US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Margins: Key to the Kingdom

When corporate profit margins are high and/or rising, companies can hire workers and stock prices can soar. When margins come under pressure, layoffs ensue, and equity returns lag. What margins do from here will be critical to the economic and financial outlook.

Corporate profit margins are currently at an elevated 18%. They have been averaging around this level for the past 14 quarters dating back to Q3 2020, which is historically long for the past few decades.

There have been two other times in the last twenty years when margins were similarly high. One period was short, lasting just four quarters from Q4 2005 to Q3 2006. The other period was longer, lasting 14 quarters from Q4 2011 to Q1 2015. Could the current period of elevated margins persist?

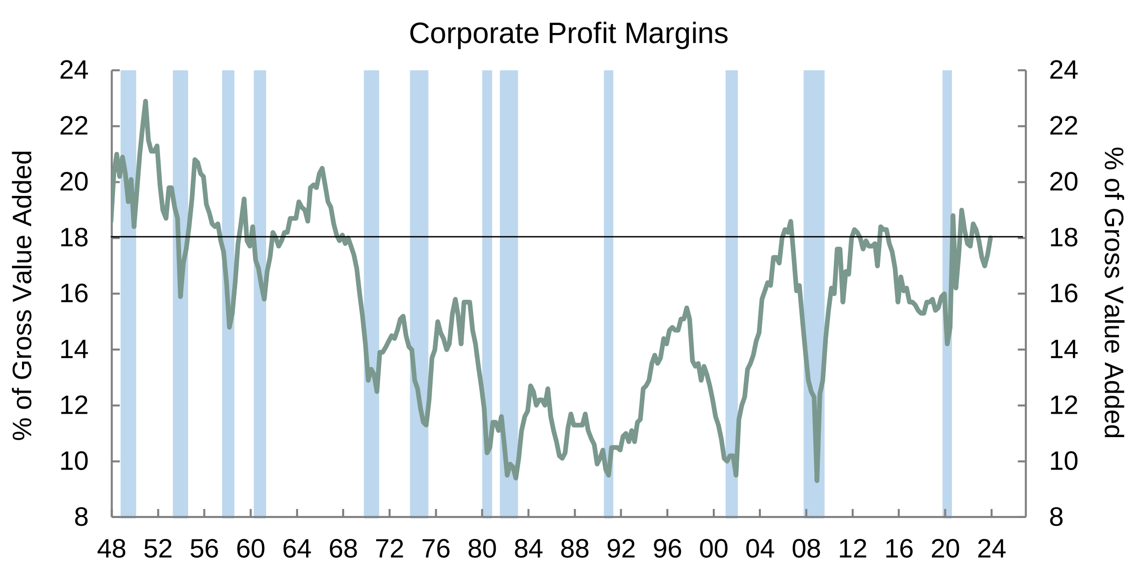
Margins were high in the late 1940s to the late 1960s. From 1948 to 1968, they averaged 18.8%. The all-time high was 22.9% in Q4 1950, and they rose to 20.5% in Q1 1966. But this impressive two-decade performance occurred alongside booming productivity growth.

During this time, output per hour grew a remarkable 2.9% at an annualized rate. Meanwhile, inflation averaged just 1.9% per annum. Living standards were soaring. Could that happen again?

Productivity growth is up 2.6% over the last year, which is solid. But over the last 14 quarters, output per hour is up a measly 0.3% at an annualized rate. This implies that **most of the improvement in margins has been due to higher inflation**. The consumer price index has grown at a 5%-plus annualized pace during this time.

Although the growth in the consumer price index has slowed to around 3.5%, this is still much too high for the Fed to lower interest rates. Consequently, **for profit margins to remain elevated or go higher, productivity will have to continue to expand in line with its current growth rate**. Can this happen?

It is possible that productivity growth made a secular upswing, powered by the promise of AI and other newfangled technologies. Maybe margins can stay high. However, if productivity growth slows, history tells us that companies will offset margin compression through some combination of layoffs and capex reductions. If so, stock prices will come under pressure and recession risk will return. Stay tuned.



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