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Investment Institute Macroeconomics

Eurozone corporate profits outlook: How they could influence the ECB

How Eurozone profits may impact monetary policy outlook

Macroeconomic Research

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Key points

- The ECB has identified the evolution of profits as one of its key criteria for loosening monetary policy. Here we review the recent profits environment and the current outlook
- Since the pandemic we have observed profit waves – with some sectors able to pass higher prices to consumers before others. But wages have tended to lag and have not caught up at all in some sectors
- We highlight that the debate around so-called greedflation was not exaggerated in 2022. But it seems unit profits are normalising. Adopting ECB assumptions, we compute their implicit targets for profits for 2024 and 2025.
- We believe that profit growth is likely to be more resilient than the ECB assumes. That remains consistent with our call that it will cut interest rates in June but will remain cautious thereafter (September and December 2024, two more in 2025).

Profit evolution matters for the ECB rate outlook

Despite the recent and sharp fall in headline inflation, the European Central Bank (ECB) has not started cutting interest rates. The ECB argues that domestic inflation remains too high. We see this as the internal price pressures upon which the ECB can act – opposed to external price pressures such as energy, food and transport costs on which the ECB has less influence.

The ECB recently admitted it will be ready to cut interest rates if greater confidence can be achieved on three criteria, namely "*wages and the evolution of wages, which constitute a large contributor to services inflation; to profits, to make sure that unit profits actually absorb as much as possible of the wage increases; and productivity, which is also something that we expect will improve in the course of 2024*".

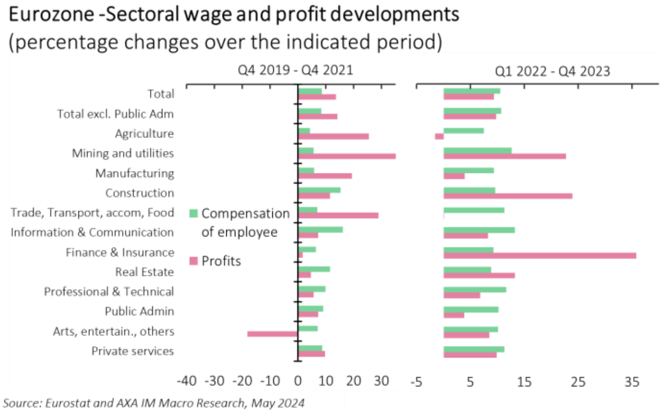
In this research paper, we focus on the second factor. Firstly, we expose reasons for the ECB's concerns over profit developments. We then estimate implied ECB profit forecasts and compare with our own outlook for profit growth. We conclude that the ECB appears optimistic in its assumption for a deceleration in profit growth.

We suggest that this is likely to limit the degree of monetary policy easing the ECB is likely to embark on from its next meeting in June, particularly for 2025. This reinforces our more cautious policy outlook and our long-held view that the ECB will remain in restrictive territory in our forecast horizon, with our forecast that the ECB deposit rate will remain at 2.75% until the end of 2025.

Profit growth in waves

We start by reviewing the evolution of profits and wages by sectors since the pandemic (Exhibit 1).

Exhibit 1: Profit evolution after the COVID and energy shocks



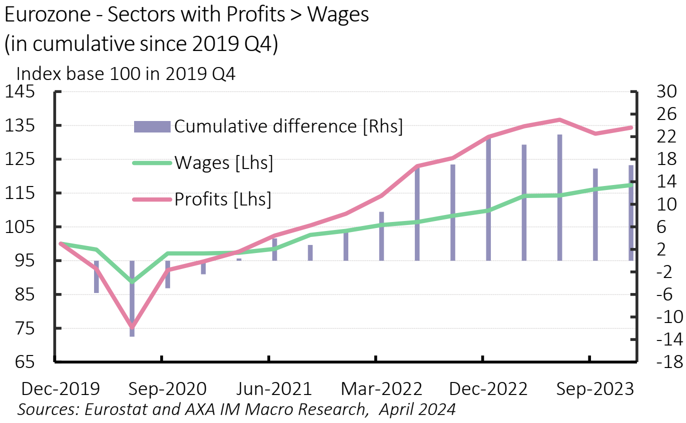
During the COVID-19 period and just after, profits in agriculture, mining and utilities, manufacturing and trade all rose sharply, some of them during lockdowns and others at the early stages of reopening. We then saw a second profit surge, boosted by the wider reopening of the economy from the second half of 2021, which benefitted leisure, entertainment, transport, accommodation, construction and real estate. A final wave occurred during the energy crisis which triggered a strong central bank reaction that finally benefitted finance and insurance. In all, wages lagged this profits evolution.

Winners take all

We can summarise those developments by looking at the cumulated profits and wages by sectors between the fourth quarter (Q4) of 2019 and Q4 2023. But because we know there can be different dynamics at work across sectors, we build two buckets based on the level of cumulated profits and wages at the end of 2023. The first bucket encompasses all sectors where current cumulated profits grew above wages: these are agriculture, mining and utilities, manufacturing, construction, trade transport, accommodation and food, and finance and insurance, accounting for approximately 54% of total profits in the economy (as of Q4 2023) (Exhibit 2).

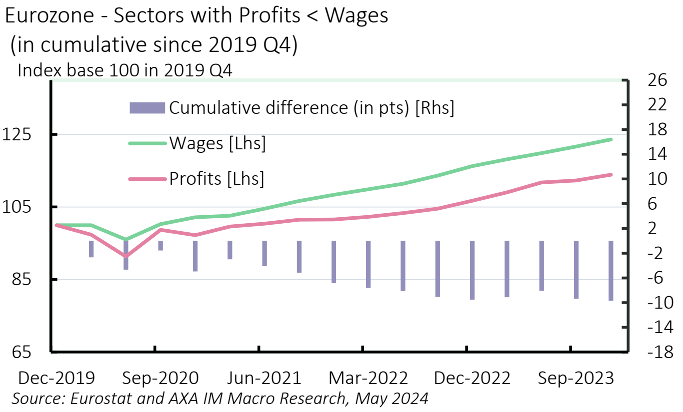
In this group, we can clearly see a rise in profits and then a partial catch-up of wages while profits were stabilising. But since the beginning of 2023, both have been broadly evolving at the same pace (except during Q2 2023).

Exhibit 2: Profits divergence with wages stays high



The second bucket comprises all the sectors which have seen wages growing faster than profits. It includes information and communication, professional and technical services, real estate, public administration, arts, entertainment and leisure. They together account for 46% of total profits (Exhibit 3).

Exhibit 3: While others keep lagging



In this group, profits rose but wages increased by more overall until 2022 and then the two broadly evolved similarly. Sectors such as leisure and entertainment employ workforces usually paid close to minimum wages, and these have for most of the time increased inline, with inflation (while profits have stalled). Another explanation applies to professional and technical, information and communication. Here, employers were probably facing more acute pressure to attract and keep employees, despite not being able to generate higher profits.

This shows that there is not a common momentum across all sectors, but something more heterogeneous, which also

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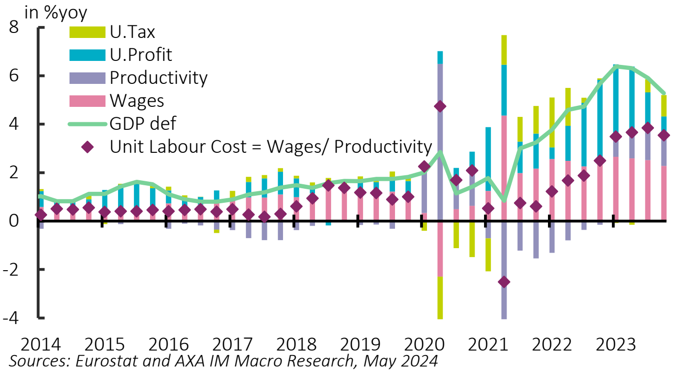
highlights the complexity faced by central banks when it comes to calibrating monetary policy.

Greedflation or normal pass through?

We illustrate the recent domestic inflation drivers by using the GDP deflator – a measure of general inflation in the domestic economy – and its breakdown by unit labour costs (ULCs), unit profits and unit taxes (subsidies and/or taxes)[1].

Exhibit 4: Contribution of profits and labour cost to deflator

Decomposition of the euro area GDP deflator



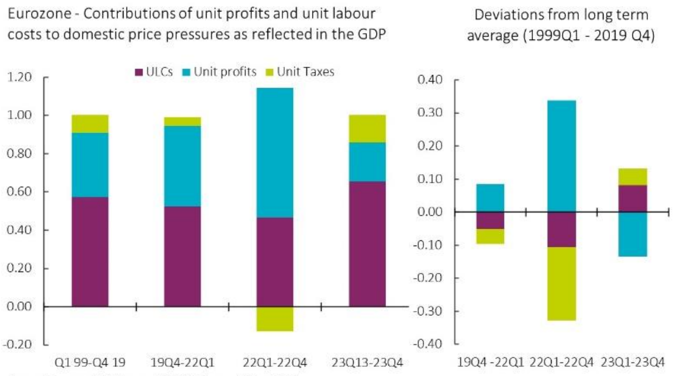
Sources: Eurostat and AXA IM Macro Research, May 2024

An unusually high contribution from unit profits (Exhibit 4,blue bar) drove the increase in the GDP deflator in 2021 and then between mid-2022 and mid-2023, before being more balanced with ULCs (Exhibit 4, purple dots = pink + mauve bars). Although this picture is somewhat obscured by productivity, which recovered rapidly in 2021 and declined thereafter.

To get a clearer view, we replicate and update an ECB blog [2]looking at the contribution share of ULCs, unit profits and unit taxes between 1999 and 2019 (Exhibit 5, left chart – left bar) and then look at the deviation from the long-term average in recent years (Exhibit 5, right chart). This shows a small deviation of unit profits in 2019-2021 period but a surge in 2022. It is now obvious that profits led 2022's inflation spike.

The contribution of unit profits to GDP deflator was much lower in 2023 and its levels is below its historical average (blue bar on the right chart). On the other side, ULCs deviation turned positive (with higher wages and lower productivity) as well as unit tax as government spending faded. The fall in unit profit contribution is somewhat mechanical, as it could not continue to rise at 2022's pace. But what matters is what we can expect in 2024-2025.

Exhibit 5: Obvious deviation of unit profit in 2022



Source: Eurostat, ECB blog and AXA IM Research, May 2024

What could the ECB have in mind?

Every quarter, the ECB provides an updated set of forecasts for many macroeconomic variables including real GDP, the GDP deflator and ULCs (Exhibit 6). You can probably guess what comes next. We make basic assumptions that taxes follow nominal GDP growth (which has been true until 2019, due to recent extraordinary support from the government). This leaves only unit profits unaccounted.

But with some reverse-engineering and using the latest weight for ULCs, we can compute a unit profit growth consistent with the ECB's other assumptions.

Exhibit 6: ECB assumptions (March 2024)

In %	2024	2025	2026
Real GDP	0.6	1.5	1.6
GDP Deflator	2.9	2.3	1.9
Unit Labour Costs	4.4	2.3	1.7

Source: ECB Macroeconomic Projections and AXA IM Research, March 2024

Using those assumptions, we found that the ECB is probably expecting unit profits to grow by +0.4% in 2024 and +2.0% in 2025. Focusing on profits only (by multiplying unit profit growth by real GDP growth), it means the ECB is expecting profits to be flat at 0.2% in 2024 but to rebound by 2.9% in 2025.

That remains consistent with the ECB's communication "*that unit profits must absorb as much as possible of the wage increases*". The ECB is not expecting any rise in profits in 2024 or that would mean companies are passing increasing labour cost to consumer prices.

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[1] $ULC = \frac{Wages}{Productivity} = \frac{Compensation\ of\ employees * \frac{employment}{employees}}{real\ GDP}$

$$Unit\ Profit = \frac{Gross\ operating\ surplus\ (profits)}{real\ GDP}$$

[2] Arce, O., Hahn, E. & Koester, G., "How tit-for-tat inflation can make everyone poorer", The ECB Blog, March 2023

We now assess whether these implicit ECB profit forecasts are realistic given past patterns. To assess this, we estimate historic profits based on changes in real GDP and core inflation. This relation is nearly an identity as real GDP refers to the evolution of volume while inflation accounts for the nominal part. Then, we simply apply our in-house forecasts to estimate future profit outlooks. This simple 'model' points to another deceleration of profits growth to around 4.5% in average for 2024 (from 8.1% in 2023) and 4.2% in 2025. This would remain above the historical average of around +3% since 2000 (also excluding the global financial crisis and pandemic periods). Again, we acknowledge this is a (very) simplified model, but it suggests the ECB's forecasts of 0.2% and 2.9% are too low, particularly for 2024.

Monitoring profits live

Official profits data are computed on a quarterly basis and released approximately two months after the end of the relevant quarter. This makes them cumbersome to use for policy decision-making. To overcome this limitation, we have developed a tool to follow the evolution of profits in real-time[3]. Then, we compare those developments to two indicators:

- An estimate based upon variables from the European Commission business surveys.

- Year-on-year evolution of 12 months trailing Earnings Per Share (EPS) for the MSCI EMU (European Economic and Monetary Union) Index.

Our proxy is estimated using the selling price expectations in the next three-months in the services and manufacturing sector as well as current business confidence in services sector[4].

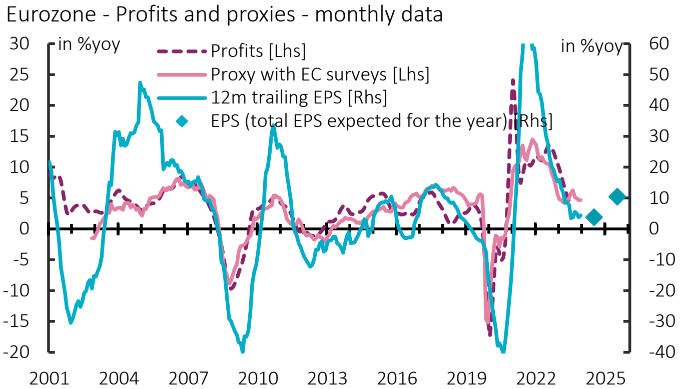
Twelve-month trailing EPS consensus is computed by rolling year-on-year profits over the last 12 months. EPS estimates are more volatile than broader, whole economy profits, reflecting erratic movements in market sentiment, in particularly during crises as analysts can abruptly revise forecasts. It also represents only listed equities, so it is not always a good representative sample of companies' profits of the whole economy, which are what the ECB focuses on. We also use EPS consensus forecasts for year end-2024 and 2025 (blue dots).

Fourth quarter corporate profits rose by 4.7% year-on-year. Looking at our proxies for Q1, we have mixed signals:

- 12-month trailing EPS consensus points to a small deceleration but remaining still at a high level (4.7% year-on-year in Q1 from 6.6% and +4% year-on-year in Q2) while the year-end target is currently 3.8%, suggesting that the market assumes a deceleration of profits over the course of the year, but still to a higher pace than the ECB forecast. It is also the case for expected EPS in 2025, currently at 10.4%.

- Our in-house proxy signals a rebound to +5.4% year-on-year from 5.1% in Q4 and 4% year-on-year in Q2 (based on April data) (Exhibit 7).

Exhibit 7: Profits – not a clear deceleration



Source: Eurostat, European Commission, Bloomberg and AXA IM Macro Research, May 2024

In any case, we are observing some convergence between profit and ULCs growth. However, we believe that the ECB wants more, its forecast suggesting almost a hard landing for profits to actually absorb rising labour costs. This is not what we are seeing and underlines some caution over what this will mean for prospective easing by the ECB over the coming quarters.

[3] We annualise profits with a cubic interpolation (on quarterly data) and compute yearly changes.

[4] It has an interesting track record with a high R^2 of 0.71 over 2001-2023 and a root median square error of 2.8 which can appear high, but it is inflated by some big misses during the covid period.

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Our Research is available online: www.axa-im.com/investment-institute

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