Mo' money mo' problems: the impact of rising wages on corporate margins

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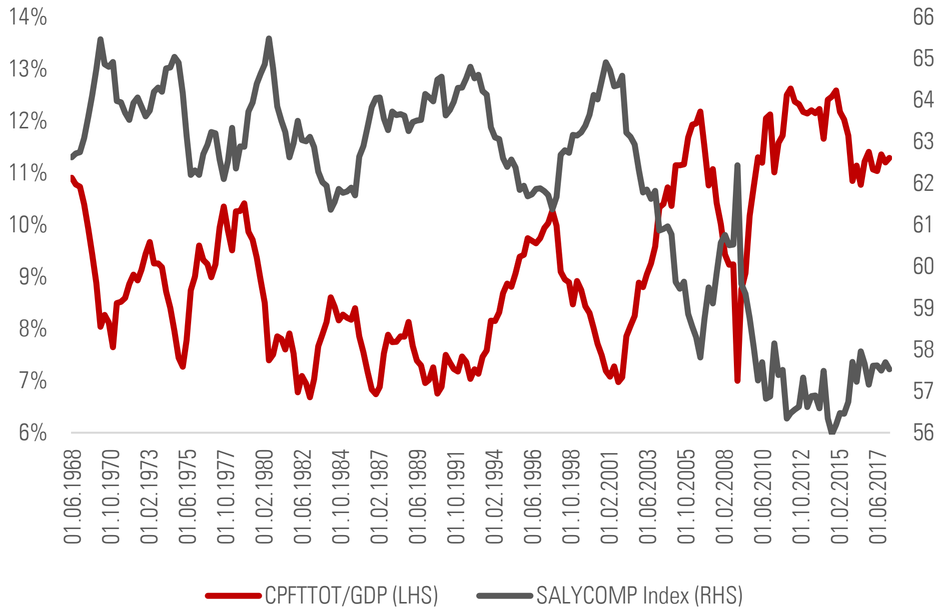
Many investors are concerned about the risk of rising inflation. They are concerned – and rightly so given where US equities currently trade relative to their history – that higher inflation will lead to higher interest rates and that this will impact stock valuations.

While this is indeed a pertinent concern, another victim of rising inflation is likely to be corporate margins. It is essential to recognise that the primary cost item for many businesses is employee compensation. One of the reasons corporate margins have remained elevated for so long has been the limited pricing power of labour in recent years.

Chart 1: Pricing power of labour and corporate margins



Source: Bloomberg

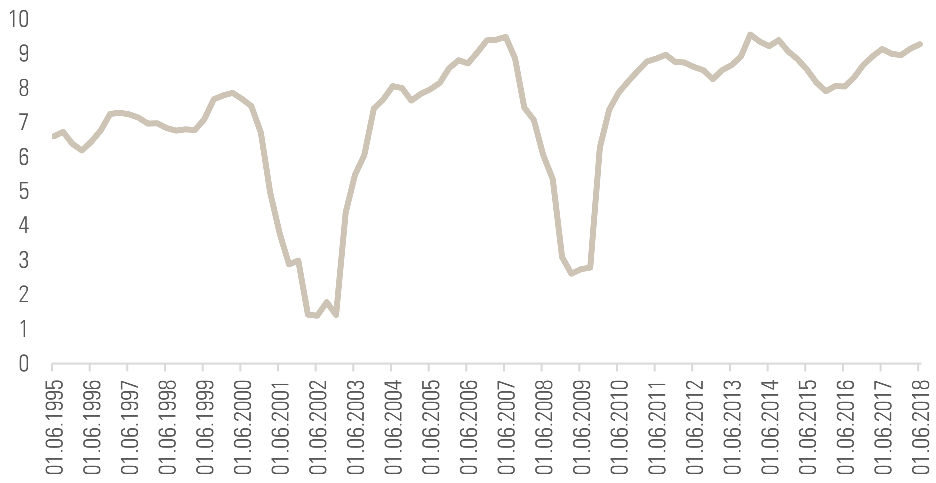
Chart 1 clearly shows the inverse correlation between employee compensation as a percentage of gross value added domestic corporate business (grey line) and corporate profits as a percentage of nominal GDP (red line). It shows that the very limited pricing power of labour in the last decade has allowed profits to remain elevated. If this were to change, the impact on profit margins and thus earnings would likely be material. While labour productivity can offset some wage pressures, a material improvement would be required from current levels in order to do so. Over the past decade, productivity growth has declined from a post-war average of 2% to a growth rate of just 1.2% annually, with productivity growth of just 0.6% annually over the past five years.

To some extent, the ability to hold down wages and salaries has been supported by cheaply available imports from China and other countries. A lack of private investment spending and therefore lower GDP growth despite an excess supply of capital have also played a role. This containment of labour compensation has been the primary force behind the sustained level of US corporate profit margins over the last 10 years, as shown in Chart 2.

Summary

1. After a decade of low labour costs, there are early signs of upward pressure on wages, both in published data and anecdotally.
2. Any increase in labour costs could hurt corporate margins and, ultimately, investment returns, especially for companies with stretched valuations.
3. A focus on quality companies that can maintain margins will be essential, as will selecting stocks that are less susceptible to valuation compression.

Chart 2: MSCI USA index profit margins



Source: Bloomberg

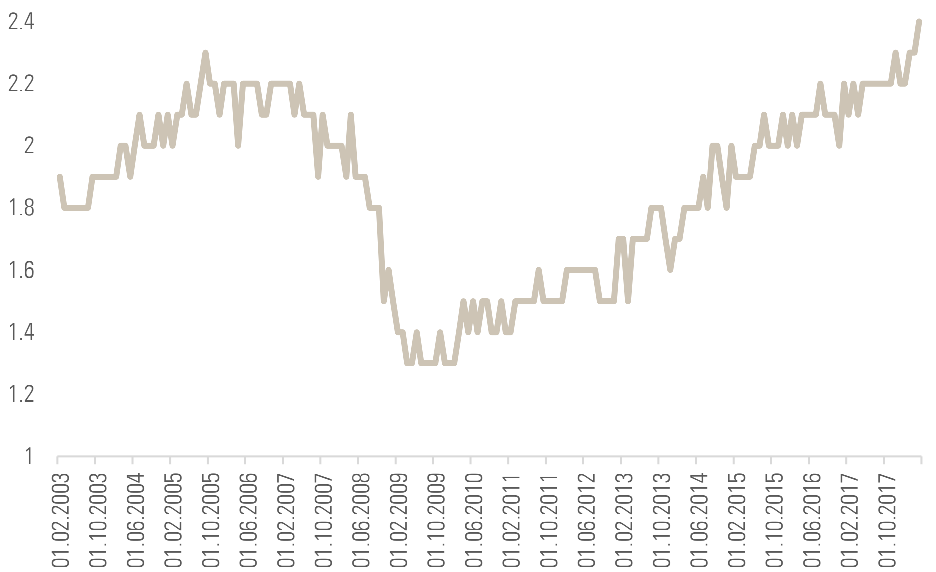
Looking at previous cycles, elevated profits are regularly associated with sub-par profit growth over the following five-year period. This is because historically, in a competitive economy, elevated corporate profits do not tend to last and profit margins have been mean-reverting.

Early signs of upward pressure on wages are emerging

We are beginning to see the signs of upward pressure on labour costs. The quits rate is an indication of an individual's willingness to quit their job in order to take up a new one and is believed to be a good leading indicator for labour cost pressure. It has now risen above the previous cycle high, as shown in Chart 3 below.

"We are beginning to see the signs of upward pressure on labour costs."

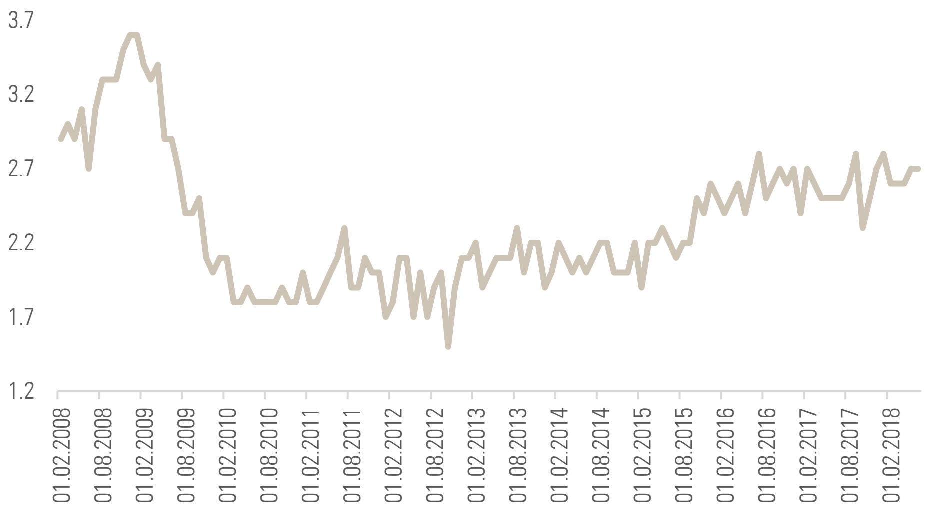
Chart 3: US quits rate



Source: Bloomberg

In Chart 4, we can see the yearly percentage change in US average hourly earnings (total hourly remuneration, in cash or in kind, paid to employees in return for work done) over the past 10 years. While it has been steadily creeping higher, it remains well off the highs of 2008, for the moment.

Chart 4: US average hourly earnings

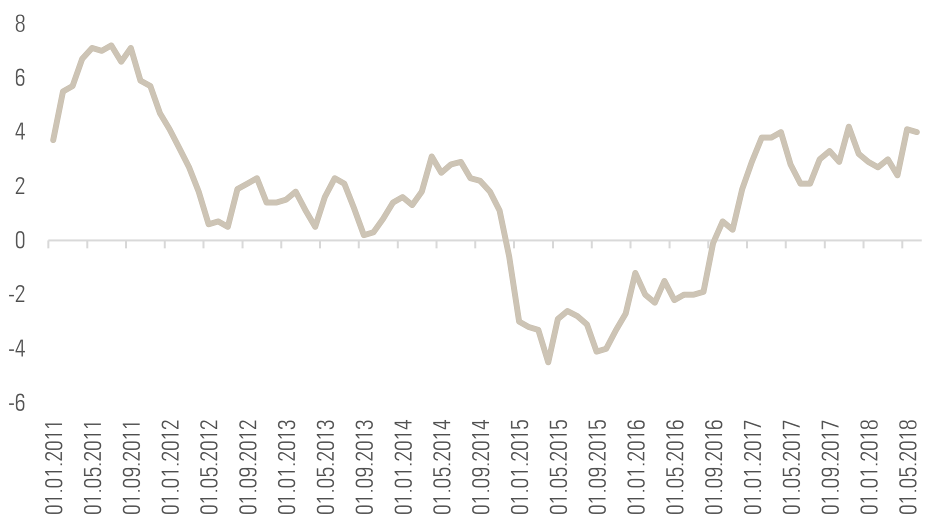


Source: Bloomberg

Rising inflation may drive wages higher

In June 2018, the US Producer Price Index (PPI) figure came in at 4%, the highest reading since November 2011 (as shown in Chart 5 below). Producer prices are a measure of the change in the price of goods as they leave their place of production.

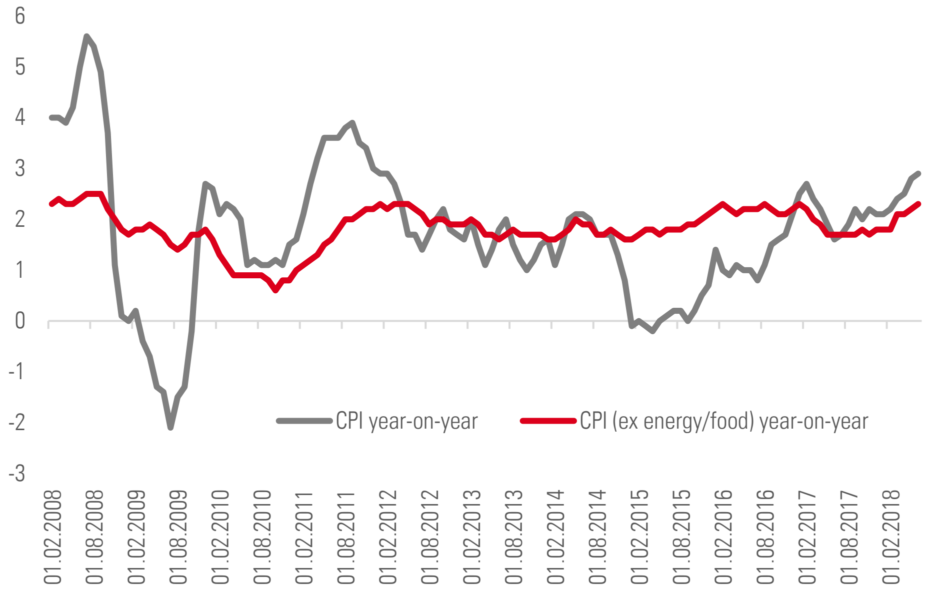
Chart 5: US Producer Price Index



Source: Bloomberg

In addition, the US Headline Consumer Price Index (CPI) figure of 2.9% in June showed consumer prices rising at the fastest pace since January 2012 (Chart 6, grey line). While rising energy prices have had an impact, if we look at the Core CPI Index, which excludes energy and food costs (and is therefore not as volatile), we nonetheless see a sharp rise over the last 12 months (Chart 6, red line). The rises in both PPI and core CPI are together likely to put upward pressure on wages.

Chart 6: US consumer price indices



Source: Bloomberg

Anecdotally, when meeting companies, participating in quarterly earnings conference calls and attending investor conferences in the US, we are hearing that firms in various industries are finding it increasingly hard to attract talent and are raising wages in order to do so.

In 2016, there were 1.3 job seekers for each opening in the US. There are now 0.9 potential staff for each job vacancy. In other words, there are more jobs than there are workers to fill them. For context, at the height of the financial crisis the ratio was 6.6 to 1.*

"There are more jobs than there are workers to fill them."

As well as this, in California, the state mandated minimum wage is being raised incrementally from $11 currently to $15 by 2022. In Washington DC, it will reach $15 by 2020 from $10.50 currently. Walmart, the largest global employer, raised its minimum wage for 1 million of its US employees to $11 last year. Others have since followed suit.

In all probability, a slowdown in profit growth will take the form of an increased share of revenue going to employee wages and salaries, and a smaller, more normal share going to the bottom line, thus reducing earnings.

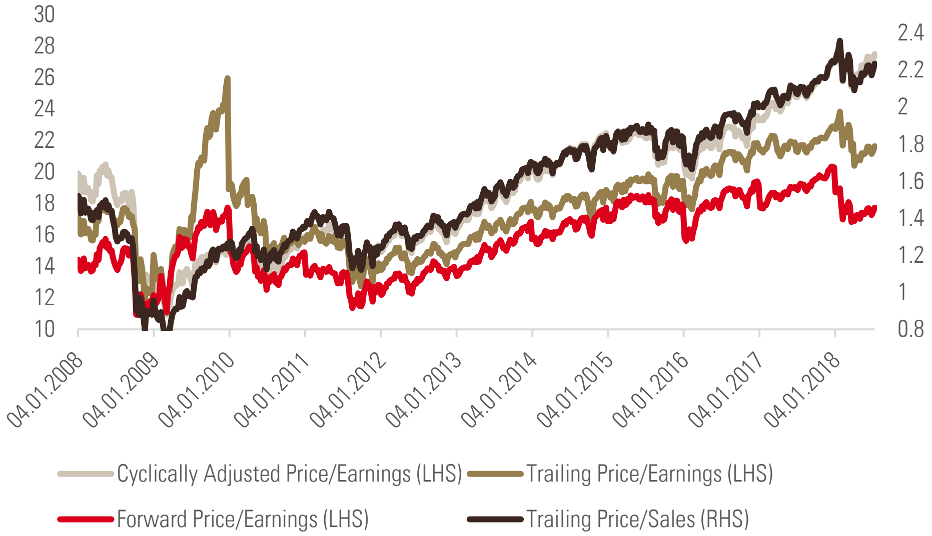
Weaker corporate earnings will likely hit valuations

As well as the direct impact on corporate margins themselves, a great deal of investor confidence may be quietly resting on the assumption that current margins are permanent. Outcomes to the contrary could accelerate the re-valuation of stocks to less extreme levels.

Valuations are high on a multitude of measures. Even using the cyclically adjusted price earnings (CAPE) ratio – defined as price divided by the average of the prior 10 years of earnings, adjusted for inflation – the US market is now trading at nearly twice the long-term historic average of 16.85x and at the highest level since the dot-com bubble. Moreover, this is before adjusting for the elevated level of underlying corporate margins sustained over the last 10-year period, as per Chart 2 above. Normalising corporate margins relative to long-term historic levels would send this valuation measure (and others) into the stratosphere.

Chart 7 below shows where we currently stand on numerous valuation measures on a 10-year view. Interestingly, the price-to-sales metric, which is the only one not reliant on currently elevated margins, is extremely high (black line).

Chart 7: US valuation multiples using different metrics



Source: Bloomberg

It is notable that earnings for the S&P 500 index have grown 4.9% annually since 1929, while GDP has grown 6.1%. Since the financial crisis 10 years ago, however, earnings have grown 10% annually – double the historical growth rate. Granted, earnings were depressed during the crisis, but GDP has grown just 2.9% annually since then. It is unrealistic to expect that earnings per share (EPS) growth will continue to outpace GDP growth by seven percentage points a year, especially if wage pressures manifest themselves and lead to margin compression.

Given the heavy reliance on both high earnings and the maintenance of high price-to-earnings ratios, even a gradual normalisation of profit margins is likely to weigh on investment returns.

Focus on quality companies

In light of this, exposure to good quality companies – including those that can maintain their margins despite rising cost pressures – or companies that have the ability to raise margins from depressed levels through self-help mechanisms will become increasingly important, as will having exposure to stocks that are less susceptible to valuation compression.

Currently at Unigestion, we are controlling exposure to expensive stocks within our portfolios using both a proprietary top-down valuation constraint and a bottom-up focus on the expensiveness of individual companies. We have a strong natural bias toward quality companies and we are currently leveraging our top-down quality focus when building our portfolios. When conducting our individual company analysis, we are focusing on companies that are best positioned to maintain corporate margins by utilising competitive moats to insulate themselves from external pressures.

So, mo' money for employees may indeed lead to mo' problems for investors. Vigilance and process discipline will be imperative moving forward.

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*Source: https://www.bloomberg.com/view/articles/2018-07-11/workers-should-get-bigger-raises-as-u-s-economy-strengthens

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