



MORNING BRIEFING

June 28, 2017

Puzzling Productivity & Profitability

See the [collection](#) of the individual charts linked below.

(1) Oomph and Oompah in Germany. (2) Lots of reasons why productivity should be growing faster. (3) Technology goes from replacing brawn to brain. (4) Is that good or bad for productivity? (5) Amazon Web Services and UBER reducing demand for servers and autos. (6) Record-high profit margin belies productivity funk. (7) Stagnation is a myth: Real pay is growing. (8) Powerful forces keeping a lid on price inflation. (9) Nonfinancial corporations have lots of cash and are spending it on capex, not just buybacks.

Germany: Oomph! The word “oomph” sounds like it might be of German origin. In fact, it is an American expression dating back to 1935-40. It is imitative of the sound made during physical exertion, as when lifting a heavy object. Then again, Oomph! is a German industrial metal band formed in Wolfsburg, Germany in 1989. Today, the industrial metals business is booming in Germany, and so are many other industries. June’s Ifo Business Confidence Index soared to a new record high, led by its current situation component ([Fig. 1](#)). The series is available since 1991. The diffusion indexes for the German manufacturing, construction, wholesale trade, and retail trade components all were very strong this month ([Fig. 2](#)).

The German MSCI stock price index (in euros) is up 7.4% ytd and 29.3% y/y, compared to the US MSCI index, which is up 9.1% ytd and 18.8% y/y ([Fig. 3](#) and [Fig. 4](#)).

It’s too early for Oktoberfest, but not too early to have a couple of steins of beer in a Bavarian Biergärten while listening to an oompah band. If you start dancing, try to avoid the [slapdancers](#).

Perversely, this happy story has yet to show up in Germany’s productivity statistics, which are just as puzzlingly weak as those in the US ([Fig. 5](#) and [Fig. 6](#)). Over the past 20 quarters, the German measure was up at an annual rate of 0.4%, while the US rate was 0.7%.

US Productivity: Why the Long Face? Something just doesn’t add up: Despite the weak pace of productivity growth in the US, inflation is very low. Inflation-adjusted pay per worker is at a record high. Measures of corporate profit margins are at record highs. There’s a lot of anecdotal evidence that productivity-enhancing technological innovations are proliferating in many industries. The cloud allows for a much more efficient use of high-tech hardware and software across the economy. Automation and robotics have been integrated over the Internet to communicate and to interact seamlessly. The Great Disruptors—including Alphabet, Amazon, Microsoft, Tesla, and Uber—are forcing all their competitors to boost their efficiency or risk going out of business. Perhaps no industry has made more progress in increasing its productivity than the oil and gas producers, thanks to fracking technologies.

Yet none of these productivity-boosting developments are showing up in the official productivity numbers. Lots of explanations have been proffered by economists and technologists. Economists are well known for making assumptions. The optimists among them assume that the data are wrong, and will eventually be revised higher. That happened in the late 1990s. The optimists say that the government’s bean counters may be underestimating the economy’s output.

The pessimists say we are in a period of secular stagnation. Some of them claim that all the latest and future technological innovations are unlikely to boost productivity to the extent that the truly revolutionary technologies of the past had done—such as the steam engine, electricity, indoor plumbing, automobiles, air conditioning, and computers. They even question whether computers have done much to increase productivity beyond boosting the production of computers.

That's an interesting point because, after growing rapidly during the 1980s and 1990s, inflation-adjusted capital spending on both information processing equipment and software has slowed significantly ([Fig. 7](#)). Yet in current dollars, they now account for 28.4% of total capital spending, up from 17.0% during 1980 and 8.5% during 1960 ([Fig. 8](#)).

Could it be that technological innovation aimed at complementing (or un-employing) the brain has a different impact on productivity than innovations that replace brawn? The proliferation of the cloud certainly explains why spending on IT hardware and software has slowed, since we can all rent just what we need from the cloud vendors, who are using their resources much more efficiently than we did when we owned our own software and servers, housed them at server farms, and woefully underutilized them. UBER is undoubtedly increasing the efficiency of the auto fleet while it must be weighing on car sales. How will we even measure the impact of self-driving cars on productivity? Now consider the following related notions:

(1) *Inflation & profit margins.* Weak productivity growth is boosting labor costs, which is defined as compensation divided by productivity. Over the past four quarters through Q1-2017, productivity in the nonfarm business (NFB) sector rose just 1.2%, while hourly compensation rose 2.3%. The NFB price deflator rose only 1.7% over this period. Yet the S&P 500 profit margin remained in record-high territory above 10.0% for 12 of the past 13 quarters, even as five-year trend productivity growth slowed from 1.5% to 0.7% over this period ([Fig. 9](#) and [Fig. 10](#)).

(2) *Real wages.* In a competitive market economy, nominal wages are determined by the value of marginal productivity. That's one of the basic principles taught in courses on microeconomics. Sure enough, the data confirm the close relationship between inflation-adjusted hourly compensation and productivity, though it's very important to use the price deflator of the nonfarm business sector, which determines the value of the marginal product produced by workers, rather than the CPI or PCED when deflating the measure of wages ([Fig. 11](#) and [Fig. 12](#)).

Over the past five years, both productivity and real compensation growth rates in the nonfarm business sector have been very weak, averaging 0.7% and 0.9% per year through Q1. However, the widespread view that real wages have stagnated for the past 15-20 years is just dead wrong. Over the past 20 years, real compensation in the NFB sector is up roughly 30% ([Fig. 13](#)). The laggard has been manufacturing, yet real compensation is up about 20% over the past 20 years in this sector.

Over this period, real average hourly earnings (using the NFB price deflator) for production and nonsupervisory workers, who currently account for 82% of total private payroll employment, rose 30%, continuing to closely track productivity ([Fig. 14](#) and [Fig. 15](#)). Nominal wages are growing remarkably slowly given the tight labor market. However, adjusted for inflation they are keeping pace with productivity, which still has an uptrend. Wages are rising faster than prices, but prices are rising very slowly for reasons that may not have much to do with productivity. Global competition, disruptive technology, and aging demographics may be playing a much greater role in keeping a lid on prices, which is also keeping a lid on wages.

US Corporate Finance: Show Me the Money. Yesterday, we wrote that S&P 500 operating earnings totaled \$958 billion over the past four quarters, with buybacks and dividends accounting for 95% of this

total. The dividend payout ratio of the S&P 500 remains around 50%. This implies that corporations are spending all their extra cash on buybacks rather than capital spending and wages.

We noted: “The problem with this widely circulated myth is that profits are not the same as cash flow.” The latter is equal to retained earnings (i.e., after-tax profits less dividends) plus the depreciation allowance. When we add the cash flow plus net bond issuance of nonfinancial corporations (NFCs), the resulting series is more often than not very close to capital expenditures plus buybacks ([Fig. 16](#)). Here are a few round numbers for 2016 based on data compiled in the Fed’s [Financial Accounts of the United States](#) (Table F.103):

(1) *Sources of cash.* NFCs had reported pre-tax profits of \$1,271 billion. They paid \$322 billion in taxes and \$617 billion in dividends. They had \$1,307 billion in capital consumption allowances (CCA). Their internal cash flow, i.e., the sum of their retained earnings and CCA, was \$1,639 billion. Their net bond issuance was \$268 billion. These sources of cash sum to \$1,907 billion.

(2) *Uses of cash.* Capital expenditures (including inventory investment) totaled \$1,670 billion last year. Buybacks totaled \$586 billion. These two categories of spending sum to \$2,256 billion.

The discrepancy between the sources and uses of cash seems large, but it tends to average out over time. Besides, the analysis above excludes lots of other items in the Fed’s accounting for this sector. The main point is that cash flow is much bigger than after-tax profits less dividends. Companies have been spending a record amount on capex, including on technology, which is cheaper and more powerful than ever.

CALENDARS

US. Wed: Advance Merchandise Trade Balance -\$66.0b, Pending Home Sales 0.5%, MBA Mortgage Applications, EIA Petroleum Status. **Thurs:** Real GDP, PCE, and GDP Price Deflator 1.2%/0.6%/2.2%, Jobless Claims 241k, Weekly Consumer Comfort Index, EIA Natural Gas Report. (Bloomberg estimates)

Global. Wed: Japan Retail Trade -1.0%/m/m/2.8%/y/y, Poloz. **Thurs:** Germany CPI 0.0%/m/m/1.4%/y/y, Germany Gfk Consumer Confidence, Japan CPI Headline, Core, and Core-Core 0.5%/0.4%/0.1% y/y, Japan Jobless Rate 2.8%, Japan Industrial Production -3.0%/m/m/6.8%/y/y. (DailyFX estimates)

US ECONOMIC INDICATORS

Consumer Confidence ([link](#)): Consumer confidence in June unexpectedly rose for the first time in three months. A strong jobs market along with rising stock and home prices are driving the present situation measure higher, while skepticism over Washington enacting legislation that will boost economic growth is hampering expectations. The Consumer Confidence Index rose to 118.9 this month after falling from a cyclical peak of 124.9 in March to 117.6 in May. June’s advance was driven by an increase in the present situation component from 140.6 to 146.3—the highest reading since July 2001. The expectations component fell for the third month from a cyclical high of 112.3 in March to 100.6 this month, still a relatively high level. Consumers viewed the current job market very favorably, with those saying jobs are plentiful (to 32.8% from 30.0%) climbing to a new cyclical high and those saying jobs are hard to get (18.0 from 18.3) sinking to a new cyclical low. Consumers’ six-month job outlook weakened a bit, with those expecting more jobs (19.3 from 18.6) edging slightly higher along with those expecting fewer jobs (14.6 from 12.1); the former is down from its March peak of 23.8%. Still, the spread between the two remained positive for the eighth straight month.

Regional M-PMIs ([link](#)): Five Fed districts have reported on manufacturing activity for this month, and they show that growth in the sector is accelerating toward February's peak rate. We average the composite, orders, and employment measures as data become available. The composite index rose from 12.8 to 16.1 in June, heading back near February's 23.5—which was the highest reading since July 2004. The New York (to 19.8 from -1.0) measure moved from contraction to expansion, while Kansas City (11 from 8) and Richmond (7 from 1) gauges improved; measures for Philadelphia (27.6 from 38.8) and Dallas (15.0 from 17.7) both slowed but continued to show robust growth. The new orders gauge rebounded from 9.6 to 12.7, as the New York (18.1 from -4-4) and Richmond (6 from 0) regions saw orders expand again, while Philadelphia (25.9 from 25.4) billings remained at high levels; Kansas City (4 from 9) and Dallas (9.6 from 18.1) manufacturers saw orders grow at the slowest pace in 10 months and three months, respectively. The employment measure slowed slightly for the third month, from March's cyclical high of 13.5 to 10.7 this month, as both the New York (7.7 from 11.9), Philadelphia (16.1 from 17.3), and Richmond (5 from 6) gauges showed that manufacturers expanded payrolls at a slower, but still solid pace; Kansas City's (15 from 11) measure rebounded back near its high for the year, while Dallas' (9.6 from 9.3) returned to February's high for this year.

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