One Thing Leads to Another: Productivity’s Rebound

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Key Points

- Is this expansion’s weak productivity growth a “statistical illusion?”
- Recent better productivity likely has legs heading into 2018.
- Stocks have done best following periods of weak productivity.

My last report was on the acceleration in business capital spending (capex) that is likely to be an economic highlight in 2018. Part-and-parcel of capex is productivity—officially known as non-farm labor productivity—which has averaged less than 1% annualized growth during the current expansion. This has been the weakest era of productivity for any expansion in modern history, with the exception of the late-1970s. But all is not lost. Not only do I think productivity is at least a bit understated—based on how it’s calculated—but there’s reason for optimism for an uptick in 2018.

Measurement problems

As noted by Gavekal Dragonomics in a great report a couple of years ago, the apparent productivity slowdown is a “statistical illusion” caused by rapid technological change. The analysis starts with a famous remark made in 1987 by economics Nobel Laureate Robert Solow: “We can see computers everywhere except in the productivity statistics.” In other words, traditional data calculations are less reliable in the midst of rapid structural and technological changes, especially when a large and expanding proportion of employment/consumption growth is generated by the services side of the economy. This is decidedly different than the manufacturing-oriented era when non-farm productivity calculations were first developed.

As a result, many ‘old economy’ activities have been replaced by online services operating on totally different business models and often delivered free at the point of sale. Such businesses are underestimated or even missed completely in gross domestic product (GDP) and productivity statistics, even though they provide services of huge economic value. The measurement problem arises because many online services generate far less revenue than the old economy businesses they replace, yet they employ large workforces and pay high wages.

The fact that countries with the fastest business innovation are also the ones apparently suffering the largest productivity disappointments corroborates the conjecture that the fault lies not in businesses’ ability to innovate, but in statisticians’ ability to measure the true value of that innovation.

There is appropriate enthusiasm about the impact of technological advances like robotics and artificial intelligence (AI); which could lead to more rapid productivity growth. Quality enhancements and innovations tend to occur more rapidly in the digital economy. There is also reason for hope using traditional productivity measurements; along with productivity’s leading indicators.

Rebound underway

We are already witnessing a sharp rebound in productivity this year. After a drop into negative territory in 2016, the year-over-year change moved back up to 1.5%; while it’s running at a 3% annualized rate as of the third quarter. On a five-year percentage change basis, we are likely stabilizing, as seen in the chart below. Assuming further acceleration, this is good news for wages as the correlation between productivity and wage growth has historically been tight.
“Productivity pop”

The other implication of a pick-up in productivity is a commensurate pick-up in GDP growth. Remember GDP growth is the product of labor force and productivity growth. My friend (and highly-regarded strategist) Jim Paulsen—who recently joined the great research firm The Leuthold Group—had this to say in his latest musings on productivity:

“A pop in productivity would finally replace those 2-ish% real GDP numbers with regular 3 handles, forcing many to recalibrate economic growth and earnings estimates. It would come at just the right moment in a recovery where wage and price pressures are intensifying. It could allow the renormalization of bond yields to be stretched over a more measured pace. Finally, a productivity pop this late in an expansion could reset the recovery clock, acting like a fountain of youth for the economy and perhaps sustain this bull market for much longer than most believe possible.”

The chart below compares productivity growth with a ratio of business capability to invest to the need to invest. A tight labor market combined with increasing cost pressures creates the greatest incentive for companies to boost productivity. The good news for productivity is that the ratio of business capability/need to invest is higher now than any time since 1970.

Productivity Set to “Pop”

Source: The Leuthold Group, as of June 30, 2017. Four-quarter moving average. *Business spending ratio = corporate
cash flow divided by capital spending, all as a ratio of unemployment ratio.

What might this mean for the stock market?

Leuthold highlights that there has been a close relationship over the past 60 years between productivity growth and U.S. stock market performance. The chart below compares productivity relative to its trend line to the S&P 500 relative to its trend line (the former is inverted and pushed forward to show the inverse and leading relationship). What you can see—and what may surprise you—is that stocks have generally performed better following periods of weak productivity and vice versa.

Productivity Infection Points Lead Stocks

Source: The Leuthold Group, as of September 30, 2017.

The conclusion is that productivity has a proclivity to "regress to the mean;" that is, periods of weak productivity are generally followed by periods of "catch-up" growth and vice versa. This analysis also helps "explain" today’s perceived-high level of stock market valuation; given that stocks are only slightly above average when compared to the 60-year trend. Finally, although there remains a long runway between the House bill put forth on tax reform and a bill that could pass through the Senate, a more competitive tax code would likely grow the capital stock, which should boost productivity.

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