Economics

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The era of easy profits is over

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Over the past two decades annual GDP growth in Canada averaged just over 4.5% in nominal terms. During that period real net profit growth in the non-financial sector averaged over 11% and corporate profit margins are currently miles above their long-term average. Simple mean reversion could wipe out no less than one third of corporate Canada's might. Higher interest rates, a slowing economy and diminishing corporate pricing power are already starting that process, but much bigger forces that fueled decades long rise in profitability are not only petering out but in fact are already in reverse. The era of easy profit is over. Will corporations accept that reality or fight back to preserve margins?

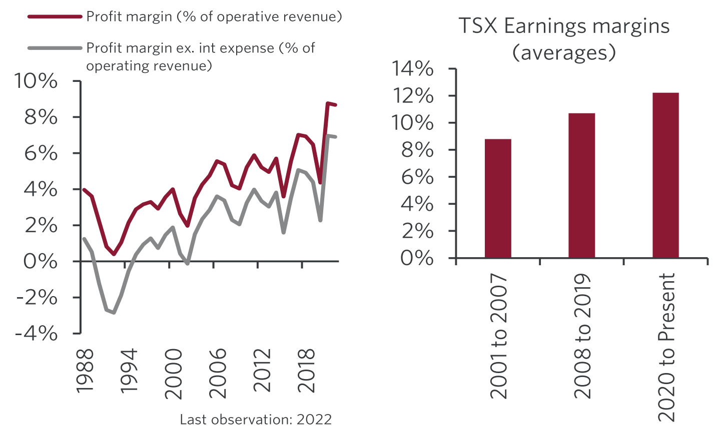
A Profit-ic legacy

At almost 9% of sales in 2022, the aggregate profit margin of non-financial corporations in Canada was hovering around its all-time high, even when excluding interest expenses (Chart 1, left). And at 12% on average since the pandemic, earnings margins in the TSX are even higher (Chart 1, right). And since we live in Canada, its aways worth checking whether that observation is valid when we exclude the energy sector and adjust for inflation. Real profits excluding the energy sector have shown less of a pronounced post-pandemic , but continue to maintain a very high level (Chart 2).

Surely, such a strong increase in margins cannot be explained where we are in the economic cycle. Profit as a share of GDP has risen from 5% in the 1990s to the current 15% while cyclically adjusted margins are showing the same trajectory (Chart 3).

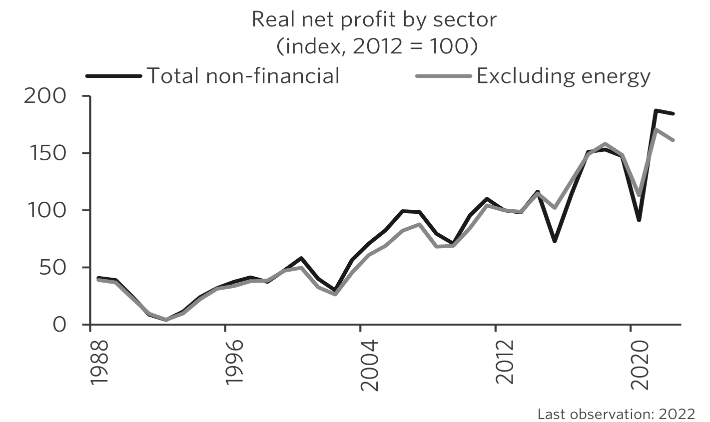
Another possible factor here is a structural change in the composition of corporate Canada with high margin sectors seeing their share in the economy rising. The rotation away from manufacturing and energy has given way to services. And many of these service sectors have seen large increases in their aggregate profit margins, with the greatest increases seen in real estate, education and health and professional scientific

Chart 1: Aggregate profit margins are close to all-time highs (L) and TSX earning margins are far in excess of historical averages (R)



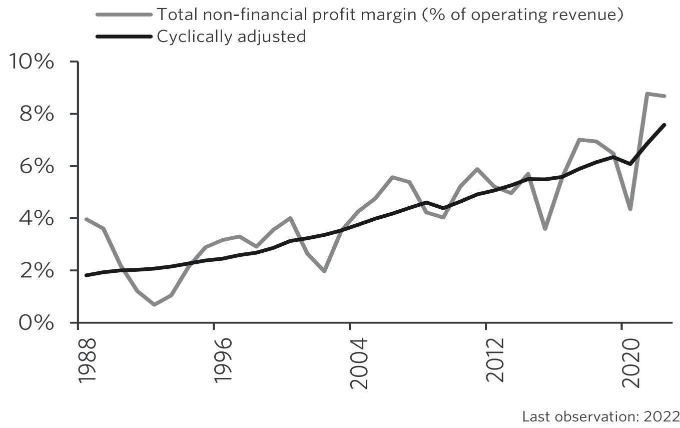
Source: Statistics Canada, CIBC

Chart 2: Excluding the energy sector and adjusting for inflation, profits remain elevated



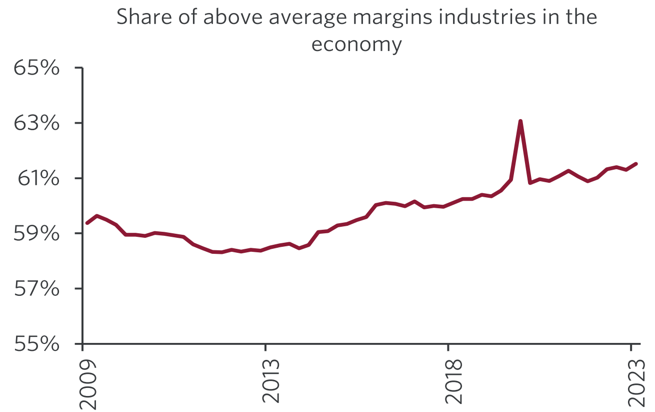
Source: Statistics Canada, CIBC

Chart 3: Even abstracting from the business cycle, margins have trended up



Source: Statistics Canada, CIBC

Chart 5: High margin industries are occupying a greater share of GDP



Source: Statistics Canada, CIBC

services (Chart 4). In fact, the share of the economy of higher-margin industries has been on the rise over the past two decades (Chart 5). However, we estimate that the shift in composition explains less than 20% of the bump in margins during that period.

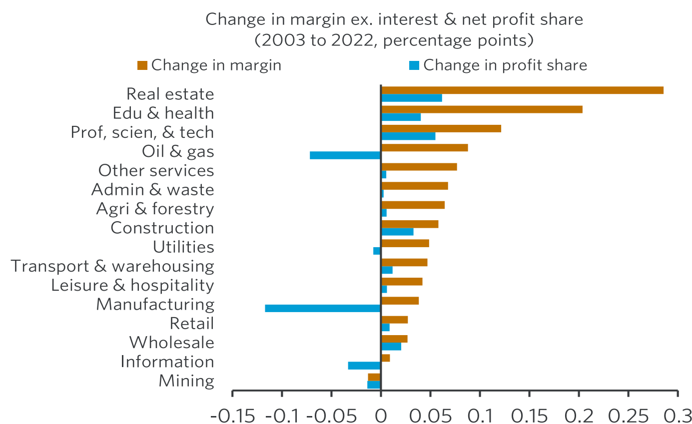
Furthermore, Canada is not unique here, with the US seeing an even stronger surge in profitability with non-financial margins rising from an average of 10% in the 1990s to around 15% at the end of 2022 based on estimates from a Fed researcher (Palazzo, 2023). Similar trajectories are evident in across most other developed countries. That supports the notion that what's behind the strong margin performance are major macro forces with global reach.

Post-COVID profit surge is fading

Take another look at Chart 1. There are three periods that deserve attention. The period before 2001 dot-com meltdown where aggregate margins averaged about 3%, the period between 2001 and COVID where margins averaged north of than 5% and the surge in margins during the recovery from COVID. Zooming in on the last period, it's clear that fat margins were supported by strong pent up demand and government support, but we believe that another key factor here was that corporate pricing power remained strong throughout the pandemic. For example, in the US where this is somewhat better measured, non-financial corporate profit accounted for over 40% of the growth in unit prices during COVID, whereas over the six-year period prior to the pandemic, corporate profits only accounted for 3% of unit price growth (Chart 6). While this does not tell us much about consumer inflation, it's an important signal that margins certainly did widen at the peak of the pandemic shock.

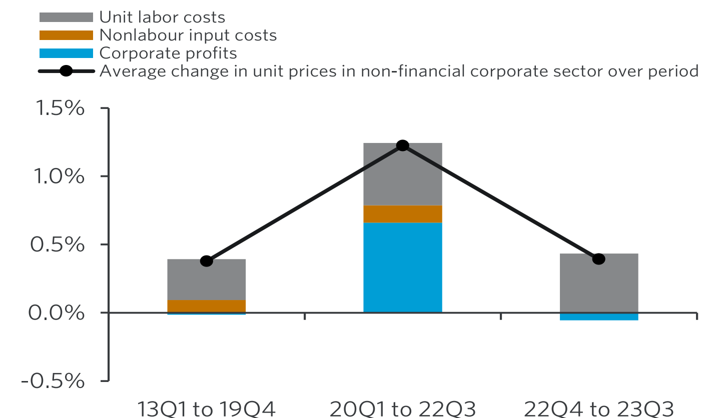
But that was largely temporary and with supply chain disruptions no longer an issue, margins have declined notably. That trend will continue in the coming quarters as businesses face a margin squeeze under the weight of high interest rates and a weakening economy. Faced with that pressure on gross

Chart 4: Service sectors have increased in both their share of profits and their margins



Source: Statistics Canada, CIBC

Chart 6: US non-financial corporate profits accounted for a disproportionate share of price increases during the pandemic years

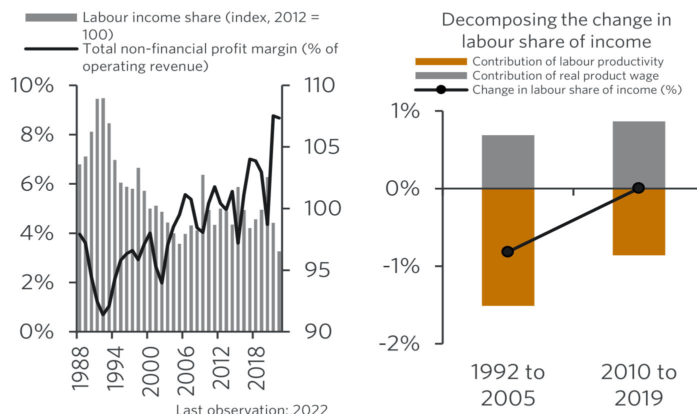


Source: US Bureau of Economic Analysis, CIBC

margins, businesses will seek to protect net margins by cutting costs — either via higher productivity from their work force, slower wage gains, layoffs or some mix of all of these. We expect only limited success here due to the fresh memory of the struggle to re-hire after the pandemic.

Where exactly we land as we exit the pandemic experience is a difficult question. The starting point to the answer begins with digging deeper into the forces that shaped corporate profitability over the past two decades.Those forces are well documented, and it's a long list. Among those cited in the literature are a dramatic decline in labour's bargaining power, increased globalization, lower anti-trust enforcement, increased corporate concentration, barriers to entry, larger scale and reduced marginal cost to due to technology, lower corporate taxes, tariffs and interest rates. That combination of factors has produced the most pro-business conditions in history, with large externally oriented corporations benefitting the most.

Chart 7: Lower labour costs helped raise profit margins (L) due to strong productivity growth prior to the financial crisis (R)



Source: Statistics Canada, CIBC

How did we get here?

In the Canadian context, we zoom in on three of those trends that we believe are likely behind most of the rise in profitability over the past two decades: a declining labour share of income, technological innovation and globalization.

The dynamics of the labour share of income track non-financial profit margins fairly well in Canada (Chart 7, left). Profitability was low during the 1990s when labour costs were elevated and then moved up as these costs declined. To understand what was driving the changes in the labour income share we can decompose it into two main parts: the real product wage and labour productivity. The real product wage represents how much wages rise above the overall level of prices in the economy (the GDP deflator) and labour productivity represents how much output is generated from labour. An increase in real wage growth pushes labour costs higher and improved productivity brings it down.

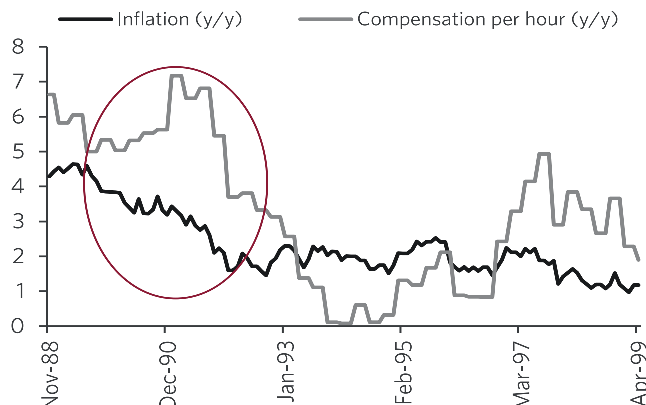
The large decline in the labour income shares from the early 1990s to its trough in 2005 is due to labour productivity growth outstripping real wage growth (Chart 7, right). Firms' investment in new technologies helped generate higher returns on capital, but this did not come at the expense of labour. That period also corresponds to a sharp acceleration of the employment rate, rising to record highs just before the Great Financial Crisis (GFC), suggesting most of this gain was due to capital that was complementary to labour (i.e., increased labour productivity to support more hiring) rather than a substitution away from labour. No small part of this era was the effect of globalization and the information age that drove the cost of intermediate inputs lower, allowing new technologies to support labour. In fact, as illustrated Chart 8, the surge in productivity also protected the economy from significant inflationary pressure even when wages were rising quickly in the early 90s.

From the aftermath of the GFC until just before the pandemic, the labour income share has moved sideways, but stayed at a low level and continued to support high profitability. However, underneath the hood, an unfavorable balance has been brewing. Productivity growth shifted down, likely reflecting weak investment and increased precautionary motives from major shocks during this era. Real wage growth also edged up as demographic pressures started emerging with baby boomers moving into retirement. Still, real wage growth was likely held in check given the weaker bargaining power of labour. Absent that, the labour share could have risen more, and profitability might have been much weaker.

The markup of a superstar

Arguably the most important biproduct of those forces in Canada and other advanced economies is the increase in product markups. One prominent study has found that aggregate US markups have increased by three-fold since 1980 as the market-share of high-markup firms has increased (De Loecker et al, 2020). The argument goes that globalization and technological change has resulted in the most productive firms

Chart 8: Strong productivity growth pre-GFC insulated the economy from price pressure



Source: Statistics Canada, CIBC

eating up the lions share of sales, increased their dominance to become "superstar" firms and their flexibility to boost margins (Autor et al, 2020).

There is evidence this has emerged in Canada to some degree. As mentioned earlier, GDP share of industries with above average profit margins has been steadily rising since the financial crisis. Markups are best estimated using firm-level data but in lieu of available data, we develop a coarse proxy of product markups to get a sense of how they may have evolved in Canada. Our proxy points a similarly meteoric and similarly timed rise in markups (Chart 9) as in the US, according to some estimates (Traina, 2018). This measure is the ratio of CPI-X (CPI excluding volatile items) relative to the price index of investment goods. One can think of this as the cost of goods and services sold relative to how global input costs are evolving. The investment goods deflator is determined by global prices and is highly correlated with Canadian import prices. It has also been identified by researchers as an indicator of firms shifting from labour to capital, another explanation for the fall in the labour share (Karabarbounis and Neiman, 2013).

Our proxy shows a substantial increase in markups since the late 1980s in Canada. The fastest pace of the increase was from 2002 to 2013, which lines up with China's entry into the WTO, the subsequent explosion of global trade and Canada's role as a small-open economy. However, since 2013, markups have been flat, which also corresponds to the period when "slow"—balizaton kicked in.

Looking to the pandemic, this proxy suggests markups jumped in 2021 by their fastest pace since 2010, but normalized quickly the following year similar to what we observe in the US.

Putting it all together

We bring all of these forces together into an empirical model that looks to explain changes in profit margin excluding interest costs by sector. We explain changes in profit margins based on the changes in sectoral labour productivity, the sectoral real wage product, our aggregate markup proxy and aggregate real GDP growth to capture cyclical forces. We pull together non-financial industries into ten sectors and estimate our model using a panel framework — and model that captures changes across sectors and across time.

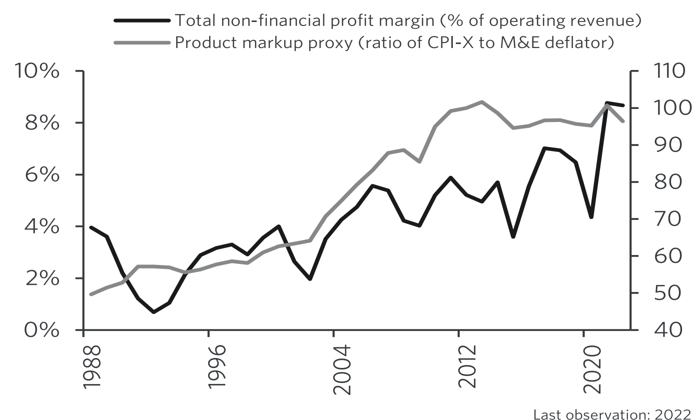
The bottom line is shown in Chart 10. The changes in margins from 1992 to 2016 (excluding the GFC years) were mostly driven by cyclical forces, increased markups and labour productivity growth. Rising real wage growth was a drag on profitability — this can be thought of as a markup on labour. Wages were rising faster than prices, pushing down profits. However, the era prior to the pandemic saw the contribution of markups shrink but wage growth was even weaker during these periods and that combined with strong cyclical forces explains the uptick in profitability from 2017 to 2019.

During the post-pandemic and high inflation years of 2021 and 2022, weak real wage growth, a strong cyclical rebound and a jump in markups mostly explain the surge in profit margins. Labour productivity actually was drag on profitability during these periods.

Looking ahead, the ongoing margin squeeze due to higher interest rates and slowing demand will not end when those cyclical conditions ease. Pre-covid profit conditions should not be extrapolate forward and earning expectations will need to take into account a changing environment. One in which, labour costs are likely to skew higher given demographic pressure from retiring baby boomers, while geopolitical tensions and the "de-risking" of global supply chains will continue to put pressure on productivity and markups. A prolonged period of high interest rates, particularly in the US, won't help either.

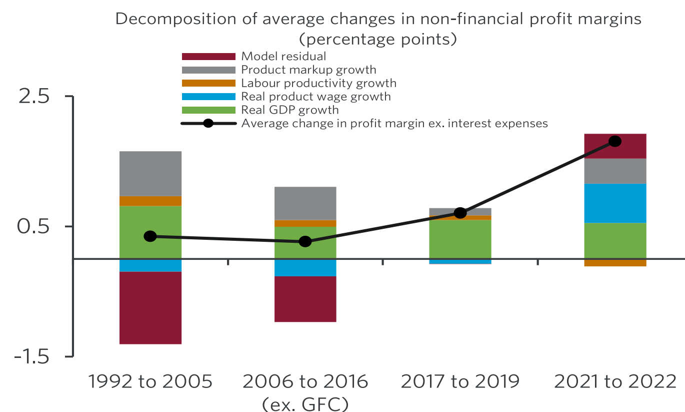
To minimize the damage, Canadian firms will have no choice but to make drastic changes. Staring them in the face is the anemic productivity record and the need to renew and deploy capital in creative ways that is complementary to labour. And they have the means to do that as the explosion of non-financial

Chart 9: CIBC's product markup proxy for Canada shows a meteoric rise prior to the GFC



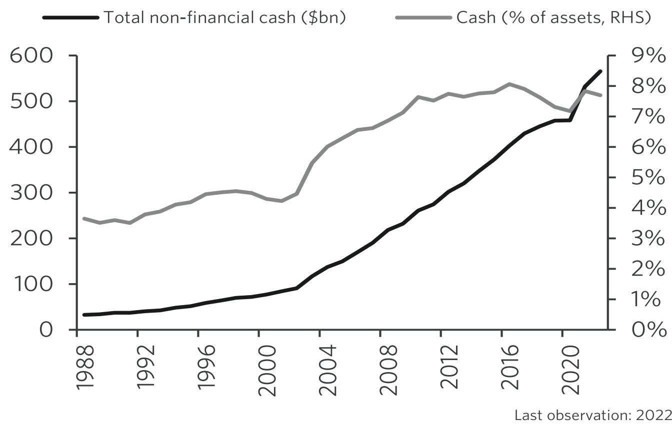
Source: Statistics Canada, CIBC

Chart 10: After cyclical forces, changes in markups have been the biggest driver of profits historically



Source: Statistics Canada, CIBC

Chart 11: Canadian firms continue to sit on piles of cash



Source: Statistics Canada, CIBC

profit margins as also been accompanied the accumulation of a mountain of cash worth almost 8% of their assets (Chart 11).

Capital spending growth in Canada has been a serial disappointment for many years. One of the reasons might be that easy profit reduced the motivation to invest. With the era of easy profit might coming to an end, a growing number of firms will find that capital spending become a necessity as opposed to an option.

Table: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q2A	23Q3F	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2023F	2024F	2025F
Real GDP Growth (AR)	1.4	-1.1	1.0	-0.7	1.3	1.7	2.1	1.1	0.6	2.1
Real Final Domestic Demand (AR)	1.2	1.3	0.0	-0.3	1.4	2.3	2.2	0.9	0.9	2.3
Household Consumption (AR)	-0.1	0.1	0.0	-0.8	1.2	1.7	2.1	2.0	0.4	2.0
All Items CPI Inflation (Y/Y)	3.5	3.7	3.2	3.1	2.3	1.8	1.7	3.9	2.2	2.0
Unemployment Rate (%)	5.2	5.5	5.8	6.2	6.3	6.1	5.9	5.4	6.1	5.6

Table: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	23Q2A	23Q3A	23Q4F	24Q1F	24Q2F	24Q3F	24Q4F	2023F	2024F	2025F
Real GDP Growth (AR)	2.1	5.2	1.5	1.1	0.6	0.2	1.2	2.5	1.5	1.7
Real Final Sales (AR)	2.1	3.7	1.9	1.4	0.6	0.5	1.2	2.8	1.6	1.7
All Items CPI Inflation (Y/Y)	4.0	3.5	3.3	2.9	2.4	2.2	2.3	4.1	2.4	2.2
Core CPI Inflation (Y/Y)	5.2	4.4	4.0	3.4	2.9	2.8	2.6	4.8	2.9	2.3
Unemployment Rate (%)	3.6	3.7	3.8	4.1	4.2	4.3	4.3	3.7	4.2	4.0

Table: Canadian interest rates (end of period)

Variable	2023 Dec 12	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Overnight target rate	5.00	5.00	4.75	4.00	3.50	3.00	2.50
98-Day Treasury Bills	5.03	5.05	4.60	3.90	3.35	2.85	2.45
2-Year Government Bond	4.21	4.40	4.00	3.40	3.00	2.70	2.60
10-Year Government Bond	3.42	3.65	3.50	3.35	3.20	2.90	2.95
30-Year Government Bond	3.21	3.50	3.60	3.50	3.40	3.10	3.05
Canada - US T-Bill Spread	-0.36	-0.25	-0.65	-1.25	-1.40	-1.15	-0.90
Canada - US 10-Year Bond Spread	-0.84	-0.90	-0.90	-0.85	-0.65	-0.75	-0.35
Canada Yield Curve (10-year — 2-year)	-0.79	-0.75	-0.50	-0.05	0.20	0.20	0.35

Table: US Interest rates (end of period)

Variable	2023 Dec 12	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
Federal funds rate (midpoint)	5.375	5.375	5.375	5.375	4.875	4.125	3.625
91-Day Treasury Bills	5.39	5.30	5.25	5.15	4.75	4.00	3.35
2-Year Government Note	4.75	4.80	4.65	4.50	4.10	3.30	3.10
10-Year Government Note	4.26	4.55	4.40	4.20	3.85	3.65	3.30
30-Year Government Bond	4.34	4.70	4.55	4.40	4.30	3.90	3.65
US Yield curve (10-year — 2-year)	-0.49	-0.25	-0.25	-0.30	-0.25	0.35	0.20

Table: Foreign exchange rates

Exchange rate	2023 Dec 12	2024 Mar	2024 Jun	2024 Sep	2024 Dec	2025 Jun	2025 Dec
CAD-USD	0.74	0.70	0.72	0.73	0.74	0.77	0.78
USD-CAD	1.36	1.42	1.39	1.37	1.35	1.30	1.29
USD-JPY	146	154	150	148	145	135	130
EUR-USD	1.08	1.03	1.05	1.08	1.11	1.15	1.16
GBP-USD	1.26	1.18	1.20	1.23	1.27	1.32	1.34
AUD-USD	0.66	0.61	0.62	0.63	0.64	0.66	0.67
USD-CNY	7.18	7.33	7.32	7.30	7.25	7.20	7.10
USD-BRL	4.95	5.20	5.20	5.40	5.00	5.20	5.40
USD-MXN	17.42	18.50	19.00	19.20	19.00	18.75	18.50

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