Daily Macro Insights: Why profit margins can stay so high

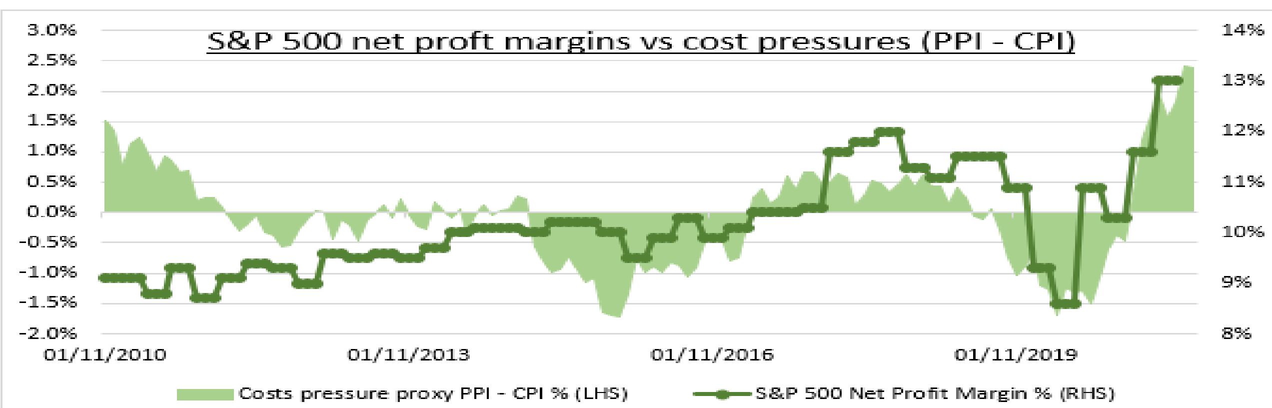
19/08/2021

FUELLING EARNINGS: S&P 500 company profit margins surged to a record 13% last quarter and are key to the run of profit surprises we see taking markets higher. They are also the reason many are so cautious on future profits growth: that these high margins are unsustainable and will be hit by rising costs and inflation. We disagree for 3 reasons: 1) we see cost pressures peaking now (see chart), and more than offset by the revenue rebound, 2) a rising tech sector weighting continues to structurally boost S&P 500 margins, and 3) 're-opening' segments, from hotels to airlines, have barely begun to recover weak margins.

MISUNDERSTOOD PRESSURES: We see company cost pressures as peaking now – not next year – and being offset today by strongly rising revenues. We proxy this by the difference between producer prices (costs to make something) versus the consumer prices (the costs of selling something). A similar message is seen from forward looking purchasing manager index data for surging input prices minus lagging output prices. We see margins supported both by peaking cost pressures and by more strong GDP growth, which is forecast at 6.2% this year and 4.2% next, more than double the Fed's 1.9% long-term GDP growth estimate.

SECTOR MARGINS: Part of the higher S&P 500 margins is structural. The tech (XLK) sector has profit margins of 21%, the highest of any, and this is the largest sector today. It has seen its weight rise around 50% the past decade and is set to keep increasing. Secondly, several 're-opening' sectors like industrials (XLI), consumer discretionary (XLY), and energy (XLE) have still depressed margins that are set to recover as global economies re-open.

TODAY: Fed's intensifying $120bn bond tapering debate is sparking natural and overdue volatility. We see markets well-supported as the Fed moves slowly to a year end taper start.



Source: Refinitiv, Factset, eToro calculations

Ben Laidler, Global Markets Strategist. Email: benla@etoro.com