

Thackray Report

Earnings will Not Save the Day Profit Margins Declining !

May 17, 2022

Written by Brooke Thackray

Corporate profit matters. In mid-2021, profit margins reached a record level, helping the stock market to record levels. Corporate profit margins tend to be a regressive time series, regressing back to the mean. At very high levels, it is only a matter of time before profit margins decline. After the year 2000, there has been a slight shift in corporate profit margins, on average, moving higher. Corporate profit margins have shown an increase relative to the pre-established mean in previous years, largely as the result of large companies (some with monopolies) being able to dominate their industries and charge higher margins. It is possible that there has been a structural change with higher margins. Nevertheless, even if profit margins have shifted up a bit, the profit margin level reached in mid-2021 was extremely high and has been "regressing" lower. In all probability, profit margins will continue to move lower.



Ultimately, it is earnings that drive the stock market. A growing economy helps to increase earnings, which helps to push the stock market higher. Higher profit margins means higher profits and higher stock market prices. Declining profit margins are not good for stock market prices. Declining profit margins means lower corporate earnings, which will likely translate into lower stock prices. Of course, the P/E multiple on stocks can expand, but this is going to be hard to do with a Federal Reserve that is tightening and a slowing economy.

Not only are profit margins at a high level and declining, they will likely continue to decline as inflation ravages the economy. Most investors are familiar with the CPI report showing that inflation is currently 8.3% for consumers. Inflation is also occurring for corporations. Companies are paying more for the materials that are necessary in order to make their final product. Below is a graph of the Producer Price Index (PPI) for manufacturing companies, which measures cost inputs. Manufacturers can "eat" the higher costs for a while, but eventually the costs have to be passed on to the consumers.



Can higher prices be passed on to consumers?

It is going to be difficult for companies to pass on higher prices to consumers. If real wages are increasing, this would allow companies to pass on their higher costs as consumers can afford to spend more. This is not the case today. Real wages are decreasing as nominal wages are not keeping up with inflation (see graph below). With less "real money" consumers are going to have cut back their "real purchases," particularly in discretionary spending. This translates into an environment of decreasing demand for products and services. This makes it very difficult for manufacturers to pass on their costs.



The unemployment rate is so low that it might be bad.

When the unemployment rate reaches a low level (below 4%), the rate tends to stay at this level for a long time. Eventually, low unemployment rates create supply side inflation as wages start to move higher. At this point, the Federal Reserve starts to raise interest rates to cool inflation and a recession ensues. In the graph below, recession (grey bars), tend to occur when the unemployment rate has reached a level below 4% and is starting to turn higher. The problem is that the Federal Reserve let inflation get way too high and now has to raise interest rates. Inflation is not rising because of rising wages. It is rising as the result of reckless government and central bank policy. If real wages were to rise, this would result in an even greater inflation push and make it very difficult to control. The Federal Reserve knows that it has take action on inflation before it spills over into wages.



With the current rate of unemployment rate at a low level, it is going to be difficult for it to head any lower in an economy that is showing signs of slowing. A rising unemployment rate will create a situation of lower demand and make it very difficult for companies to pass on higher production costs.

Unemployment is a lagging signal. By the time the unemployment rate starts to move higher, the economy will probably already be slowing substantially. If there is one signal in the market that could "shock" investors, it is a rising unemployment rate. If we get three unemployment rate increases in a row, the buy-the-dip mentality will be seriously challenged and it could cause capitulation in the markets. Keep this on your radar.

Currently, the business climate "feels good." Profit margins are high and unemployment is low. Maybe this is as good as it gets. These indicators could remain fairly stable for a while, but they are susceptible to moving in directions that do not support higher stock prices. Higher producer prices and declining real wages are going to pressure companies to reduce their profit margins as consumers are not going to easily accept higher prices. Lower profit margins are going to force companies to reduce their costs, including hiring less workers. Overall, the macro environment in the economy is not conducive for strong corporate earnings. It takes time for macro factors, such as declining profit margins to work through the economy and into the stock market. Nevertheless, investors should be paying attention to the macro factors because they set the background for future stock market performance.

Disclaimer: Comments, charts and opinions offered in this report are produced by www.alphamountain.com and are for information purposes only. They should not be considered as advice to purchase or to sell mentioned securities. Any information offered in this report is believed to be accurate, but is not guaranteed. Brooke Thackray is a Research Analyst with Horizons ETFs Management (Canada) Inc. (“Horizons ETFs”). All of the views expressed herein are the personal views of Brooke Thackray and are not necessarily the views of Horizons ETFs (Canada), although any of the opinions or recommendations found herein may be reflected in positions or transactions in the various client portfolios managed by Horizons ETFs, including the Horizons Seasonal Rotation ETF. Comments, opinions and views expressed are of a general nature and should not be considered as advice to purchase or to sell mentioned securities. Horizons ETFs has a direct interest in the management and performance fees of the Horizons Seasonal Rotation ETF (the “ETF”), and may, at any given time, have a direct or indirect interest in the ETF or its holdings. Commissions, management fees and expenses all may be associated with an investment in the Horizons Seasonal Rotation ETF (the “ETF”). managed by Horizons ETFs Management (Canada) Inc. The ETF is not guaranteed, its value changes frequently and past performance may not be repeated. The ETF may have exposure to leveraged investment techniques that magnify gains and losses and which may result in greater volatility in value and could be subject to aggressive investment risk and price volatility risk. Such risks are described in the prospectus. The prospectus contains important detailed information about the ETF. **Please read the prospectus before investing.**

While the writer of this newsletter has used his best efforts in preparing this publication, no warranty with respect to the accuracy or completeness is given. The information presented is for educational purposes and is not investment advice. Historical results do not guarantee future results

Mailing List Policy: We do not give or rent out subscriber’s email addresses.

Subscribe or Unsubscribe to the Thackray Market Letter: Please visit alphamountain.com.