MORNING BRIEFING
December 5, 2017

Bountiful Profits

See the collection of the individual charts linked below.

(1) Lots of GDP producing lots of profit. (2) Book profits at record high. (3) Dividends flat at record high. (4) Retained earnings recovering from energy-led profits recession. (5) Corporate cash flow at record high along with tax-based depreciation. (6) High profit margins. (7) Bottom line: Looking up. (8) Proprietor's income is 60% the size of corporate profits.

Profits I: Record Highs. The National Income & Product Accounts (NIPA) reports preliminary quarterly corporate profits along with the second revision of GDP. For Q3, that transpired on November 29, when real GDP was revised to 3.3% from the preliminary 3.0%. That solid gain followed Q2's solid gain of 3.1%. Both nominal and real GDP continue to rise into record-high territory. Not surprisingly, NIPA profits data are doing the same. Let's review the cornucopia of corporate earnings data compiled in the NIPA:

(1) *Aggregate book profits.* Pretax corporate "book" profits, i.e., as reported to the IRS, rose to a record high of $2.34 trillion (saar) during Q3 (*Fig. 1*). That's up 7.3% y/y. Corporate profits taxes totaled $476 billion (saar) (*Fig. 2*). Melissa and I have been noting of late that there is a big difference between the NIPA profits tax series and the actual corporate tax revenues collected by the IRS. The former has been consistently higher than the latter (*Fig. 3* and *Fig. 4*).

We are still looking into the reasons for this divergence. It may be that the NIPA, which are focused on measuring current production, may not reflect all the deductions used by companies to lower their actual tax bill. There may also be some issues with respect to how profits earned abroad are treated.

In any event, after-tax book profits rose to a record high of $1.86 trillion (saar) during Q3, up 10.0% y/y (*Fig. 5*). That solid gain was foreshadowed by the earlier release of S&P 500 aggregate reported earnings, which rose 11.4% y/y through Q3. By the way, S&P 500 aggregate reported earnings tends to account for roughly 50% of after-tax book profits (*Fig. 6*).

(2) *Aggregate and industry cash profits.* Again, the NIPA focus on current production since the accounts are designed to measure GDP, which is the broadest measure of the economy's current production. Therefore, the NIPA adjust profits to eliminate inventory profits and profits related to the accounting for the historical cost of depreciating capital goods and infrastructure. The inventory valuation adjustment (IVA) accomplishes the former, while the capital consumption adjustment (CCAdj) does the same for the latter (*Fig. 7*).

These two adjustments haven't changed the underlying story told by book profits. After-tax profits from current production (i.e., on a cash-flow basis) rose 7.7% y/y through Q3 to $1.74 trillion (saar), matching the previous record high during Q4-2014. This series was depressed during 2015 by the energy-led profits recession.

The NIPA show pretax profits from current production derived from domestic and foreign operations. Domestic nonfinancial and financial industries' profits remain on uptrends but below recent highs (*Fig.*

8). On a pretax and current production basis, the NIPA series for net profits from the rest of the world has been stuck around an annualized $400 billion rate since the start of the current economic expansion (*Fig. 9*). However, gross profits receipts from overseas rose to a record high of $733.3 billion (saar) during Q3.

(3) *Dividends and retained earnings.* The NIPA data show that dividends paid by all US corporations has been flat at a record high around an annualized $1.0 trillion since Q3-2014 (*Fig. 10*). Retained earnings (i.e., undistributed corporate profits on a cash flow basis including the IVA and CCAdj) has recovered in recent quarters from the energy-led profits recession (*Fig. 11*). It totaled $740 billion (saar) during Q3, still 13.0% below the record high during Q3-2010.

(4) *Cash flow.* Nevertheless, corporate cash flow rose to a record $2.38 trillion (saar) during Q3 (*Fig. 12*). This series is the sum of retained earnings and tax-reported depreciation, which rose to a record $1.64 trillion last quarter. Previously, Debbie and I have noted that while many corporations have been buying back their shares, there has been plenty of cash flow left over to fund capital spending. Besides, quite a bit of the buybacks seems to have been funded by borrowing in the bond market.

(5) *Profit margin.* While Thomson Reuters' measure of the S&P 500 operating profit margin was at a record high of 10.8% during Q3, the comparable NIPA after-tax profit margins relative to GDP remain below cyclical highs, but are still high nonetheless (*Fig. 13* and *Fig. 14*). The Q3 margin was 9.5% based on book profits and 8.9% based on cash profits. In any event, Joe and I have observed that following the Trauma of 2008, corporate managements have seemed to be much more focused than ever before on maintaining as high a profit margin as possible.

(6) *Bottom line.* The bottom line is that US corporations are in great shape.

Profits II: Proprietors' Income. Almost always ignored in discussions of corporate profits is proprietors' income, which is included in personal income on a pretax basis including the IVA and CCAdj. It is up 2.7% y/y and in record-high territory. A comparison with pretax corporate profits, also including IVA and CCAdj, shows that proprietors' income recently has approximated 60% of corporate profits (*Fig. 15* and *Fig. 16*). Here are some definitions from the NIPA:

(1) "Nonfarm proprietors' income measures the income, before deducting income taxes, of sole proprietorships, partnerships, and other private nonfarm businesses that are organized for profit but that are not classified as corporations. Sole proprietorships are businesses owned by a single individual. Partnerships include most associations of two or more of: individuals, corporations, noncorporate organizations that are organized for profit, or of other private businesses. Other private businesses are made up of tax-exempt cooperatives, including credit unions, mutual insurance companies, and rural utilities providing utility services and farm marketing and purchasing services."

(2) "Unincorporated businesses … are able to move assets freely between business and personal accounts with little, if any, reporting requirements, and tax liabilities are not separated between unincorporated businesses and their owners. In fact, the income of unincorporated businesses is generally reported on individual income tax returns; while compensation paid to employees is separately reported, the income of the business is not distinguished from the labor of the business owner and therefore reflects the incomes that accrue as a result of the owner's own labor and entrepreneurship. Similarly, dividend and interest incomes are separately reported but do not distinguish between business and personal receipts."

(3) "Reflecting the concepts of national economic accounting, nonfarm proprietors' income in the NIPAs is defined as that arising from current production."

Obviously, the wellbeing of small unincorporated businesses is an important contributor to the wellbeing of the overall economy. Corporations, partnerships, and sole proprietorships all are likely to increase their payrolls and expand their capacity when their profits are rising. They are likely to retrench when their profits are falling.

We soon should find out whether the Republicans' tax reform plans include substantial benefits, not only for corporations but for other businesses as well.

CALENDARS

US. **Tues:** Merchandise Trade Balance -$47.1b, ISM & Markit NM-PMIs 59.0/54.7. **Wed:** ADP Employment 192k, Productivity & Unit Labor Costs 3.0%/0.5%, MBA Mortgage Applications, EIA Petroleum Status Report. (*Wall Street Journal* estimates)

Global. **Tues:** Eurozone Retail Sales -0.7%m/m/1.6%y/y, Eurozone, Germany, France, and Italy Composite PMis 57.5/57.6/60.1/55.0, Eurozone, Germany, France, and Italy NM-PMIs 56.2/54.9/60.2/53.2, UK Composite & NM-PMIs 55.8/55.0, Japan & China Composite & MN-PMIs. **Wed:** Germany Factory Orders -0.2%m/m/7.0%y/y, Australia GDP 3.0%, BOC Rate Decision 1.00%. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose to yet another record high last week for all three indexes. LargeCap's forward earnings was higher for a 19th straight week, MidCap's for a 15th week, and SmallCap's for the 14th time in 15 weeks. Momentum remains strong as the yearly change in forward earnings is up from six-year lows in early 2016, and should remain strong whether the new tax rates take effect in 2018 or 2019. In the latest week, the rate of change in LargeCap's forward earnings edged down to 10.2% y/y from a 70-month high of 10.3%, which compares to a six-year low of -1.8% in October 2015; MidCap's rose to a 72-month high of 15.8% from 15.4%, which compares to a six-year low of -1.3% in December 2015; and SmallCap's dropped to 11.1% from a 16-week high of 11.4%, which compares to a 39-month high of 13.0% in mid-July and a six-year low of 0.3% in December 2015. LargeCap's consensus growth rates expected for 2017 and 2018 have remained strong throughout this year instead of falling. Furthermore, the growth rates for 2018 should improve for all three indexes if the corporate tax rate change becomes effective in 2018. Here are the latest consensus earnings growth rates for 2017 and 2018: LargeCap 11.4% and 11.2%, MidCap 10.5% and 14.3%, and SmallCap 5.3% and 20.0%.

S&P 500/400/600 Forward Valuation (*link*): Forward P/E ratios rose for all three indexes last week. LargeCap's weekly forward P/E rose to an 11-year high of 18.2 from 18.0. It's up from a 15-month low of 14.9 in January 2016 and the post-Lehman-meltdown P/E of 9.3 in October 2008, but remains well below the tech bubble's record high of 25.7 in July 1999. SMidCap's P/Es had stalled for most of 2017 following the post-election meltup, but has been rising again recently. MidCap's forward P/E rose to a 37-week high of 18.6 from 18.3, and is slightly higher than LargeCap's P/E again after being below during August and September for only the second time since 2009. MidCap's P/E remains below its 15-year high of 19.2 in late February when Energy earnings were depressed, and the record high of 20.6 in January 2002, but is up from a three-year low of 15.0 in January 2016. SmallCap's rose to a 51-week high of 20.2 from 20.0, which compares to a 15-year high of 20.5 in December 2016 when Energy's earnings were depressed. That's up from a three-year low of 15.5 in February 2016, and just 0.7ppt below SmallCap's record-high P/E of 20.9 in April 2002. Prices remain near record highs for all three indexes, but their "E"s still remain low as the bottoms-up consensus awaits final passage of the legislative and timing changes to the tax rate. Looking at their daily forward price/sales (P/S) ratios, valuations last week were mostly steady for the three indexes: LargeCap's P/S of 2.05 is down a tad from its record high of 2.06 on Thursday, MidCap's 1.33 is down from a record high of 1.39 in early March, and SmallCap's 1.05 is down from 1.08 in early March and its record high of 1.17 in November 2013.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): With the Q3 earnings season nearly 99% complete, Q4 earnings revisions activity has slowed considerably. The S&P 500's Q4-2017 EPS forecast rose two cents w/w to $34.74, and is down only 0.7% from $34.98 at the end of Q3. The $34.74 estimate represents a forecasted pro forma earnings gain for Q4-2017 of 11.6%, up from 11.5% a week earlier and compares to Q3-2017's blended estimate/actual of 8.4%, Q2's 12.3%, and Q1's 15.3% (which was the strongest growth since Q3-2011 owing mostly to easier comps for Energy). Since the end of Q3, Q4 estimates are higher for three sectors, lower for seven, and steady for one. Energy's Q4 forecast has jumped 18.0% followed by these sectors: Utilities (up 3.1%), Tech (2.0), and Telecom (0.0). Materials' Q4-2017 forecast has fallen 9.4% for the worst decline, and is followed by: Industrials (-8.9), Real Estate (-5.9), Consumer Discretionary (-5.2), Health Care (-2.3), Financials (-1.9), and Consumer Staples (-1.1). The S&P 500's Q4-2017 forecasted earnings gain of 11.6% y/y would be its sixth straight gain after four declines. Nine of the 11 sectors are expected to record positive y/y earnings growth in Q4-2017, and four are expected to beat the S&P 500's forecasted y/y earnings gain of 11.6%. That's because analysts expect Energy to report another large profit jump in Q4 relative to very low earnings a year ago. That's better than Q3-2017, when eight sectors rose y/y, but down from Q2-2017, when all 11 sectors rose y/y for the first time since Q3-2011. The latest forecasted Q4-2017 earnings growth rates vs their blended Q3-2017 growth rates: Energy (125.5% in Q4 vs 161.0% in Q3), Materials (25.9, 7.0), Tech (14.4, 24.0), Financials (14.0, -7.3), S&P 500 (11.6, 8.4), Utilities (9.3, -4.6), Consumer Staples (8.6, 4.7), Consumer Discretionary (5.6, 3.8), Health Care (4.6, 8.3), Industrials (4.0, 3.1), Real Estate (-1.0, 3.8), and Telecom (-2.1, -2.8). On an ex-Energy basis, S&P 500 earnings are expected to rise 9.3% y/y in Q4, up from 6.1% in Q3 (which was the slowest growth since ex-Energy earnings rose just 2.2% in Q2-2016) but down from gains of 9.6% in Q2 and 11.0% in Q1.

US ECONOMIC INDICATORS

Manufacturers' Orders & Shipments (*link*): Both core capital goods orders and shipments in October were much stronger than first reported in the advance durable goods report. Nondefense capital goods orders ex aircraft (a proxy for future business investment) rose 0.3% (rather than falling 0.5% as initially reported), climbing 5.4% the past four months to its highest reading since September 2014. The comparable shipments measure (used in calculating GDP) climbed for the 11th time in 12 months, up 1.1% m/m—vs 0.4% preliminary—and 9.3% y/y to its highest reading since the end of 2014. Both core capital goods orders and shipments expanded at double-digit rates of 15.5% and 14.0% (saar), respectively, during the three months ending October, based on the three-month average. Headline manufacturing orders slipped a smaller-than-expected 0.1% in October, after an upwardly revised 1.7% gain in September, first reported up 1.4%. October's decline reflected a drop in volatile aircraft orders; excluding transportation, orders rose for the fifth month, by 0.8% m/m and 3.1% over the period.

GLOBAL ECONOMIC INDICATORS

Japan Consumer Confidence (*link*): Consumer confidence in November reached a 50-month high, boosted by surging stock prices and a robust job market. The consumer confidence index is up 3.8 points since its recent low last November to 44.9—the best reading since September 2013. All four components have contributed to the upswing in confidence. Over the past 12 month through November, income growth (to 43.0 from 40.6 y/y) climbed to its highest level since May 2007, while employment (49.3 from 43.3) and willingness to buy durable goods (44.0 from 40.8) were both at their best readings since September 2013; the overall livelihood (43.2 from 39.8) component continued to bounce around its recent high recorded earlier this year.

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