

# HAVE U.S. PROFIT MARGINS PEAKED?

**How Deglobalization  
May Alter U.S. Equity Portfolios**



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Since the early 1990s, underlying market forces have paved the way for profitability growth and significant margin expansion at U.S. corporations. Globalization increased while labor's collective bargaining power weakened. Interest rates (until this year) and tax rates declined. Anti-trust enforcement abated while technology helped drive efficiencies and greater economies of scale. Together, these forces drove nearly 5% pre-tax margin expansion over the succeeding decades. Without this expansion, strategists calculate pre-pandemic U.S. equity values would have likely been 40% lower.

Most economists would agree globalization - kicked off when China entered world trade in 2000 - was the biggest contributor to U.S. profit margin expansion. As technology enabled market integration, American companies began outsourcing labor to China and other emerging economies at the same time as they began importing large volumes of intermediate and final goods from those countries. Outsourcing labor and importing materials helped hold down inflation and capital intensity. As a result, China and emerging nations saw their world exports double, reaching 40% in 2021, and American companies, particularly those in the technology sector, saw profits soar.

## Labor Rises

Globalization, along with technology and market concentration, caused labor share to fall. Economists have identified a tight relationship between worker compensation and productivity from 1950 until 2000. Beginning in 2000, however, real wage growth flatlined for more than a decade. Outsourcing, along with automation, provided an effective threat against higher wage demands, curbing collective bargaining power. Until this year, unionization rates in the U.S. had fallen to their lowest historical levels and impacted workers' ability to garner either higher wages or employment contracts indexed to inflation. Over the last twenty years, companies in sectors without unions saw a greater fall in wages (and a greater rise in profits) than those where union membership remained constant.

Stagnant wage growth enabled a sharp rise in corporate profit margins, but the days of persistent profit margin expansion may be coming to an end. The Covid-19 pandemic (and the concurrent Great Resignation) may have reinstated the traditional relationship between compensation and productivity. With quit rates at all-time highs, labor demand outstripping supply, and unionization efforts rising again, workers are on more stable footing. American corporations now cite wage pressure as their most significant cost headwind, and with inflation pushing up raw material and logistics pricing, profit margins may succumb to the burden of rising wages. If the compensation-productivity relationship fully reverts, profit margins could fall to late 1990s levels, implying a 33% reduction.

Certain investors may argue that increased automation will help offset some labor pressures. While industrial robot imports to the U.S. spiked in 2021 to \$1.3 billion, the amount represents a de minimis 0.02% of last year's \$6 trillion in manufacturing output. Although automation is unlikely to mitigate rising labor costs in the near term, reshoring supply chains will certainly increase operating expenses. Motivated in part by pre-pandemic trade tensions with China, U.S. reshoring increased domestic manufacturing employment by approximately 0.5% per annum over the last decade. Covid-induced supply chain bottlenecks, particularly for critical components, may have finally ushered in an era of widespread reshoring.

Riding increased populist and protectionist rhetoric, anti-globalization sentiment is the highest it has been in nearly two decades. "Progressive capitalism," a term embraced by the Democratic Party, has also taken root in certain circles that believe globalization occurred unfettered and with little regard for community. Progressive capitalists argue for a rebalancing of globalization that structures the economy around community and place rather than around the lowest prices and wages.

## The Paradox of Technology

Standing at the crossroads is the sector that arguably most enabled globalization: technology. Tech companies' profit margins could materially contract under a deglobalization regime, a move that would influence the composition of the S&P 500 Index. Since the late 1990s, the sector's contribution to S&P profit has risen dramatically, from just 11% of earnings in 2005 to 27% last year. The largest technology companies, like Alphabet, Apple, Meta, and Microsoft, are among the most profitable publicly traded companies in the history of the large-cap equity market. Capitalizing on research and development and various intangible assets, including brand value, software, and algorithms, digitally advanced sectors of the economy have grown two to three times faster than firms in heavy industry. Asset-light, heavily digitized companies now account for a much greater contribution to U.S. GDP than even a decade ago.

Technology companies have also arguably benefited most from market concentration and, as a result, have maintained the ability to charge higher prices. A long-term decline in new business formation saw a halving of publicly listed companies since 2000 that created significant market narrowing and led to mega-cap technology companies accounting for nearly 20% of the S&P at its recent peak. Due to economies of scale, larger firms tend to wield more pricing power and can therefore better absorb wage and other cost pressures than their smaller peers. In previous inflationary environments, defined as accelerating headline CPI inflation at a level above 5%, companies with the highest pricing power outperformed the lowest by nearly 5%, according to some U.S. equity strategists.

## Ramifications on Portfolio Construction

Investors would be remiss to downplay technology's critical role in modern economies. Like energy, it touches all facets of personal consumption and finances and is inherent to industrial efficiency and future innovation. Unfortunately, technology's profit-maximizing rise helped create the income inequalities confronting the U.S. today. From a wealth standpoint, improved corporate profitability has benefited only those with exposure to it, predominantly white Americans, two-thirds of whom hold shares in publicly traded companies as opposed to just one-third (or fewer) Black and Hispanic Americans. While a potential negative for shareholders, a more active labor movement, brought about in part by a supply-chain-induced shift toward local sourcing, could finally inject much needed real income growth for the least affluent Americans, particularly those in under-resourced communities.

If deglobalization weakens technology's leadership in the S&P 500, it could pave the way for higher composite weights in traditionally capital-intensive industries like energy, industrials, and utilities. Because of their inherently local nature and persistent union memberships, these sectors are less likely to feel negative impacts from deglobalization or powerful collective bargaining. From a U.S. Core portfolio perspective, the pricing power of larger companies would suggest a continued preference by investors for large capitalization names, while a shifting index composition, illustrated most prominently by the doubling of energy since 2019, suggests at least equal weighting sectors, particularly technology. As an ESG-integrated asset manager, Boston Common currently chooses to avoid direct investment in fossil fuel extractors, focusing our efforts instead on identifying industrial and utility companies critical to the energy transition that should help our U.S. Core strategy keep pace with traditional energy's recent growth. In the same vein, the firm remains committed to seeking long-term investment in companies that promote a better allocation of capital for all Americans.

### Sources

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## ABOUT MICHELLE

Michelle leads Boston Common's U.S. Large Cap Core Equity Strategy and heads up the firm's multi-asset solutions business. She also serves as a global consumer discretionary sector analyst.

Over the course of her career, Michelle has championed an understanding of ESG criteria as part of quality investing and views attention to ESG-related behavior as a way to improve the inclusivity of global capital markets. Prior to joining Boston Common, Michelle was the Chief Investment Officer for Baldwin Brothers, an ESG-Integrated multi-family office, where she was the architect of the firm's U.S. equity strategies and asset allocation framework. Earlier in her career, she was the senior Consumer Discretionary sector analyst for Ameriprise's RiverSource Investments (now Columbia Threadneedle).

Michelle earned an AB cum laude in History from Princeton University and conducted graduate research at the Humboldt Universitaet in Berlin. She holds the Chartered Financial Analyst and Chartered Alternative Investment Analyst designations, is a member of the Boston Economic Club and Boston Women's Leadership Council, and serves on the Board of Trustees for The Sage School (Foxborough, MA) and finance committee for the SouthCoast Community Foundation (New Bedford, MA).