



## Profit outlook should keep the US stock market in check

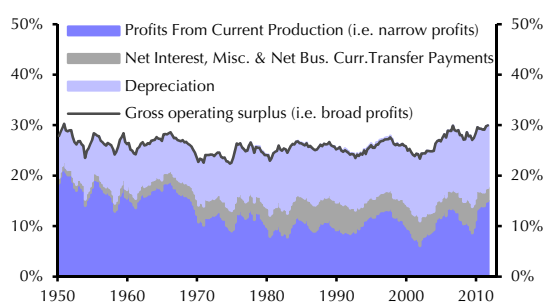
- *Margins are stretched*
- *How did UK retail sales fare over the Christmas period? (00.01 GMT)*
- *China's annual export growth likely to have slowed in December*

### Key Market Themes

The fourth quarter **US corporate earnings season** kicked off on Monday with Alcoa due to report later in the day after this edition of the *Capital Daily* was published. The reporting season is unlikely to be especially upbeat as the profits cycle is now peaking. Looking ahead, the growth rate of profits in 2012 is likely to be much less rapid than in the past couple of years. Indeed, it may even be slightly negative. (See our *Global Markets Update*, "US stock market at risk from the earnings cycle", published on Monday.)

Profits are pro-cyclical. In other words, they tend to grow more rapidly than corporate income (or output) during the early stages of economic recoveries. This is because margins – or profit per unit of income – tend to rise as firms' unit costs initially fall (or grow more slowly) relative to the prices of the goods they sell.

**CHART 1: OPERATING SURPLUS AS A SHARE OF THE INCOME OF THE US NON-FINANCIAL SECTOR**



Sources – Thomson Datastream, BEA, Capital Economics

This cycle has been no different as can be surmised from a broad measure of domestic profits – firms' gross operating surplus (GOS). (See Chart 1.) This is the

surplus income (before corporate income tax) available to firms after they have paid workers and their taxes on production and imports (less subsidies). In Q3, the GOS was equal to 30% of the income of the US non-financial corporate sector, up from a cyclical trough of just over 27% in Q2 2009. (Data for Q4 will be published until the end of March.)

As Chart 1 shows, the broad profit share is now at its highest level in more than six decades. In other words, margins are stretched. A further rise in the profit share is likely to depend on a continued drop in labour's share of income from its lowest level in more than sixty years.

Perhaps this will happen. After all, there is little reason to expect workers' bargaining power to improve any time soon when the unemployment rate remains so high and when there is little evidence that the forces of globalisation are about to go into reverse. But we would be surprised if labour's share did not rise by a little from here as productivity growth falters.

Even if we are wrong and the profit share does edge higher, though, we are not convinced it will propel the stock market higher. Valuations are not especially compelling from a historical perspective and the crisis in Europe is likely to continue to curb investors' enthusiasm for risk. The upshot is that we expect the S&P 500 to end 2012 around the 1,150 mark. (**John Higgins**)

### What to watch for today: North America

No major data or events scheduled for today.

### Continental Europe

No major data or events scheduled for today.

November's 0.6% monthly fall in **German industrial**

### KEY DATA AND EVENTS

		GMT	Previous	Median	CE Forecasts
Tue 10 <sup>th</sup>	<b>Chn</b> Exports (Dec)	-	(+13.8%)	(+13.4%)	(+13.5%)
	<b>Chn</b> Imports (Dec)	-	(+22.1%)	(+18.0%)	(+17.5%)
	<b>Chn</b> Trade Balance (Dec)	-	+\$14.5bn	+\$8.8bn	+\$9.3bn
	<b>UK</b> BRC Retail Sales Monitor (Dec)	00.01	(-1.6%)	(+0.4%)	(-0.5%)

m/m(y/y) unless otherwise stated; p = provisional estimate

**production** confirmed that the recovery in what had been the strongest sector of the euro-zone's strongest economy has gone into reverse. (Data released on Monday.) While the decline did not quite offset last month's 0.8% rise, it left the annual growth rate at a 22-month low of 3.6%.

Admittedly, other data on Monday morning revealed that German **exports** remained resilient in November, probably thanks to the earlier period of wage restraint that has boosted Germany's competitive position. A 2.5% monthly increase left the annual growth rate at a robust 8.4%. And with imports falling slightly, the **trade surplus** widened from €12.5bn to €15.1bn.

In all, then, while Germany should fare better than most other euro-zone economies in the coming months, we doubt that it will avoid a recession. We see GDP falling by a weaker than consensus 0.5% this year and perhaps about 1.5% in 2013. (**Jennifer McKeown**)

## UK

December's **BRC retail sales monitor** (00.01 GMT) will show whether the late rush to the shops made up for the weak start to Christmas shopping. Anecdotal evidence does suggest that high street spending gathered momentum closer to Christmas. However, shopper numbers reportedly dropped off around the new year. And although John Lewis reported strong sales over the last 5 weeks, it is one of the high street's top performers. What's more, retailers have been resorting to bigger price discounting – meaning that stronger sales volumes may only have been achieved at the expense of smaller margins. Overall, we would be surprised if the BRC's measure of like-for-like sales growth remained quite as weak as November's -1.6%. After all, last year's figures were pulled down by the effects of the snow. And the CBI distributive trades survey covering the start of December improved a bit. The BDO High Street Sales Tracker rose too. Nonetheless, we doubt that the BRC measure will have broken into positive territory. We have pencilled in growth of -0.5%. (**Vicky Redwood**)

## Japan

No major data or events scheduled for today.

## China

Today sees the release of the **trade** data for December. **Exports** to the euro-zone have been slipping while those to other areas have been holding up. The message from China's neighbours has also been mixed with Korea's export numbers for December better than expected while Taiwan's export readings worryingly low. We are expecting a further drop in China's annual pace of export growth. With the domestic economy slowing, y/y **import** growth is likely to have declined too.

**Loan** data for December released on Sunday showed net new lending stronger than anticipated – another sign that policy is being eased. We expect further cuts to the required reserve ratio soon to support continued strong lending growth in the first half of 2012. (**Mark Williams & Qinwei Wang**)

## Other Asia-Pacific

No major data or events scheduled for today.

**Australia's retail sales** flatlined in m/m terms in November. (Data were released on Monday.) Retail sales have been weakening since mid-2011, which fits with the unemployment rate drifting upwards. What's more, we see the labour market loosening further by mid-2012. These data support our view that the Reserve Bank of Australia is likely to lower its cash rate by 25bp to 4.0% next month. (**Sukhy Ubhi**)

## Other Emerging Markets

No major data or events scheduled for today.

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Published at 15.25 GMT 9<sup>th</sup> January 2012

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