Key Questions:
Trade Disputes Revisited: What is the Potential Impact of Protectionist Policies on Corporate Profit Margins?

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Going forward, protectionist policies are a material risk to the tailwinds of higher profit margins that equity market investors have benefited from during the past 15 years.

In November 1999 Warren Buffet stated the following: “In my opinion, you have to be wildly optimistic to believe that corporate profits as a percent of GDP can, for any sustained period, hold much above 6%.” What one the greatest investors of our era didn’t know at the time was that US corporate profitability was about to embark on a structural increase largely due to a wave of globalization and China joining the global supply chain by becoming a member of the World Trade Organization (WTO) on December 11, 2001. While globalization was not the only factor that increased corporate profitability, it was one of the largest drivers on increased profitability over the ensuing decade and beyond.

From 1929 to 1998 corporate profits as a percentage of GDP averaged 5.7% and rarely increased beyond 7% in the post-war era. Buffet was likely aware of this data at the time of his statement. From 2002 to 2017, however, corporate profits as a percentage of GDP averaged 8.8% and have not been below 8% since 2004. When analyzing data for the S&P 500 Index, the patterns are similar. In fact, the net profit margin for the S&P 500 based on trailing twelve month earnings recently hit 10.6%, an all-time high.

A study by Empirical Research Partners, estimates that 40% of the increase in profit margins during this time was due to lower wage costs. Offshoring labor to lower cost countries/producers accounted for most of the lower labor costs, with higher productivity accounting for the rest. Approximately 33% of the margin increase was attributable to lower effective tax rates with the offshoring of earnings (this does not include the recent tax reform which pushed margins higher). The remainder margin increase was driven by lower interest rate costs.

Going forward, protectionist policies are a material risk to the tailwinds of higher profit margins that equity market investors have benefited from during the past 15 years. While the ultimate outcome is unknowable, historical data shows that there have been powerful benefits from globalization to corporate earnings.

In 1999 Buffet continued his thoughts: “In addition, there's a public-policy point: If investors, in aggregate, are going to eat an ever-growing portion of the American economic pie, some other group must settle for a smaller portion. That would justifiably raise political problems—and in my view a major re-slicing of the pie just isn't going to happen." Perhaps Buffet was better able to predict the future than we initially thought.

In our view, equity investors should remain invested, but also remain vigilant of the specter of protectionist policies which may adversely impact corporate profitability in the future.

For more information, please contact your Key Private Bank Advisor.

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