

# Eroding profit margins will push U.S. into recession in 2020 says leading forecaster Stephen Gallagher

[marketwatch.com/story/eroding-profit-margins-will-push-us-into-recession-in-2020-leading-forecaster-](https://www.marketwatch.com/story/eroding-profit-margins-will-push-us-into-recession-in-2020-leading-forecaster-)

Rex Nutting

Stephen Gallagher stands out among Wall Street economists because he's one of the few willing to go on the record to forecast a recession in 2020. Also because he's not blaming it on tweets, Trump or tariffs.

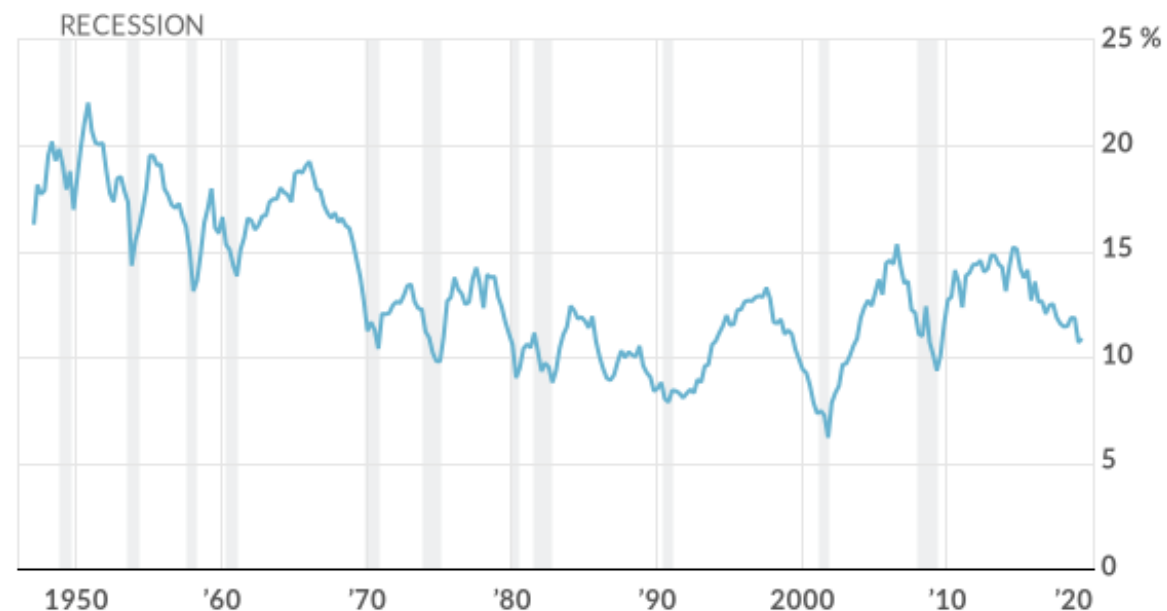
The chief U.S. economist for Societe Generale also stands out because he's just won MarketWatch's Forecaster of the Month contest, which we designed to recognize the most accurate U.S. economic forecasters.

Gallagher's recession story is a relatively simple one: U.S. recessions are typically preceded by an erosion in corporate profit margins, or profit per dollar of revenue. Costs generally rise near the end of the cycle while sales flatten out.

Profit margins for U.S. nonfinancial corporations peaked in 2015 at 15.2% of gross value added, and have fallen to 10.9% in the latest quarter.

## Profit margins

Before-tax profits as share of gross value added



Note: U.S. nonfinancial corporations

Source: BEA/Haver Analytics

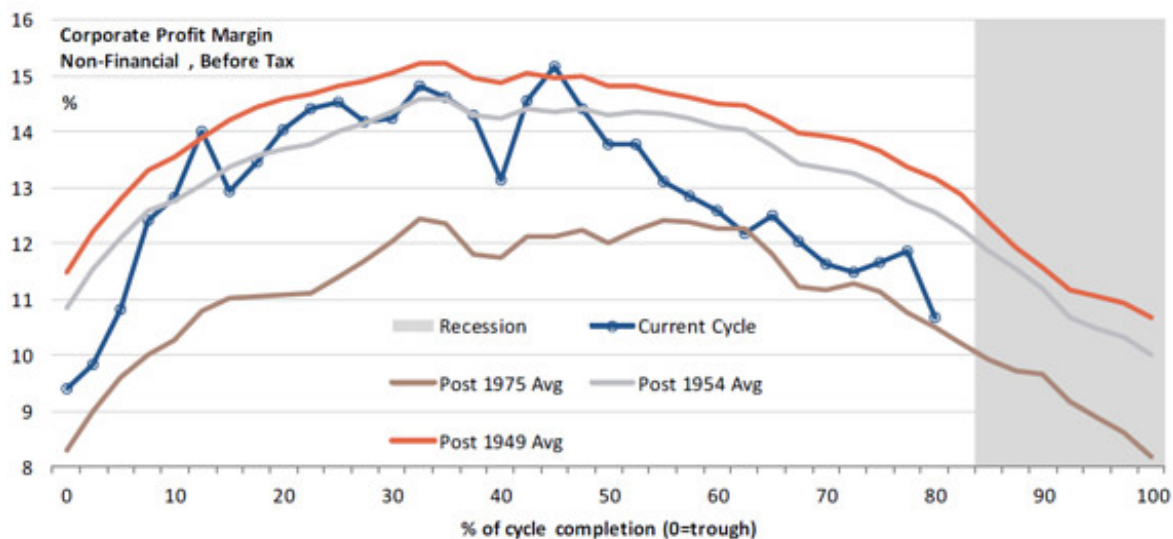
Corporations are earning about 11 cents for every dollar of value added.

Gallagher has been warning about a slow squeeze on profits since 2016.

## Cost-cutting

Since few corporations have any pricing power, the only way for managers to defend their margins against higher labor costs is to turn defensive, focusing on cost-cutting instead of growth. Once companies begin to reduce investment and payrolls, it's only a matter of time before consumer spending stalls.

Oddly perhaps, one way corporations could avoid narrowing margins would be to aggressively invest in productivity-enhancing technologies. That isn't happening. Although investments in R&D and software are up, capital spending on structures and equipment is quite weak.



## *Societe Generale*

This chart shows the historic trend in profit margins at various stages of the business cycle, as well as the margins in this cycle.

"The erosion in margins is the key to business-cycle dynamics," Gallagher said in an interview. If the U.S. does enter a recession in 2020, "history is very likely to view it as a trade-war recession," he wrote early in 2018. But trade tensions are only the catalyst, not the main cause, he says.

When companies' margins are fat, they are able to roll with the punches. But when profits are thin, managers cut costs at the first sign of danger.

"With a backdrop of weak profit expectations, the trade uncertainty poses serious challenges for business planning," Gallagher wrote in a note to clients in August. "In an environment of much stronger profit margins, the same trade uncertainty would likely

pose less of a deterrent.”

#### Mild recession

Gallagher expects the recession to be fairly mild. Aside from a need to correct excessive leverage in some sectors of corporate debt, he sees few other imbalances.

It’s possible that the Fed could cut interest rates aggressively enough to prevent an outright recession. Although lower rates won’t do much to resolve the underlying erosion of profit margins, they would ease the debt service burden on many overleveraged companies and consumers.

He thinks the Fed will cut rates one more time this year (mostly likely at the end of this month) and then four times early in 2020 as the recession hits.

	Stephen Gallagher’s forecast	Number as reported*
ISM	52.0%	49.1%
Nonfarm payrolls	142,000	130,000
Trade deficit	-\$52.8 billion	-\$54.0 billion
Retail sales	0.2%	0.4%
Industrial production	0.4%	0.6%
Consumer price index	0.1%	0.1%
Housing starts	1.235 million	1.364 million
Durable goods orders	-0.3%	0.2%
Consumer confidence index	130.5	125.1
New home sales	685,000	713,000

\*Subject to revisions

Gallagher’s victory in the September forecasting contest was his fourth overall. He earned the award with accurate forecasts on six of the 10 indicators we track: the consumer price index, nonfarm payrolls, new home sales, consumer confidence index, durable goods orders and industrial production.

The runners-up in the September contest were Robert Brusca of Fact and Opinion Economics, Ian Shepherdson of Pantheon Macroeconomics, Jim O’Sullivan of High Frequency Economics, and Richard Moody of Regions Financial.

The MarketWatch median consensus published in [our Economic Calendar](#) includes the predictions of the 15 forecasters who have earned the most points in our contest over the past 12 months, plus the forecast of the most recent winner of the monthly contest.

The economists in our consensus forecast are: Ryan Sweet of Moody's Analytics, Christophe Barraud of Market Securities, Jim O'Sullivan of High Frequency Economics, Richard Moody of Regions Financial, Ian Shepherdson of Pantheon Macro, Michelle Girard's team at NatWest Markets, Seth Carpenter's team at UBS, Andrew Hollenhorst of Citigroup, Lou Crandall of Wrightson ICAP, Stephen Stanley of Amherst Pierpont Securities, Michael Feroli of J.P. Morgan Chase, Lewis Alexander's team at Nomura Securities, Michelle Meyer's team at Bank of America Merrill Lynch, Paul Ashworth's team at Capital Economics, and Stephen Gallagher at Societe Generale.

Rex Nutting is a columnist and MarketWatch's international commentary editor, based in Washington. Follow him on Twitter @RexNutting.

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