Where are we Now? – Global profits: recession or rebound?

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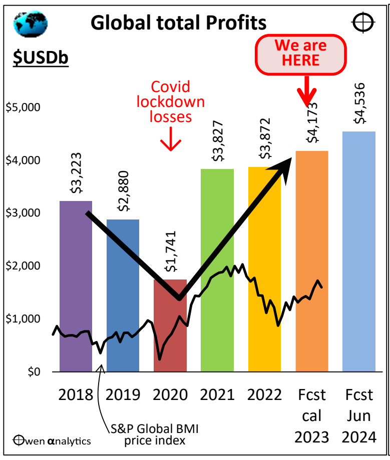
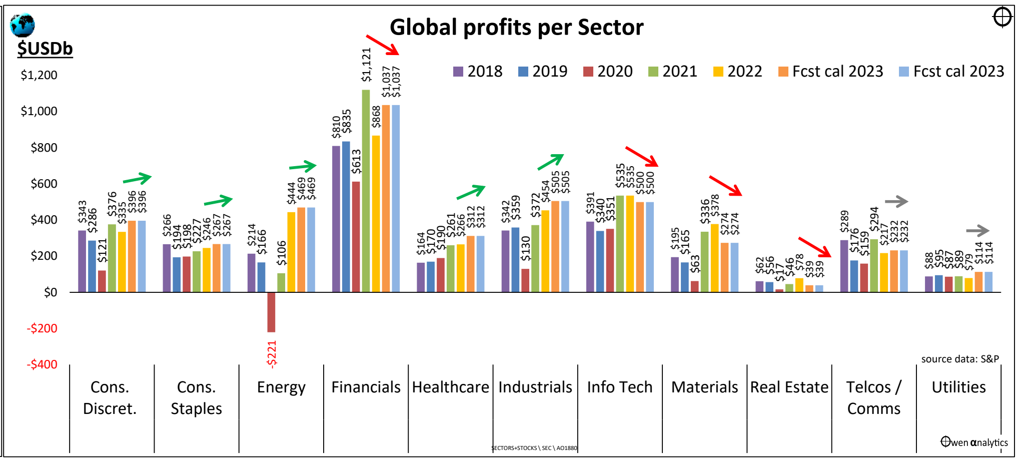
While media headlines warn of possible global recessions ahead, global profits are booming! There appear to be no obvious signs of impending recession in the latest profit results, or profit outlooks. What is behind the numbers?

Global listed companies posted US$3.8 trillion in profits for the 12 months to June 2023. This was more than double the 2020 Covid year profits, and 32% above pre-covid 2019 profits. So far in 2023, profits are down a little on last year, but analysts outlooks are predicting an immediate turnaround to boom-time profit growth ahead. Is this achievable?

Why are profits outlooks important? Because they are the number one driver of share prices and portfolio returns.

Here is our picture of aggregate global profits in recent years, from 2018 to 2022, plus 'consensus outlooks' (more on this later) for calendar 2023 and 2024. The left chart shows the global profit picture across all industry sectors, and the right chart breaks it down by sector.





<u>2018</u> (purple bars) – was the peak pre-Covid year for global profits, despite nine rate hikes from the US Fed, and Trump's trade wars triggering recession fears and a slump in global share markets in 2018. Profits totalled a record USD$3.2trillion, assisted by Trump's tax cuts.

<u>In 2019</u> (blue) - global profits fell back to $2.9 trillion. Economies were booming with the Fed switching from rate hikes to rate cuts, but global profits were dragged down by some big losses - including Altria/Marlboro, Boeing, and GE (all self-inflicted), and also a raft of profit cuts, eg big retailers like Walmart and Starbucks, most of the oil/gas majors, most of the big banks, and even in Apple, Facebook, Disney, AT&T, and many others posted lower profits.

Then the Covid lockdowns hit in 2020!

<u>In 2020</u> (maroon) - the covid lockdowns knocked global profits down by another 40% globally, to just $1.7 trillion in calendar year 2020. The lockdowns wiped out USD $1.1 trillion in global profits. Dividends also fell by 14% in 2020. This was less than the decline in profits because much of the reported 'losses' were from write-offs of asset values and also bank bad debt-provisions that were not cash-flow related.

<u>In 2021</u> (green) - share markets rebounded strongly as company profits soared back to well above their pre-Covid levels. In 2021, companies didn't just recover the $1.1 trillion lost in 2020, they posted profit increases of $2.1 trillion, bringing total global profits to $3.8 trillion, some $1 trillion <u>above</u> 2019 pre-Covid profits.

Where did this extra $1 trillion in company profits come from? Mainly, it came from the government spending spree, funded by war-time-like deficits and debts (ie future tax-payers). The profit bonanza was not sustainable of course. It relied on artificial and temporary zero interest rates and government hand-outs.

In 2022 (yellow) - aggregate profits were flat at $3.9 trillion, as the monetary and fiscal supports were wound back.

In 2023 (orange) – profits in the first half of 2023 were down a little on the prior half, but most results were well above expectations.

A note on 'Consensus' forecasts

The 'forecast' figures are arrived at using outlooks compiled by panels of research analysts working for the big brokers and investment banks. Their outlooks are largely based on forecasts and 'guidance' from the companies themselves. US companies (which make up 60% of global stock market value) are notorious for beating their forecasts – ie under-promising and over-delivering. S&P keeps a tally of this phenomenon for many years. In recent decades, the S&P500 group of companies have beaten their quarterly profit forecasts around 65-70% of the time. In the recent June quarter results, 76% of US companies beat the 'consensus' forecasts.

Curiously, Australian companies as a whole are famous for doing the opposite - over-promising and under-delivering. Australian companies have a long history of starting off with bullish, ego-boosting promises, but then progressively downgrading their forecasts during the year as reality sets in. August is reporting season in Australia, so we will bring you the results next month.

Where are we now?

Current consensus outlooks, and current pricing levels, assume profits will surge +20% (ie an additional US$750b in profits) in the coming year. This is inconsistent with the much-feared 'recession' or 'hard landing' scenario that grabs media headlines and priced into bond markets with steeply negative yield curves.

Given the consistently strong track record of companies beating forecasts, we would ordinarily say that there is a reasonably strong case that the forecasts can be achieved, as they almost always are.

However, the ambitious forecasts require closer scrutiny.

The big drivers of global profits

Although most of the media focus on a small handful of tech stars, the biggest drivers of global profits are two relatively boring sectors – banks ('financials') and fossil fuels ('energy').

Banks

Although banks account for only 15% of overall global stock market value (and barely rate a mention in the media except in a crisis like the GFC, and isolated collapses like Silicon Valley Bank and Credit Suisse), banks are by far the largest contributor (25%) to global profits and dividends.

Bank profits fell heavily in 2020 (mainly bad debt provisions in the Covid recession), rebounded strongly in 2021 (mainly writing back unused bad debt provisions, plus soaring investment banking activity in the tech boom), then fell back in 2022 (mainly due to lower investment banking activity - IPOs, SPACs, etc).

In 2023, bank profits were set to rise strongly, with higher margins after the rate hikes. However, banks are now starting to raise their bad debt provisions in anticipation of a global slowdown. Most of the rising arrears and bad debt provisions in the June quarter results were on credit cards and commercial property. Investment banking activity is also much slower this year than in the 2021 tech/SPAC/IPO boom.

Fossil fuels

The ‘energy’ sector is small (just 4% of global stock market value) but it still manages to post massive losses that inflict enormous damage to the aggregate profit figures (not to mention global warming, poisoning rivers, habitats, wildlife, etc).

There are several forces at work that cause regular bouts of losses from the fossil fuel dinosaurs – volatile and highly cyclical oil prices, magnified by leverage; high fixed costs bases, and capex costs; the nasty habit of company boards continually over-paying for ego-boosting new projects and acquisitions in booms (usually with debt), then writing them off in the inevitable busts; huge clean-up costs after disasters, remediation of polluted sites, fines for bribery & corruption, and a host of other self-inflicted mishaps.

Miners (in the ‘Materials’ sector) are also just as guilty here. (The big Australian miners and fossil fuel producers are prime examples of these afflictions).

The fossil fuel sector was the largest contributor to global losses in 2020 when oil prices collapsed (including the negative oil price crisis in April), but returned to small profits in 2021 when prices recovered. The sector was by far the largest contributor to the growth in total global profits in 2022 (increasing profits by +US$430b) after prices soared with the Russia/Ukraine war and sanctions.

Fossil fuel profits are forecast to rise in 2023 to around $470b. Ordinarily, a deep US/global recession would see demand and prices collapse (like in 2020) resulting in massive losses again. However, supporting prices now are Russian sanctions, lower production growth (higher costs of equity and debt capital due to fossil fuel financing bans), and also production controls (the negative oil price nightmare in 2020 will probably ensure OPEC never risks that again with price wars).

What about US ‘big-tech’?

The global aggregate profit recovery in 2021, the surge in 2022 and into 2023, and the consensus forecasts for the coming year, have been accounted for already by the ‘financials’ and ‘energy’ sectors discussed above, without even mentioning the attention-grabbing tech/online stars – US ‘big tech’.

These US giants are spread across three sectors - ‘Consumer Discretionary’ (eg Amazon, Tesla), ‘Tech’ (Apple, Microsoft, Nvidia), and the ‘Telco /Comms’ sector (Alphabet/Google, Meta/Facebook, Netflix).

These warrant a separate story – ‘Were are we now? US profits: recession or rebound?

Stay tuned!

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