First Trust
Monday Morning OUTLOOK

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Profits Poised for Growth

COVID lockdowns crushed the economy in the first half of 2020, with real GDP down 5.0% at an annual rate in the first quarter and 31.4% at annual rate in the second quarter, the latter of which was the steepest drop in real GDP for any quarter since the Great Depression in the 1930s.

But for the third quarter, the US is tracing out a V-shaped bounce and likely grew somewhere between 30 - 35% at an annual rate, the fastest increase in real GDP for any quarter since at least World War II. The rebound is due to two things...a shift in activity toward businesses that were able to stay open because they were "essential" or found new ways of getting things done, and the actual reopening of businesses in recent months. Still, because many types of businesses are regulated, and because some companies will never reopen, it looks like it'll take until late 2021 for real GDP to fully get back to where it was pre-COVID-19.

Yet, stock market investors are not buying shares of GDP, they're buying shares of specific companies providing specific goods and services, many of which have had and will have robust profits or healthy rebounds in profits to entice investors.

Economy-wide corporate profits peaked in the fourth quarter of 2019 but then fell 12% in Q1 and another 10.3% in Q2. Converting these figures into annualized changes, profits declined at a 37.6% rate in the first half of 2020, versus a total 2-quarter drop of 19.2% for real GDP.

In other words, profits dropped faster than the overall economy.

Look for this process to go in reverse for the third quarter and beyond.

First, it's normal for profits to grow faster than the economy in the early stages of economic recoveries. The profit share of GDP bottomed at about 7% in both the 2001 and 2007-09 recessions, but eventually peaked north of 12.0% of GDP. They are now 9.4% of GDP

Second, the labor share of GDP (wages, salaries, and fringe benefits) surged in the first half of the year as firms reduced payrolls rapidly but not quite as rapidly as production fell. Many employers operated on a forward-looking basis, realizing they could ill afford to layoff workers who they figured they would want and need when the crisis passed. But that also means less of an increase in payroll costs as the economy heals.

Third, many firms have trimmed other costs, beyond payrolls, supporting the bottom line. Think less travel and less office space, in particular. Yes, of course, airlines, for example, get hurt when fewer people travel for business, but they can trim costs, so a dollar saved by the firm for which someone is traveling doesn't need to mean a full dollar less in profit for the firm providing travel services.

Bottom up forecasters have been predicting record levels of overall corporate profits next year, and we concur from a top down approach. Bottom line, the rise in stocks is not based on fantasy, but the fact that profits and low interest rates continue to reflect undervalued equity prices for most industries.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-13 / 7:30 am	CPI – Sep	+0.2%	**+0.2%**		+0.4%
7:30 am	"Core" CPI – Sep	+0.2%	**+0.3%**		+0.4%
10-14 / 7:30 am	PPI – Sep	+0.2%	**+0.2%**		+0.3%
7:30 am	"Core" PPI – Sep	+0.2%	**+0.2%**		+0.4%
10-15 / 7:30 am	Initial Claims – Oct 11	825K	**825K**		840K
7:30 am	Import Prices – Sep	+0.3%	**+0.1%**		+0.9%
7:30 am	Export Prices – Sep	+0.4%	**+0.1%**		+0.5%
7:30 am	Philly Fed Survey – Oct	14.0	**11.3**		15.0
7:30 am	Empire State Mfg Survey – Oct	14.0	**18.5**		17.0
10-16 / 7:30 am	Retail Sales – Sep	+0.8%	**+0.9%**		+0.6%
7:30 am	Retail Sales Ex-Auto – Sep	+0.4%	**+0.3%**		+0.7%
8:15 am	Industrial Production – Sep	+0.6%	**+0.7%**		+0.4%
8:15 am	Capacity Utilization – Sep	71.9%	**71.9%**		71.4%
9:00 am	Business Inventories – Aug	+0.4%	**+0.4%**		+0.1%
9:00 am	U. Mich Consumer Sentiment- Oct	80.5	**81.0**		80.4