



## Client Bulletin

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# Q2 Updated Profits View and Outlook

- **Q2 NIPA profits up despite earlier indications of weakness**
- **Expansion to continue at generally moderate pace into 2014**
- **Profits forecast range for next three quarters has narrowed as upper boundary edges up, lower boundary moves up considerably**
- **Outlook for global and domestic economies beyond early 2014 remains heavily dependent on government policies around the world, especially in China, Europe, and the United States**

The rough “plateau” we had used to describe the profits trend now looks like a moderate, bumpy rise (chart 1; for an explanation of the profits equation, please see *Where Profits Come From*, available on request or at [www.levyforecast.com](http://www.levyforecast.com)). In late July, with the comprehensive revisions and first release of second-quarter NIPA data, first-quarter after-tax NIPA profits changed from flat to up about 2% (quarter-over-quarter), and our estimate for second-quarter profits changed from down slightly to flat. Then, last week, the second release of second-quarter NIPA data (and first NIPA release of profits) showed that profits rose by almost another 3% from the first quarter to the second. Furthermore, the outlook for the next three quarters

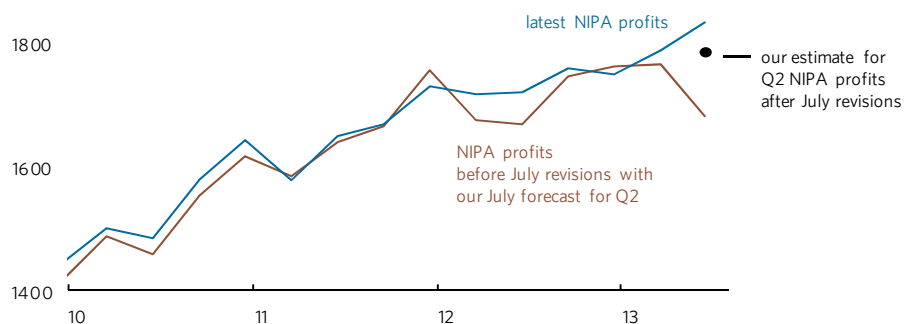
appears both less uncertain and overall better than a month ago—which was before evidence of Beijing’s resurging determination to halt the Chinese economy’s deceleration and clear signs of euro area backsliding on austerity brightened the global outlook for the next few quarters.

Based chiefly on an improved global outlook, we have substantially reduced the downside potential for profits and modestly raised the upside for the next four quarters (chart 2). Profits are unlikely to change greatly over the next few quarters and have the potential to either rise or fall modestly. The further into 2014 we look, the larger the political uncertainties loom once again. As before, the upside will remain constrained to moderate gains because, even under relatively favorable conditions, balance sheet excesses and at least moderate fiscal tightening in the United States limit the economy’s potential. Meanwhile, the downside potential increases the further out we go because of the possibilities of returning austerity in Europe, Chinese government failures to manage their growing economic challenges, increasing secular troubles in the other emerging market (EM) economies, and the potential for further fiscal drag in the United States. *Still, for now, the outlook for profits is relatively benign, even if it is below consensus expectations.*

**NIPA After-Tax Profits through Second Quarter 2013**

CHART 1

NIPA Profits after Tax, seasonally adjusted and adjusted for tax law distortions to depreciation  
\$ billions, seasonally adjusted, annual rate



The second quarter upside surprise was driven by two factors. First, the impact of sequestration-related cuts to federal government spending appears to have been largely delayed until the current quarter. Thus, much of the fiscal contraction we expected in the second quarter in all probability has been taking place in the third. Second, U.S. exports and earnings from abroad performed better than expected in the second quarter. End-of-quarter data showed a sharp improvement in net exports in June, although this improvement faded somewhat in July.

As for the future, the primary change to our profit source forecast is a decline in foreign saving (an improvement in the current account deficit and, in particular, the trade deficit). We now expect a more favorable trade balance in the second half of 2013 primarily because recent government policy actions in China and Europe have improved the global outlook for at least the next several months.

We will not necessarily have to wait long for more clarity on the 2014 outlook.

- We hope to gain more insight into the outlook for euro area fiscal policy following the German federal elections on September 22. Following that, the governments throughout the euro area may be inclined to speak more frankly about future fiscal policy and to make budgetary decisions.

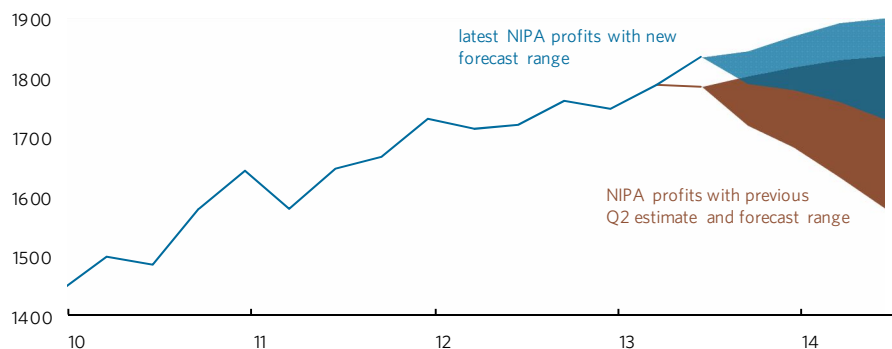
- Meanwhile, more data on Chinese economic performance and, perhaps, some clarification on Chinese government economic policy may shed light on the answer to a critical question: has Beijing really beefed up ongoing spending, or has it simply rushed some programs along to give the economy a brief push?
- Developments in the rest of the EM sector will provide a clearer sense of the magnitude of the problems and how much they threaten global and U.S. conditions. Although the growing strains in the EM economies will detract from global profits and growth, they do not appear likely to derail the expansion at least until mid 2014, if then.
- Finally, U.S. fiscal policy for fiscal year 2014 (beginning October 1) remains a source of uncertainty. However, in the present political environment, there does not appear to be a strong push for any major changes.

Wall Street's expectations for future earnings are still likely to come down from current levels (currently the consensus expects 13% year-over-year growth for S&P 500 earnings in both Q4 and 2014 as a whole), but the downward revisions are not likely to be as large as they have been in recent years. For 2014, a relatively good global performance (read: sufficient government help) could support a continued rise in U.S. corporate profits, whereas a not-so-good global performance (not enough government help) would likely mean a more erosive trend, with downside risks growing as the year progresses.

## NIPA After-Tax Profits Four-Quarter Forecast

CHART 2

NIPA Profits after Tax, seasonally adjusted and adjusted for tax law distortions to depreciation  
\$ billions, seasonally adjusted, annual rate, forecasts through Q2 2014





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