Investment Insights

Has Corporate America Entered a 'New Normal' of Higher Profits?

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With significant research and analysis by the Americas Equity Asset Class Team

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Introduction

Wall Street profitability has soared in 2018, boosted in part by tax cuts approved near year-end 2017. But other factors are at play, some of which—some market observers have suggested—may be structural changes that could permanently boost profits. We're always skeptical of the "this time is different" argument, so we looked carefully at four factors that may explain higher profit margins at U.S. firms. We found some cause for margins to be higher, but over time—assuming U.S. interest rates and labor costs abroad continue to rise—we expect margins to eventually retreat.

Key Takeaways

- We studied four areas that arguably could contribute to a secular shift in the profitability of U.S. corporations.
- We found that the rising prevalence of tech companies appears to be a structural shift having a meaningful impact on overall market profit margins. Other factors, however, appear to us to be poised to effect mean-reversion on margins.
- Overall, we see no reason to change our long-term assumptions for valuing equity markets.

On the Up and Up?

Consider this opening paragraph from a recent CNN news story:[1] "Corporate America is growing *practically nonstop* thanks to massive tax cuts and a booming economy" (emphasis added).

Hyperbole like this usually sounds alarm bells in our ears. To date, no tree has grown to the sky, and bull runs have always run out.

We're also cautious of "this time it's different" arguments, especially at this point in the cycle. Investors can be so eager to keep the good times going that they often deceive themselves into rationalizing an analytical approach that justifies even higher prices.

We, however, prefer to stay grounded in rational valuation estimates based on fundamentals. And for some time, our analysis of the fundamentals has told us that U.S. stock prices in aggregate have run well ahead of their fundamentals. Yet, when the fundamentals change, we need to be prepared to change our minds.

Other asset managers recently have made just that point—that the fundamentals underlying U.S. profit margins have changed, specifically in four areas. In other words, there are four arguments for higher margins in the future:

1. Market Composition: Technology companies are claiming a larger slice of the market pie, and these companies are currently more profitable than others.
2. Rising Rates: Lower rates made the cost of debt cheaper for leveraged companies, boosting their profits. But will it continue?
3. Higher Concentration: The presence of more monopolistic firms means the market will more likely operate above its cost of capital.
4. Globalization: Operating worldwide should raise revenue and lower labor costs, and companies with sustainable competitive advantages won't need to pass these benefits on to customers.

We'll take these arguments in turn.

Tech to the Fore

There's something to this market compensation argument. Information technology became the largest sector in the Russell 3000 Index more than two decades ago, but in that time has continued to take market share from every other sector but financials and energy (see Exhibit 1).

1 Egan, M. 2018. "Corporate America is raking in fat profits. Will it last?" *CNN*. Aug. 13, 2018. https://money.cnn.com/2018/08/13/investing/earnings-season-stock-market/index.html

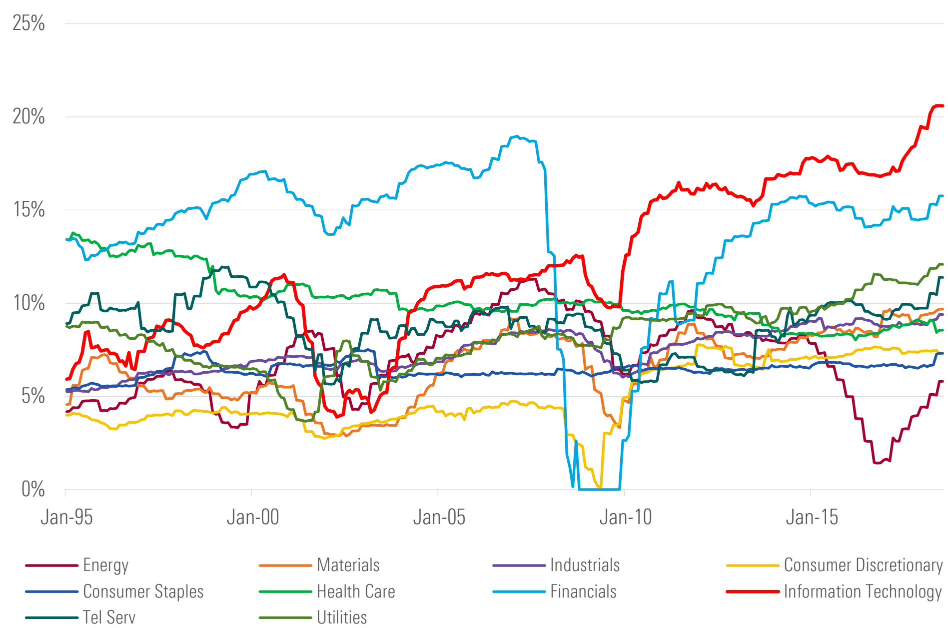
Exhibit 1 U.S. Stock Market Increasingly Dominated by Tech Companies

	12/31/1989	07/31/2018	Net Change
Consumer Discretionary	17.5%	12.9%	-4.6%
Consumer Staples	14.5	6.2	-8.3
Energy	3.5	5.9	2.4
Financials	9.3	18.2	8.9
Healthcare	11.6	14.1	2.6
Industrials	14.4	10.6	-3.8
Information Technology	**9.3**	**24.4**	**15.1**
Materials	8.0	3.1	-5.0
Telecom	2.1	1.8	-0.3
Utilities	9.8	2.9	-6.9

Source: Morningstar Direct[SM]. U.S. stock market represented by the Russell 3000 Index.

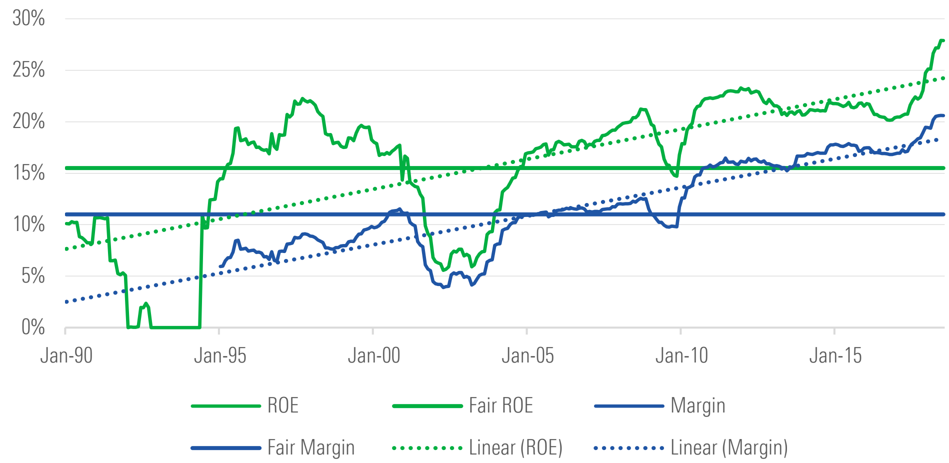
Meanwhile, the tech sector has become the most profitable (see Exhibit 2) and has become more profitable over time (Exhibit 3).

Exhibit 2 Tech Firms Have Been the Most Profitable [%] Sector in the Market



Source: Morningstar Direct[SM]. U.S. stock market represented by the Russell 3000 Index. GICS sector weight trendline data as of 07/31/2018.

Exhibit 3 Tech Firms' Profitability Has Enjoyed an Upward Slope



Source: Morningstar Direct[SM]. Tech sector represented by the S&P 500 Technology Index. Data as of 07/31/2018.

The tech sector has seen strong growth, with six of the top 10 fastest growing industries within it. Tech stocks also tend to be more likely to carry a Morningstar Economic Moat Rating for having greater competitive advantages.

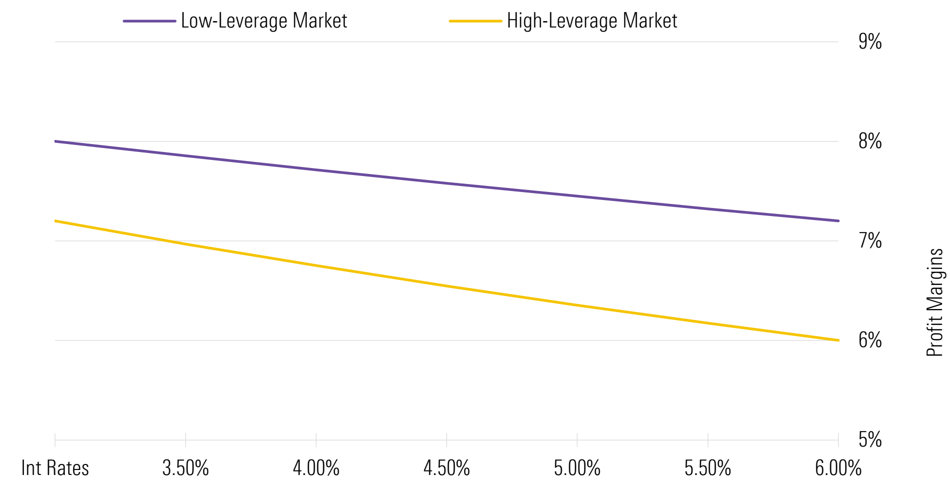
Taken together, these factors lead us to believe that the market composition issue appears to be a structural shift that's already having meaningful impact on investors.

Rising Rates Should Put Pressure on Margins

Rates can have a profound impact on profits, especially for leveraged companies. Historically low interest rates since 2009 have lowered the cost of debt financing, but rates have begun to rise and appear poised to continue to climb. How might rising rates—the levels of which are still well below long-run averages—dent corporate profits?

We did some sensitivity testing to look at the relationship between rates and margins and estimate that, for every half-point of rate increase, margins might be expected to contract by 10 to 20 basis points (see Exhibit 4). Given our expectations for higher rates, we expect margins might be lowered by nearly 1% for a high-leverage company and half that for a low-leverage firm.

Exhibit 4 Rising Rates Should Lower Profit Margins, Especially for Firms With Higher Leverage



Source: Morningstar Investment Management estimates as of 09/15/2018.

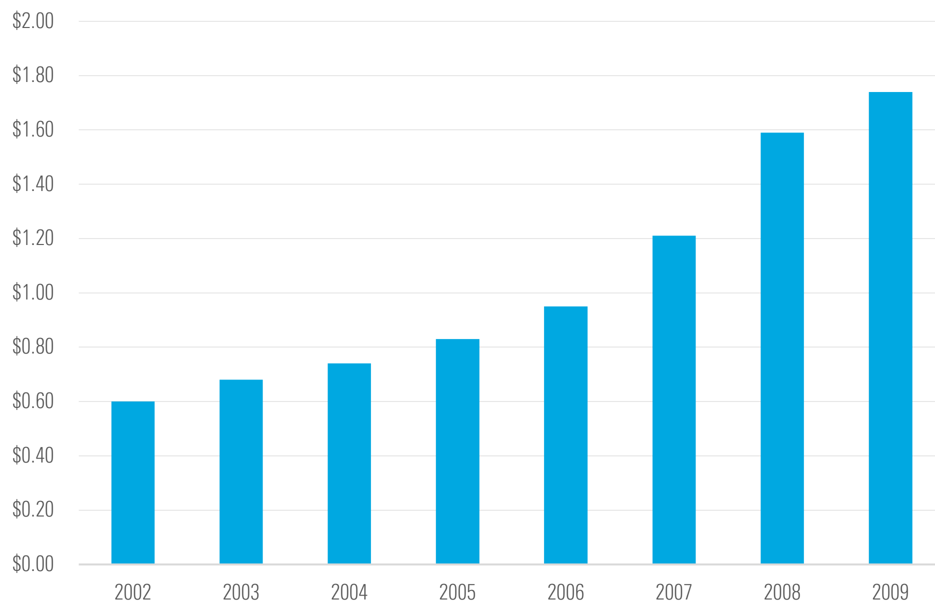
Concentration and Margins: A tenuous connection

We found that the U.S. market as a whole has not grown appreciably more concentrated in recent years. A handful of industries look quite concentrated domestically, but in those cases major foreign competitors provide significant competition. Partly for that reason, the correlation between concentration and profitability within U.S. industries is weak. We therefore concluded that the evidence did not support adjusting our U.S. fair margins based on market concentration alone. However, our research in this area left us with a tool to measure global concentration, which can be incorporated into our fundamental research on global sectors and global industries.

Globalization May Prove to Drag on Margins

It's a well-known story that multinational firms have been able to lower labor costs by moving jobs overseas, and this has boosted margins. But compensation costs abroad have steadily risen. Exhibit 5 shows rising labor costs in China, but we see similar data elsewhere. We see no compelling reason to expect global wages to further drive margin improvements for U.S. companies. In fact, we believe profits would more likely moderate as labor costs continue to increase.

Exhibit 5 Average Hourly Compensation Costs in U.S. Dollars of Manufacturing in China



Source: U.S. Bureau of Labor Statistics, International Labor Comparisons. Data: 2002-2009.

We Don't See a 'New Normal' for U.S. Margins

Apart from the rising importance and profitability of tech companies on the U.S. market, we see most of these arguments from their opposing viewpoint—that, if anything, these factors will likely contribute to the mean-reversion of profitability for U.S. companies rather than being arguments for higher margins. Specifically, we believe rising rates and labor costs abroad could help bring today's lofty profits back to earth.

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