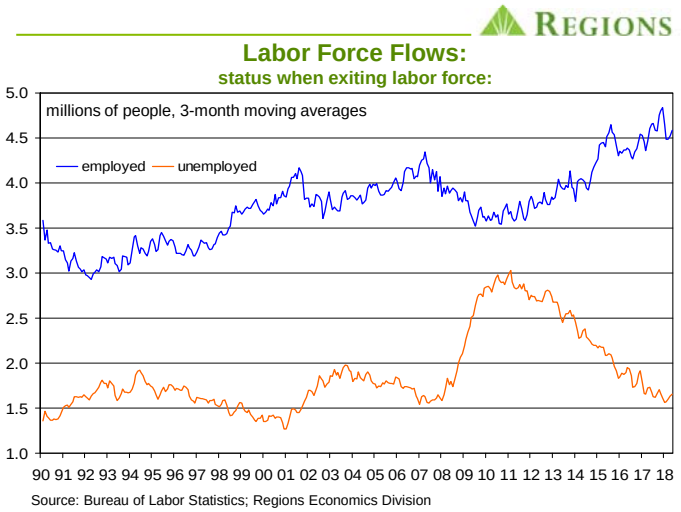
While we do think there is room for the number of underutilized labor resources to fall further, it is less clear just how much room there is. For instance, we had thought the "equilibrium" level of underutilized labor resources to be roughly 13.0 million persons, but with the actual number having fallen significantly below this mark, we clearly need to reconsider our calculation. We think there clearly is room for further reduction in the number of those working part-time for economic reasons.

This is better seen by scaling the number of those in this category to the size of the labor force rather than simply looking at the current level, as this allows for the changing size of the labor force over time. For instance, as of May the 4.948 million people working part-time for economic reasons accounted for 3.06 percent of the labor force. At the height of prior expansions, this share has been closer to 2.25 percent, and using this share of the current labor force would leave us with 4.038 million people working part-time for economic reasons, almost a million fewer than in this group as of May. Again, to the extent people in this group do transition to full-time work with little or no upward pressure on hourly earnings, firms are effectively adding to labor input with potentially little or no impact on reported growth in hourly earnings.



Another dynamic which, at least in our view, has contributed to sluggish growth in hourly earnings is the number of people each month who transition from not being in the labor force to being employed. The BLS data on labor force flows, which provide the details beneath the reported net change in the labor force each month, tell us that over six million people per month continue to transition from not in the labor force in one month to being in the labor force the next month. Those making this transition are either new entrants into the labor force or are being drawn back into the labor force after having, for various reasons, previously exited the labor force. The data also tell us that the overwhelming majority (over 70 percent at present) of those making this transition are employed upon entering the labor force, as the prior chart shows.

It is plausible to argue that this steady influx into the ranks of the employed has helped blunt upward pressure on wage growth. As the people making this transition are not captured in the U3 unemployment rate prior to their becoming employed, failing to account for them can lead one to expect a faster rate of wage growth based on the U3 rate than is warranted, and we think this has been the case for some time now. Obviously this inflow cannot continue at this pace indefinitely, and while the average number of people making this transition month has slowed over recent months, it is still well above historical norms. To some extent, this is a testament to the damage done during the 2007-09 recession, i.e., that so many people lost jobs and left the labor market either out of frustration or in order to go to/back to school to enhance their skill sets.



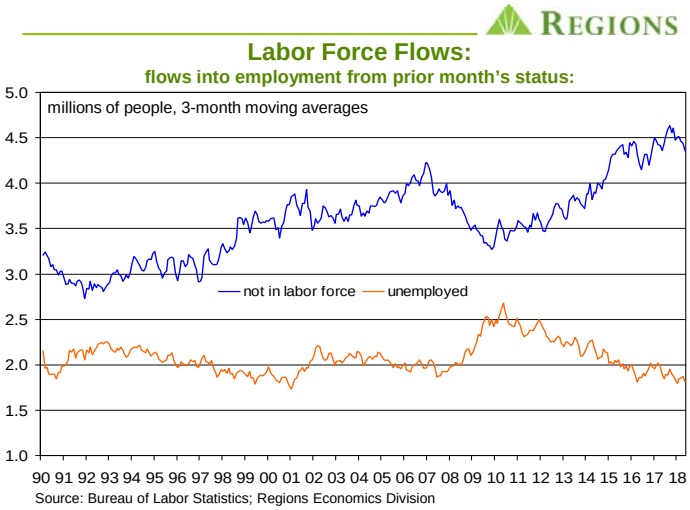
To be sure, one must also consider the flip side of these inflows into the labor force, i.e., those transitioning from into the labor force in one month to not in the labor force in the next month, which we do in the above chart. As seen in the chart, the vast majority of those who exit the labor force in a given month are employed in the month before exit, though note the spike in exits amongst those unemployed during and in the years following the 2007-09 recession.

It is obviously the net flow, i.e., the difference between inflows and exits, that matters in terms of the effects on wage growth. More specifically, it is the net flow over time, rather than in any one month, that matters; as with any other data series, no meaningful conclusions can be drawn from the net flow in any given month. We prefer to look at the running 12-month totals of inflows and exits and take the difference as the most relevant gauge of pressure, either upward or downward, on labor supply

that in turn can impact wage growth. For instance, as of May over the past 12 months 838,000 more people had transitioned into the labor force than had exited the labor force.

We think it an important point that the effects on wage growth, at least as captured in the average hourly earnings figure that gets so much attention upon the release of the monthly employment reports, go beyond the net flow number. In other words, how close it is to being a one-for-one trade between the number of people entering the labor force and the number of people exiting the labor force matters to some extent, but what matters more is the gap between the wages being earned by those entering the labor force relative to the wages being earned by those exiting the labor force.

If those leaving the labor force are older, more experienced, and more costly workers who are retiring and those entering the labor force are younger, less experienced, and cheaper workers, then average hourly earnings will be biased lower even if inflows and exits exactly offset each other. Though difficult to quantify, it is simply not plausible to argue this trade hasn't been biasing growth in average hourly earnings lower over the past few years. And, given that we are still in the early phases of the Baby Boomer generation retiring from the work force, this dynamic will continue to weigh on average hourly earnings for some time to come. This is one illustration of why, though it is easily the most popular measure of wage growth, we think average hourly earnings to be the least useful measure of wage growth. Still, even our preferred measure of growth in labor costs, the Employment Cost Index, is showing growth in labor costs lagging what we've seen in past episodes of significant tightening in labor market conditions.



We think it also worth pointing out the extent to which firms are able to draw from the pool of unemployed workers in order to add to labor input. In addition to showing the number of people transitioning from not into the labor force in one month to employed in the next month (which we also show in our first chart on Page 3), the above chart shows the number of those making the transition from unemployed in one month to employed in the following month. This number has steadily trended lower since peaking in mid-2010, and it is reasonable to expect it to continue to so do over coming quarters. One reason we say this is that the long-term unemployed, i.e., those unemployed for 27 weeks or longer, continue to account for an atypically high share of the total number of unemployed. As of May, those unemployed for 27 weeks or longer accounted for 19.4 percent of the total number of unemployed workers. While not even within shouting distance of the cyclical peak of over 45 percent, this share is nonetheless well above the historical average, particularly the shares seen as past expansions have approached their peaks. There is considerable empirical evidence showing that the longer the duration of unemployment, the lower the probability of finding a job.

That said, it will be interesting to see if coming months bring a reversal of the long-running downward trend in the number of people transitioning from unemployed to employed. If labor supply constraints are indeed as binding as some think, it would follow that firms will reach deeper into the pool of unemployed workers, providing whatever training is necessary to get these new hires up to speed. Still, we think it more likely that greater numbers of the long-term unemployed will ultimately exit the labor force, and firms' diminished ability to hire from the pool of the unemployed could serve as a source of upward pressure on wage growth, particularly to the extent the flows of people transitioning into the labor force begin to ebb, as at some point will be the case.

We have for some time now been hearing analysts proclaim that firms are "running out of workers to hire." We've not found this argument to be all that compelling, particularly to the extent it has been based on the behavior of the headline unemployment rate. Closely tracking the data on labor force flows has led us to conclude a still-elevated degree of labor market slack would act as a drag on wage growth. At some point, however, labor supply constraints will become far more binding than has thus far been the case. We will continue to closely watch the data on net flows, i.e., the difference between entrants into and exits from the labor force, as a key indicator of labor supply pressures. We do think it likely that what have been sizeable net inflows over the past several quarters will ultimately slow and perhaps even become net outflows, if for no other reason than simple demographics. In and of itself, that will be a source of upward pressure on wage growth.

In the interim, however, the extent to which firms invest in technology, either to enhance labor productivity or to substitute capital for labor, as is becoming more common, will go a long way in determining the extent to which wage pressures build. Immigration flows are another wild card in the wage growth equation, but given how contentious this issue has become one can't even speculate on the ultimate impact on labor supply. If nothing else, this discussion has hopefully illustrated that explaining wage growth patterns is far more complex than simply looking at the headline unemployment rate.

No one will argue that the unemployment rate sinking further below 4.0 percent won't contribute to upward pressure on wages. Our point, however, is simply that there is far more to the story than the unemployment rate and, as such, we won't be surprised to see wage growth continue to underperform expectations over the remainder of the current expansion. And, not to further complicate matters (who, us?), but if we are wrong on this point, that raises the question of whether, if not when, the FOMC will use faster wage growth as the basis on which to raise the Fed funds rate at a faster pace than they and market participants now anticipate. That, however, is a discussion better left for another month's *Outlook*.

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Q4 '17 (a)	Q1 '18 (p)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)		2016 (a)	2017 (a)	2018 (f)	2019 (f)
2.9	2.2	3.8	3.3	2.6	2.3	2.0	1.8	Real GDP[1]	1.5	2.3	3.0	2.4
4.0	1.0	2.9	2.3	2.1	2.1	2.0	1.9	Real Personal Consumption[1]	2.7	2.8	2.4	2.1
								Business Fixed Investment:				
7.1	7.6	6.0	5.9	4.4	4.0	3.8	3.0	Equipment, Software, & IP[1]	0.3	4.4	6.8	4.2
6.3	14.2	7.4	5.4	4.4	3.2	1.9	0.9	Structures[1]	-4.1	5.6	6.5	3.2
12.8	-2.0	3.4	2.8	4.4	4.6	4.6	3.9	Residential Fixed Investment[1]	5.5	1.8	1.9	4.1
3.0	1.1	2.1	2.5	3.0	1.8	1.3	1.1	Government Expenditures[1]	0.8	0.1	1.8	1.8
-653.9	-650.9	-642.4	-645.1	-647.6	-649.2	-653.4	-661.9	Net Exports[2]	-586.3	-621.8	-646.5	-658.4
1.259	1.320	1.296	1.306	1.319	1.326	1.336	1.347	Housing Starts, millions of units[3]	1.177	1.208	1.310	1.342
17.7	17.1	17.0	16.9	16.7	16.6	16.5	16.4	Vehicle Sales, millions of units[3]	17.5	17.2	17.0	16.4
4.1	4.1	3.8	3.8	3.7	3.7	3.7	3.7	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7
1.5	1.5	1.6	1.6	1.5	1.3	1.1	1.0	Non-Farm Employment[5]	1.8	1.6	1.5	1.1
1.2	3.3	2.1	2.5	2.6	2.7	2.1	2.5	Real Disposable Personal Income[1]	1.4	1.2	2.2	2.5
1.9	1.8	2.0	2.0	1.9	1.9	2.1	2.0	GDP Price Index[5]	1.3	1.8	1.9	2.0
1.7	1.8	2.2	2.3	2.1	1.9	2.0	2.0	PCE Deflator[5]	1.2	1.7	2.1	2.0
2.1	2.3	2.8	2.9	2.6	2.2	2.1	2.0	Consumer Price Index[5]	1.3	2.1	2.6	2.1
1.5	1.6	1.9	2.1	2.1	2.1	2.1	2.1	Core PCE Deflator[5]	1.8	1.5	1.9	2.1
1.7	1.9	2.3	2.4	2.5	2.3	2.4	2.4	Core Consumer Price Index[5]	2.2	1.8	2.3	2.4
1.18	1.41	1.67	1.90	2.13	2.17	2.42	2.63	Fed Funds Target Rate, %[4]	0.39	0.98	1.78	2.46
2.37	2.76	2.93	2.98	3.03	3.10	3.15	3.20	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.93	3.18
3.92	4.28	4.53	4.60	4.65	4.73	4.78	4.84	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.52	4.81
-2.6	-2.5	-2.6	-2.8	-2.7	-2.8	-3.0	-3.0	Current Account, % of GDP	-2.4	-2.4	-2.6	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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