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PRODUCTIVITY PICKUP

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KEY TAKEAWAYS

Productivity grew 3% in the third quarter, the best quarter since 2014.

Improved capital spending leads us to believe that the progress may persist.

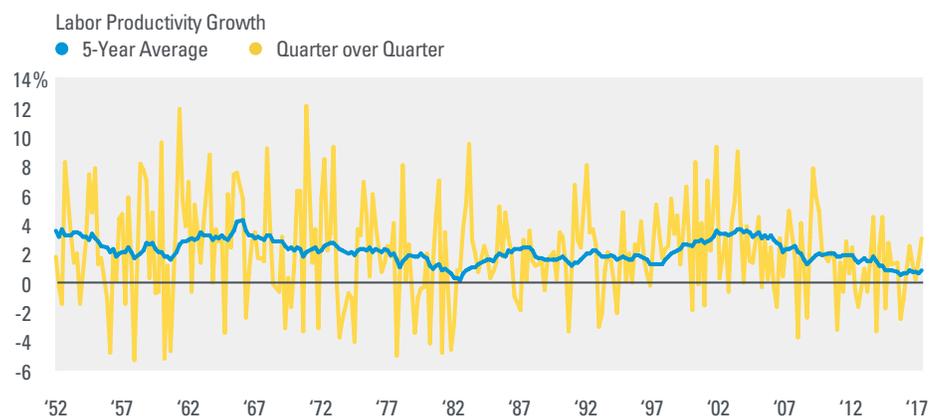
Productivity growth is an important contributor to GDP, helps raise the standard of living, and provides an offset for rising wages.

Productivity for the third quarter of 2017 rose 3.0%, the largest one quarter increase since the third quarter of 2014 and over double the average quarterly growth rate since the start of 2009. This surge is significant, as a lack of productivity growth has been one of the main factors that has kept U.S. economic growth, as measured in gross domestic product (GDP), to an average of just 2.2% since the end of the Great Recession. In fact, the five-year average of productivity growth has been under 1% since the fourth quarter of 2014. Dating back to the start of record keeping in 1947, 1981 to 1983 was the only other period with productivity growth as slow. While productivity can fluctuate quite a bit from quarter to quarter, supporting evidence from increased spending on capital goods and the slow continued unwinding of labor disruptions from the Great Recession lead us to believe that a return to a healthier rate of productivity growth may be here to stay.

WE'RE STILL EARLY IN THE PROCESS

Productivity is impacted by a lot of factors and can change quite a bit from quarter to quarter, so it's hard to place much stock in any one quarter. Part of the quarter's growth may have been an offset for weakness in prior quarters, as even with the strong third quarter, year-over-year productivity growth remained modest at 1.5% and the five-year average only sits at an annual growth rate of 0.8% [Figure 1]. Nevertheless, both numbers are the best since the second quarter of 2015.

1 IMPROVED THIRD QUARTER PRODUCTIVITY GROWTH MAY BE SIGNALLING A REVERSAL IN THE LONG-TERM TREND



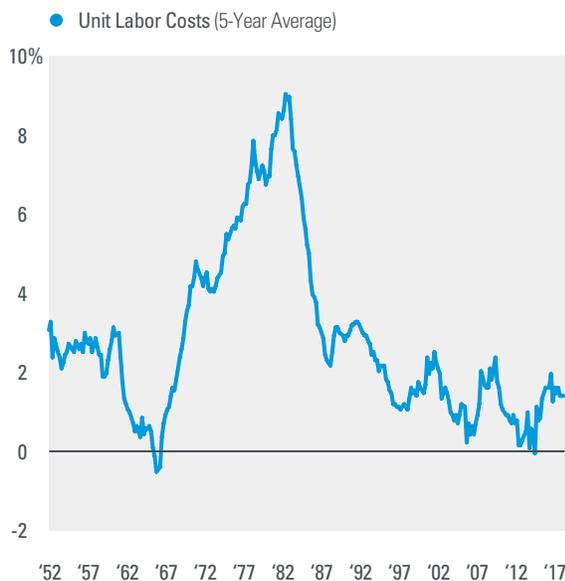
Source: LPL Research, Bureau of Labor Statistics 11/13/17

Performance illustrated is historical and no guarantee of future results.

Of greater concern, manufacturing productivity collapsed during the quarter, falling 5%, the worst level, excluding the Great Recession, since the U.S. Bureau of Labor Statistics started tracking the data in 1987. Both the general growth in productivity and the decline in manufacturing may have been affected by Hurricanes Irma and Harvey. The hurricanes may have caused more serious disruptions in less productive industries, such as food services, skewing the overall number somewhat higher. But within manufacturing, the hurricanes may have left equipment sitting idle, causing manufacturing in general to look artificially weak.

Nevertheless, the strong number for the quarter is a move in the right direction. The recent rebound in shipments of non-defense capital goods excluding aircraft and strong growth in private investment in equipment in the last two GDP reports (over 8% annualized real growth in both the second and third quarter of 2017) are a strong sign that businesses are increasing investment in productivity and the recent pickup may have staying power.

2 IMPROVED PRODUCTIVITY MAY HELP CONTAIN UNIT LABOR COSTS



Source: LPL Research, U.S. Bureau of Labor Statistics 11/13/17

Performance illustrated is historical and no guarantee of future results.

WHY LABOR PRODUCTIVITY MATTERS

If economic growth is going to increase, you either need more hours of labor (from more people working or people working longer hours) or more stuff produced per hour worked. There's simply no other way to do it. The basic formula for productivity is the change in the amount of goods and services produced (the "product" of GDP) per hour of labor. More important than economic growth alone, productivity is the part of economic growth that flows through to improved standards of living. An economy will grow if more people work more total hours, assuming productivity stays constant, but standards of living will remain largely the same. Growth is simply a reflection of a larger labor pool. But if productivity picks up, the value of an hour of work rises, which can often be accompanied by organic increases in wage growth.

The recent third quarter provides a nice example. During the quarter, each person added 3% more value for each hour worked. At the same time, compensation for an hour of labor rose 3.5%. That 3.5% increase absent productivity increases would be tough for companies to carry. But if you look at what it cost to create an additional dollar of GDP, the costs only rose 0.5% since much of the increased cost was offset by the rise in productivity. Looking back over the last four quarters, hourly compensation rose by 1.4%, but productivity rose by 1.5%, which means additional productivity more than offset increased compensation. Because productivity growth has been low, the growth in unit labor costs has actually been fairly high despite slow wage growth [Figure 2]. Improved productivity would help contain those costs even if wages started to rise more quickly.

Over the long run, productivity growth and wage growth should generally stay in line with each other, keeping the labor share of income fairly constant. In fact, the labor share of income declined sharply beginning in 2001 as productivity started to decline, and a reversal in productivity may also move the labor share of income back toward historical norms.

HOW TO IMPROVE PRODUCTIVITY

Improved productivity can come from a lot of different places. You can think it through on an individual level: What would make you more productive? Better resources might help. Better use of the resources you already have can often be more powerful, perhaps through additional training. Experience can make a difference. Think about the ramp-up when, say, your usual computer operating system gets an upgrade. It's supposed to be an upgrade—better, faster, stronger. But we all know there's some time spent both learning new features and hunting down how to do things you already knew how to do that are now in a different place or work a little differently. The most effective tool is often the one you know how to use, not necessarily just the latest product that has greater potential. But at some point, investing in getting to know the upgrade becomes worthwhile, even if initially it creates inefficiencies.

Taking this example, we see several factors providing a positive potential backdrop for productivity. Companies appear to be putting more resources at workers' disposal, as is clear in growing capital goods shipments. But workers also need a period of adjustment to develop the appropriate skills. The Great Recession caused massive disruptions in the labor force that lasted well into the expansion. When workers are unemployed, skills can deteriorate and opportunities for continued on-the-job training are lost. At the

same time, new equipment and new technologies require a ramp-up period. Looking at [Figure 1](#), periods of disruption, technological improvement, and ramp-up can come in long cycles. There was a down cycle in productivity from about 1966 to 1981, about 15 years. Then the period between 1981 to approximately 2003, about 22 years, saw a combination of stability and periods of rapid improvement. We have now been in a period of about 14 years of declining productivity that has been accompanied by rapid advance in technologies like data analytics and robotics. The realization of the potential of these technologies for productivity may just be getting started.

CONCLUSION

Increases in productivity are the key to raising GDP growth in a way that's sustainable, raises the standard of living, and helps provide an offset for rising wages. Recent data on productivity provide some early evidence that over a decade of slowing productivity may be starting to reverse. With capital equipment purchases rising, the decline in lingering labor disruptions from the Great Recession, and a workforce with an improving skill set to make better use of new technologies, the support structure for a reversal certainly seems in place. Progress may be choppy and will be impacted by the ebb and flow of the global economy, but we believe the odds are good that the third quarter was the beginning of a more enduring shift in the path of productivity growth. ■

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Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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