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Higher Wages Dent Profits

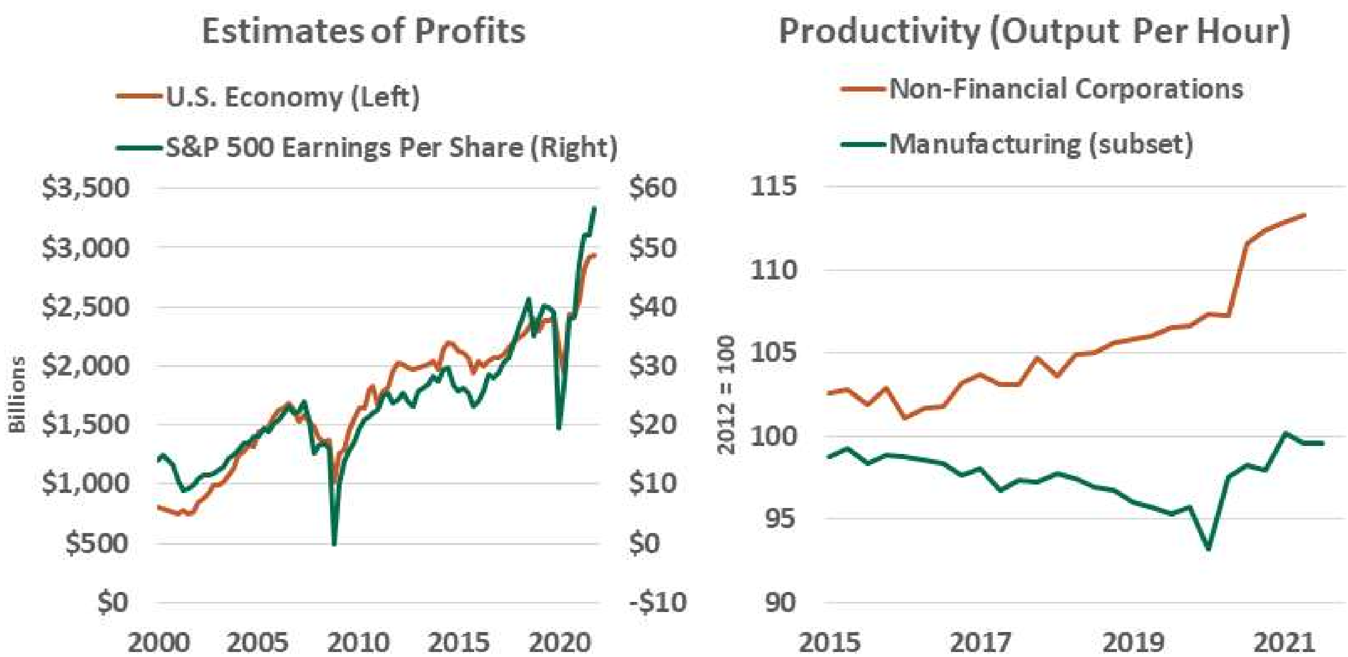
Businesses are unable to fully pass on the higher cost of labor, thereby challenging profits.

By Ryan James Boyle

Profits are the residual of revenues and costs. The word comes from the Latin *profectus*, which can also mean progress, growth and success. Far more than an accounting concept, profits are a sign of a successful business, and high aggregate profits are a sign of a growing economy. They are therefore worth watching as a signal of how the current economic cycle is evolving.

Economists track profits as published by the Bureau of Economic Analysis (BEA), reflecting results from a very broad range of large and small companies. This approach is distinct from the quarterly earnings tracked by investors, which are disclosed in the financial statements of publicly-traded firms. The latter measure is somewhat skewed by outcomes from large firms in sectors like technology, energy and financials. Both BEA profits and corporate earnings reports have been on a highly favorable course, but how long can the good news carry on?

The primary expenses for a typical business include rent, raw materials and labor. In the course of the recovery, the costs of all of those categories have trended upward, but at varying paces. Commercial leases run for long terms, keeping rent growth in check. Input costs have varied, with shortages afflicting many products and **energy** becoming more expensive. Labor has been the most persistent challenge to maintaining profitability recently, especially for employers reliant on large numbers of workers.



Sources: S&P, BEA, BLS, Haver Analytics

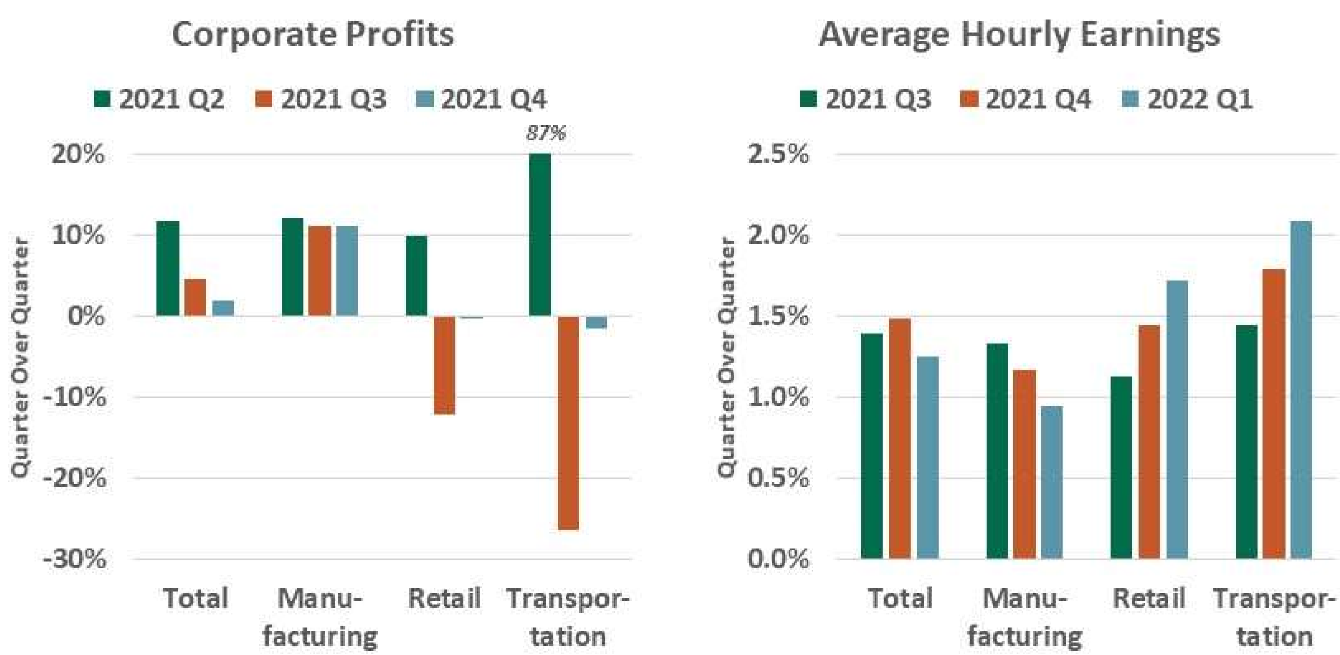
Competition for labor remains intense. Last year, the **recovery in labor force participation** fell short of expectations. Employers made more generous offers and gave larger raises to keep their staff on payrolls. Once they are set, salaries rarely fall.

The U.S. has enjoyed a string of **favorable employment reports**, with consistently high payroll growth and low unemployment rates. However, we are closely watching growth in compensation. As of March, overall wages grew by 5.6% year over year. In the prior cycle, over the interval of 2010-2019, pay growth averaged 2.4% and never exceeded 3.6%; today's readings are beyond anything seen since the high-inflation era of the 1970s.

The dynamic between pay and profits has been especially active lately.

But in the last growth cycle, the consumer price index climbed at an average rate of only 1.8%. Demand recovered gradually, and profit growth was limited. Wage growth in excess of

inflation was a comfortable position for workers. Now, hourly earnings are gaining at a rate that may look high, but they are still not keeping pace with hot inflation.
Compensation gains over the past year have been noticeable in many sectors, with the largest raises going to the lowest-paid workers. Debates over raising the national minimum wage are a distant and irrelevant memory, as employers' need for workers led to higher compensation, which firms were not shy about advertising. Several prominent employers have their own minimum pay policies, effectively setting a floor for all other employers who are in the same local markets.
Employers can offset the impact of higher payrolls by making productivity-enhancing investments in technology, limiting the need for staffing and making better use of workers' time. Measures of productivity growth have been elevated ever since the COVID shutdowns; a shift away from labor is evident in self-checkout kiosks and online restaurant ordering platforms. Greater output per hour helps to preserve profits.
Some of the higher payroll cost has been passed along in final prices, but not entirely. For instance, the prices of restaurant food grew 7.5% year over year in February, and alcoholic beverages (away from home) 4.5%. However, nonsupervisory wages grew by 14.3% in restaurants and 12.3% in bars over the same interval. The change in the cost of labor is far surpassing the increase in prices that managers can pass on. When costs rise faster than revenues, profits are squeezed.



Sources: BEA, BLS, Haver Analytics

The most recent reading of economic profits published by the Bureau of Economic Analysis (BEA), through the fourth quarter of 2021, bears this out. Across the economy, profits were up 25% for the full year 2021, more than making up for the 5% decline witnessed in the challenging year of 2020. But the appreciation is cooling, with overall growth of only 0.7% from the third to fourth quarter. Details within those numbers reveal a mixed picture.

Profits were challenged in the sectors that are most reliant on labor and were in greatest demand in the pandemic recovery. Retail, transportation and warehousing rely on an ample supply of lower-paid workers, together representing 15% of U.S. employment. Prices **started to gain mid-year** as demand returned, initially boosting profits. However, shippers' pricing power was not sufficient to prevent profit declines in the second half of 2021, even before the current energy price pressures took hold. It is no coincidence that this is the same time that these sectors raised pay aggressively to attract and retain staff. Wage gains in these sectors have steadily outpaced the higher compensation seen across the rest of the economy.

Productivity will need to grow to offset higher wage expenses.

Profits can be volatile. In expansion cycles, net income will jump initially, then carry on unpredictably. Falling profits do not always signal a recession, but they should not be ignored; lower margins may cause employers to initiate layoffs that can spark a broader contraction. Thus far, very low weekly jobless claims give no indication of layoffs; employers are holding on to every worker they have, a strategy that can also challenge profits.

Ultimately, profits are a residual, and they are holding steady through a bout of rising costs and higher prices. If nothing changes, with pay growing and prices rising to hold profits steady, the economy will have entered a wage-price spiral. If higher costs make profits fall, that will have implications for investors. Thus far, payroll reports are not showing a decline in employee compensation, suggesting margins will be pressured, or an inflationary feedback loop is forming.

Close tracking of its composition takes attention away from the original meaning of *profectus*: growth and success. Whether on one business' balance sheet or the full economy, profits are a sign of good performance. We will continue to monitor the rising costs that put this progress at risk.

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