LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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# PRODUCTIVITY ON THE RISE

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## KEY TAKEAWAYS

Signs of sustainable productivity growth are emerging, thanks to solid economic fundamentals and the tailwind of fiscal stimulus.

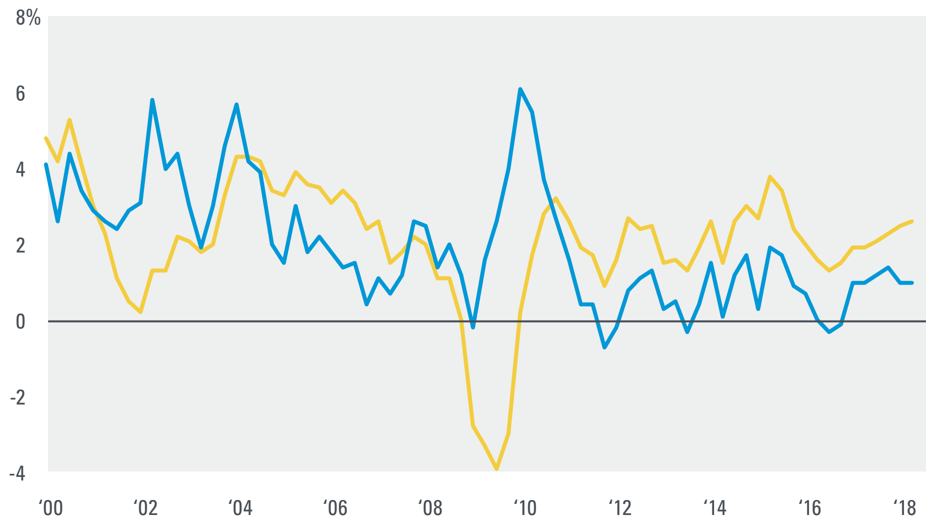
Changes in tax laws have provided extra cash for firms, allowing them to compete for new market share.

Higher productivity typically flows through to improved standards of living and lower unit labor costs.

**Productivity gains play an important role in economic output, and recent gains support an encouraging picture of the U.S. economy.** Productivity, first and foremost, is a primary driver of gross domestic product (GDP) growth [Figure 1]. In the second quarter of 2018, nonfarm productivity rose 2.9%, its fastest pace of growth since the first quarter of 2015. Business sector productivity grew 3.6%, its biggest quarterly jump since the fourth quarter of 2009, while manufacturing sector productivity rose 0.9%. Nonfarm productivity grew primarily from an increase in output per hour of work (versus the number of hours worked). Output increased 4.8% quarter over quarter (its fastest pace since 2014), while hours worked grew 1.9% (versus a 2.2% rise in the first quarter).

While recent gains have been encouraging, the longer-term trend in productivity growth has been muted. Nonfarm productivity grew 1.3% year over year in the second quarter, in line with the 1.3% average since June 2009 (the end of the Great Recession), but below the 2.6% average from the beginning of 2000 to June 2009.

**1 PRODUCTIVITY INCREASES ARE AN IMPORTANT COMPONENT OF GDP GROWTH**




Source: LPL Research, Bloomberg 08/30/18



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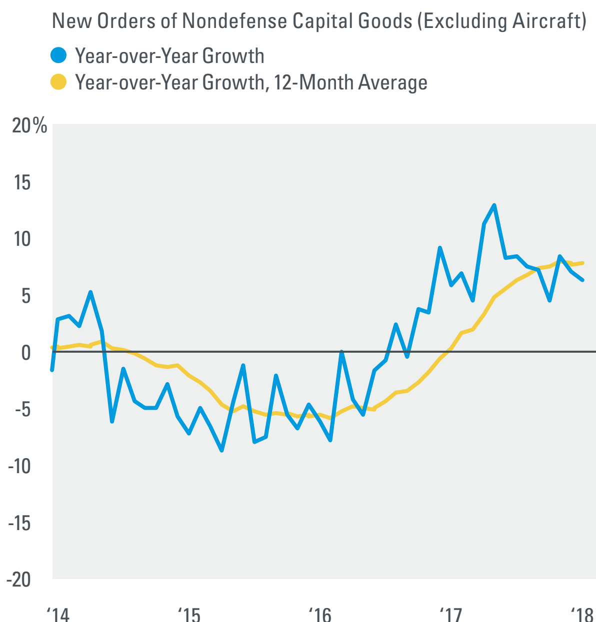
However, signs of sustainable productivity growth are emerging, in our view, thanks to solid economic fundamentals and the tailwind of fiscal stimulus. Productivity, a crucial piece of an economic expansion, may continue to improve as U.S. companies ramp up capital expenditures and the labor market continues to tighten.

## SIGNS OF PRODUCTIVITY GROWTH

One driver of productivity gains may be a pickup in business investment. The Institute for Supply Management's New Orders Index, which tends to be a leading indicator for business spending and the economy, has remained above 60 for 16 straight months, the longest such streak since 1973. New orders of nondefense capital goods (excluding aircraft) have also picked up over the past two years [Figure 2].

These capital goods orders, our best proxy for current business investment, have grown in every month since May 2017 by at least 5% year over year, a pace of growth barely breached from 2012 to 2017. New orders have rebounded strongly from depressed levels after global economic growth slowed in 2015, fueled by fiscal stimulus that has boosted corporations' incomes.

**2 SIGNS OF STRONG CAPEX GROWTH IN NEW ORDERS**




Source: LPL Research, Bloomberg 08/30/18

Business spending is an important input for productivity. If workers have better equipment, better resources, and better training, they have the means to boost production. Tax cuts have provided an extra injection of cash for firms that is fueling a surge in business spending as they invest in resources in an effort to gain market share. Changes in tax laws have also allowed businesses to expense capital purchases and bring their overseas profits back to the U.S. (known as repatriation), providing a lift to business spending. Looking forward, we see a continued pickup in business spending as corporations continue to realize the benefits of fiscal stimulus. In turn, stronger business spending naturally lifts employee productivity.

Improvements in the labor market have also helped fuel productivity. The U.S. unemployment rate has dipped as low as 3.8% this year, a 48-year low. Anecdotal evidence also hints toward U.S. companies' struggle with a shortage of available and qualified employees. Respondents in the Federal Reserve's (Fed) July Beige Book noted they had difficulty finding qualified labor, and shortages were reported across several skilled professions. As labor becomes increasingly scarce, employers are forced to focus on improving productivity among their existing workers to boost output.

## PRODUCTIVITY AND WAGES

More important than economic growth alone, productivity typically leads to increases in wages and improved standards of living. If more people work more total hours, assuming productivity stays constant, economic growth is simply the product of a larger labor pool. However, if productivity picks up, the value of an hour of work rises, which can often be accompanied by organic increases in wage growth.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Substantial wage growth has been another missing factor in the economic expansion. While recent Employment Cost Index (ECI) readings have been strong, ECI growth has averaged 2.4% in the current tightening cycle, far below the 3.3% average rise during the Fed's last tightening cycle. The absence of wage growth is especially curious given that unemployment is at a cycle low, and we believe mild productivity growth may be one of the reasons for this. Modestly accelerating wages boost incomes and empower the U.S. consumer, which could fuel faster growth in consumer spending (typically accounting for about 70% of output).

Wages have been scrutinized lately because of pricing pressures' role in the Fed's monetary policy decisions. While we understand the concern around the economy overheating and the Fed's influence on financial markets, we believe there is ample time before inflationary wage pressures can weigh on output. Each of the past five recessions started with wage growth in excess of 4.0%, so wages have room to grow before the pace reaches alarming levels. We believe increasing productivity at this point in the cycle may spur healthy wage growth, instead of excessive inflationary pressures.

While a potential force pushing wages higher, productivity can also help control unit labor costs (the cost of producing one unit of output) by offsetting some of the added wage costs. If workers are paid more for making widgets, but they can make more widgets in an hour (productivity!), the cost to businesses for making widgets can be contained, which can help mitigate inflationary pressures and support healthy profit margins for U.S. companies.

## CONCLUSION

Even in the midst of a healthy expansion, the U.S. economy's growth potential has been hindered by muted productivity. However, we believe we are seeing an improving environment for productivity. Solid productivity growth may continue as business investment rises and the labor market continues to strengthen. In turn, higher productivity growth may stimulate wage increases, which could help lift consumer spending further (leading to an additional boost in U.S. GDP growth). For now, we still forecast U.S. real GDP will grow up to 3% in 2018, with the potential for an upside surprise if companies continue to respond to fiscal stimulus and the return of a more traditional business cycle. ■

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