Standard Life Investments

Weekly Economic Briefing
Global Overview

Diverging corporate fortunes
22 July 2014

The profitability of firms matters a lot for the overall economy. When profits are weak, firms hire less, pay lower wages and are less likely to invest for the future. Unfortunately, comparing profit trends internationally is not easy since the listed sector varies in size across countries and does not cover the whole economy. Even national accounts measures of corporate profits are not always compiled on the same basis. The most comparable measure is something called gross operating surplus (GOS). GOS is essentially the gross output of firms less the cost of intermediate goods and services as well as the compensation of employees.

When we compare the trends in the growth rate of GOS between the US and the Euro-zone, we can see that American firms have been in better shape than their European counterparts for a long time (see chart 1). Since the beginning of 1995 (the earliest the data are available for the Euro-zone), GOS has grown at annualised rate of 5.1% in the US, compared with 3.3% in the Euro-zone. This also helps to explain why nominal GDP growth has been weaker in the Euro-zone over the same period (3.2% versus 4.5%). Although post-crisis profits have been weaker than their pre-crisis profits in all the major economies, the deterioration has been more pronounced in Europe than elsewhere. Whereas GOS growth has averaged 3.3% in the US since the beginning of 2007, it has dropped to just 0.9% in the Euro-zone and 1.2% in the UK. The upshot is that, while the US profit share is above its pre-crisis peak, the profit shares in the Euro-zone and UK are well below their peaks. Little wonder then that wage growth remains tepid in both economies. More recently there has been meaningful improvement in corporate profitability on this side of the pond. The annual rate of GOS growth has picked up to 3.5% in the UK and 2.2% in the Euro-zone. However, looser policy, further relative wage adjustment and economic reform will be necessary if Euro-zone corporate sectors are to return to their former glory. Meanwhile, profit growth in the US took a dive in the first quarter, having previously been on a healthy upward trend. In our view, that was more to do with the weather than any genuine change in the corporate outlook, therefore we expect a rebound in the coming quarters.

Chart 1: Euro-zone corporates underperform

Source: Eurostat, Bureau of Economic Analysis (as of Q1 2014)

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Cautious corporates

It will come as little surprise to hear that **the corporate sector in the Euro-zone has had a tougher time than many of its international peers over recent years.** The Gross Operating Surplus (GOS) and mixed income of the corporate sector fell for four consecutive quarters over 2012 as the debt crisis raged. Since then we have seen a moderate improvement in this measure of corporate profits as economic conditions stabilise. Indeed, aggregate corporate profits were up 2.2% year-on-year (y/y) in Q1, from just 0.7% y/y at the start of 2013, although this only represents around half of the pre-crisis average (see chart 6). These figures are nominal, which means that the weak inflation environment is part of the story here. Harmonised inflation across the euro area was confirmed at 0.5% y/y in June and anaemic price growth is expected to weigh on corporate profits over coming quarters. Meanwhile, we expect underlying profit growth to improve only slowly as the recovery remains subdued in the Euro-zone. Industrial activity indicators have softened over Q2 and there have been few signs of any meaningful acceleration following the disappointing Q1 GDP print of 0.2% quarter-one-quarter (q/q). **A combination of weak inflation and a slow recovery make it unlikely that - in the near term at least - we will see a return to corporate profits around the 4-5% mark seen before the crisis.** Further forward we will need to see accelerating economic reforms as well as looser policy to change this story.

The breakdown of these data by member state provides a predictable reminder of the scale of cross country divergence within the currency union (see chart 7). The GOS for the German corporate sector has accelerated to over 5% y/y, in spite of weak inflation in this economy. Other countries have seen a less pronounced bounce, although the trend has been generally higher. The GOS in the French corporate sector improved to 3.1% y/y in Q1, while the Italian equivalent stumbled slightly to a still positive 1.4% y/y. In Spain, corporate profit growth remained negative at -0.2% q/q in Q1, although part of this relative weakness was likely caused by the weaker inflation environment, with prices having stagnated over the quarter.

While we expect corporate sectors in the UK and US to continue taking a more expansionary stance as the outlook for profits improves, Euro-zone corporates are likely to be more cautious. Measures of capacity utilisation are running comfortably below pre-crisis rates and private sector debt burdens remain large in many parts of the currency union. Outstanding loans to non-financial corporations continue to decline. This likely represents a combination of both weak credit demand and continued balance sheet adjustment in the banking sector as the European Central Bank (ECB) carries out its Comprehensive Review (CR). Last week, the central bank released more details around how it will announce the results of its Asset Quality Review and stress tests. Banks with capital shortfalls will have just two weeks to outline new capital plans and between six and nine months to cover those gaps. It is important that the CR establishes the ECB as a credible regulator and brings to light any shortfalls in banking sector capitalisation. Indeed, while the corporate sector may not be ready to start investing heavily as yet, it will require a healthy banking sector to facilitate this expansion.

Chart 6: Gradual recovery in profits

Chart 7: German corporates winning

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