Bank Financial Group

Observation

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TD Economics
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HIGHLIGHTS

- Corporate profits have rebounded strongly after a dismal performance during the recession. After declining by 25% in 2008, profits rose more than 30% in 2009.
- Gains in profits have been due to both a rebound in financial sector performance after the crisis of 2008 and by dramatic increases in labor productivity.
- Strong labor productivity growth is the natural outcome of the rebound in real GDP in the second half of 2009 combined with the continued decline in U.S. payrolls. As the economic recovery enters its second phase, hiring will resume and productivity growth will slow.
- As a consequence, after a strong initial rebound coming out of the recession, corporate profit growth will likely slow through the second half of 2010
- Corporate profits are likely to rise by 8.6% in 2010 (fourth quarter-to-fourth quarter) and slow to 5.7% in 2011.

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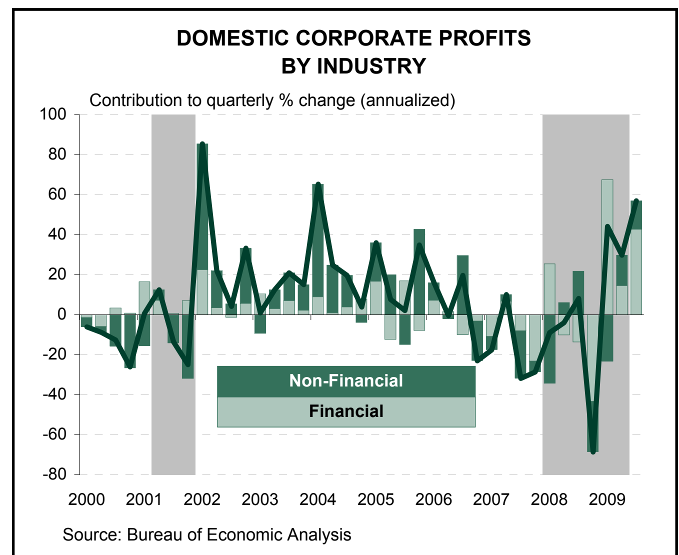
U.S. CORPORATE PROFIT GROWTH TO SLOW AS HIRING RESUMES

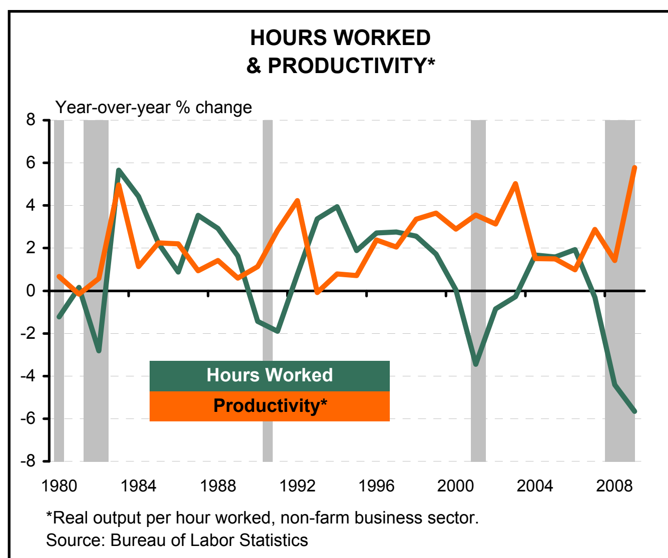
After a 25.1% decline over the course of 2008, corporate profits rebounded by 21% over the first three quarters of 2009. Fourth quarter corporate profits will be released on March 26th. According to estimates by Macroeconomic Advisers, profits rose by 41.4% (annualized) in the fourth quarter, and are up 31.9% on a year-over-year basis. The rebound in corporate profits has been primarily due to two factors: a return to more normal conditions in financial markets; and, a steep rise in labor productivity that coincided with the return of positive economic growth. Looking ahead, as the U.S. economic recovery gains further traction, increases in real GDP will be more evenly split between additional workers and productivity growth, leading to a slowdown in corporate profit growth from its heightened pace emerging from recession.

Financial sector profits rebound after cataclysmic decline

Given the financial crisis that accompanied the Great Recession, it should come as no surprise that financial sector profits took a disproportionate share of the decline in corporate profits during the economic contraction. Nonetheless, it is important to recognize this sea change for what it is: financial profits have in the past been a stabilizing force over business cycles. In both of the past two recessions, financial sector corporate profit growth fell in the lead up to recession but continued to grow through the downturn. In contrast, during this recession, financial profits fell 73% and were responsible for half of the peak-to-trough decline in domestic industry corporate profits.



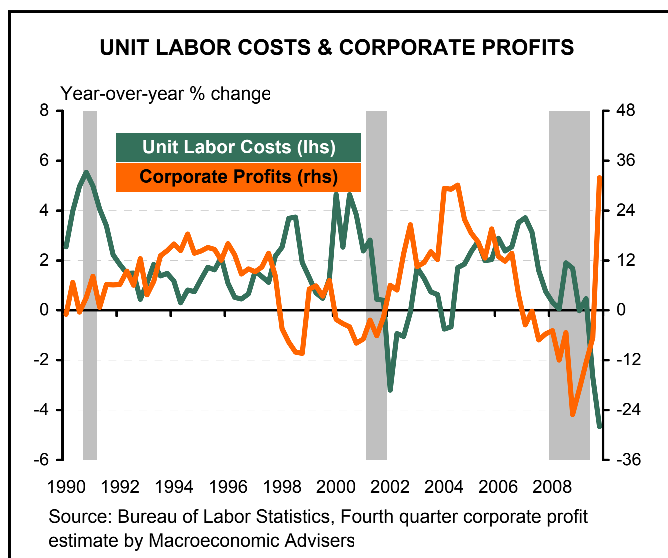
As financial conditions moved away from crisis mode in 2009, financial corporate profits rebounded quickly from these extraordinarily low levels. By the third quarter of 2009, the financial industry's profits had regained their level at the outset of the recession, still below peak, but well above their trough in the midst of the financial crisis. Financial profits are correlated with overall economic activity, but also impacted by relative movements in interest rates. A steep yield curve (low short-term interst rates relative to long), is, in general, a positive for financial corporate profits. While we expect short-term rates to remain low over

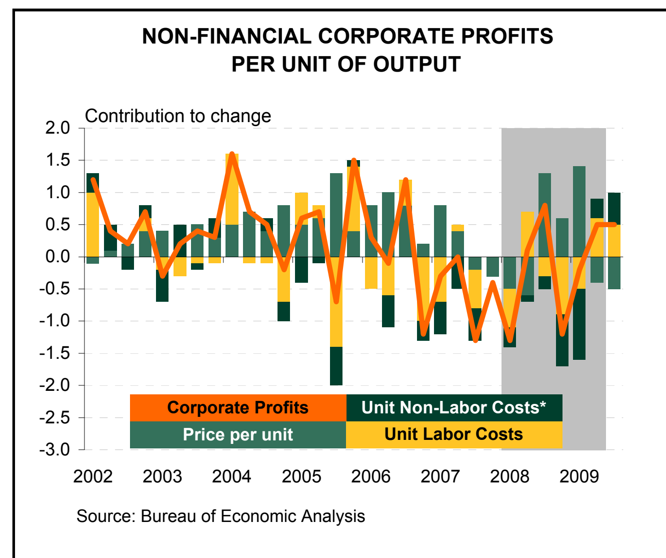


the course of 2010, the spread between short and long-term interest rates will widen only slightly over the course of the year. By early 2010, we expect the Federal Reserve to begin normalizing short-term rates, which will lead to a flattening in the yield curve. As a result, while financial sector balance sheets will likely continue to improve, profit growth should be expected to slow from its recent heightened pace.

Less workers, but still more stuff

The rebound in the financial sector is however, only one component of the overall rebound in corporate profits. The other key part of the story is gains in labor productivity. One of the more salient features of the Great Recession has been the magnitude of the drop in employment, even in comparison to the decline in total economic activity. The U.S. has shed 6.1% of its workforce since employment peaked in





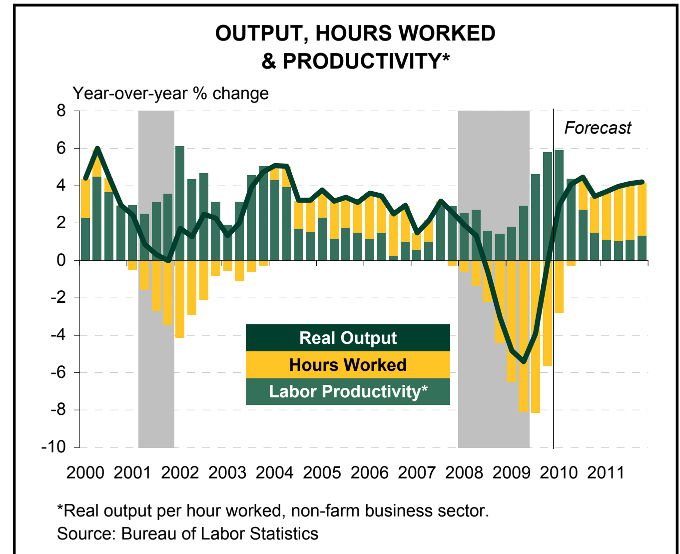
December 2007, more than any recession in modern times. In comparison, real GDP has declined by 3.8% – significant, but a smaller decline than experienced in several other major industrialized countries. While it is not uncommon for the U.S. to shed more jobs than output, the discrepancy between output and employment during the Great Recession is one for the record books. Unlike past deep U.S. recessions, labor productivity growth in the non-farm business sector never turned negative over this recession. The decline in production was due entirely to fewer worker hours being spent producing goods and services. This trend was accentuated in the second half of 2009, when real GDP grew at an annual rate of 4.0%, but U.S. payrolls fell an additional 2.4% (annualized).

The increase in productivity has resulted in dramatically lower labor costs for businesses. Unit labor costs (the cost of labor per unit of output) in the non-farm business sector fell by a whopping 4.7% over the course of 2009, its largest decline in record. The fall in the cost of labor, while primarily due to rising productivity, has also been due to a slowdown in real wage growth. Real compensation per hour ended 2009 down 0.6% from a year earlier.

In both per unit terms and in aggregate, the recent turnaround in profits has been a story of less spent on inputs, rather than higher prices for output. Nonetheless, there are limits to how much firms can squeeze out of existing workers. As shown in the chart, productivity growth usually surges at the outset of an economic recovery, but then falls back as more workers are added. We expect growth in real output per worker to slow to around 1.2% (annualized) over the next several quarters (for more on our economic forecast please see our *Quarterly Economic Forecast*).

The good news is that the rebound in profits means that firms are now in a good position to begin re-hiring. After shedding 8.4 million jobs, the U.S. economy will likely add 2.2 million over the course of 2010 and 4.2 million in 2011. While a lofty unemployment rate will likely continue to keep a lid on wage pressures in the near term, labor markets will begin to tighten over the course of the year and rising production and income will be more evenly split between corporate profits and wages.

The bottom line is that after a strong rebound coming out of the recession, corporate profit growth is likely to grow by 8.6% on a fourth quarter-over-fourth quarter basis in 2010, before slowing to 5.7% in 2011.



*Real output per hour worked, non-farm business sector.
Source: Bureau of Labor Statistics

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