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No grounds for earnings pessimism

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NO GROUNDS FOR EARNINGS PESSIMISM

Despite the crisis on the world's stock markets, 2007 was a good year for German companies. There are many indications that small and medium-sized enterprises in particular were able to improve their earnings position, increasing both their sales and their number of employees. However, the large companies also boosted their profits. The 30 companies listed in the DAX, for example, saw their pre-tax profits rise by 17.5 %. All told, earnings at non-financial corporations (according to the national accounts definition) rose by 7.9 % in 2007, having posted double-digit growth rates in each of the three preceding years.

Less favorable backdrop for earnings

Will this upturn in profits continue in 2008, despite the many pressures companies face? Or will the negative impact of the financial market crisis, the oil price shock, and the rampant euro send profits tumbling? On top of these pressures, wage settlements which far exceed those of previous years have recently been agreed in some sectors, such as the chemical industry and the public sector. The acceleration in income growth could also serve to dampen the development of profits. Indeed, the wage restraint of recent years is now widely agreed to have been a key contributor to improved corporate earnings. So, where do we stand today in terms of the future trend in profits? Based on the current overall economic picture, this Working Paper endeavors to address this question.

The German economy got off to an unexpectedly strong start in 2008, and – despite the difficult environment – economic growth picked up a great deal of pace in the first quarter. Although the economy will cool off over the coming months, in line with expectations, real GDP growth should come in at an annual average of 2.4 %. Nominal value added is expected to rise by nearly 4 %. Similar to the trend of the past four years, we expect the performance of corporations to be slightly above-average compared to the overall economy.

Germany: Profit indicators

| in EUR bn | Whole economy | | | | | | | Non-financial corporations | | | | | | |
|-------------------------------------|---------------|---------|---------|---------|---------|---------|--------------------|----------------------------|--------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 ¹⁾ | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 ¹⁾ |
| Gross value added | 1933.19 | 1949.41 | 1998.74 | 2026.40 | 2094.22 | 2172.18 | 2256.9 | 1191.13 | 1201.34 | 1240.09 | 1266.71 | 1324.79 | 1387.77 | 1448.8 |
| - depreciation | 321.88 | 323.03 | 327.64 | 335.58 | 339.48 | 345.22 | 353.9 | 182.72 | 183.11 | 185.21 | 190.98 | 191.80 | 194.22 | 199.1 |
| - employee compensation | 1129.61 | 1133.17 | 1137.80 | 1131.00 | 1149.99 | 1181.33 | 1229.8 | 741.07 | 743.66 | 750.65 | 750.31 | 766.05 | 792.07 | 826.9 |
| - production levies minus subsidies | 10.67 | 13.32 | 19.03 | 20.66 | 25.70 | 27.49 | 29.0 | 2.87 | 4.56 | 9.09 | 9.70 | 13.80 | 15.34 | 17.0 |
| = operating profits ³⁾ | 471.03 | 479.89 | 514.27 | 539.16 | 579.05 | 618.14 | 644.2 | 264.47 | 270.01 | 295.14 | 315.72 | 352.94 | 386.14 | 405.8 |
| Earnings | | | | | | | | 270.24 | 265.70 | 319.04 | 350.99 | 389.96 | 420.72 | 440.9 |
| Entrepreneurial and property income | 447.80 | 467.53 | 530.03 | 561.25 | 601.87 | 643.18 | 668.9 | 10.41 | 8.29 | 50.84 | 47.87 | 57.92 | 84.29 | 88.0 |
| % change on previous year | Whole economy | | | | | | | Non-financial corporations | | | | | | |
| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 ¹⁾ | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 ¹⁾ |
| Gross value added | 1.5 | 0.8 | 2.5 | 1.4 | 3.3 | 3.7 | 3.9 | 0.8 | 0.9 | 3.2 | 2.1 | 4.6 | 4.8 | 4.4 |
| - depreciation | 1.7 | 0.4 | 1.4 | 2.4 | 1.2 | 1.7 | 2.5 | 2.2 | 0.2 | 1.1 | 3.1 | 0.4 | 1.3 | 2.5 |
| - employee compensation | 0.7 | 0.3 | 0.4 | -0.6 | 1.7 | 2.8 | 4.1 | 0.3 | 0.3 | 0.9 | 0.0 | 2.1 | 3.4 | 4.4 |
| = operating profits ³⁾ | 3.5 | 1.9 | 7.2 | 4.8 | 7.4 | 6.8 | 4.2 | 1.7 | 2.0 | 9.3 | 7.0 | 11.8 | 9.4 | 5.1 |
| Earnings | | | | | | | | 0.6 | -1.7 | 20.1 | 10.0 | 11.1 | 7.9 | 4.8 |
| Entrepreneurial and property income | 1.7 | 4.4 | 13.4 | 5.9 | 7.2 | 6.9 | 4.0 | 12,4 ²⁾ | -2,1 ²⁾ | 42,6 ²⁾ | -3,0 ²⁾ | 10,1 ²⁾ | 26,4 ²⁾ | 3,7 ²⁾ |

¹⁾ forecast; ²⁾ change in EUR bn; ³⁾ in the whole economy incl. Self-employed income.

Increase in labor income up sharply

Labor income is rising sharply in 2008. For the first time since 2002, the increase in union wage rates per hour is likely to be well above the 2 % mark again. We expect both the union rates per hour and effective wages per employee to grow by 2 ½ - 3 % in 2008. The rise in employment is also having a benign effect on labor income. Although the momentum on the labor market will probably wane significantly in the course of the year, the annual average rate of growth in employment is likely to pan out at 1.4 %. All told, employee compensation in the overall economy will probably rise by a good 4 %, increasing at a rate of just under 4 ½ % for corporations.

Earnings momentum lower, but upward trend continues

By deducting employee compensation, amortization and production spending (minus subsidies) from the gross value added, one arrives at an important earnings ratio, the operating surplus of companies. This can be interpreted as the operating profit from business activity, which – in the overall economy – also encompasses self-employed income. On the basis of our economic forecast, we expect to see an aggregate rise of 4.2 % in the operating surplus in 2008, down from 6.8 % last year. A similar growth rate is expected (4.0 %) for entrepreneurial and property income, which shows operating profits adjusted for paid and received property income. After four years of sharply rising profits, then, a moderate trend is anticipated for 2008. The main reasons for this are the subdued economic momentum, rises in the prices of a large number of import goods, and the faster rate of increase in labor incomes. The operating surplus of non-financial corporations is likely to rise somewhat more strongly than the aggregate operating surplus again in 2008, due to the healthy industrial economy. Here, we expect a rise of 5.1 % after 9.4 % in 2007 and an even more impressive 11.8 % in 2006. Against the backdrop of the various pressures which currently prevail, a downturn in the profit momentum of corporations is probably inevitable. On the other hand, the fact that the uptrend in profits will presumably continue – despite the fact that 2008 is proving to be a difficult year – is a positive factor.

Of course, the principles underlying the national-accounts based profit calculation cannot be applied directly in calculating the profits of corporations listed in stock market indices such as the DAX. The fundamental differences are:

- The accounting standards which apply to the profits of individual companies differ significantly from the calculation methods used in the national accounts.
- The major stock corporations listed in the DAX generate a large part of their profits – or at least an above-average part compared with German companies as a whole – abroad. The aggregate operating surplus, on the other hand, shows only the development in Germany. This year in particular, profits generated abroad are likely to develop less favorably, due to the sluggish economy in some countries and the weakness of the US dollar.

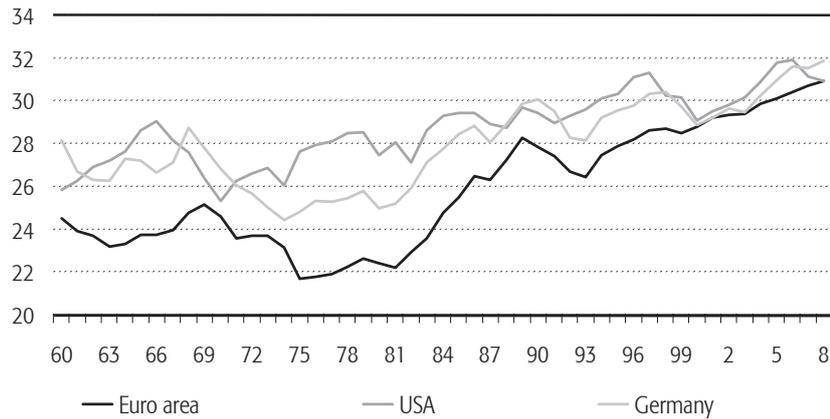
After a string of years in which profits rose more strongly than labor income, our estimates for 2008 point to a fairly balanced trend. As a result, the wage ratio – i.e. the share of employee compensation in national income – is unlikely to decline further in 2008. In 2000, the wage ratio still stood at 72.2 %. Since then, with the labor market weak, it has fallen steadily to 64.7 % in 2007. According to our estimates, in 2008 it could rise again slightly for the first time in 8 years, reaching 64.9 %.

Not only in Germany, but in many other countries, too, corporate profits currently account for a major share of GDP. A comparison between Germany, the euro area countries and the USA shows that the profit ratio (adjusted for self-employed income) in these

Trend in profit ratio up

regions has been more or less the same of late. Measured against the levels seen in the seven-ties and eighties, the increase in the profit ratio in the euro area has been especially striking, but Germany has also seen a pronounced rise. In other words, in the two largest economic blocs the (functional) distribution of incomes has converged to a quite remarkable degree.

Profit share indicator*
adjusted for imputed labor income of the self-employed, in percent



* ratio of gross operating surplus to GDP; on gross basis before depreciation.
Source: AMECO data base, own calculations.

Net return on capital*
adjusted for imputed labor income of the self-employed, in percent



* ratio of gross operating surplus less depreciation of capital to net capital stock.
Source: AMECO data base, own calculations.

A similar trend is also evident in the return on real capital, measured as the operating surplus relative to the capital stock. Since hitting a low at the beginning of the eighties, the return on real capital has been rising, though not without fluctuations. The USA posted particularly strong rises in the nineties, while Germany has been doing so since the beginning of the current decade. The USA's long-standing lead over Germany with regard to this particular profit measure has, in the meantime, virtually evaporated. This is further evidence that Germany has made up a great deal of ground when it comes to the earnings power of its corporate sector.

Upturn in investment looks set to continue

The much improved profit position of German companies gives cause to hope that the upturn in investment seen in recent years will continue, notwithstanding the current adverse backdrop. The need to expand capacities in response to healthy levels of utilization, and to implement technological innovations in order to safeguard competitiveness, is a strong reason to invest. Net investment in relation to overall disposable income, which stood at 3.9 % in 2006, is still way below the levels seen at the beginning of the nineties (around 12 %), and is also lower than it was around the turn of the millennium (around 8 %). If the corporate earnings picture remains rosy – as can be assumed at the present time – the investment ratio should also climb back towards earlier levels.