Peak Profit Margins?
A US Perspective

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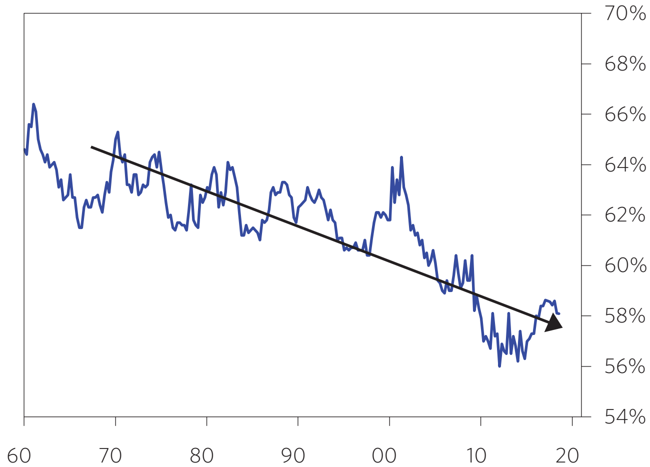
Over the last two decades, US corporate profit margins have surged and have contributed more than half of the excess return of equities relative to cash. Without that consistent expansion of margins, US equities would be 40% lower than they are today. Margins have been rising for 25 years, and when we look at market pricing, it appears to us that the market is extrapolating further margin gains.

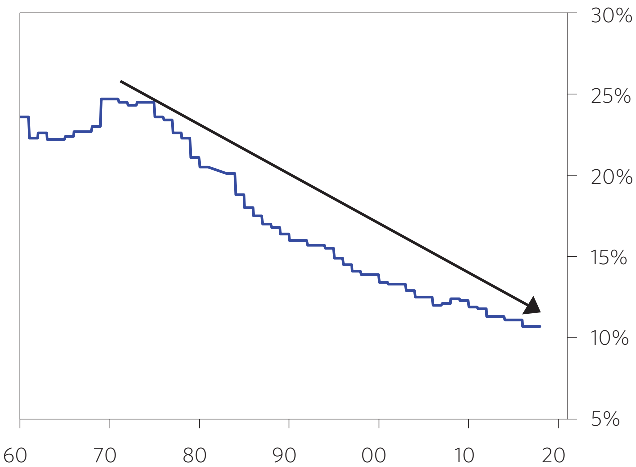
The long-term valuation of equities hinges heavily on what happens to margins going forward: if margin gains can be extrapolated, then valuations look reasonable; if margins stagnate, then valuations are a bit expensive but not terrible; if margins revert toward historical averages, then equities are highly overvalued.

Over the last few decades, almost every major driver of profit margins has improved. Labor's bargaining power fell, corporate taxes fell, tariffs fell, globalization increased, technology allowed for greater scale and lower marginal costs, anti-trust enforcement fell, and interest rates fell. These factors have produced the most pro-corporate environment in history. Many of these drivers of high profit margins are now under threat. Before we get to analyzing each, the following panel shows how everything moved in the same direction, in favor of corporates.

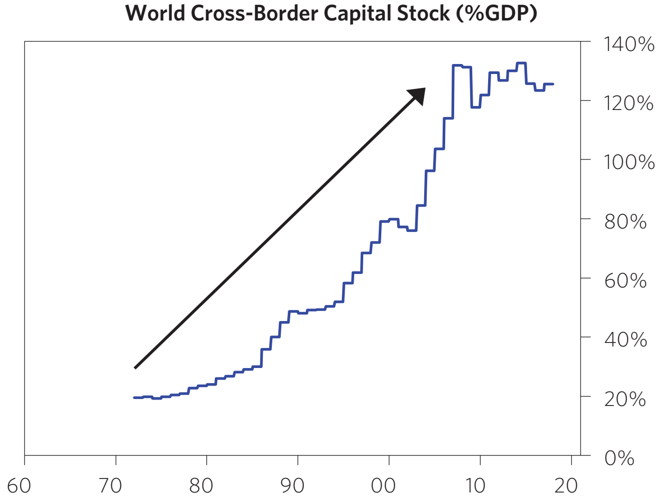
Labor Share of Output



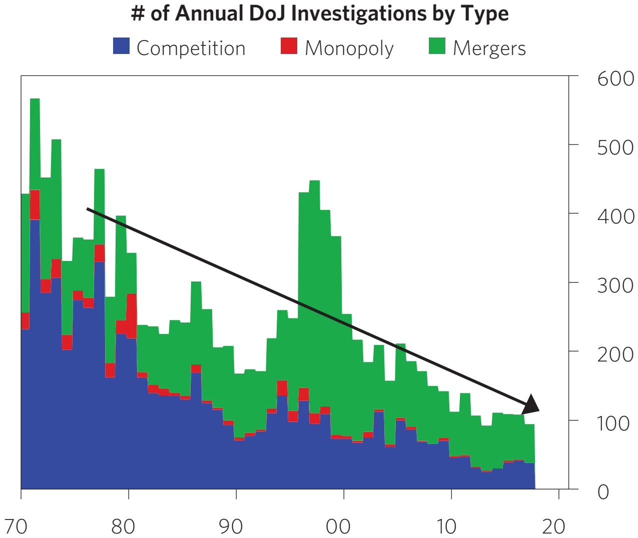
Union Members (% Labor Force)



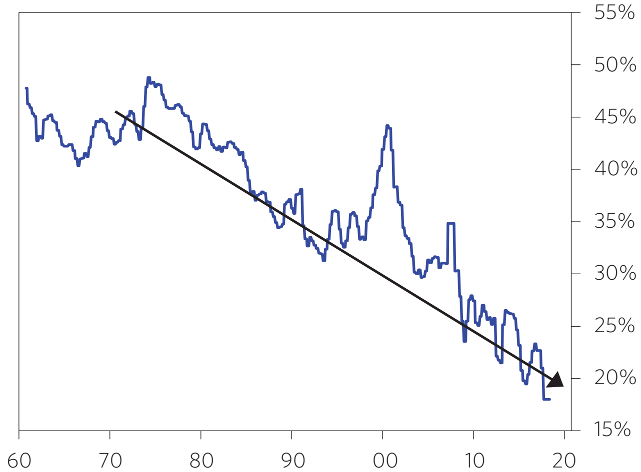
World Cross-Border Capital Stock (%GDP)



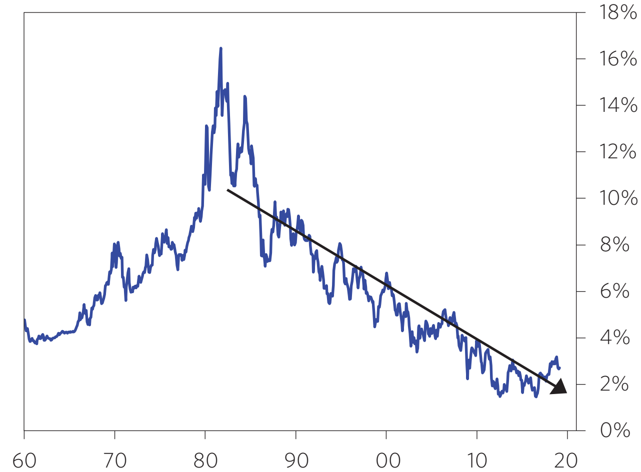
# of Annual DoJ Investigations by Type



US Listed Corp Effective Tax Rate

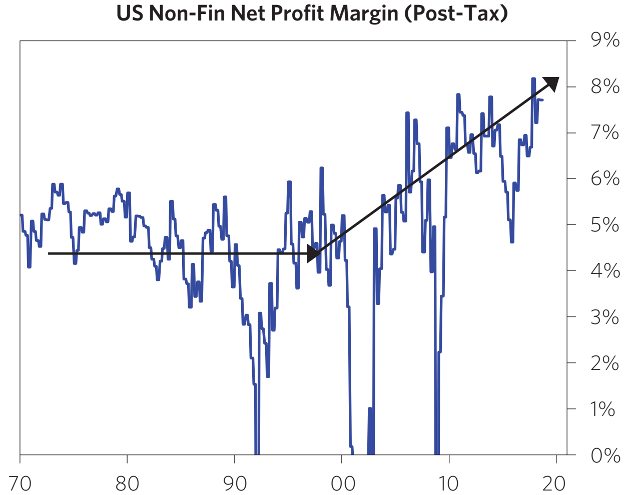


US Bond Yield

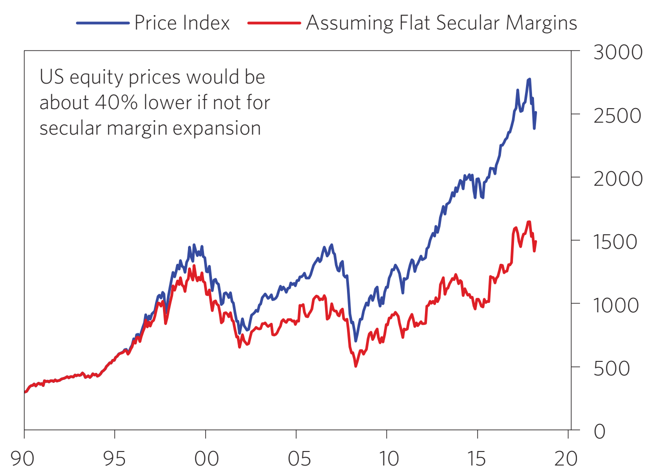


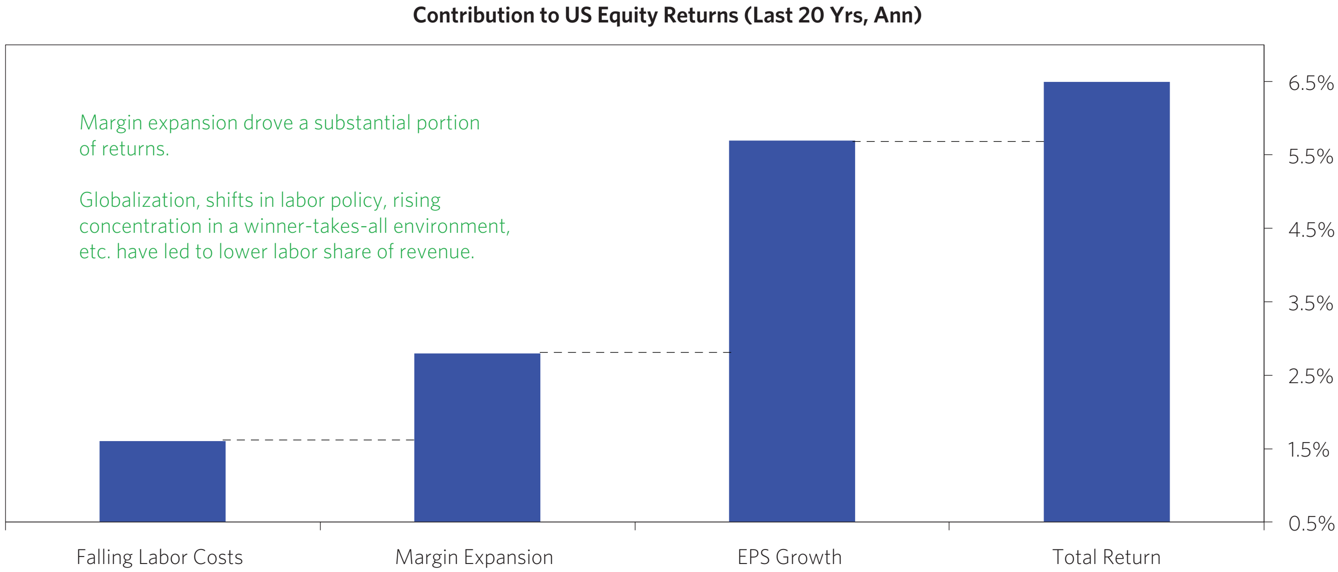
These phenomena compounded on each other as globalization weakened labor's position, corporates gained political power, and policies reinforced the shift. Many of these pressures that allowed for so much improvement in profit margins are unlikely to continue being supports, and some are likely reverting. We think there is a decent chance that we are at a major turning point for corporate margins, and if that is correct, US equities have a major valuation problem.

US Non-Fin Net Profit Margin (Post-Tax)



US Equities

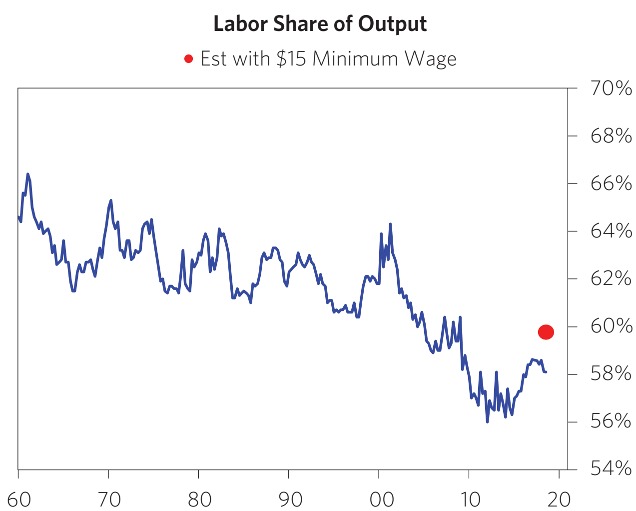


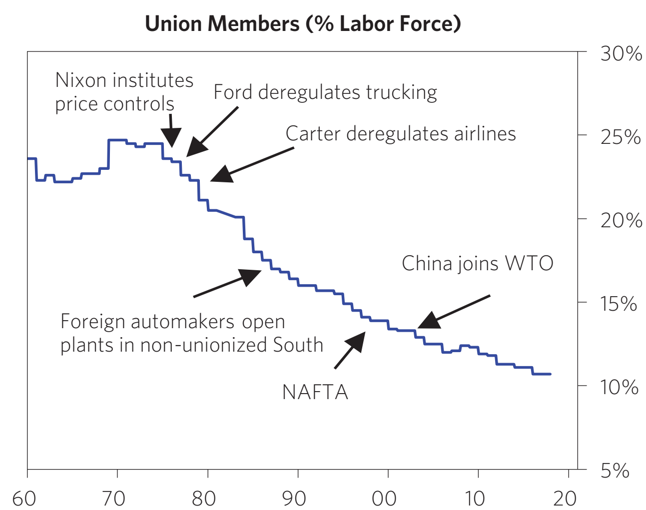


Below, we walk through the evolution of major forces behind the secular increase in US profit margins.

Decline in Organized Labor Has Reduced the Bargaining Power of Labor

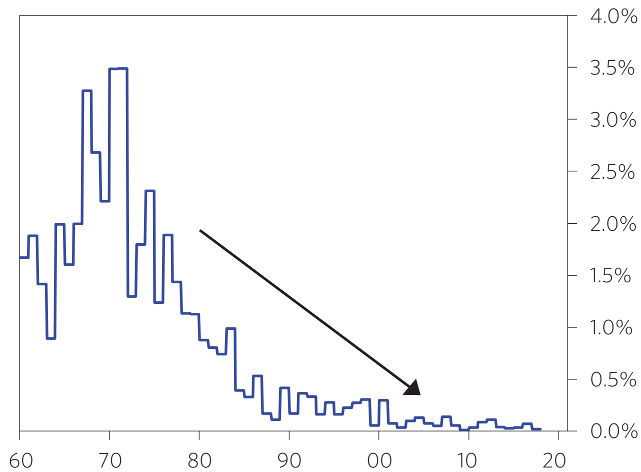
As we show above, the biggest force behind the US profit margin expansion has been the decline in the labor share of output. One factor that has contributed to the reduction in labor's bargaining power versus capital is the decline of organized labor and unions. This phenomenon has occurred over decades for an array of reasons intertwined with the other forces on margins—like access to pools of cheaper foreign labor and advancing automation technology. In the chart below on the left, we also show what the impact would be if a $15 minimum wage were adopted.



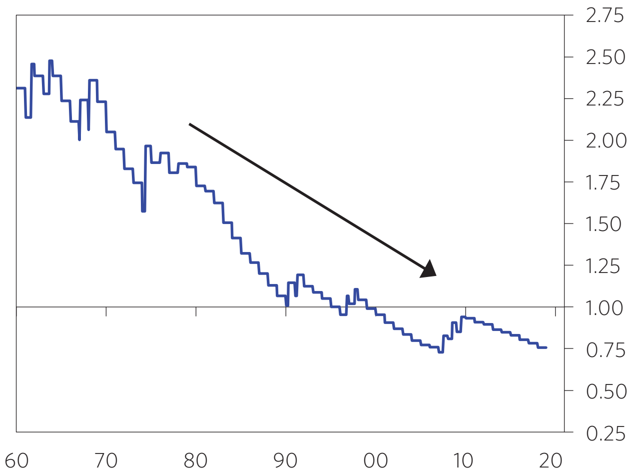


As union membership has fallen, the share of employees involved in labor strikes has collapsed, reflecting both the shrinking size of unions and less frequent strike activity among the remaining unions. This again reflects the dwindling power that organized labor can exert over employers.

% Employees Involved in Work Stoppages

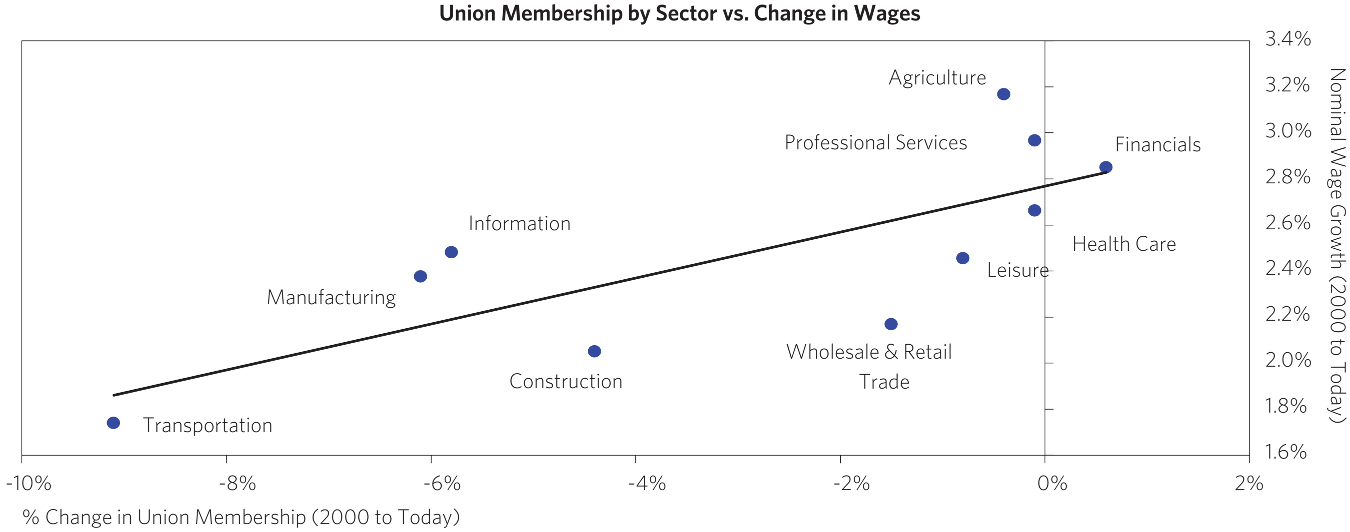


Productivity-Adj Real Minimum Wage (Indexed to 1995)



While changes in union activity have been smaller in recent years, even small moves toward or away from unionization can be linked to changes in how much firms pay their employees. Over the last 20 years, sectors that de-unionized more saw their wages fall relative to those where union membership remained more constant.

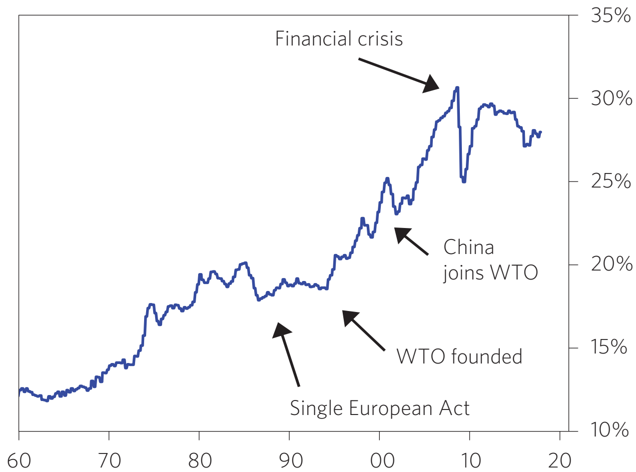
Union Membership by Sector vs. Change in Wages



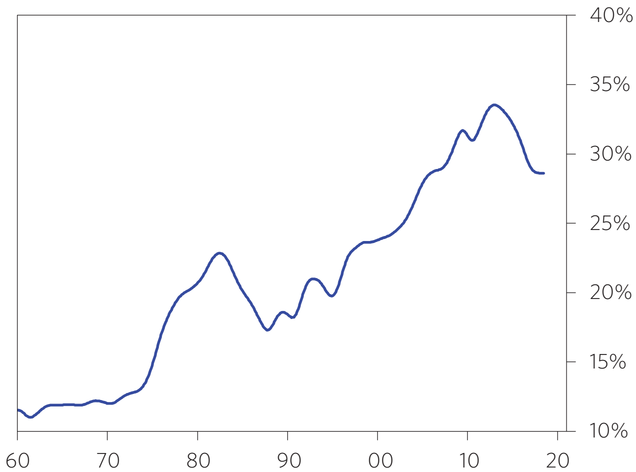
Globalization: US Corporations Saw Major Benefits from Globalization, Especially Access to Cheap Labor Pools in Countries Like China

The pace of globalization accelerated after 1990 as technology helped the world become more integrated, allowing pools of capital and labor to come together efficiently. As borders became more porous, corporations increasingly shifted their operations abroad (often building at lower cost), outsourced a range of activities, and tapped into new, faster-growing foreign markets. This directly reduced the labor costs for producing goods and exerted a downward pressure on US workers' wages. As shown below, this trend accelerated after 2001, when China joined the WTO, and has already started to flatten out.

World Nominal Exports (%GDP)

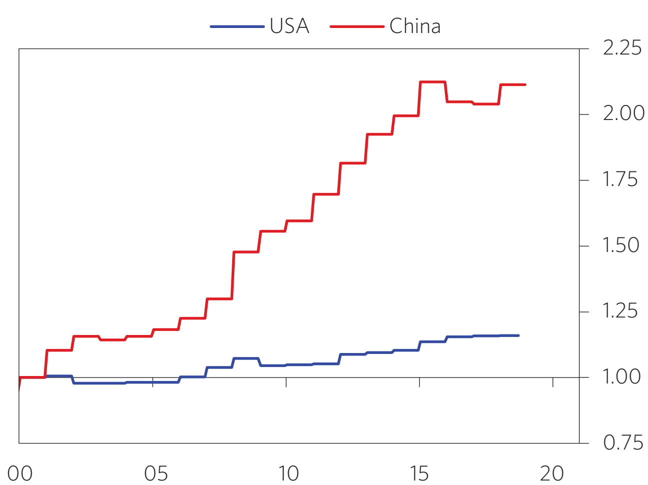


Foreign Share of US Corporate Sales



A big part of this globalization wave was driven by developed world corporations tapping (directly and indirectly) into the cheap labor pool in China, allowing them to significantly reduce their net production costs. While some of this was passed on to consumers through lower goods prices, a big portion was retained by these companies in the form of higher profit margins. Over time, this cost differential has been eroded as the labor price in China has risen relative to that in the US. The measure shown below on the left captures labor costs adjusted for worker productivity, while the right-hand chart shows how much nominal wages have risen in China relative to those in the US.

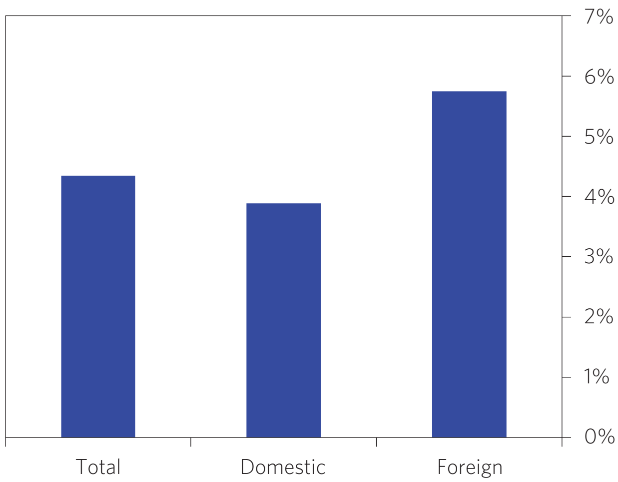
Unit Labor Cost (Indexed to 2000)



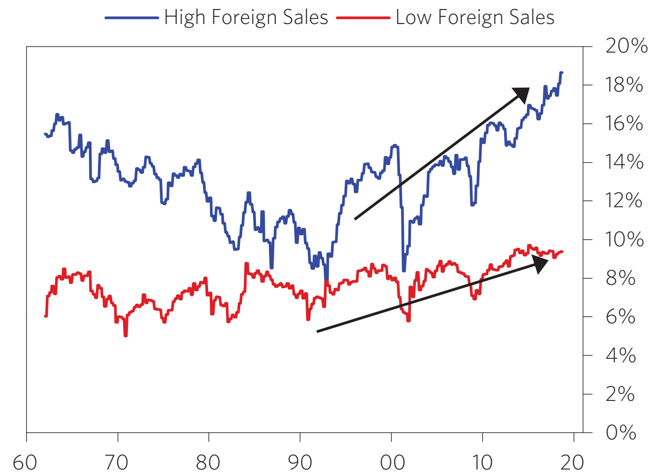
Relative Nominal Wages: China vs. US

Access to foreign markets has allowed US companies to both tap into the growing demand in these regions and to reduce costs as a result of cheaper labor and materials. The charts below compare the revenue growth and profit margins of US companies that have more sales exposure to foreign markets versus the ones that are more domestically focused. This highlights how companies that have higher exposure to faster-growing foreign markets have seen a stronger pace of revenue growth and a bigger improvement in profit margins. That said, the domestically oriented sectors and companies have also benefited (though to a lesser degree) from this globalization trend via lower input costs.

Non-Fin ex-Resources Sales Growth (1995–Today, Ann)

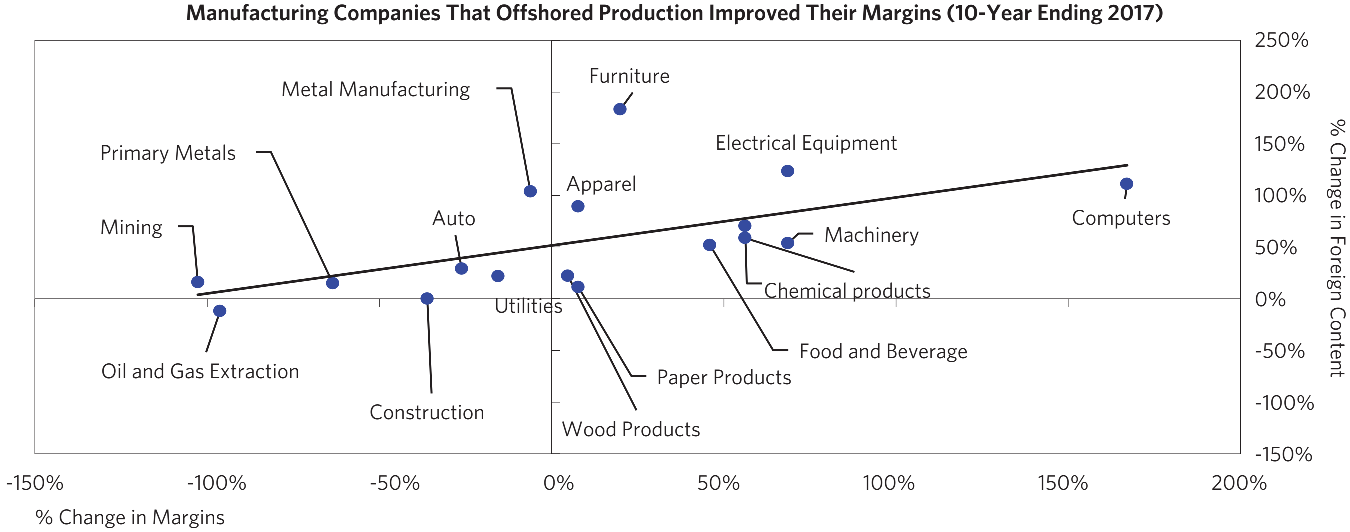


Operating Margin



The next chart tries to more directly connect the change in margins to the change in the share of input costs that has been outsourced across manufacturing sectors, where we have good data from government reporting. Segments like computers, electrical equipment, and machinery, which have seen a larger increase in foreign-made content (e.g., moved abroad more to lower costs), have seen bigger increases in margins than segments like utilities and construction, which are still primarily domestically sourced.

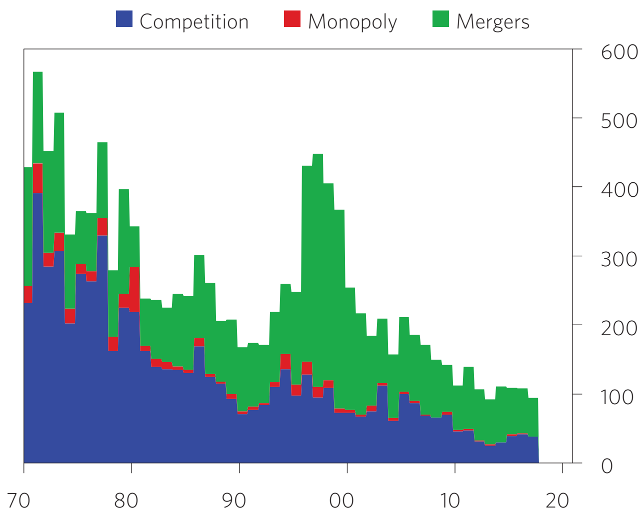
Manufacturing Companies That Offshored Production Improved Their Margins (10-Year Ending 2017)



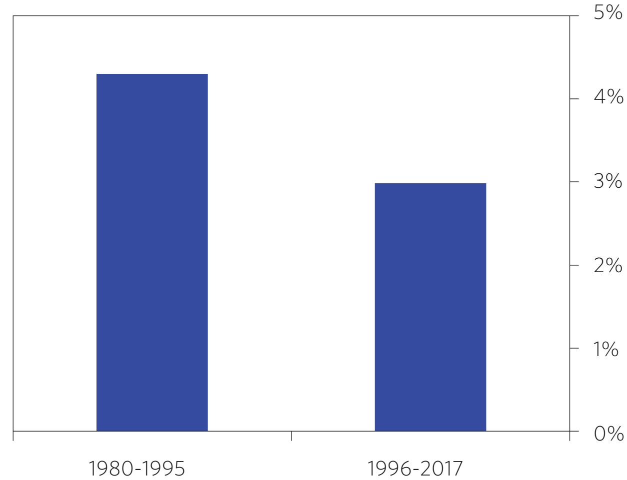
Consolidation: We Have Seen a Gradual Relaxation in Anti-Trust Enforcement (Merger Enforcement), Allowing Larger, More Dominant Firms

The charts below show some trends that are indicative of a gradual relaxation in policies that target firm concentration and competition and that have effectively allowed the formation of larger, more dominant firms. The chart on the right shows the share of pre-merger notifications that the FTC and DoJ (the two US merger enforcement agencies) flag for additional information requests, signaling an intent to pursue a deeper investigation. The share of transactions flagged in this way fluctuates on a year-over-year basis, but has been lower overall since 1995 than it was in the 15 years prior.

# of Annual DoJ Investigations by Type

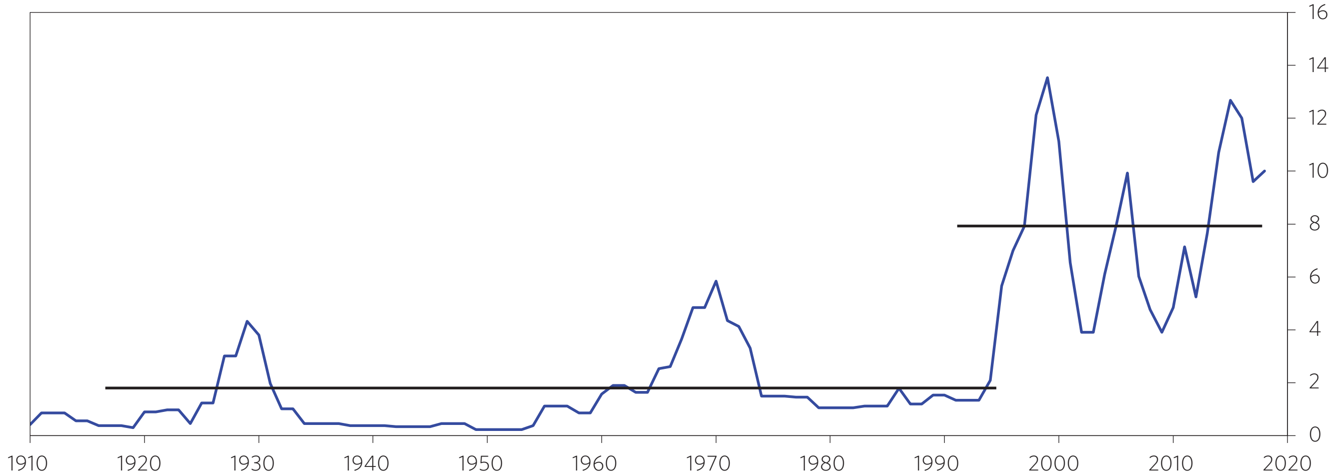


DoJ & FTC Second Requests for Info (% Eligible M&A Transactions)

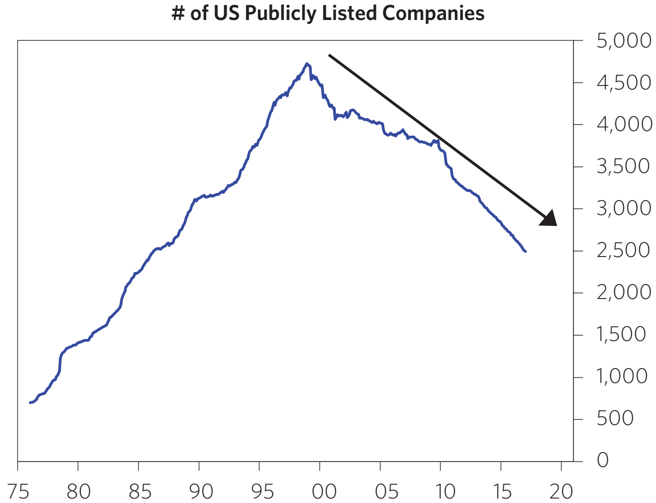


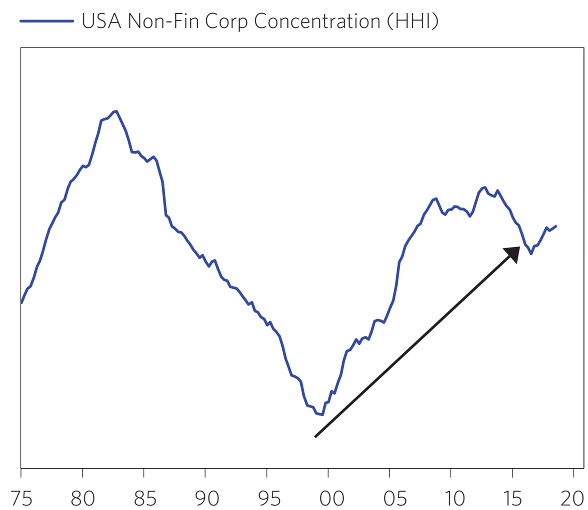
We have seen a significant increase in the scale of merger activity after 1990, and the total number of publicly listed companies has shrunk. After declining in the 1980s and 1990s, firm concentration has picked up materially since 2000.

Mergers and Acquisitions (%GDP)



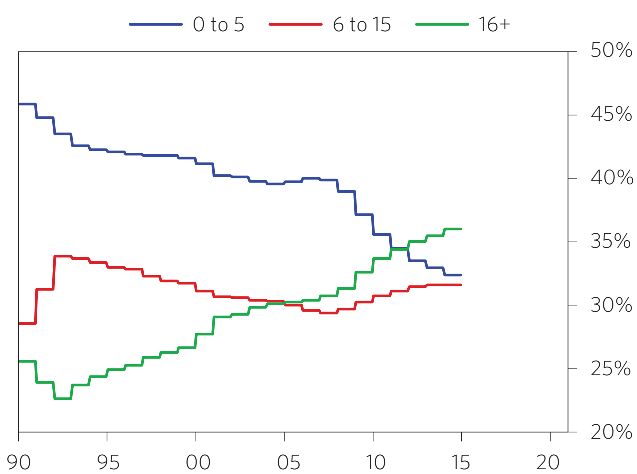
# of US Publicly Listed Companies



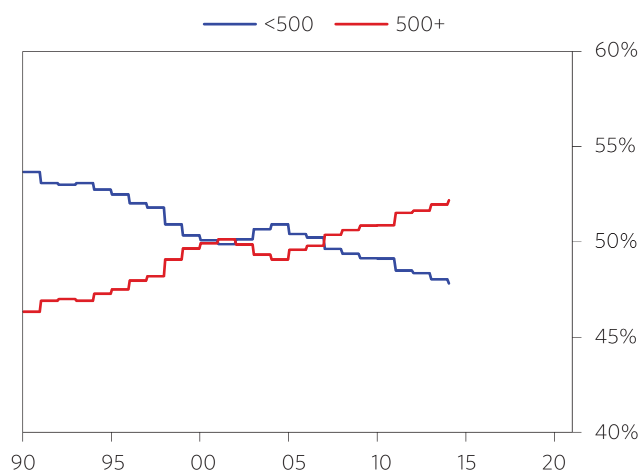


As a result, today the average US business is larger and more established. Now, US workers are more likely to work at a firm with more than 500 employees than they were in 1990.

Firm Age Breakdown (Years)

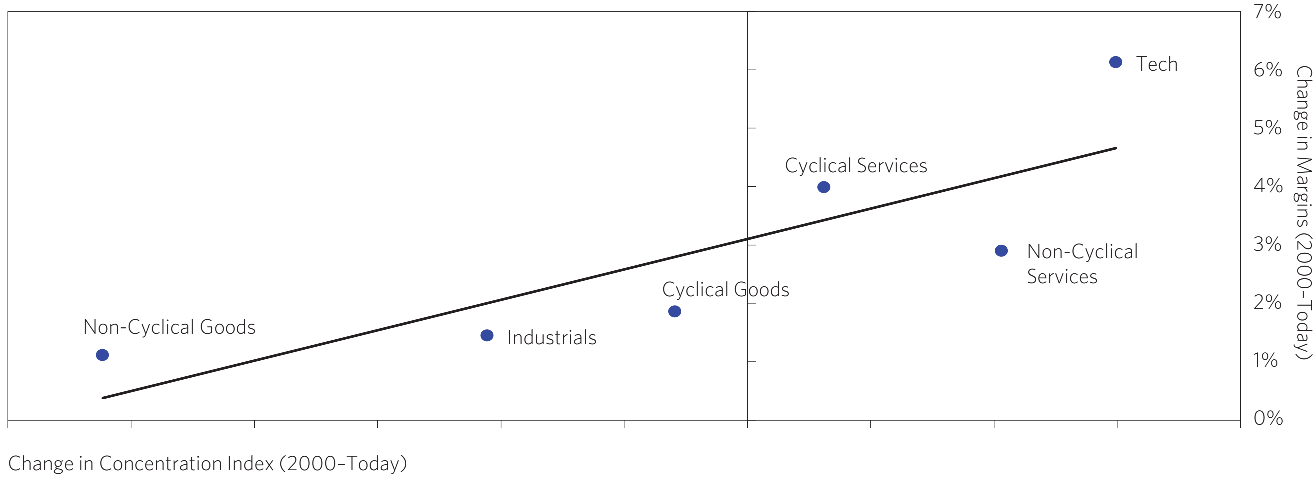


% Employed at Firms by Size (# of Employees)



Rising sales concentration within a sector has shown a strong positive relationship with expanding margins, suggesting that greater pricing power comes from having more economies of scale, less head-to-head competition within a market, and overall higher bargaining power against labor.

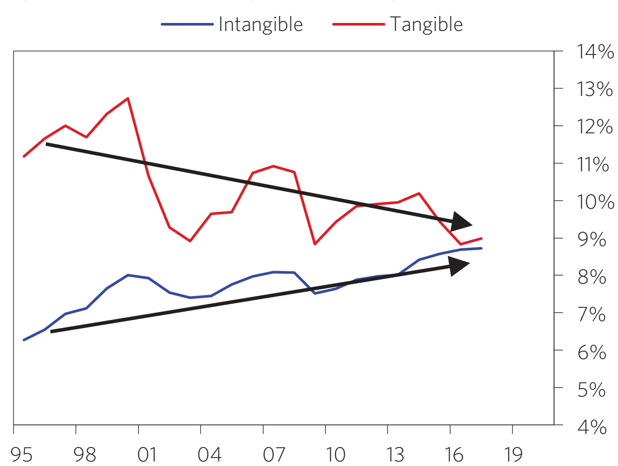
Sector Change in Concentration vs. Change in Margins



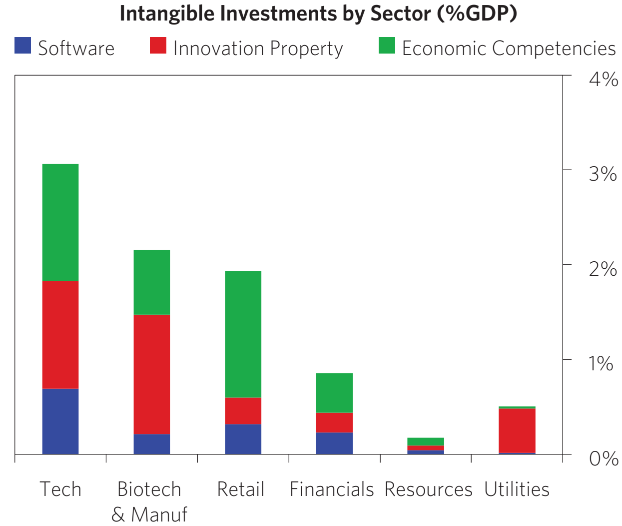
Scalability and Winner Takes All: Greater Scalability and Winner-Takes-All Dynamics Have Further Supported the Rise of Larger, More Dominant Firms and Margin Resilience

Another major shift over the past few decades that has helped firms increase and maintain their high profit margins is the ability for large firms to scale up their operations without raising costs by as much, and that high operating leverage and sheer scale have contributed to "winner-takes-all" dynamics in many sectors. In many ways, with the changing nature of the overall economy and demand, the secular shift away from tangible investments—like physical equipment and buildings—and toward intangible investments—like intellectual property, including software and patents, for example—has facilitated the production and consumption of these scalable products (e.g., software) and has helped these companies build a "moat" (increasing barriers to entry for new entrants). The left-hand chart below shows how the share of intangible investments of companies in the US, Europe, and Japan has risen secularly. The chart on the right breaks down the various forms intangible investment can take, from software investment to economic competencies (which include management improvements, organizational design, marketing, and the like) to innovation property (including patents, research and development, etc.).

Big Three Economies' Tangible and Intangible Investments (%GDP)

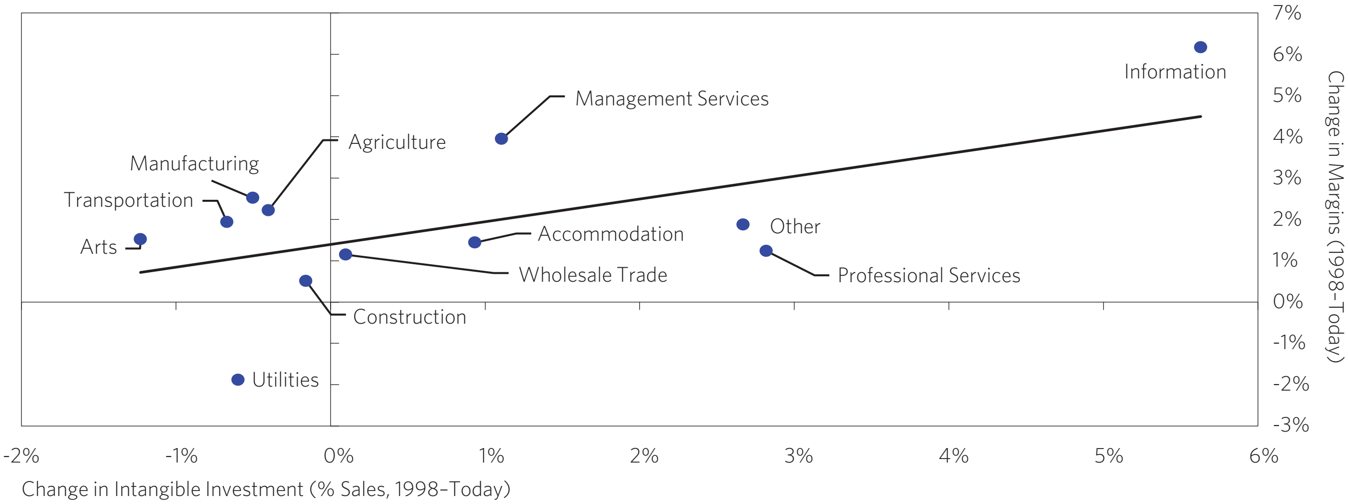


Intangible Investments by Sector (%GDP)



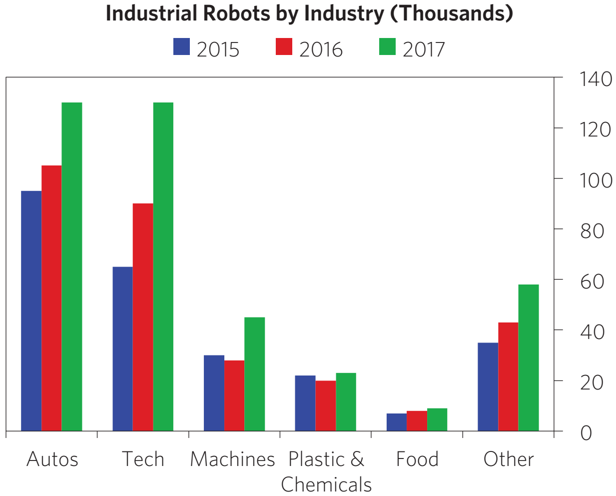
It is interesting to see the relationship between the growth in intangible investments at the sector level and the increase in sectors' profit margins over the past 20 years. This is not meant to suggest that this force is by any means the dominant driver of the margin changes, but rather how a number of forces (such as this one) have all come together to support the profit margins of particular sectors, like information technology.

Change in Intangible Investment vs. Change in Margins



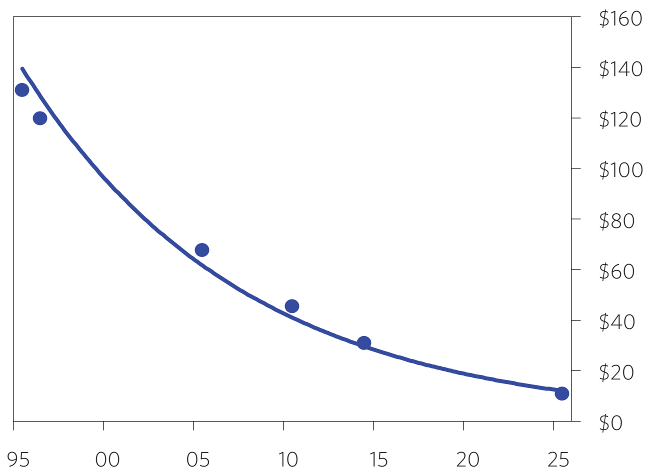
The impact from a continued shift toward automation is one more such force that supports corporate profits. While at this point it is hard to quantify its impact, it could have a more material impact in the future. There are early signs of companies in a broad range of industries purchasing more industrial robots in recent years as costs of robots have gone down, while a few sectors (autos and electronics) have seen a larger adoption so far.

Industrial Robots by Industry (Thousands)



Source: International Federation of Robotics

Industrial Robot Cost Decline (Unit Cost USD, Thousands)



Source: ARK Investment Management, LLC

Though only a few sectors have implemented automation in a large way so far, the table below shows how several sectors have the potential to be meaningfully impacted as costs come down and adoption becomes more widespread. The measures shown below assess how often workers across sectors are required to perform different skills, and assess how automatable those skills are with the technology currently available to determine how automatable the hours worked in each sector are overall.

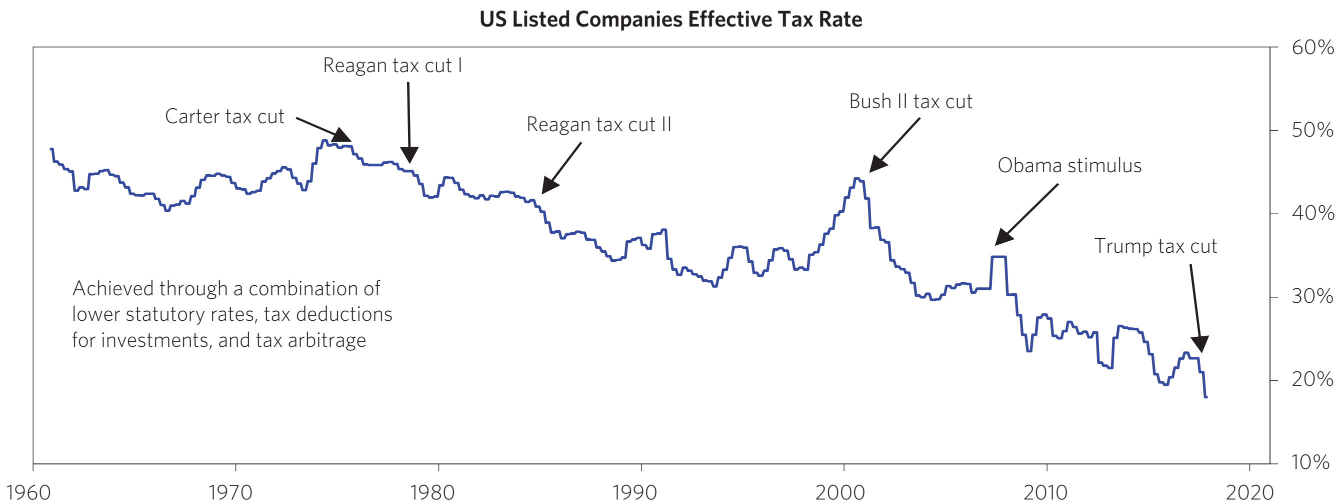
Current Technical Feasibility of Automation by Activity Type and Sector**

Sector	Automation Potential	Managing Others	Applying Expertise	Stakeholder Interactions	Unpredictable Physical Work	Data Collection	Data Processing	Predictable Physical Work
Accomodation and food services	73%	2%	4%	22%	5%	8%	10%	48%
Manufacturing	60%	5%	13%	8%	8%	22%	11%	33%
Agriculture	60%	3%	5%	7%	51%	11%	9%	13%
Transportation and warehousing	57%	4%	8%	14%	14%	22%	14%	24%
Retail trade	53%	3%	6%	26%	5%	15%	28%	17%
Mining	51%	7%	11%	8%	24%	21%	12%	17%
Other services	49%	7%	12%	17%	13%	15%	11%	25%
Construction	47%	5%	10%	8%	41%	15%	11%	10%
Utilities	44%	7%	14%	13%	19%	23%	13%	12%
Wholesale trade	44%	5%	12%	24%	11%	17%	19%	12%
Finance and insurance	43%	6%	19%	23%	0%	16%	34%	3%
Arts, entertainment, and recreation	41%	10%	13%	24%	15%	13%	11%	14%
Real estate	40%	7%	12%	21%	19%	16%	17%	8%
Administrative	39%	6%	13%	14%	23%	21%	13%	10%
Health care and social assistance	36%	8%	14%	14%	11%	20%	13%	21%
Information	36%	5%	25%	20%	7%	16%	20%	6%
Professionals	35%	7%	27%	16%	2%	19%	23%	5%
Management	35%	10%	25%	16%	3%	17%	24%	5%
Educational services	27%	22%	29%	10%	8%	13%	10%	7%

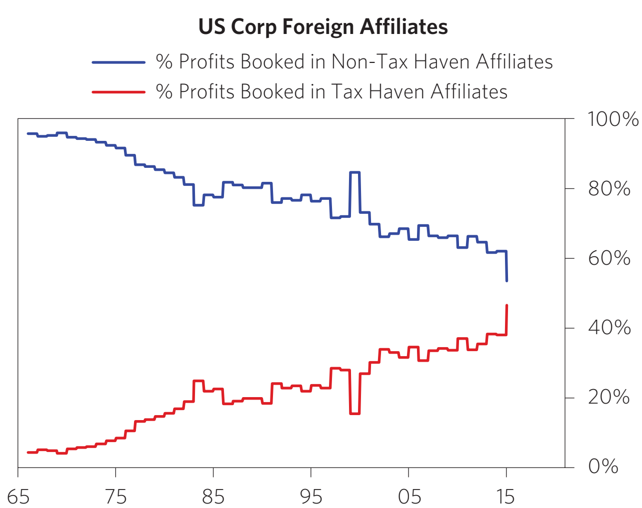
***% of time spent on activities that could be automated by adapting current technology*
Source: McKinsey & Company

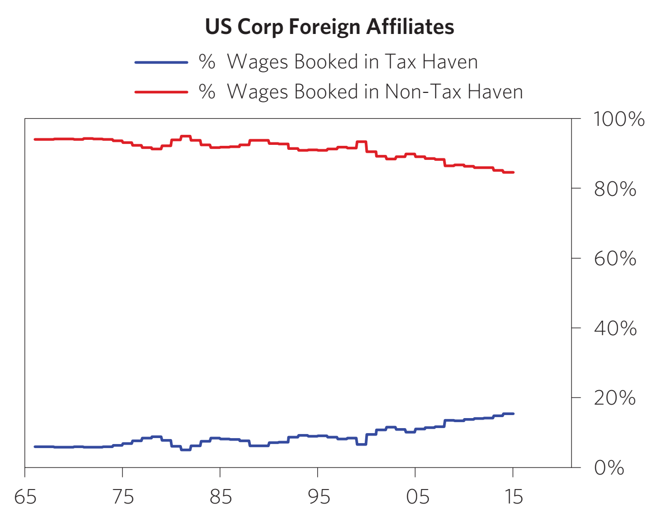
Falling Tax Rates: It Has Also Been a Very Favorable Tax Environment for Corporations

Over the last four decades, corporate tax policy has consistently favored business, and as a result the effective rate has fallen from 45% to about 20%. The effective tax rate that companies pay is now at all-time lows from a combination of declining statutory rates and the use of loopholes that lower the rate companies actually pay on their earnings. The chart below summarizes a number of the key actions that led to the decline in effective US corporate tax rates over the last 40 years.



One of the long-standing arbitrages that companies took advantage of was their ability to book foreign revenues offshore while booking very few operational costs there. This was particularly beneficial for companies with large amounts of intellectual property (e.g., tech, pharma), which could seamlessly move assets offshore.

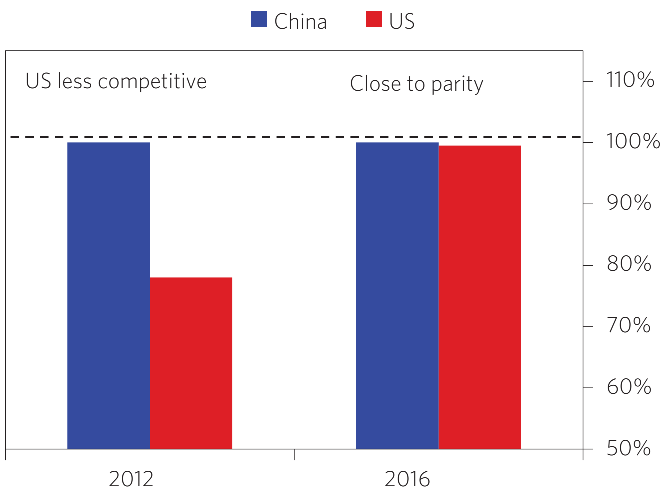




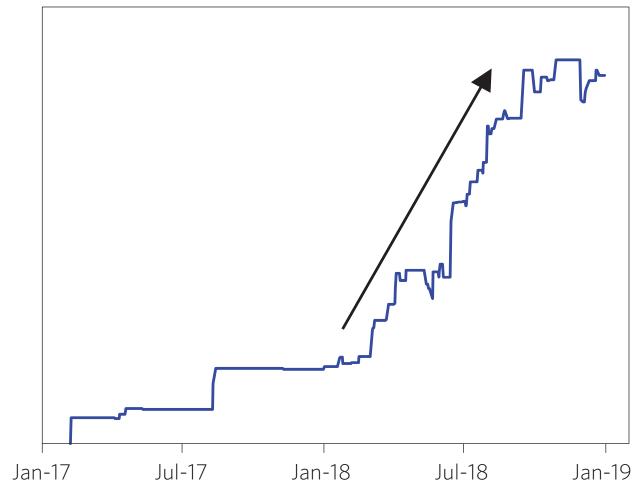
Some of These Supports Are Unlikely to Persist

Looking ahead, some of the forces that supported margins over the last 20 years are unlikely to provide a continued boost. Incentives for offshore production have been reduced as global labor costs have moved closer to equilibrium, with domestic costs and rising trade conflict increasing the risk of offshoring, while the potential tax rate arbitrage from moving abroad is now much smaller.

Deloitte Competitiveness Survey

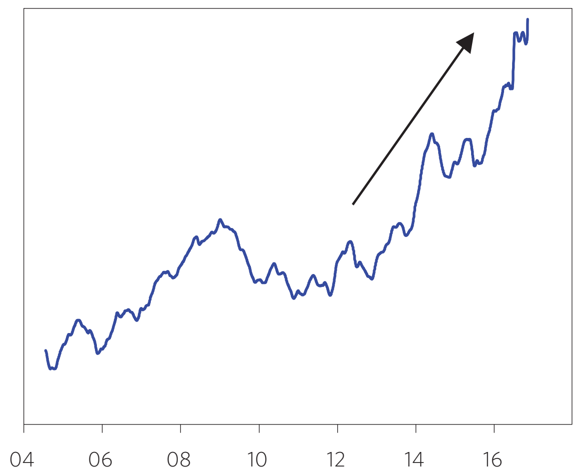


Global Tit-for-Tat Gauge

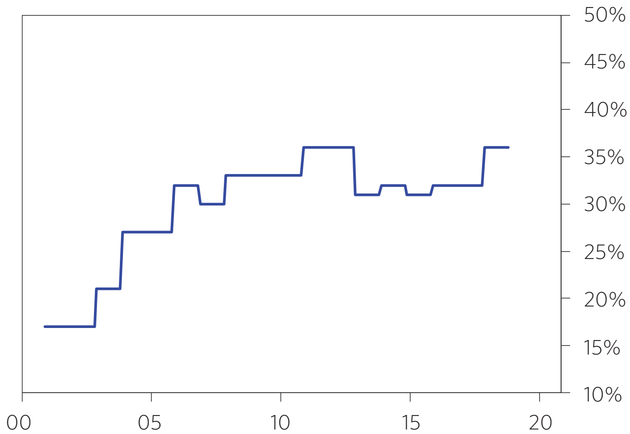


At the same time, we have seen popular sentiment begin to sour against the forces that have driven margin expansion, as well as against the companies that have benefited most from them. As we have discussed at length in prior research papers, we are in the midst of a populist backlash against rising inequality and increasingly seeing a move toward more protectionism. Recent surveys show increasing animosity toward globalization and the power of companies more broadly and a bit more welcoming attitudes toward government regulation of firms.

Anti-Globalization Sentiment Gauge

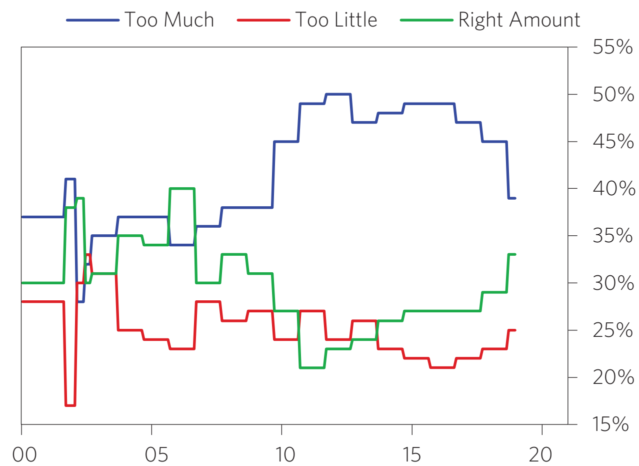


% Report Being "Very Dissatisfied" with Power of Major Corporations



Source: Gallup

Perception of US Government Regulation of Business



Source: Gallup

Furthermore, we have recently seen an increase in the discussion on taxing mega-profitable firms that have benefited from current policy. Below, we list some of the measures around taxing and regulating superstar tech firms being discussed globally. For example, Europe's potential "digital services tax" is explicitly designed to close the tax arbitrage (by introducing a sales tax on online revenues from residents). While the current impact of these proposed rules on the overall profitability of these tech giants is relatively small, they are a straw in the wind that the tide might be turning and that the multi-decade boost from favorable taxation policies is unlikely to be repeated.

Theme	Specific Action	Companies Affected	Country/Region
Taxation	Digital Service Tax on Revenue	All Tech	Europe
Taxation	Online Platforms Liable for Collection of Local Taxes	Ebay, Amazon, AirBnB	Germany
Hate Speech/ National Security	Platform Legal Liability for Hate Speech	All Tech	Germany, UK
Property Rights	Platform Legal Liability for Copyright Violation	All Tech	Europe
Data Protection Privacy	Restrictions on Monetization of Data	All Tech	Europe
Monopoly Power	Abuse of Platform Power	All Tech	Europe
Platform Neutrality	E-Commerce Platforms Restricted to Marketplace Facilitation Only (Can't Sell Own Products/Favor Products)	Amazon, Walmart	India

While there is no precision to when and how much each of the factors described above will weigh on profit margins and how much can be offset (for example by automation picking up), it will be hard for companies to maintain the current level of profitability over the coming decade, let alone increase the margins further from here.

