



MORNING BRIEFING

August 12, 2019

What's the Matter With Profits?

See the [collection](#) of the individual charts linked below.

(1) Record Chinese exports despite global slowdown. (2) OECD economies bottoming? (3) US labor market remains strong. (4) Annual revisions don't change big picture on GDP, but profits are weaker than before. (5) Compensation revised higher. (6) S&P 500 aggregate earnings don't get revised and are in record-high territory. (7) So why the downward revision in NIPA profits if S&P 1500 earnings remains strong? (8) Sub-chapter S corporations have a big impact on profits-related comparisons. (9) Profits' share of National Income down, while compensation's share is up. (10) S&P 500 profit margin and comparable NIPA measure diverging in recent years. (11) Fruit cocktail vs orange juice. (12) Warning label.

Global Economy: Hitting Bottom? Just after the gloom about the gloomy global economic outlook got gloomier at the beginning of last week, it got less gloomy later in the week. Last Thursday, we learned that China's merchandise exports rose 10.4% y/y to a record high in yuan, based on seasonally adjusted data ([Fig. 1](#) and [Fig. 2](#)).

Also on Thursday, the OECD reported a better-than-expected reading for the composite leading indicator for the 36 member countries of this organization. It held steady at 99.1 in June, beating expectations of another decline ([Fig. 3](#)). Our friends at Moody's Analytics' website Economy.com reported: "The headline suggests that growth momentum should remain stable in the OECD area as a whole, but the geographical breakdown was less upbeat, showing that growth is expected to slow further in the U.S., Germany and the euro zone as a whole. For most of the other major economies—such as France, Italy, Canada, Japan, and Brazil—the CLI pointed towards a steady pace of expansion. The only standouts were China and the U.K., whose indexes rose slightly over the month. We caution that Brexit means there is huge uncertainty over the U.K. forecasts, especially as a no-deal exit on October 31 is still on the table."

Last Thursday as well, Japan's real GDP was reported showing an increase of 1.8% (saar) during Q2. That was a solid showing, though it was lower than the 2.8% gain in the previous quarter. However, boosting Japan's economy is consumer spending in advance of a consumption tax hike scheduled for October. That suggests that consumer spending could weigh on economic growth during Q4 and next year.

Also on Thursday, in the US, initial unemployment claims was reported at 209,000 during the 8/3 week, near recent historical lows. On Tuesday, June's JOLTS report showed job openings (at 7.35 million) exceeding the number of unemployed workers (at 5.98 million during June) for the 16th month in a row ([Fig. 4](#)). There's no gloom in the US labor market.

Profits I: Big Downward Revision in NIPA. At the end of July, the Bureau of Economic Analysis released its *2019 Annual Update of the National Income and Product Accounts* (NIPAs). Updated estimates of the NIPAs are usually released in July. They incorporate newly available and more comprehensive source data, as well as improved estimation methodologies. The timespan of this year's update is Q1-2014 through Q1-2019.

The report states: "The picture of the economy presented in the updated estimates is very similar to the picture presented in the previously published estimates." That's true for real GDP. That's not the case for corporate profits.

The key takeaway is that NIPA data are complicated and can be misleading if not properly understood and interpreted. The revisions in the data can occasionally paint a significantly different picture of the economy than the preliminary data.

First, here's real GDP: "From 2013 to 2018, real GDP increased at an average annual rate of 2.5 percent; in the previously published estimates, real GDP had increased at an average annual rate of 2.4 percent. When measured from the fourth quarter of 2013 to the fourth quarter of 2018, real GDP increased at an average annual rate of 2.4 percent, the same as previously estimated." Now for the profits shocker:

(1) *Pre-tax book profits.* The revisions reduced corporate profits before taxes as reported to the IRS, especially since mid-2016 ([Fig. 5](#)). Q1-2019 was revised down by \$165 billion from \$2.2 trillion (saar) to \$2.0 trillion, and is now down 1.4% y/y rather than up 3.3%, as previously reported ([Fig. 6](#)).

(2) *After-tax book profits.* On an after-tax basis, book profits (i.e., as reported to the IRS) was revised down most sharply since early 2018, when it was slashed by \$413 billion for the year ([Fig. 7](#)). For Q1-2019, profits was cut by \$142 billion at an annual rate. Before the revision, Trump's corporate tax cut had boosted after-tax book profits to new highs last year. That's no longer the case, as the new estimates for Q1-2018 through Q1-2019 are all below 2017's readings.

(3) *Profits from current production.* Another measure of corporate profits is used in calculating National Income as well as corporate cash flow. It is called "profits from current production," and it adjusts book profits by including the Inventory Valuation Adjustment (IVA) and Capital Consumption Adjustment (CCAdj). These two adjustments restate the historical cost basis used in profits tax accounting for inventory withdrawals and depreciation to the current cost measures used in GDP.

During Q1, on an after-tax basis, the cash-flow measure of profits was revised down by \$221 billion to \$1,791 billion (saar) during Q1-2019, a decline of 2.9% y/y rather than an increase of 2.4% ([Fig. 8](#)). It remained in record-high territory last year thanks to Trump's tax cut, but less so after the revisions.

National Income showed little revision until Q1-2019, when it was revised higher by only \$110 billion (saar) to \$17.9 trillion. So the downward revisions in profits were mostly offset by

upward revisions in some of the other components of National Income. Here are their upward revisions just during Q1-2019: compensation (\$237 billion), net interest (\$103 billion), and proprietors' income (\$17 billion) ([Fig. 9](#)).

Profits II: S&P 500 Earnings Still Strong. Debbie and I regularly compare NIPA's after-tax book profits measure to aggregate S&P 500 reported net income, which is based on GAAP and never gets revised ([Fig. 10](#)). As a result of the revisions, the former has now been flat around \$1.8 trillion since Q1-2012 through Q1-2019. On the other hand, the S&P 500 measure of aggregate profits is up 40% over this same period.

The S&P 500 measure has tended to account for roughly 50% of the NIPA measure ([Fig. 11](#)). It accounted for 63.3% during Q1.

Since most of our efforts in forecasting the stock market are focused on the S&P 500 stock price index, we pay more attention to the S&P 500 data on earnings than on NIPA profits. We can add the earnings of the S&P 400 MidCaps and the S&P 600 SmallCaps to the earnings of the S&P 500 LargeCaps to get closer to the all-encompassing NIPA measure. However, they don't add much to earnings. The S&P 500 tends to account for about 91% of S&P 1500 aggregate earnings ([Fig. 12](#)).

Profits III: The Impact of S Corporations. So what gives? If S&P 500 aggregate earnings remains strong, why the downward revision in NIPA profits?

According to the *NIPA Handbook*, corporate profits includes all US public, private, and "S" corporations. It also includes other organizations that do not file federal corporate tax returns—such as certain mutual financial institutions and cooperatives, nonprofits that primarily serve business, Federal Reserve banks, and federally sponsored credit agencies.

Most of the difference between the NIPA measure of profits and the S&P measure is attributable to sub-chapter S corporations and private corporations. So most of the downward revision in NIPA profits must be attributable to them. We don't have the data on private corporations that is included in profits. We do have some data for S corporations, though the available series is only through 2015, which means it isn't relevant to the latest revisions for 2016-2018. Nevertheless, consider the following:

(1) *Definition.* On its website, the IRS [explains](#) the difference between C and S corporations: "A C corporation is taxed on its earnings, and then the shareholder is taxed when earnings are distributed as dividends. S corporations elect to pass corporate income, losses, deductions and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the pass-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income."

As a result, most of the income of S corporations is paid out as dividends.

(2) *Impact on National Income shares.* The IRS estimates that there were 4.6 million S corporation owners in the US in 2014—over twice the number of C corporations. The IRS data on S corporation dividends and the BEA data on pre-tax corporate profits show that the ratio of the two has increased from 8%-9% during 1992 to about 20% from 2000-2015 ([Fig. 13](#)).

This suggests that S corporations have had a significant impact on exaggerating the increase in corporate profit's share of National Income over this period. Obviously, I am assuming that S corporation dividends are more like labor compensation than profits. Excluding these dividends from profits shows that this adjusted measure's share of National Income has been relatively flat around 9%, while the all-inclusive measure has been trending higher from 1992 to 2015, which is the latest available data for S corp dividends ([Fig. 14](#) and [Fig. 15](#)).

(3) *Impact on effective corporate tax rate.* Since S corporations tend to distribute most of their earnings to their limited number of shareholders as dividends, which are then taxed as personal income, they boost corporate profits even though they actually directly benefit the employees of the S corporations. This also explains why NIPA's effective corporate tax rate has been well below the statutory rate.

Profits IV: Tale of Two Margins. The downward revision in NIPA profits obviously lowered both the profits share of National Income as well as profit margin measures based on the NIPA data. Consider the following:

(1) *National Income shares.* The revised NIPA data now show that the share of pre-tax profits from current production in National Income has declined from a cyclical high of 14.5% during Q1-2012 to 11.2% (down from the preliminary 12.6%) during Q1-2019 ([Fig. 16](#)). That's the lowest share since Q2-2009.

On the other hand, over the same period, the labor compensation share has increased from 60.4% to 63.1% (up from the preliminary 62.2%), the highest since Q4-2009 ([Fig. 17](#)).

(2) *Profit margins.* Data on the S&P 500 profit margin is available since Q1-1992 ([Fig. 18](#)). We found that it has been correlated with a NIPA proxy for the profit margin, i.e., after-tax corporate book profits divided by nominal GDP, most of the time. That has not been the case in recent years, as the former has been moving higher while the latter has been moving lower.

During Q1-2019, the S&P 500 profit margin was 10.3% using reported earnings and 11.6% using operating earnings ([Fig. 19](#)). Both are near last year's record highs.

(3) *Bottom line.* The conclusion is that comparing NIPA profits and S&P 500 earnings is like comparing apples and oranges. Actually, the NIPA measure is more like a fruit cocktail with lots of different fruit juices. That makes it hard to explain the latest NIPA revisions, especially since the S corp data are only available through 2015. For those of us in the stock market, what matters—and remains bullish—is the trend in the S&P 500 earnings.

(4) *Warning label.* The above analysis of the relationship of NIPA and S&P profits was inspired by several recent email queries about their divergence from our accounts. To repeat: The key

takeaway is that NIPA data are complicated and can be misleading if not properly understood and interpreted. The revisions in the data can occasionally paint a significantly different picture of the economy than the preliminary data. The NIPAs should come with a warning label: “The following data are prone to misinterpretation if not carefully analyzed, and may be revised significantly from time to time.”

CALENDARS

US. Mon: Monthly Federal Budget -\$120.0b. **Tues:** NFIB Small Business Optimism Index 104.0, Headline & Core CPI 1.7%/2.1% y/y, NY Fed Q2 Household Debt & Credit Report. (DailyFX estimates)

Global. Mon: None. **Tues:** Germany ZEW Survey Current Situation & Expectations -5.9-/28.0, Germany CPI 0.5%/m/m/1.7%/y/y, UK Employment Change 62k 3m/3m, UK Unemployment Rate (3-mth) 3.8%, Japan Machine Tool Orders -1.1%/m/m/-1.0%/y/y. (DailyFX estimates)

STRATEGY INDICATORS

Global Stock Markets Performance ([link](#)): Last week saw the US MSCI index fall 0.4% to 3.6% below its 7/27 record high. The AC World ex-US dropped 1.4% for the week and is nearing a bear market again at 17.1% below its record high in January 2018. The US MSCI's weekly performance ranked 20th among the 49 global stock markets we follow in a week when only 15 of the 49 countries rose in US dollar terms. That compares to the prior week's 24/49 ranking, when the US MSCI fell 3.2% as just three markets rose in the broadest underperformance since early October. Among the regions, EM Latin America was the sole gainer last week with an increase of 0.2%. Also outperforming the AC World ex-US last week: EM Eastern Europe (-0.1%), EMU (-0.6), EAFE (-1.3), and EMEA (-1.3). The regions underperforming last week: EM Asia (-2.6) and BRIC (-2.1). Argentina was the best-performing country with a gain of 6.3%, followed by Hungary (3.8), Egypt (3.3), Sri Lanka (1.7), and Denmark (1.2). Of the 18 countries that underperformed the AC World ex-US MSCI last week, Pakistan fared the worst, falling 9.5%, followed by South Africa (-5.4), the Philippines (-5.0), Greece (-5.0), and Korea (-4.2). The US MSCI's ytd ranking fell one place last week to 9/49, with its 16.8% ytd gain nearly triple that of the AC World ex-US (6.2). All regions and 36/49 countries are in positive territory ytd. The regions that are outperforming the AC World ex-US ytd: EM Eastern Europe (10.7), EM Latin America (7.8), EMU (7.7), and EAFE (7.0). EM Asia (0.4) is the biggest laggard ytd, followed by BRIC (4.8) and EMEA (6.2). The best country performers ytd: Argentina (29.8), Egypt (25.7), New Zealand (20.8), Switzerland (19.4), and Russia (19.2). The worst-performing countries so far in 2019: Pakistan (-25.3), Chile (-10.9), Poland (-9.9), Korea (-9.6), and Malaysia (-5.1).

S&P 1500/500/400/600 Performance ([link](#)): All of these indexes fell last week for the third time in four weeks. LargeCap's 0.5% fall was a tad less than the drops recorded by MidCap (-0.7%) and SmallCap (-0.8). LargeCap ended the week 3.5% below its 7/26 record high of 3025.86, and MidCap weakened to 7.3% below its 8/29 record high. SmallCap remained in a correction at 15.3% below its 8/29 record after narrowly averting a bear market at the end of May. Just 11 of the 33 sectors moved higher last week compared to five rising a week earlier. Last week's

best performers: LargeCap Real Estate (1.8), MidCap Real Estate (1.5), SmallCap Real Estate (1.2), LargeCap Utilities (1.0), and LargeCap Materials (0.7). MidCap Energy (-8.3) was the biggest decliner, followed by SmallCap Communication Services (-5.0), SmallCap Energy (-4.8), MidCap Communication Services (-4.1), and LargeCap Energy (-2.2). In terms of 2019's ytd performance, all three indexes are still recording double-digit percentage gains for the year, but barely so for SmallCap. LargeCap leads with a gain of 16.4% ytd, just 2.1ppts ahead of MidCap (14.3) and well ahead of SmallCap (10.2). Thirty-one of the 33 sectors are positive ytd, with the cyclicals leading the top performers: LargeCap Tech (26.3), MidCap Tech (26.2), LargeCap Real Estate (23.8), SmallCap Tech (21.8), and LargeCap Communication Services (19.6). MidCap Energy (-25.7) is the biggest decliner so far in 2019, followed by these underperformers: SmallCap Energy (-16.8), SmallCap Communication Services (2.1), LargeCap Energy (2.8), and MidCap Consumer Staples (3.0).

S&P 500 Sectors and Industries Performance ([link](#)): Four of the 11 S&P 500 sectors rose last week as six outperformed the S&P 500's 0.5% drop. That compares to two rising a week earlier, when five outperformed the S&P 500's 3.1% decline. Real Estate was the best-performing sector with a gain of 1.8%, ahead of Utilities (1.0%), Materials (0.7), Health Care (0.4), Consumer Staples (0.0), and Consumer Discretionary (0.0). Last week's underperformers: Energy (-2.2), Financials (-1.7), Information Technology (-0.8), Communication Services (-0.6), and Industrials (-0.6). All 11 sectors are still higher so far in 2019, compared to just two sectors rising during 2018, when the S&P 500 fell 6.3%. These six sectors have outperformed the S&P 500's 16.4% rise ytd: Information Technology (26.3), Real Estate (23.8), Communication Services (19.6), Consumer Discretionary (19.4), Industrials (17.0), Consumer Staples (16.7). The ytd laggards: Energy (2.8), Health Care (5.6), Financials (13.6), Materials (14.2), and Utilities (14.8).

Commodities Performance ([link](#)): Last week, the S&P GSCI index fell 1.9% as 14 of the 24 commodities moved higher. That compares to a 2.2% decline a week earlier when just two commodities rose in the broadest underperformance since December 2017. The index had nearly climbed out of a correction during mid-April, recovering to a drop of 10.0% from its high in early October after being down as much as 26.9% from that high on 12/24. It's back in a bear market now at 20.5% below its October high. Nickel was the strongest performer for the week as it rose 7.3%, ahead of Lead (6.0), Silver (4.6), Corn (3.8), and Gold (3.5). Unleaded Gasoline was the biggest decliner, with a drop of 11.2%, followed by Brent Crude (-5.8) and Zinc (-5.2). The S&P GSCI commodities index is up 6.8% ytd following a decline of 15.4% in 2018. The top-performing commodities so far in 2019: Nickel (46.0), Unleaded Gasoline (21.5), Crude Oil (19.8), Gold (17.7), and Corn (10.6). The biggest laggards in 2019: Natural Gas (-27.6), Cotton (-18.4), Live Cattle (-13.8), and Kansas Wheat (-12.7).

S&P 500 Technical Indicators ([link](#)): The S&P 500 price index fell 0.5% last week and continued to test its short-term 50-day moving average (50-dma) for the first time since the end of May. However, the index remained well above its long-term 200-day moving average (200-dma). The index's 50-dma relative to its 200-dma rose for 25th time in 26 weeks to a 16-month high, forming a Golden Cross for a 20th week after 16 weeks in a Death Cross formation. The index had been in a Golden Cross for 137 weeks through late November, and its previous Death Cross lasted for 17 weeks through April 2016 (when its 50-dma bottomed at a then-four-

year low of 4.5% below its 200-dma in March 2016). The current Golden Cross reading of 5.3% is up from 5.1% a week earlier and from -5.2% in early February, which had matched the lowest reading since November 2011. It's still down from a 55-month high of 7.2% in February 2018. The S&P 500's 50-dma rose at a slower rate as the price index fell to 0.7% below its 50-dma from a hair above its 50-dma a week earlier. It had peaked recently during mid-July at a 19-week high of 4.3%. That was up from a 22-week low of 4.2% below its falling 50-dma at the end of May, but down from 6.6% above during mid-February, which was its highest since October 2011. The 200-dma rose for a ninth week, but at a slightly slower pace. It had been rising for 16 weeks through mid-May after falling from October to February in the first downtrend since May 2016 (when it had been slowly declining for nine months). The index traded above its 200-dma for a tenth week, but was down to an eight-week low of 4.8% above its rising 200-dma from 5.1% a week earlier and from a 17-month high of 8.8% at the end of July. That compares to 14.5% below its falling 200-dma on 12/24, which was the lowest since April 2009, and remains well below the seven-year high of 13.5% above the index's rising 200-dma during January 2018.

S&P 500 Sectors Technical Indicators ([link](#)): Four of the 11 S&P 500 sectors traded above their 50-dmas last week, down from six a week earlier as Financials and Tech moved below. The four sectors still trading above their 50-dmas: Communication Services, Consumer Staples, Real Estate, and Utilities. All 11 sectors had been below their 50-dmas in early January. The longer-term picture—i.e., relative to 200-dmas—shows 10 sectors trading above currently, unchanged from a week earlier. Energy was below for a fourth week after being above for a week for the first time since early October. Ten sectors are in the Golden Cross club (with 50-dmas higher than 200-dmas), unchanged from a week earlier and compared to just two in February and all 11 in January 2018. Energy is the sole laggard, not having been in a Golden Cross for 38 straight weeks. All 11 sectors have rising 50-dmas now, up from 10 a week earlier as Energy moved higher for the first time in four weeks. Ten sectors have rising 200-dmas, unchanged from a week earlier; Energy has had a mostly falling 200-dma for more than eight months. That compares to just two sectors with rising 200-dmas in early January, in what was then the lowest count since all 11 sectors had falling 200-dmas two years before.

US ECONOMIC INDICATORS

PPI ([link](#)): The Producer Price Index for final demand ticked up 0.2% in July after gains of 0.1% in each of the prior two months, with the yearly rate holding at 1.7% y/y—the lowest since January 2017. Prices for final demand goods rebounded 0.4% last month, following declines of 0.4% and 0.2% the prior two weeks—with over half July's gain attributed to a 5.2% jump in gasoline prices. The yearly inflation rate for final demand goods (0.4% y/y) remained around zero for the third month; it was at 4.4% a year ago. Meanwhile, prices for final demand services slipped 0.1%, after a five-month gain of 1.3%, with a decline in the price for guestroom rentals a major factor. The services rate edged down to 2.3% y/y, matching its recent low in March; it peaked at 3.0% at the end last year. Meanwhile, there's no deflation in the pipeline: Intermediate goods prices fell 2.0% y/y in July—holding at June's rate with the steepest decline since August 2016; the crude price was 10.4% below a year ago, its second straight double-digit decline.

GLOBAL ECONOMIC INDICATORS

Global Leading Indicators ([link](#)): In June, the OECD's composite leading indicators (CLIs)—designed to anticipate turning points in economic activity relative to trend six to nine months ahead—pointed to stable growth momentum in the OECD area as a whole, an upgrade from signs of stabilizing growth momentum in May, which was an upgrade from April's assessment of easing growth momentum. June's OECD's CLI was unchanged at 99.1, which was the lowest level since October 2009. Among the major OECD economies, France's CLI (99.2) continues to point to stable growth momentum, which now is the case for Canada (98.9) as well. Meanwhile, signs of stabilizing growth momentum remain the assessment for Japan (99.3), with similar signals now emerging in Italy (99.0), an upgrade from easing growth momentum in May. CLIs for the US (98.8), Germany (98.7), and the overall Eurozone (99.0) are still predicting an easing of growth momentum. Brexit uncertainties make the UK's direction harder to predict, though June's survey shows growth momentum is expected to remain stable—albeit at historically low trend rates. Among the major emerging economies, stable growth momentum is still the expectation for China's (98.9) industrial sector, though the recent rise in trade tensions introduces an air of uncertainty. Stable growth momentum is still the assessment for India (100.2) and Russia (99.4), with similar signs now emerging in Brazil (102.2).

UK GDP ([link](#)): Economic growth posted its first quarterly contraction since Q4-2012 during Q2, heightening recession concerns leading up to the new 10/31 Brexit departure date. Real GDP fell 0.2% last quarter, slowing from Q1's 0.5% expansion—which was boosted by an unprecedented stockpiling by manufacturers in the run-up to the initial 3/29 Brexit deadline. Two of the three major industry groupings posted declines last quarter, while the service sector showed little gain. Service industries (which account for about 80% of the private-sector economy) expanded only 0.1% during Q2, slowing for the third straight quarter—which averaged quarterly gains of 0.5%. Meanwhile, production industries (which include manufacturing) contracted 1.4% during Q2, the steepest decline since Q4-2012, as manufacturing activity plummeted 2.3%, driven by the biggest fall in car production on record during the month of April, as factories were unable to reverse the closures planned for when they had expected Britain to leave the EU. Construction activity fell 1.3% last quarter following a 1.4% gain and a 0.5% loss the prior two quarters.

UK Industrial Production ([link](#)): Output has lost momentum since reaching a cyclical high in March. Headline production edged down 0.1% in June after a 1.2% gain and a 3.1% loss the prior two months; output advanced 2.4% during the first three months of the year. Manufacturing production contracted 3.2% during the three months through June after expanding 3.6% during the three months through March. Over the past three months, capital (-2.5%), intermediate (-2.5), consumer durable (-2.9), and consumer nondurable (-5.0) goods production all were in the red. IHS Markit's M-PMI in July remained stuck at a 6.5-year low of 48.0, the third reading below 50.0—the demarcation line between contraction and expansion. The UK manufacturing sector is battling slower global growth, political uncertainty, and the unwinding of earlier Brexit stockpiling. According to the report: "Production volumes fell at the fastest pace in seven years last month as clients delayed, cancelled or re-routed orders away from the UK, leading to a further decline in new work intakes from both domestic and overseas

markets.”

France Industrial Production (*link*): Output in June posted its largest decline since January 2018, while July’s M-PMI revealed overall manufacturing activity swung from expansion to contraction. Headline production, which excludes construction, sank 2.3% in June after a two-month increase of 2.5%, pushing the ytd change near zero. Manufacturing output fell for the third time this year, losing 2.2% in June and dipping below zero ytd. All of the main industrial groupings contracted in June, led by energy (-3.7%) and consumer nondurable goods (-3.1) output, followed by capital (-2.8), consumer durable (-2.1), and intermediate (-0.3) goods production. IHS Markit’s July survey shows France’s M-PMI fell from 51.9 in June to 49.7 in July, with both production and orders contracting. The deterioration in overall new business was partially driven by falling foreign demand. Some survey participants linked the latest decrease to the ongoing slowdown in the automotive sector.

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