Bridgewater®

Daily Observations

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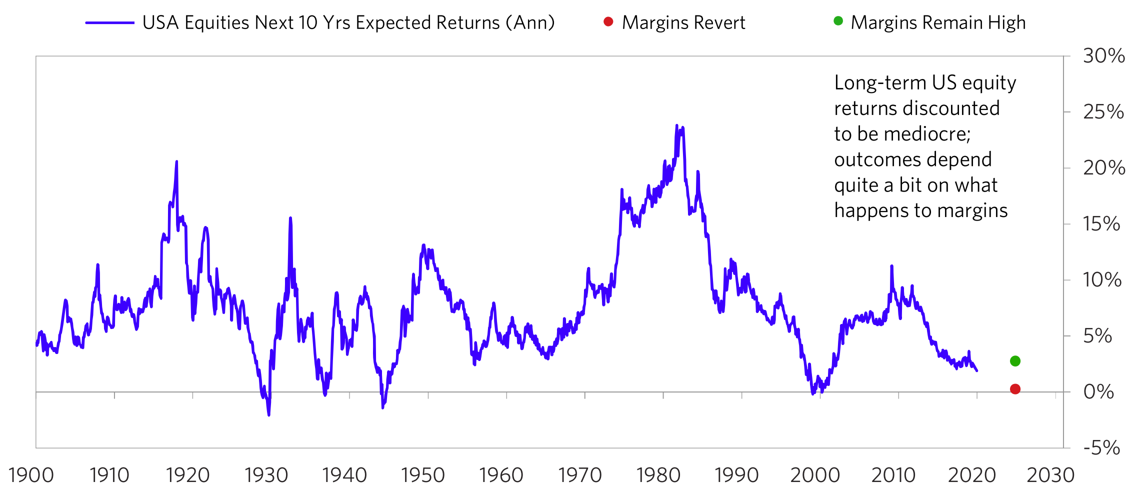
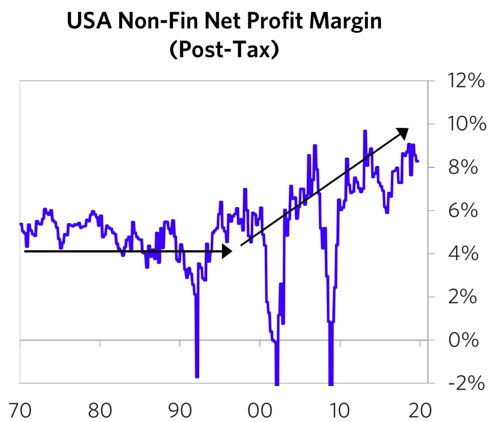
Discounted Returns Are Low and Risks Are High: Rising Secular Risks to US Corporate Margins

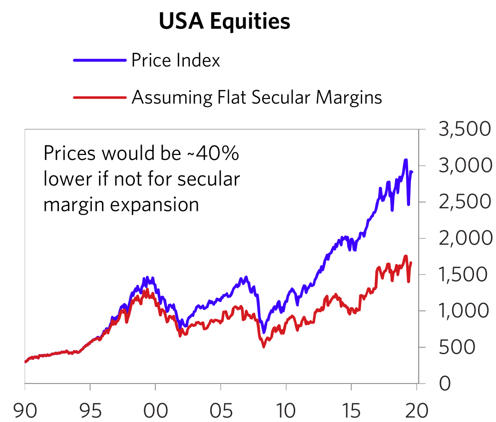
While our tactical view on US equities is driven by other considerations, the evolution of profit margins will be a material driver of the long-term expected returns for US equities. Over the last two decades, US corporate profit margins have surged and have contributed almost half of the excess return of equities relative to cash. Looking ahead, discounted returns are mediocre if secularly high margins are maintained. A reversal of these secular trends at current valuations would produce a lost decade for US equity investors.

Looking beyond the current cyclical downturn in profits, we see recent developments making it more likely that profit margins will come under pressure. Globalization, perhaps the largest driver of developed world profitability over the past few decades, has already peaked. Now the US-China conflict and global pandemic are further accelerating moves by multinationals to reshore and duplicate supply chains, with a focus on reliability as opposed to just cost optimization. Rising anticorporate sentiment in a time of record budget deficits creates a substantial risk of higher taxes and more regulation that could lead to lower concentration and pricing power. This could happen fairly quickly depending on the outcome of the election. The main positive tailwind of the past few decades that may continue is automation. Below, we walk through these forces in more detail. The chart below shows our estimate of the long-term expected returns for equities and a range depending on the secular path of margins.



To highlight the importance of margins, without their consistent expansion over the past two decades, US equities would be about 40% lower than they are today.

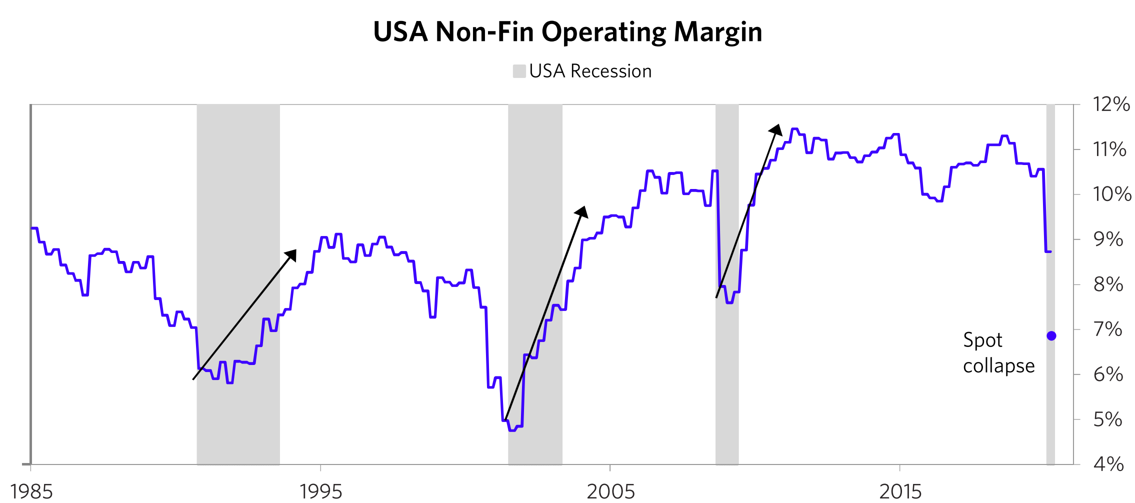




Today's *Observations* will walk through our thoughts on the varying pressures on margins over different time frames.

Margins Have Collapsed and Will Likely Bounce Back as Companies Only Hire Back Workers Gradually as Demand Improves

Margins have collapsed massively on a spot basis, as the pandemic caused a sudden drop in demand and it takes time for corporations to adjust costs down. As you can see, in all past recoveries from recessions over the past three decades, margins rebounded rapidly to a new, higher level as employment and wages lagged the recovery in demand for the cyclical and structural reasons we will discuss below.



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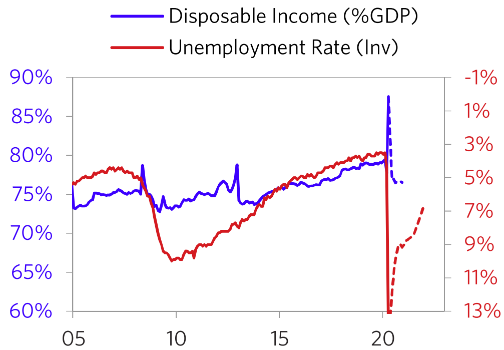
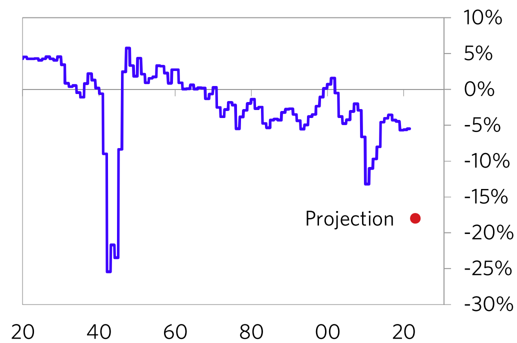
One reason profit margins recover quickly from a recession is that government saving and spending behavior is counter-cyclical and supports household income, allowing households to spend even as their jobs and wages take time to recover. The divergence between the unemployment rate and disposable income and the level of government deficit today are unprecedented given the nature of the shock and the response. As economies open up and demand recovers, we should see this dynamic support corporate profitability.

While unemployment is set to remain high, household income is steady...

USA Household Income vs Unemployment



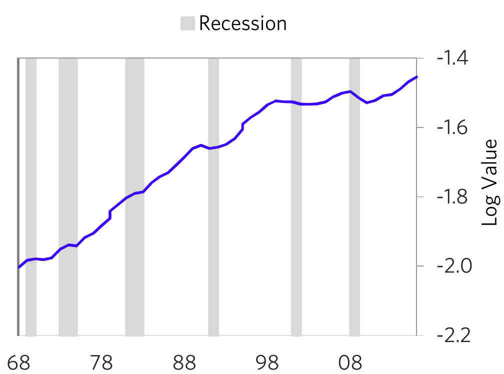
USA Budget Deficit (%GDP)



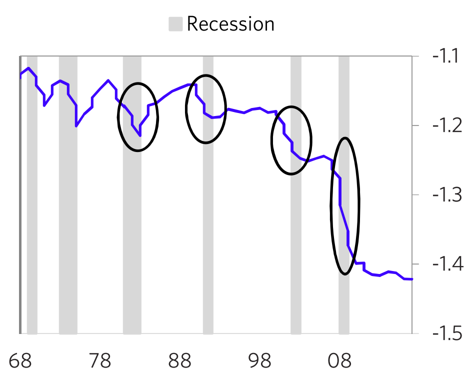
...supported by government spending

Apart from the cyclical dynamics, recessions and the resulting turmoil allow companies to make more structural changes that are otherwise difficult in normal times. For example, most of the displacement of routine jobs (which are the kind of jobs automation replaces) occurs during these recessions. We expect another such move toward machines over workers in this environment, and this will be a support to margins.

USA Non-Routine Cognitive Jobs



USA Routine Jobs



Most routine jobs displaced during recessions

Source: © 2012 by Nir Jaimovich and Henry E. Siu, Job Polarization and Jobless Recoveries

The table below is mostly meant to highlight the large scope for further automation. Only a few sectors so far have implemented automation on a large scale, and the table shows how several sectors have the potential to be meaningfully impacted as costs come down and automation becomes more widespread. The measures shown below assess how automatable the skills required in different sectors currently are, given the technology available.

Current Technical Feasibility of Automation* by Activity Type and Sector

Sector	Automation Potential	Managing others	Applying expertise	Stakeholder interactions	Unpredictable physical work	Data collection	Data processing	Predictable physical work
Accommodation and food services	73%	2%	4%	22%	5%	8%	10%	48%
Manufacturing	60%	5%	13%	8%	8%	22%	11%	33%
Agriculture	60%	3%	5%	7%	51%	11%	9%	13%
Transportation and warehousing	57%	4%	8%	14%	14%	22%	14%	24%
Retail trade	53%	3%	6%	26%	5%	15%	28%	17%
Mining	51%	7%	11%	8%	24%	21%	12%	17%
Other services	49%	7%	12%	17%	13%	15%	11%	25%
Construction	47%	5%	10%	8%	41%	15%	11%	10%
Utilities	44%	7%	14%	13%	19%	23%	13%	12%
Wholesale trade	44%	5%	12%	24%	11%	17%	19%	12%
Finance and insurance	43%	6%	19%	23%	0%	16%	34%	3%
Arts, entertainment, and recreation	41%	10%	13%	24%	15%	13%	11%	14%
Real estate	40%	7%	12%	21%	19%	16%	17%	8%
Administrative	39%	6%	13%	14%	23%	21%	13%	10%
Healthcare and social assistance	36%	8%	14%	14%	11%	20%	13%	21%
Information	36%	5%	25%	20%	7%	16%	20%	6%
Professionals	35%	7%	27%	16%	2%	19%	23%	5%
Management	35%	10%	25%	16%	3%	17%	24%	5%
Educational services	27%	22%	29%	10%	8%	13%	10%	7%

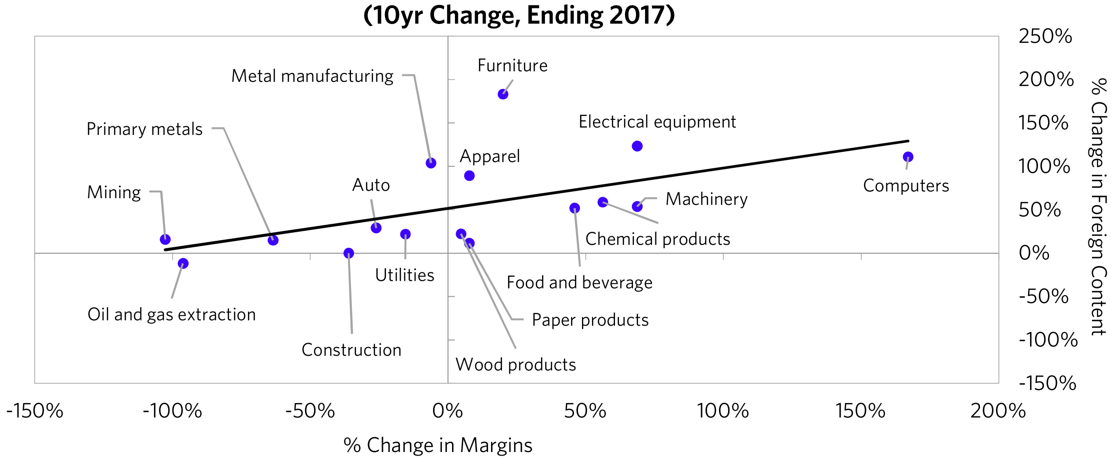
**% of time spent on activities that could be automated by adapting current technology*
Source: McKinsey & Company

Globalization Was a Massive Support but Is Behind Us; Now the Moves Toward Reshoring and Supply Chain Resiliency Mean Higher Costs for Companies

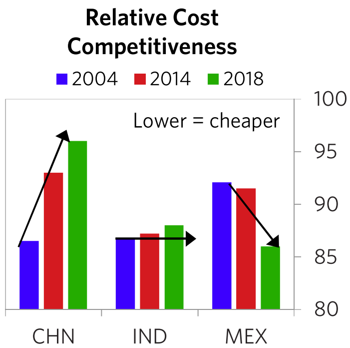
The global pandemic and renewed escalations in the US-China conflict are creating substantial pressures for shifts in supply chains across many sectors and countries. While efficiency and costs were the key drivers of the outsourcing wave that began in the 1990s, now the main reason to consider supply chain retooling is "business continuity": preparing for disruptions, whether due to geopolitical and trade conflicts or events like COVID-19. **This new focus on resiliency and diversification marks a turning point with major implications for corporate profitability.**

Globalization was a massive support for corporate margin expansion. One way to directly observe this is the relationship between the increase in profit margins and the direct degree of offshoring at sector level.

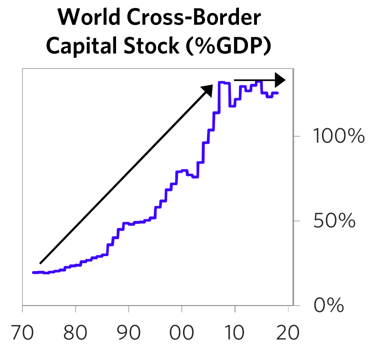
Manufacturing Companies That Offshored Production Improved Their Margins (10yr Change, Ending 2017)



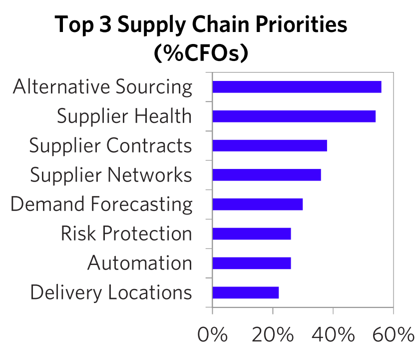
With the labor arbitrage with China already closed, globalization had already peaked by 2010.



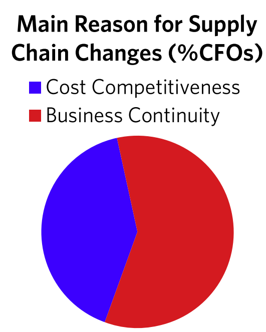
Source: Boston Consulting Group



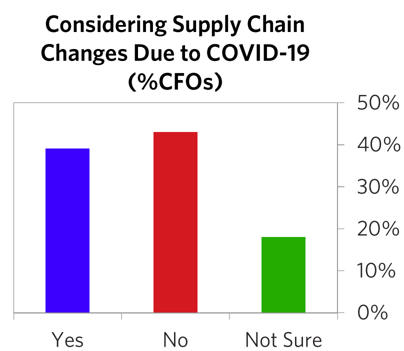
And now with the US-China conflict and the vulnerabilities exposed by COVID-19, we are likely to see a reshuffling of supply chains, and while this will make supply chains more robust/resilient, it will be more costly for corporations. As shown below, CFOs of large US companies now list "alternative sourcing" and "supplier health" as their top supply chain priorities. Whereas in prior decades shifting supply chains was mostly a cost issue, now the main reason to consider supply chain retooling is to prepare for disruptions due to geopolitical and trade conflicts or events like COVID-19 (i.e., "business continuity"). About 40% of CFOs are considering supply chain changes as a result of the pandemic.



Source: PWC COVID-19 CFO Pulse



Source: Morgan Stanley



Source: PWC COVID-19 CFO Pulse

We have seen some announcements of supply chain moves by critical industries, and the companies making those moves are doing so at substantial costs in order to decrease their supply chain risk. Most recently, Intel and TSMC have announced their intention to build production facilities in the US, despite the higher costs, for the complex tech components they create for the US government and companies.

> **Intel** on proposal to build US foundry working with US Department of Defense, as described in the *Wall Street Journal*: *"'We're very serious about this'…[Intel plans to]* ***build and operate a plant that could provide advanced chips securely for both the government and other customers****…'The timing is better and the demand for this is greater than it has been in the past, even from the commercial side.'"*

> **TSMC** on reports it will build a foundry in Arizona: *"We are now actively evaluating the US fab [chip factory] plan…* ***There is a cost gap, which is hard to accept at this point.*** *Of course, we have—we are doing a lot of things to reduce that cost gap."*

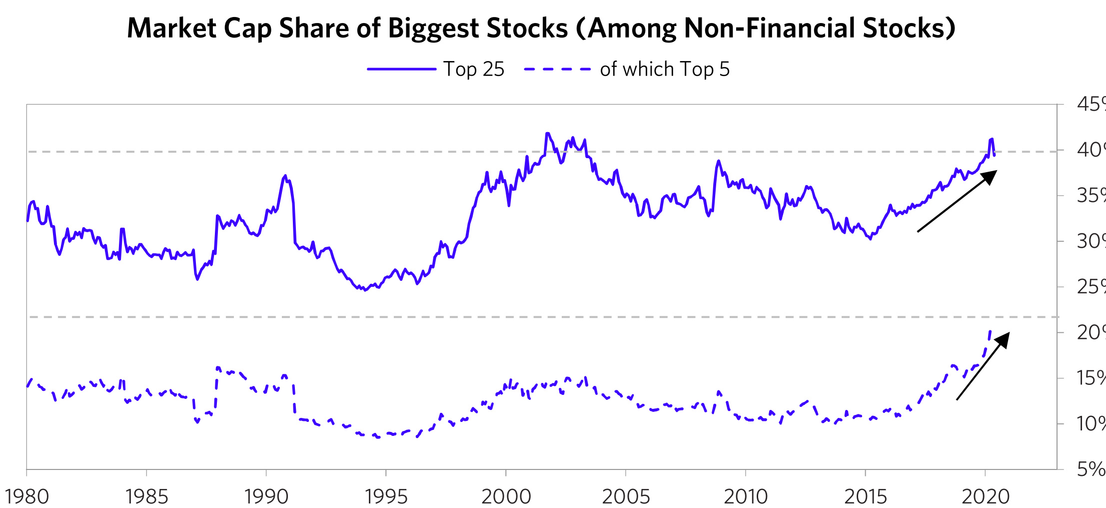
And other companies that had already started diversifying away from China in response to the trade war are accelerating this push because of COVID-19:

> **Best Buy** on plans to further reduce goods imported from China: *"We're leveraging many of the same techniques we did as we were working through the tariffs on the appropriate sourcing and the inventory availability…[The coronavirus] is just one more piece of evidence that will continue to put pressure on diversifying supply chains across the globe."*

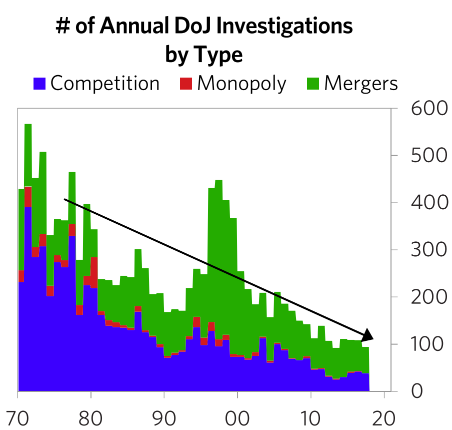
> **Wistron** (iPhone manufacturer) on billion-dollar investment into India, Vietnam, and Mexico to diversify from China: *"We understand from a lot of messages from our customers that they believe [moving 50% of capacity outside of China] is something we have to do. They're happy and appreciate that we can continue to make such a move and they will continue to work with us."*

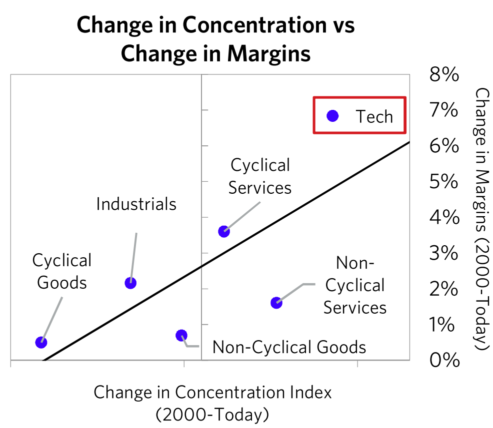
While Firm Concentration Is Likely to Initially Increase with This Shock, Pressures Against Consolidation Will Build as Things Normalize

The first impact of the virus is likely toward more concentration, not less. Not only are some of the strongest players in sectors that are more positively impacted by the virus (tech, online), this environment also allows the most dominant companies with the strongest balance sheets to further consolidate their position. The market pricing is reflecting this.



Once again, on a backward-looking basis, rising concentration can be linked to higher profit margins, suggesting that greater pricing power comes from having more economies of scale, less head-to-head competition within a market, and overall higher bargaining power against labor.





The table below (for the decade ending in 2018) breaks down the attribution of US profit margins by sector, and is further broken down into each sector's contribution to aggregate margins due to (1) the change in their weight in the index and (2) the organic expansion in margins. **This shows that the revenue and earnings pie shifting toward these higher profit margin technology companies has been a sizable driver of the overall increase in US listed profit margins.**

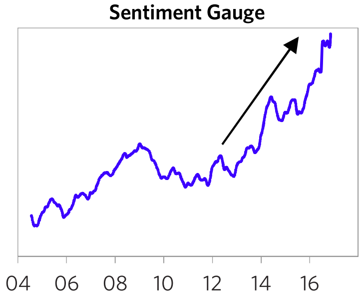
USA Sector-Level Attribution of Margin Growth (2007-2018)

	Contribution to Earnings			Chg in Index Weight	Level of Margins	
	Total	of which Index Composition Chg	of which Organic Margin Chg		2007	2018
All Companies	**32.1%**	**13.5%**	**18.7%**	**-**	**9.4%**	**11.6%**
Cyclical Services	7.6%	3.3%	4.3%	-0.3%	7.8%	9.6%
Non-Cyclical Services	0.8%	0.2%	0.5%	-1.2%	7.4%	7.6%
Information Technology	13.2%	10.1%	3.1%	5.1%	13.7%	17.4%
Industrials	5.2%	1.4%	3.8%	-2.9%	9.0%	11.2%
Cyclical Consumer Goods	6.1%	1.1%	5.0%	-1.9%	1.6%	6.0%
Non-Cycl Consumer Goods	-0.6%	-2.7%	2.1%	1.1%	13.0%	12.6%

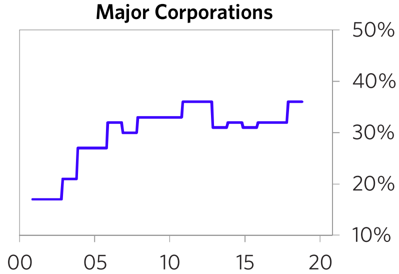
The rising share of tech companies with higher levels of profit margins has been a support to the aggregate index

Over the last few years we have already seen popular sentiment begin to sour against the forces that have driven margin expansion, as well as against the companies that have benefited most from them. As we have discussed at length in prior *Observations*, we are in the midst of a populist backlash against rising inequality and increasingly seeing a move toward more protectionism. Surveys show increasing animosity toward globalization and the power of companies more broadly and a bit more welcoming attitudes toward government regulation of firms.

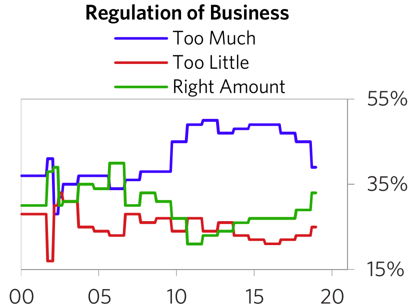
Anti-Globalization Sentiment Gauge



% Report Being "Very Dissatisfied" with Power of Major Corporations



Perception of US Government Regulation of Business



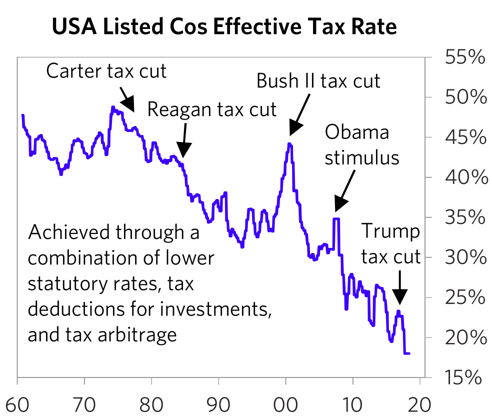
As the table below highlights, there has been a broad acceleration in the number of regulatory actions directed toward curbing US corporate advantage over the past year. Investigations into anticompetitive practices by some of the largest US tech companies are now being conducted across all levels of government, including the DoJ, the FTC, and Congress.

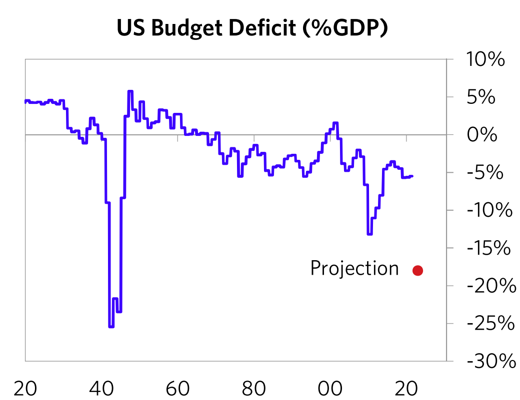
Recent Actions to Curb Tech Sector Power

Date	Geography	Tech Companies Affected	Theme	Program	Status
2020	USA	Facebook, Google	Platform Power	US attorney general says that big online platforms may no longer need legal protections, like preventing tech companies from being sued, that helped foster innovation	Proposed
2020	USA	Amazon, Facebook, Google	Market Power	The FTC will now review hundreds of small acquisitions made by big tech firms over the past 10 years	Investigation Ongoing
2020	USA	Amazon, Facebook, Google	Market Power	The Justice Department's proposed budget includes significant funding for the antitrust division	Proposed
2019	DEU	FAANG	Market Power	Germany proposes strengthening the intervention powers of its competition watchdog	Proposed
2019	DW	Consumer Facing Multinationals	Taxation	OECD proposes its new corporate tax framework targeting "international tax shopping," shifting to taxation based on where revenue occurs	Proposed
2019	USA	Facebook, Google	Market Power	New York and Texas launch broad antitrust investigations; 48 states sign onto investigation of Google and 45 states sign onto investigation of Facebook	Investigation Ongoing
2019	USA	Amazon, Uber, Lyft	Labor	California Assembly passes a bill that reclassifies many gig-economy contract workers as employees	Proposed
2019	EUR	Apple	Taxation	EU courts rule Apple must pay €13 bln in back taxes to Ireland	Appeal Ongoing
2019	FRA	Google	Taxation	Google to pay €500 mln in fines and €500 mln in back taxes to France	Implemented
2019	USA	Amazon, Facebook, Apple, Google	Market Power	House Judiciary Committee demands emails and records for probe into anticompetitive behavior	Investigation Ongoing
2019	USA	Amazon	Market Power	FTC launches investigations against Amazon over potential anticompetitive behavior and use of third-party sellers	Investigation Ongoing
2019	USA	Amazon, Facebook, Google	Market Power	Broad antitrust investigation by the Justice Department	Investigation Ongoing
2019	USA	Facebook	Data Privacy	FTC fines Facebook $5 bln over privacy practices, the agency's largest fine to date	Implemented
2019	FRA	Facebook, Google	Taxation	Imposes a 3% tax on digital revenue	Implemented

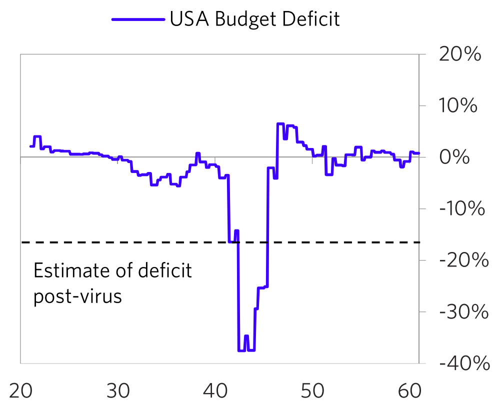
Rising Budget Deficit Could Mean Higher Taxes and Other Cost Burdens for the Highly Profitable Corporate Sector

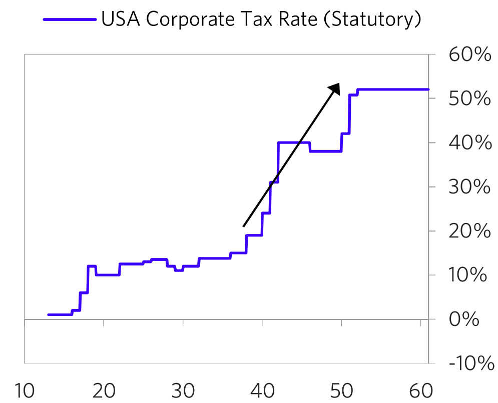
Over the last four decades, corporate tax policy has consistently favored business, and as a result the effective rate has fallen from 45% to about 20%. The effective tax rate that companies pay is now at all-time lows from a combination of declining statutory rates and the use of loopholes that lower the rate companies actually pay on their earnings. The chart on the left below summarizes a number of the key actions that led to the decline in effective US corporate tax rates over the last 40 years. Now, as the US government engages in massive fiscal stimulus creating a large deficit, the risks appear tilted toward a reversal of secular trends of pro-corporate tax policy.





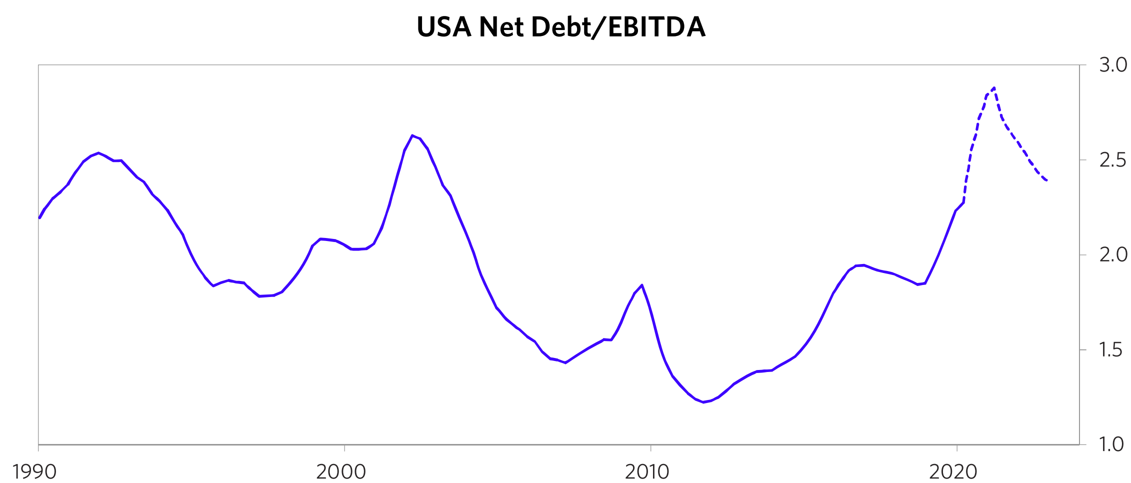
Looking back to the 1940s, corporate tax rates spiked after the US ran up massive deficits during the war. There is no guarantee the same thing will happen going forward, but given the secularly low level of effective tax rates and political sentiment, a less favorable tax environment seems probable, especially once we are out of the current hole.





There Is Also a Big Question of How Much of the Future Profits Will Accrue to Today's Shareholders

Even if overall profits recover, some companies will die or their shares will devalue along the way. Left with lower levels of profits and cash shortfalls, companies are likely to come out on the other side of the coronavirus more indebted. Already, in the first quarter US companies (both private and public) borrowed more than $600 billion, of which public companies borrowed $300 billion. So far, equity issuance has not been used much to fill funding gaps, but as corporations try to delever and repair their balance sheets the pace of dilution can increase, and that is something to watch out for.



Fed Changes to Corporate Bond Buying Program Are Indicative That They Will Iterate to Get What They Want

Larry Cofsky

As they said last week and had been saying for months before that, the Fed is committed to maintaining easy financial conditions. As the virus-induced economic crisis produced a huge hole in the financial markets and the economy, the Fed purchased government and agency bonds at a record pace, committed to keeping rates at zero for as long as it takes, and rolled out a slew of facilities to ensure that solvent private-sector borrowers get access to capital. And importantly, they made it clear that they will iterate if what they are doing is not working. On Monday, the Fed announced changes to the implementation of its purchases of corporate bonds in the secondary market. Early indications were that there were some difficulties implementing their bond purchase program, and our read is that these changes make it more likely that the Fed will be able to purchase corporate bonds. The total amount of corporate bonds that the Fed could potentially buy on the secondary market is roughly $250 billion for now, but if needed this capacity could likely be increased with more capital from the US Treasury. Last week, stocks and spreads had their worst week since the beginning of the crisis, but we wouldn't read too much into the timing. But we do see this move as indicative that the Fed is committed to maintaining easy financial conditions, and that if their current programs aren't working, they will make changes until they do.

- The Fed announced that they would buy corporate bonds according to an index (which they created) that incorporates all borrowers that are eligible for the secondary purchase program. The Fed's program for secondary purchases previously worked on a clunky "opt in" basis that was apparently creating operational difficulties.
- On the announcement, there was a reversal in market sentiment as credit reversed losses on the day and ended higher (IG CDX down 10bps to 70bps, HY CDX down 30bps to 450bps), and equities rose modestly (S&P +1%).

Investment-Grade Corporate Spreads

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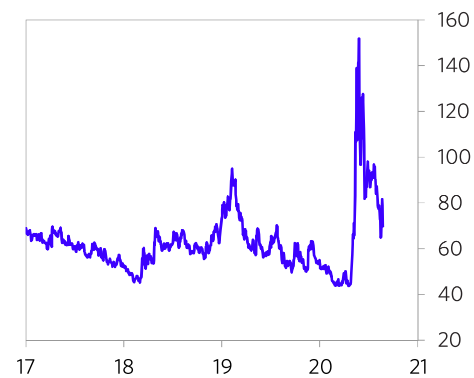
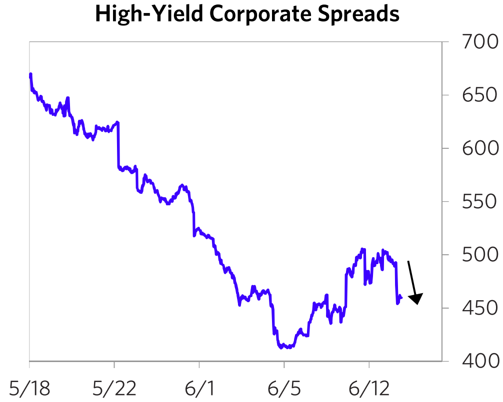


High-Yield Corporate Spreads



High-Yield Corporate Spreads