The Daily Feather

Land Ho! Margin Compression Spotted Over the Horizon

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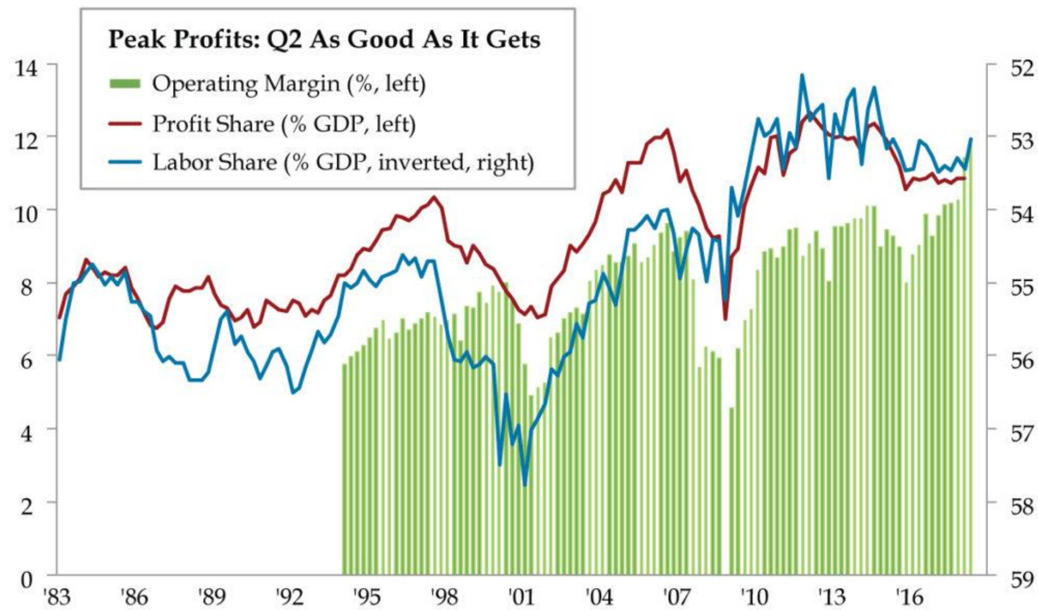

Source: BEA

VIPs

- Buybacks at over $180B for the S&P500 companies doubling last year's pace; no reason to expect slowing this quarter

- **S&P500 operating margins hit a record of 11.8% last quarter; a remarkable 30% growth over 2016**
- **Materials, labor, and transportation costs are rising indicating a topping of near-term operating margins**
- **If forecasts are met for today's Employment Cost Index, we'll have witnessed the briskest acceleration since late 2007 into early 2008**
- **Labor as a portion of margins have declined throughout the current cycle, and have most likely bottomed**
- **Margin compression is expected in the coming quarters with cost the most acute on labor front if productivity does not offset**

Working parents will tell you they rely on the adage that it's the quality of time you spend with your children, not the quantity. As simple as this sounds, it's a tricky thing to achieve for Type A personalities. "Use your listening ears, put your screens down, lead by example, be present!" These are the things the angel on our right shoulders scream at us, the same chastisements we dole out to our tykes. If you can be on the receiving end of what you say, it's likely memories will be made and cherished.

Investors should be equally vigilant in their approach to earnings. That means putting your listening ears on and muting the financial media muted. It's the earnings quality that matters, not the quantity spoon-fed via the duplicitous earnings-per-share drivel.

Think about it in the simplest terms. You're fully aware of several factors that should give you pause, though you'd be forgiven for not connecting the dots. You know share buybacks are hitting fresh record highs (thank you taxpayer). (In the first quarter they came in north of $180 billion, double last year's pace. Expect the second quarter to top the first.) You also know that the Federal Reserve has been suppressing interest rates for your entire career. And you know corporate tax rates have fallen. What exactly do these eps-boosting friendlies tell you about how profitable a company is running their companies? Somewhere in the vicinity of zilch.

Now that you've hopefully not put your screen down, your instincts have kicked in. You know in your bones that adults should know better than to follow a sullied profitability gauge. So go there, grow up.

That brings us to operating margins, a measure arrived at by dividing a company's operating profit by its sales. If operating margins are expanding, a company's costs are declining relative to each dollar of sales. PS. Nix the EBITDA while you're throwing out the eps. The 'D' is for depreciation, which reflects the capital expenditures required to run a business and should be baked into the cake.

In the event you're bracing for bad news, don't. S&P 500 operating margins are expected to hit a record 11.8% in the second quarter. Last year at this time, they clocked in at 10.1%; in 2016, 9%.

If it sounds too good to be true, know we are witnessing the formation of a top. Costs are on the rise for labor, raw materials and transportation. Tack on the tariff terror and you begin to get the picture.

If you suspect crying 'tariff" wolf is akin to weather excuses in prior earnings seasons, you're not alone. The actual earnings hit has been marginal at best…to date. That said, Factset reported Industrials complaining of the pinch via tariffs outnumbered any other sector. What may surprise you (not us) is that same Industrials sector will be double-whammied next quarter. Higher labor costs, as the skilled-worker shortage begins to bite, will collide with the squeeze tariffs induce.

If you were to rank what drives decision-making in the C-Suite, it's safe to surmise that wages and salaries paid dominate the cost side of a company's profit and loss statement. That should focus your attention on today's Employment Cost Index for the second quarter. Forecasts call for a .7% quarter-on-quarter rise on the heels of the first quarter's .8% increase. This succession would mark the biggest acceleration since late 2007 into early 2008. (Remind us, what followed these quarters?)

To make matters worse, crushing labor cost also galvanize central banks' resolve. Higher labor costs are written in to the Fed's playbook. It will make policymakers more confident that higher core inflation threatens which will embolden the Fed to push through with that fourth rate hike of the year come December.

As per Markit's principal economist Emily Crowley: "Expectations for future increases (of subcontractor rates) reached a five-year high; tightening labor market conditions combined with an uptick in activity are driving expectations of future rate increases. The South and West are having the most trouble finding workers leading to stronger wage escalation." The proverbial bottom line: it's happened, post-facto, end of story. Prudent investors are planning for the margin compression that's already occurred.

To be crystal clear, it's well past time the working man and woman got their fair portion of the profit pie. That doesn't mean shareholders will cotton to their profit party being rudely interrupted. <u>We've come through an extraordinary era over which labor as a portion of margins have declined throughout the current cycle.</u>

As is the case with Wall Streeters who've never experienced rising interest rates, many investors have never witnessed margin compression via rising labor costs. The tantrum thrown could replicate that of a toddler not getting their way for the very first time.