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Will US company profits remain robust in 2024?

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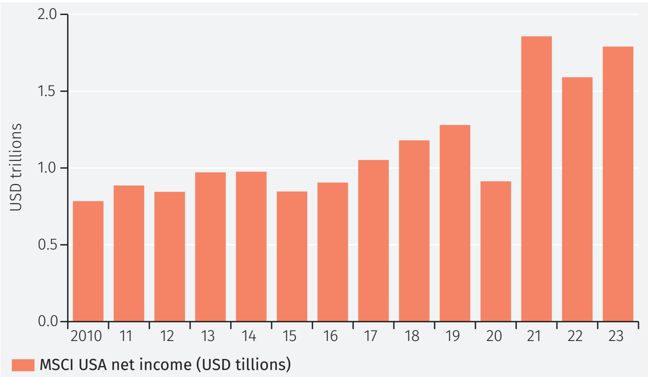
Company earnings are a key point of focus for investors and play a vital role in valuation analysis. When aggregated, the net income of US companies can be useful to gain insights into the health of the broader economy. In this edition of *Infocus*, Economist Sam Jochim looks at what the latest data tell us.

All 606 companies in the MSCI USA index have now reported Q4 2023 earnings.[1] Total net income, or profit, for those companies was USD441.41 billion in that quarter. This marks a decline relative to the first three quarters of the year but leaves net income for 2023 at USD 1.79 trillion, 12.6% above the USD 1.59 trillion reported in 2022 although 3.6% below the peak seen in 2021 (see Figure 1).

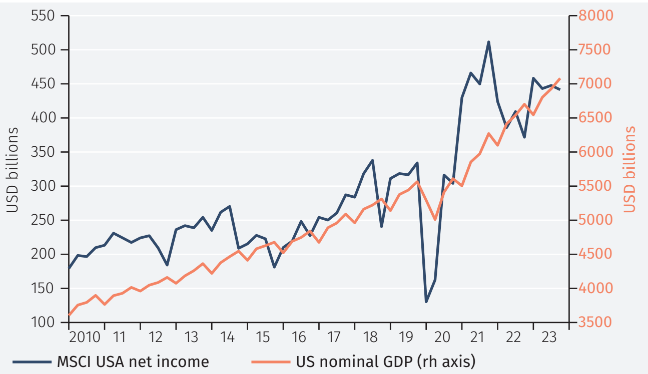
1. Annual net income of the MSCI USA index



Sources: FactSet and EFGAM calculations. Data as at 19 April 2024.
Past performance is not indicative of future results.

Plotting quarterly MSCI USA net income against quarterly nominal US GDP is interesting (see Figure 2). The correlation for quarter-on-quarter and year-on-year changes is 16.6% and 44.7% respectively.[2] The positive correlation coefficients highlight that, while more volatile, US company profitability tends to trend with nominal GDP.

2. Quarterly net income of the MSCI USA index and nominal US GDP



Sources: FactSet and EFGAM calculations. Data as at 19 April 2024.
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Since nominal GDP growth is a function of real GDP growth and inflation, it is also informative to look at the correlation between MSCI USA net income and these variables. For quarter-on-quarter changes, the correlation is 15.4% with real GDP growth and 16.0% with Personal Consumption Expenditures (PCE) inflation. For year-on-year changes, the correlations are 50.8% and 16.1% respectively. Investors have focused on inflation and monetary policy in recent quarters, but the correlations suggest that the growth outlook is more important for equity markets in the long run. Thus, if real GDP growth accelerates marginally from 2.5% in 2023 to 2.7% in 2024, as the International Monetary Fund projected in its most recent *World Economic Outlook*, then implicitly US company profits should generally remain robust.[3]

It is also interesting to look at the contribution to the aggregate of the ten most profitable companies. The contribution is volatile from one quarter to the next and so it is helpful to look at the four-quarter moving average (see Figure 3). It is important to note this reflects both the net income of the ten most profitable companies and that of the remaining companies. Thus, if the net income of the ten most profitable companies in the index is unchanged from one quarter to the next, but the other companies in the index experience a decline in profits, the contribution of the ten most profitable companies will increase. Nonetheless, it is notable that allowing for volatility, this contribution has been growing over time.

3. Contribution of 10 most profitable companies to MSCI USA quarterly net income

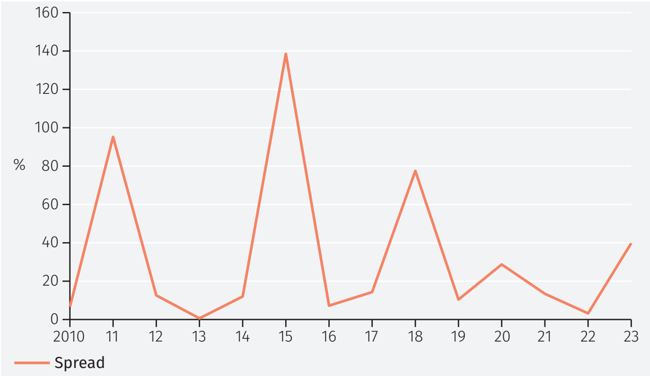
Sources: FactSet and EFGAM calculations. Data as at 19 April 2024.
Past performance is not indicative of future results.

[1] MSCI USA constituents as at 31 December 2023. There are 609 constituents but 3 are removed from the data since they are duplicates (for example, different share classes of the same company).
[2] Correlations calculated on data from Q1 2011 to Q4 2023.
[3] IMF projection from its April 2024 *World Economic Outlook* publication: https://tinyurl.com/24z7xn6s

It is also possible to estimate the proportion of MSCI USA returns generated by the top ten contributing companies. In 2023, for example, the largest ten return contributions accounted for 61.1% of the total return of the MSCI USA index. It is interesting to note that these same ten companies accounted for 21.3% of net income of the MSCI USA index, such that the difference between return contribution and profit contribution was 39.8%.

While this may seem like a large difference, it should be noted that since 2010, the spread has been higher on three occasions (see Figure 4). However, all three of these occasions also mark years in which the MSCI USA total return was relatively low and the proportion of the return from the top ten contributing companies was relatively high.

4. Return contribution – profit contribution spread (% points)[4]



Sources: FactSet and EFGAM calculations. Data as at 19 April 2024.
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It is notable that 2023 is the only year since 2010 in which the MSCI USA total return was above 20% and the difference between return contribution and profit contribution was above 30 percentage points. This gap can be partially explained by the fact that returns also reflect investors' expectations about future company profitability, not just backward-looking realised profitability. In addition, the spikes in this spread in 2011, 2015 and 2018 were consistently followed by sharp declines the next year. That is not to say this will be the case in 2024, but it is something of which to be aware.

There is of course a difference between total profits reported by companies and earnings-per-share (EPS). Markets – rightly or wrongly – care about EPS. Comparing year-on-year growth of net income and EPS for the MSCI USA index highlights an important point. From 2011 to 2023, EPS generally grew at a faster rate than net income, though the difference is marginal when growth is compounded over this time frame (see Figure 5).

5. Compounded annual net income and EPS growth

Sources: FactSet and EFGAM calculations. Data as at 19 April 2024.
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Annualising the rate of return over this time frame gives a net income growth rate of 6.6% and an EPS growth rate of 6.9%. The small difference can likely be explained by financial engineering through actions like share buybacks which reduce the number of shares available and therefore increase EPS for any given level of profits. It is important to be cognizant of the role this can play in boosting a company's EPS relative to its profitability.

In conclusion, US companies, as represented by the constituents of the MSCI USA index, appear to be in good health. Net income in 2023 was higher than in 2022 and USD 852 billion above the 2010-2023 median of USD 938 billion. MSCI USA returns in 2023 were highly concentrated and not entirely representative of the distribution of profit growth. Nonetheless, stock returns reflect future profit expectations as well as current profits. Furthermore, net income can be volatile from quarter-to-quarter and year-to-year but the positive correlation with real GDP highlights that in the battle between growth and rates, it is growth that wins in the long run. The strength the US economy is currently exhibiting could therefore be viewed as a positive signal for profit growth in 2024.

[4] Spread denotes the proportion of MSCI USA total returns accounted for by the top ten contributing companies minus the proportion of MSCI USA net income accounted for by the same ten companies.

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