Productivity Rebound: Why Now?

See the collection of the individual charts linked below.

- Geopolitical crises tend to create buying opportunities.
- Disorderly world.
- Iran is between Iraq and a hard place.
- From community organizers to dealmakers.
- Trump threatens more tariffs on China to close the trade deal.
- If productivity is making a comeback, as we expect, potential output growth is higher and NAIRU is lower than CBO estimates.
- Fed officials, focusing on “transient” disinflation story, may be missing secular one again.
- Tight labor markets may be triggering faster productivity growth.
- The “productivity-compensation gap” is a statistical mirage.

Geopolitics I: New World Disorder? In the past, geopolitical crises often created buying opportunities for stock investors. Such crises don’t have long-term bearish consequences as long as they’re resolved fairly quickly. Stocks sold off sharply on Monday morning because the widely anticipated US-China trade deal seemed to have hit a roadblock. In addition, tensions flared up in the Middle East between Israel and Gaza and between the US and Iran.

Of the two developments, the second poses a greater risk to world order than the first, in my opinion. That’s because I expect that the US and China will settle their differences on trade issues sooner rather than later. On the other hand, the differences between the Israelis and the Palestinians have been intractable for years and not likely to be resolved peacefully in the foreseeable future.

Similarly, Iran has aspirations in the Middle East that are anathema to US interests in the region, including the annihilation of Israel. Indeed, the latest flare-up in Gaza seems to have been instigated by the firing of hundreds of rockets into Israel by a group in Gaza aligned with Iran. Iran has also provided Hezbollah in Lebanon with a huge arsenal of missiles that presumably could be launched on command from Tehran.

While yet another ceasefire was declared Sunday between Israel and Gaza, the US deployed a carrier strike group and a number of bombers to the Middle East. National Security Advisor John Bolton said that this action is in response to “a number of troubling and escalatory indications and warnings.” He added: “The United States is not seeking war with the Iranian regime, but we are fully prepared to respond to any attack, whether by proxy, the Islamic Revolutionary Guard Corps, or regular Iranian forces.”

Our friends Mark Melcher and Steve Soukup at The Political Forum offered the following timely analysis of the situation:

“One suspects, given all of this, that one of two things is true: Either Iran did, indeed, miscalculate … and has just drawn a great deal more serious response than it expected; or it expected a serious response—up to and including the American intervention—and, therefore, has a plan for how it will proceed next. In either case, the risk of escalation is very real and very serious. If the Iranians now find their backs, surprisingly, up against the wall, they may well lash out. If, on the other hand, they’ve
drawn the United States into this intentionally, then, clearly, they have a reason.

“Our guess is that the former is more likely than the latter, which means that Iran is, quite probably, trying to figure out what the hell[0] happens next and how to avoid this getting back to it before it’s prepared. Israel is going to deal with the Gaza Strip. No question about that. The only questions now are what are the Americans doing there? And what is Iran’s next move?”

Geopolitics II: The Art of the Deal. There’s been a radical regime change in the US for the past two years. Under eight years of the Obama administration, we had a government led by community organizers and lawyers. Under the Trump administration, the government has been led mostly by dealmakers. The biggest deal may be the one that the US has been negotiating with China for the past 10 months over trade issues.

The Trump administration seems to have concluded that it is time to get it done. In other words, it’s either deal or no deal. The President made that clear in two tweets on Sunday morning threatening to raise the tariff on $200 billion worth of Chinese imports from 10% to 25% on Friday. In addition, the 25% tariff could also soon be slapped on the remaining $325 billion of Chinese imports.

Yesterday, our friends Jim Lucier and Kathryn May at Capital Alpha Partners provided several good insights into this situation:

(1) “Despite speculation on Sunday that China might cancel the visit, in a replay of a similar episode last September, when China responded to tariff threats by cancelling talks, the latest wires indicate that China has shrugged off the tariff threat for now and is still sending the delegation [of 100 officials for talks in Washington starting on Wednesday].”

(2) “Two weeks ago we heard that some of the President’s advisors worried that the trade deal with China might take until September to conclude. This would point to severe loss of momentum over the summer, and possibly a deal that was watered down as China slow-walked the negotiations to pressure Trump to accept a deal more to their liking. This was accompanied by commentary in the press that the trade talks, though close to a deal, were slowing as they reached their conclusion, and that the Chinese appeared to be holding out for weaker provisions on subsidies to state owned enterprises (SOE), the length of pharmaceutical protections, agricultural inspections, cloud computer, and enforcement among other issues.”

(3) “Not surprisingly, after the most recent round of negotiations in China in that week, we began to hear from Trump administration officials that it was time for deal or no deal. Treasury Secretary Steven Mnuchin was the first to say so in an interview with Maria Bartiromo of Fox Business News that broadcast on Monday, but White House Chief of Staff Mick Mulvaney followed up with even more trenchant comments at the Milken Institute conference on Tuesday when asked [about] Mnuchin’s statement.”

Stock prices rebounded Monday afternoon on confirmation that the Chinese trade delegation was still scheduled to arrive in Washington on Wednesday.

Productivity I: The Case for a Rebound. Since early last year, Debbie and I have been open to the possibility that Trump’s program of deregulation and tax cuts could have positive supply-side effects that would boost productivity growth. That would allow the economy to grow at a faster pace without heating up inflation. This scenario seems to be underway, as we discussed again yesterday. To review:

(1) Productivity. During Q1, nonfarm business productivity rose 3.6% (saar) q/q and 2.4% y/y (Fig. 1).
That latter growth rate was the best since Q3-2010. We also track the 20-quarter growth rate in productivity at an annual rate (Fig. 2). It troughed at just 0.5% during Q4-2015, the lowest since Q3-1982. It has been trending higher ever since, rising to 1.3% during Q1, the best growth rate since Q1-2014.

(2) Actual & potential GDP. The rebound in productivity boosted the growth rate in nonfarm business output to 3.9% y/y during Q1, outpacing the 3.2% increase in real GDP (Fig. 3).

The Congressional Budget Office (CBO) estimates that actual real GDP has been slightly exceeding potential real GDP since Q3-2018 (Fig. 4 and Fig. 5). The CBO estimates that potential real GDP rose 2.1% y/y during Q1 (Fig. 6).

It may be time for the CBO to consider the possibility that faster productivity growth could be boosting potential real GDP growth, especially since price inflation remains remarkably subdued. After all, the actual unemployment rate at 3.6% during April is well below the CBO's 4.6% estimate of the non-accelerating inflation rate of unemployment (NAIRU) (Fig. 7). It may be time for the CBO to lower its estimate for NAIRU given that wage inflation also remains relatively subdued.

(3) Wage & price inflation. As Melissa and I discussed yesterday, Fed officials have concluded that the recent weakness in the PCED inflation rate may be attributable to “transient” weaknesses in some of the components of this price deflator. Then again, the recent bout of disinflation could be a more structural development if faster productivity gains offset more of labor costs.

During Q1, while nonfarm productivity rose 2.4% y/y, comparable hourly compensation rose 2.5% y/y, so unit labor costs were basically flat, edging up just 0.1% (Fig. 8).

(4) Other reasons. Of course, there might be reasons other than supply-side effects for why productivity might be making a comeback. With the unemployment rate the lowest in nearly 50 years, labor is scarce. Workers with the right skill sets are especially hard to find. To attract them and keep them, higher wages must be paid. That makes economic sense only if their employers increase the productivity of their employees, especially of the ones who don’t have skills perfectly matching the requirements of their jobs.

Of course, the big puzzle in recent years has been the weakness in productivity growth despite all the anecdotal evidence of widespread technological innovations that can be implemented in almost any industry. Perhaps it simply takes time for such innovations to have an impact on productivity. We will know that only with the benefit of hindsight if productivity growth continues to rebound as we expect.

Productivity II: Compensation Getting Shortchanged? The microeconomic textbooks teach that in a competitive market economy, the wage rate tends to equal the value of the marginal product of labor. So, in theory, productivity should be the key driver of inflation-adjusted compensation. And vice versa: Real compensation arguably drives productivity, as we just argued above. In other words, causality runs both ways.

What do the data show? The quarterly release on Productivity and Costs produced by the Bureau of Labor Statistics provides data on hourly compensation (including wages, salaries, and benefits). However, the corresponding productivity series is an average rather than a marginal productivity measure.

Nevertheless, a comparison of the productivity series to inflation-adjusted hourly compensation (using the Consumer Price Index [CPI]) closely tracked one another from 1947 through the early 1970s (Fig.
They’ve been diverging ever since, with real hourly compensation lagging increasingly behind the uptrend in productivity.

This widening “productivity-compensation gap” is often depicted as proof that workers are getting shortchanged by their employers. However, most of that gap disappears when the hourly compensation series is divided by the nonfarm business price deflator rather than the CPI.

That makes sense since free-market forces should equate companies’ wage rates to the value of the marginal products of their workers, where the value is determined by the prices that the companies receive for the goods and services they produce. Those prices are likely to differ from the prices reflected in the CPI. Furthermore, as we’ve noted before, the CPI has a significant upward bias compared to deflator measures of prices (Fig. 10).

In any event, if we are seeing the start of a sustainable rebound in the growth rate of productivity, that should be reflected in a similar upturn in the growth rate of inflation-adjusted hourly compensation using the nonfarm business deflator (Fig. 11). Rising real wages could provide consumers with the purchasing power to keep the expansion going at a pace closer to the old normal one.

**CALENDARS**

**US.** Tues: Job Openings 7.35m, Consumer Credit $16.0b, Quarles, Kaplan. **Wed:** MBA Mortgage Applications, DOE Crude Oil Inventories, Brainard. (DailyFX estimates)

**Global.** Tues: Germany Factory Orders 1.5%m/m/-5.4%y/y, RBA Cash Target Rate 1.25%, BOJ Minutes of March Policy Meeting, EU Commission Economic Forecasts. **Wed:** Germany Industrial Production -0.5%m/m/-2.7%yy, Japan C-PMI & NM-PMI, China Trade Balance $33.7b, Draghi. (DailyFX estimates)

**STRATEGY INDICATORS**

**S&P 500/400/600 Forward Earnings** ([link]): Forward earnings rose w/w for a third straight week for all of the market-cap indexes. LargeCap’s has risen during nine of the past 12 weeks; MidCap’s in seven of the past eight weeks; and SmallCap’s in five of the past six weeks. LargeCap’s forward EPS is just 0.8% below its record high of $175.48 in late October; MidCap’s is 1.0% below its mid-October high; and SmallCap’s is 6.6% below its mid-October high. At their bottoms, LargeCap’s forward EPS had been the most below its record high since June 2016, and MidCap’s was the lowest since May 2015. SmallCap’s had not been this far below since October 2010. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act, but tumbled as y/y comparisons became more difficult. But that may be ending soon too. In the latest week, the rate of change in LargeCap’s forward earnings fell to a 29-month low of 5.2% y/y from 6.2% y/y. That’s down from 23.2% in mid-September, which was the highest since January 2011 and compares to a six-year low of -1.8% in October 2015. MidCap’s y/y change rose to 6.3% from 6.2%, which compares to 24.1% in mid-September (the highest since April 2011) and a six-year low of -1.3% in December 2015. SmallCap’s dropped to a 33-month low of 3.3% from 4.0%, which is down from an eight-year high of 35.3% in early October and compares to a six-year low of 0.3% in December 2015. Analysts had been expecting double-digit percentage earnings growth in 2019, but those forecasts are down substantially since October. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: LargeCap (22.7%, 3.3%, 11.8%), MidCap (22.7, 3.5, 12.6), and SmallCap (22.4, 4.3, 18.5).

**S&P 500/400/600 Valuation** ([link]): Forward P/E ratios mostly edged higher w/w for these indexes to levels well above their multi-year lows in late December. LargeCap’s weekly forward P/E was steady at
a 13-month high of 16.9, which is up from a five-year low of 13.9 during December. That compares to a 16-year high of 18.6 during January 2018—and of course is well below the tech-bubble record high of 25.7 in July 1999. Last week’s level remains above the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap’s forward P/E rose 0.1pt to 16.1 from 16.0. That’s down from a seven-month high of 16.3 in early April, but up from 13.0 during December, which was the lowest reading since November 2011. MidCap’s P/E is down from a 15-year high of 19.2 in February 2017 and the record high of 20.6 in January 2002. However, MidCap’s P/E has been at or below LargeCap’s P/E for most of the time since August 2017—the first time that alignment has prevailed since 2009. SmallCap’s P/E rose to 17.2 from 17.0, which is well above its seven-year low of 13.6 during December. That’s still well below its 51-week high of 20.2 in December 2017 (which wasn’t much below the 15-year high of 20.5 in December 2016, when Energy’s earnings were depressed). SmallCap’s P/E was higher than LargeCap’s P/E for a 15th straight week, after being below for much of December for the first time since 2003.

S&P 500 Sectors Quarterly Earnings Outlook (link): With the Q1 results continuing to flood in, the blended Q1 estimate/actual surged in what has become the typical positive earnings surprise hook seen during this point of the earnings season. Last week saw the S&P 500’s Q1-2019 EPS forecast surge 86 cents w/w to $38.75. The $38.75 estimate represents a forecasted pro forma earnings gain for Q1-2019 of 0.9%, up from a decline of 0.3% a week earlier and a 5.3% gain at the end of Q4. If it comes to pass, Q1’s gain would be its 11th straight y/y rise, but down from 16.8% in Q4 and 28.4% in Q3 (which marked the peak of the current earnings cycle). Just five of the 11 sectors are expected to record positive y/y earnings growth in Q1-2019, with none rising at a double-digit percentage rate. That compares to 10 positive during Q4, when seven rose at a double-percentage rate. Five sectors are now expected to match or beat the S&P 500’s Q1 growth rate, which compares to just four during Q4.

S&P 500 Q1 Earnings Season Monitor (link): With nearly 80% of the S&P 500 companies finished reporting revenues and earnings for Q1-2019, the y/y growth rates in revenues and earnings have slowed substantially from Q4. The revenue surprise metrics have weakened substantially, but earnings continue to beat forecasts. Of the 392 companies in the S&P 500 that have reported through mid-day Monday, 76% exceeded industry analysts’ earnings estimates. Collectively, the reporters have averaged a y/y earnings gain of 3.2%, and exceeded forecasts by an average of 6.7%. On the revenue side, just 58% of companies beat their Q1 sales estimates so far, with results coming in 0.3% above forecast and 5.2% higher than a year earlier. Q1 earnings growth results are positive y/y for 66% of companies, vs a higher 73% at the same point in Q4, and Q1 revenues have risen y/y for 69% vs a higher 75% during Q4. These figures will continue to change as more Q1-2019 results are reported in the coming weeks, but less markedly than they have recently. Looking at earnings during the same point in the Q4-2018 reporting period, a lower percentage of companies (71%) in the S&P 500 had beaten consensus earnings estimates by a lower 3.6%, but earnings were up a higher 14.6% y/y. With respect to revenues at this point in the Q4 season, a higher 62% had exceeded revenue forecasts by a higher 0.8%, and sales rose a greater 7.3% y/y. The results so far for Q1 indicate a slowdown in revenue and earnings growth from Q4, but that comes as no surprise to investors. It now appears Q1-2018 will mark the 11th straight quarter of positive y/y earnings growth and the 12th for revenue growth. Looking at the Q1 results ex-Financials and Real Estate, the earnings surprise improves to 7.1% from 6.7% and growth falls to 2.6% from 3.2%. The ex-Financials and Real Estate revenue surprise would
drop to 0.2% from the 0.3% rate with all sectors included, and revenue growth excluding Financials and Real Estate would edge down to 5.1% from 5.2%.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (link): Global economic activity in April matched January’s pace, which was the slowest since September 2016, as growth in both the services and manufacturing sectors eased. The JP Morgan Global Composite Output Index (C-PMI) fell back down to January’s 52.1 after accelerating the prior two months to 52.7. Global PMIs show the services (to 52.7 from 53.7) sector continued to outpace the manufacturing (50.3 from 50.5) sector, though both slowed last month, with the latter just shy of 50.0—the breakeven point between expansion and contraction. Looking at C-PMIs, growth in the emerging (52.4 from 52.9) and developed (52.0 from 52.7) economies grew at roughly the same pace—though the former is near recent highs, while the latter’s was the weakest since September 2016. C-PMI data signaled that the strongest rates of growth were seen in Ireland (to 53.4 from 54.1), the US (53.0 from 54.6), Russia (53.0 from 54.6), Spain (52.9 from 55.4), and China (52.7 from 52.9), though all slowed from March’s pace. The UK (50.9 from 50.0), France (50.1 from 48.9), and Australia (50.0 from 49.5) all saw slight improvements in their C-PMIs in April, though all were around the breakeven point of 50.0, while Brazil’s (50.6 from 53.1) deteriorated. Italy (49.5 from 51.5) was the only nation covered that recorded a contraction.

Global Non-Manufacturing PMIs (link): April saw the rate of expansion in the global services economy slow to a three-month low, remaining below its long-run average of 54.2. JP Morgan’s Global NM-PMI (to 52.7 from 53.7) eased along with the NM-PMIs for both the emerging (53.2 from 53.7) and developed (52.6 from 53.7) economies. The report notes that NM-PMIs for Germany (55.7 from 55.4), Ireland (54.7 from 55.3), and China (54.5 from 54.4) saw the fastest growth, with Germany’s at a seven-month high and China’s at a 15-month high. Both the US (53.0 from 55.3) and Spain (53.1 from 56.8) saw a considerable slowing in growth last month, though both held above the global average of 52.7. Brazil was the only country that experienced a contraction in their service sector, though barely, with its NM-PMI falling from 52.7 to 49.9.

Eurozone Retail Sales (link): Retail sales in March was unchanged at its record high. Sales held steady after jumping 1.4% the first two months of this year, more than reversing December’s 1.3% drop. Sales of food, drinks & tobacco climbed for the fourth month, by 0.6% in March and 0.9% over the period. Meanwhile, sales of non-food products contracted 0.4% after a two-month spurt of 2.7%, while automotive fuel sales sank 1.0% during the two months through March. March sales are available for three of the four largest Eurozone economies: Spain saw sales expand 0.3% in March and 1.6% ytd, while sales in both Germany (-0.2%) and France (-0.1) fell in March after total gains of 3.4% and 1.1%, respectively, the first two months of the year. Sales in Germany (3.2% y/y), Spain (1.8), and France (1.2) were all above year-ago levels. Among the Eurozone countries for which data are available, the largest increases in retail sales in March were registered in Lithuania (1.7) and Portugal (1.2), while the largest decreases were observed in Slovenia (-3.1) and Austria (-0.8); the largest yearly percent changes occurred in Ireland (10.8% y/y) and Luxembourg (8.6), the largest declines in Slovakia (-2.0), Austria (-1.0), and Belgium (-0.9).