

WHY YOU SHOULD KEEP AN EYE ON NIPA

Corporate-profit figures used in U.S. national-income statistics suggest that earnings quality may have declined.

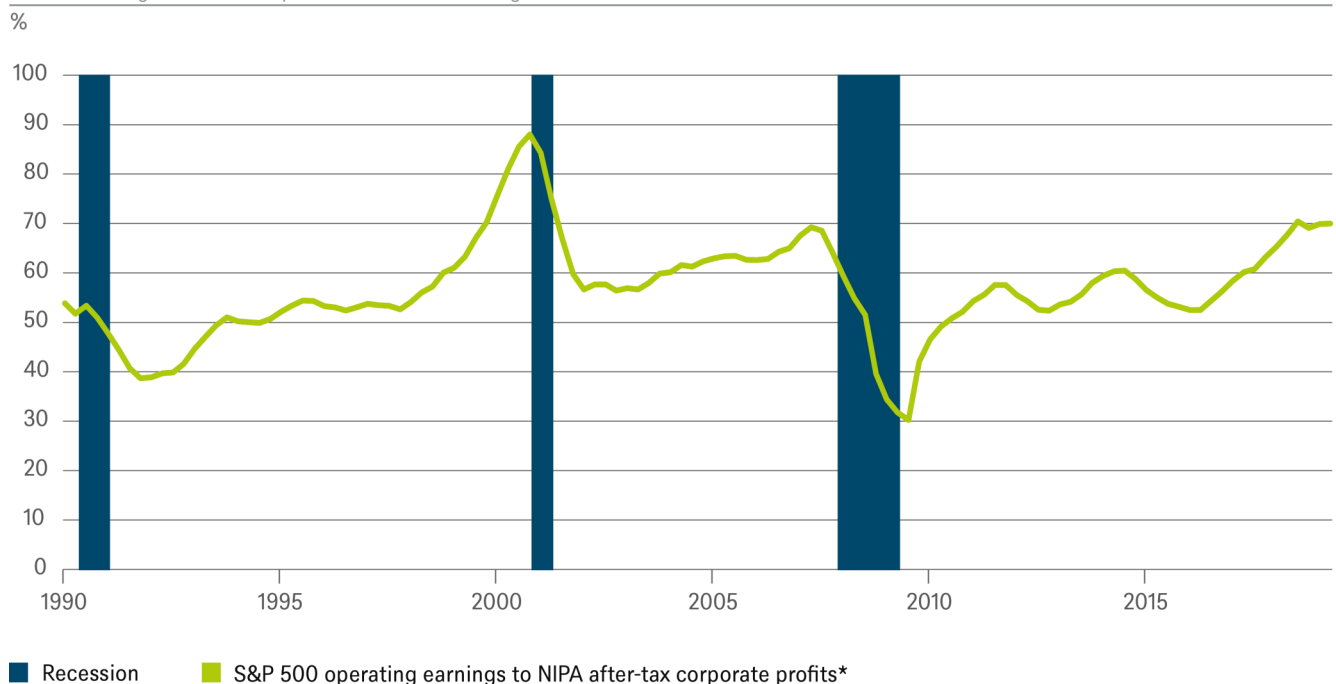
Should Wall Street investors trust reported company earnings? Especially at this stage of the economic cycle, it might be worth taking them with a teaspoon of salt. At least, that's what history suggests and what our "Chart of the Week" shows. It compares the reported operating profits for the S&P 500 with the corporate-profit figures used in U.S. national-income statistics (National Income and Product Accounts, NIPA). That is pretty revealing, especially if you look at the ratio of both measures over a long period of time. S&P 500 profits accounted for about a bit more than half of NIPA profits between 2010 and 2016. In 2019, they increased to around 70%.

NIPA profits rely primarily on corporate tax returns, filed with the U.S. tax authorities. Therefore, the way NIPA figures are compiled does not change very much across the business cycle. By contrast, reported individual company earnings, such as those used to calculate profits for the S&P 500 as a whole, are based on financial accounting standards which give corporate bean counters quite a bit of flexibility. Espe-

cially toward the end of an economic cycle, S&P 500 companies have strong incentives to use this flexibility as a means to paint a somewhat more flattering picture of the earnings situation.

Often, the full extent of the decline in earnings quality only becomes clear in the next recession. If a company is going to report a loss anyway, its (often new) management team has strong incentives to throw in all the bad news at once — everything but the proverbial kitchen sink ends up in the next earnings announcement. Such a "kitchen-sink" approach to accounting was clearly visible in the aftermath of the great financial crisis. Not that we are expecting this to happen any time soon — we judge recession risks as remaining moderate. It is not too early, however, to start to fuss over earnings quality. As we argue in a recent publication (see [U.S. Economic Outlook from November 2019](#)), the NIPA figures are certainly worth keeping an eye on, including for macroeconomic forecasting.

¹Both sets of figures also differ quite a bit in terms of coverage.



Sources: Bureau of Economic Analysis, Haver Analytics, Standard & Poor's, Bureau of Economic Analysis, National Bureau of Economic Research as of 11/19/19

* with adjustments for inventory valuation and capital consumption, quarterly moving average

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GLOSSARY

The **Great Recession** refers to the prolonged economic downturn in much of the world after the financial crisis of 2007-08.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

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