LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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THE POWER OF PRODUCTIVITY

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KEY TAKEAWAYS

First quarter productivity rose at the fastest year-over-year pace since 2010.

Higher productivity could help support output growth as the expansion ages.

Increased productivity also helps promote economically healthy wage growth.

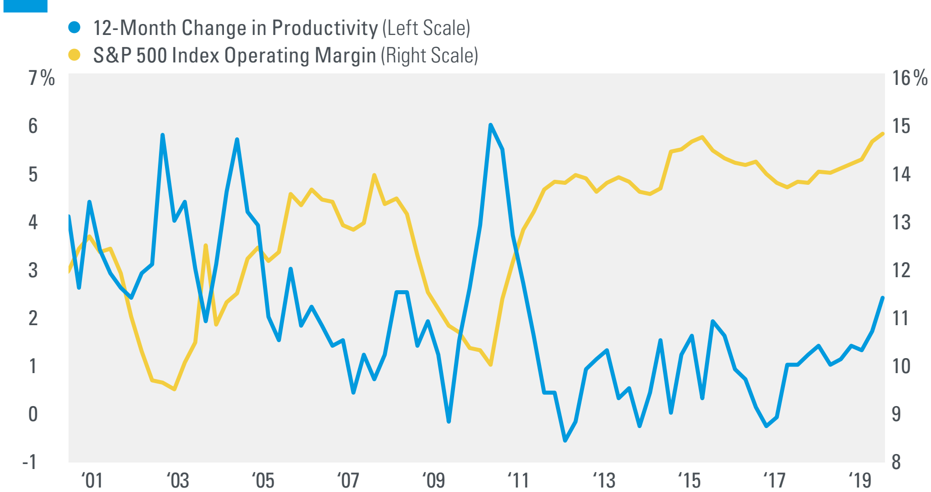
Recently, the U.S. economy has shown resilience in powering through political and trade noise. One of the most encouraging reports of late was on productivity (output per hour worked) among nonfarm employees. First quarter productivity rose at the fastest year-over-year pace since 2010, while unit labor costs grew at the slowest pace since 2013.

Growth in productivity is a key part of our economic outlook. Higher productivity boosts both consumer and corporate well-being, feeds into gross domestic product growth, and helps promote healthy inflation. A resurgence in productivity could provide the U.S. economy a timely boost, especially as many wonder what could extend this near-record expansion [Figure 1].

BOOSTING OUTPUT

Productivity has been a crucial piece of past economic expansions. Historically, productivity growth has typically spiked in the beginning of each economic cycle before tapering off later. The current economic expansion has been abnormal, though, as significant productivity growth has been absent for most of the past several years. Productivity has risen at an average pace of 1.3% year over year this cycle, about half of the 2.6% year-over-year growth from the beginning of 2000 to June 2009.

1 INCREASED PRODUCTIVITY BOOSTS PROFIT MARGINS



Source: LPL Research, Bureau of Labor Statistics, FactSet 05/10/19
All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

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We've said for a while now that conditions are ripe for increased productivity, and we've seen a modest uptick over the last 12 months—including last quarter's surprisingly strong reading. Companies are now sitting on record cash piles, and a tight labor market with cycle-high wage growth is forcing businesses to invest in their employees' development instead of looking for new hires.

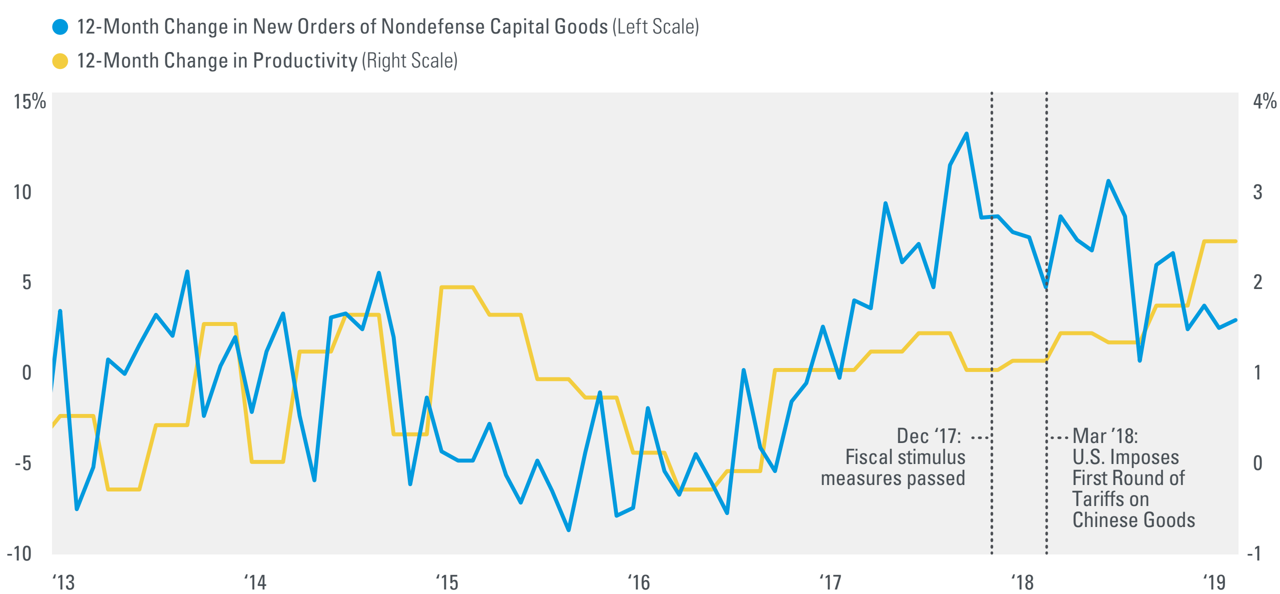
Higher productivity is an especially important priority for U.S. companies as profit growth plateaus. Operating margins in this expansion have largely benefited from accelerating profits, but we think this tailwind could slow as the cycle matures and growth moderates. Going forward, companies will have to prioritize capital expenditures (capex) for fueling output, and capex is a primary catalyst for productivity.

We've seen flickers of higher capex over the past couple of years [Figure 2]. Growth in new orders for nondefense capital goods (our favorite proxy for capex) surged from 2017 through the middle of 2018 as profits grew and fiscal stimulus incentivized corporate investment. Then, the U.S.-China trade dispute escalated, derailing the upward trend in business spending.

Although corporate fundamentals remained solid over this period, heightened trade tensions forced U.S. corporations to put spending plans on hold as the economy weathered a slide in demand. Manufacturing health gauges have declined, business sentiment has fallen to a multiyear low, and capex growth has moderated.

Trade tensions remain, despite progress in trade talks, and business sentiment is still fragile. The National Federation of Independent Business's gauge of small business optimism has hovered around a multiyear low since January, and respondents' capital expenditure plans have taken a noticeable hit. However, we still think the United States and China are working toward a deal, and we don't expect tariffs themselves to significantly impede economic activity. The lingering threat has added the chilling effect of uncertainty, which we think will dissolve with meaningful progress in trade

2 CAPEX SURGE HELPS SUSTAIN PRODUCTIVITY GAINS



Source: LPL Research, Bureau of Labor Statistics, U.S. Census Bureau 05/10/19
Past performance is no guarantee of future results.
Capex = Capital Expenditures

talks. Once there is more clarity on trade, we expect capex to pick up again as companies take advantage of fiscal incentives, record cash piles, and low borrowing costs.

HEALTHY INFLATION

Inflation has been a focal point of U.S. economic data recently. The Federal Reserve is eyeing wage and pricing pressures as it determines the future path of monetary policy. Inflationary threats have also stifled growth in past expansions, so inflation is crucial in gauging economic health.

Productivity indirectly influences inflationary pressures. Higher productivity leads to higher wages: Workers tend to get paid more when the value of an hour of work rises. Modestly accelerating wages boost incomes and empower the U.S. consumer, which could fuel faster growth in consumer spending.

However, productivity provides an added benefit of keeping employer expenses in check by reducing the cost of producing output (measured by unit labor costs). If workers are paid more for making widgets, but they can make more widgets in an hour, the cost to businesses for making widgets can be kept contained. Wages alone account for about 70% of business costs, so it's difficult to have an inflationary threat without the participation of wages.

Currently, the overarching concern is that inflation is too low. Wage growth, though, has eclipsed 3% year over year for the past several months. In our view, this is a sweet spot for wage growth, as it's moderate but below the 4% wage growth that has preceded past recessions. As the labor market tightens, we expect wage growth to rise. Increasing productivity could help temper the cost of higher wages for companies.

CONCLUSION

Even in the midst of a healthy expansion, the U.S. economy's growth potential has been hindered by muted productivity growth. The first quarter jump in productivity gave us hope that the recent surge in capex and building labor market pressure could be flowing through to output and wages. Trade tensions have been a wild card for U.S. companies, but we expect progress on the trade front to resume. As global uncertainty dies down, corporations should be able to focus more on expansion plans. ■