



Investment Strategy Group

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Investment Strategy Bulletin

Labor pays the price for high profit margins

The United States has begun to report data showing signs of an economic recovery and without a pause, analysts have been adjusting their outlook upward for Corporate America – the IBES 12-month forward operating earnings for the S&P 500 is now up 10% from three months ago at USD 69.4 per share.

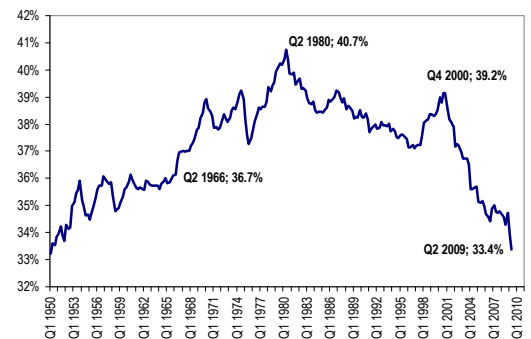
The second quarter reports from US corporations beat expectations and investors are celebrating the end of the earnings season. How did we get here? The inventory-led cycle and the government stimulus are the most obvious answers. However, the actual driving force behind the current bounce was the implementation of cost-cutting measures. As shown on the first chart, the share of US corporate employee compensation on total economic activity, measured as the national income, has never been so low post World War II. It now stands at 33.4%, compared to 39.2% during the 4th quarter of 2000. In the US, the higher-than-expected profits were the results of severe cost cutting, not revenue growth and this has important implications for the health of the economy and the strength of the stock market going forward.

From 2000 and beyond, the secular decline in labor compensation over national income did not slow consumption or the economy because consumers increased their leverage on the back of higher house prices. But today is different. The family home is still at risk and the same consumers are rebuilding their balance sheets as suggested by recent data that point to a sharp increase in the household savings rate. Though a 7.0% savings rate, measured on a net asset/liability accumulation basis, is not high in comparison to that of many other countries, it is nonetheless a remarkable turnaround from the 'dissaving' rate that the United States averaged in the 2nd quarter of 2007. If the past is any guide, the second chart also confirms that recoveries from recessions usually follow a substantial increase in the level of private sector indebtedness. With deleveraging ongoing and the supply of credit remaining severely constrained, the necessary conditions for a meaningful recovery in gross investment spending, hence in the economy, cannot be met today. As a consequence, the follow-through from consumption and corporate capital expenditure are severely constrained by structural challenges.

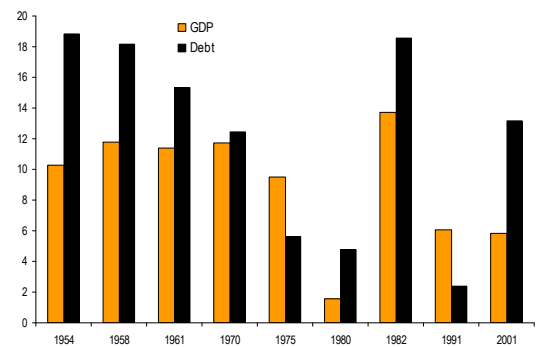
The collapse in the employee share of national income explains why profit margins have held so well. The controlling of operating expenses is fine for the shareholders of individual companies; however, as corporate expenses are largely a combination of salaries and funds paid to other companies that pay salaries too, cost cutting means that personal income suffers. This is not good for the economy as a whole, and there is therefore a natural limit to the slump of employee compensation as a portion of total economic activity which is when the positive impact of lower compensation on profits turns into a negative feedback loop of lower consumption and weaker top line growth.

The perfect era of high leverage and high profit margins is at an inflection point; labor compensation will level out and profit margins are poised for a decline due to lower revenue growth. This is good for Main Street, not so good for Wall Street which is overly focused on short-term results.

US corporate business compensation of employees as a share of national income



Cumulative percentage change in total real US non-government credit market debt vs. real GDP
8 Quarters following Official NBER recession end dates



Source: Datastream, Lombard Odier calculation

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