
Weekly Market Flash

GDP Matters, Productivity Matters More

January 27, 2017

It would appear that a lesson in US civics might be in order for Mr. Market. Investors breathlessly followed the staccato blast of tweets and executive orders emanating from Week One at the White House, rekindling the reflation-infrastructure trade that had seemed, tentatively, to be starting to take off the rose-tinted glasses. An executive order does not an actual implemented policy make, and the vaunted sausage-making process of legislative accomplishment continues to be at odds with the market's bobby-sox crush on all things Trump administration.

Meanwhile in the world of actual data, this morning we got a preliminary reading on Q4 real GDP growth. The headline number came in a bit below consensus: the quarter-on-quarter increase of 1.9 percent was about 30 basis points below expectations. That translates to an annual average growth rate of 1.6 percent, making 2016 the lowest-growth year since 2011. How do the latest data affect expectations for next year and beyond? We look at both the near-term implications and what we see as the longer-term growth headwinds fiscal stimulus will not likely solve.

Buy Now, Pay Later

The overall consensus of economist views on the US economy in the coming 1-2 years has ticked up measurably since the election. Not to the levels of four percent real growth promised on the White House website (or the credulous investor herds who appear to agree), but increasingly closer to three percent than two. Much of the incremental growth, according to the new consensus, would start to show up in the latter half of 2017 and more fully in 2018. It would be premised on the realization of at least some form of the fiscal stimulus measures being tossed around, most directly corporate tax reform and new infrastructure spending. Most economists, when asked, stress that the nature of uncertainty around any of these measures or their timing adds a level of uncertainty to their outlook. And many are careful to add that successful implementation of these policies in the short run could have deleterious knock-on effects, as higher trade and budget deficits accompanied by higher than expected inflation could likely push up interest rates and the US dollar, making exports less competitive and thus detracting from growth. There are indeed many moving parts to the growth equation, which is why we habitually argue for caution against reading too much optimism – or pessimism for that matter – into likely scenarios for any given set of policies.

All that Matters

Ultimately, though, what long-term investors should care about, more than whether fiscal stimulus measure X gets implemented and causes interest rates to do Y and the dollar to do Z, is whether economic productivity will ever get back on track. GDP growth is important, but ultimately the growth comes from only three sources: population growth, an increase in the percentage of the population in the labor force, or productivity (the ability to produce more goods and services for each hour of effort and cost). Forget about the first two. Population growth is anemic: 1.2 percent per year for the world and just 0.8 percent per year for the US. Meanwhile the labor force participation rate, which reached a peak of about 68 percent at the beginning of the 21st century, has slumped to less than 63 percent for a variety of structural and cyclical reasons (more retirees, lingering effects of the recession etc.).

That leaves productivity. Unfortunately, there's not much good news here either. Average output per hour, the standard measure of productivity, was lower for the last ten years than it has been for any ten year period since 1950. The current calendar decade thus far has been even worse: the 0.72 percent average annual growth rate for the period since 2010 is only one quarter of the rate for the 1960s, the most productive decade to date.

Opinions vary on why this is so, from the "best growth is behind us" view of the likes of Robert Gordon (author of "The Rise and Fall of American Growth") to techno-optimists like Thomas Friedman of the New York Times who

imagine that the true value-creating capabilities of more recent innovations have yet to bake themselves into macroeconomic statistics (Friedman ascribes 2007 – the year the iPhone was introduced – as a pivotal year in world history *sine qua non*). A separate but likewise relevant question is whether a new bout of technology-inspired productivity, particularly if it were to come from the gains in robotics brought about by deep-learning methods of artificial intelligence, might be severely counterproductive in its effect on the labor market. Again – lots of moving parts to consider in the complex adaptive system that is our economy.

Now, a genuine burst of real productivity (of the non-job killing ilk) could potentially smooth out the rough edges of the fiscal overheating that would be the likely outcome of the kind of programs this administration appears to want to implement. That is, of course, if the protectionist dark side of these programs were, at the same time, to not materialize. All those things combined could be a recipe for sustainable growth. But we will need to see far more evidence that any of them are likely to transpire before we think about joining the growth bandwagon.

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