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Palos Weekly Commentary

Issue **No. 19** | **MAY 9** 2019

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Macro View

By Hubert Marleau

The Weekly Narratives of May 9, 2019

The U.S. Economy Is as Good as It Gets:

An economy is the outcome of near-constant interaction between millions of individuals. What we call "the economy" is in fact a highly complex, multi-level system. The complexity makes it impossible to master. Thus, economists have come up with the notion that an economy has a natural resting state. It is based on an observation that individuals are essentially self-interested and reasonably rational people who faces all kinds of constraints and emotions; but in the end they find their way through changing market prices that balance supply and demand. The model tends to yield an equilibrium that generates a level of welfare. In this connection, I employ a single-equation economic model that describes the historical inverse relationship between rates of unemployment and corresponding rise in wage rates— the Phillips curve. It makes complete sense that there is an inverse relationship between unemployment and wage rates but finding an equilibrium point that matches a given level of unemployment with the right inflation rate is not as obvious.

For example, year-over-year average hourly earnings rose from 1.25% at the start of 2012 to 3.25% today while the unemployment rate decreased from 9.0% to 3.6%. The WSJ plotted the annual change in average hourly earnings versus the unemployment rate on a scatter diagram for this cycle. It showed that the macroeconomic relationship between wages and unemployment known as the Phillips curve has worked quite well. The correlation might not be as good as it once was, but there is enough empirical evidence and theoretical validity to use the Phillips curve as rule of thumb to forecast inflation. Yet, investors should be aware that the rule can fail to capture odd outcomes. There is no guaranteed equilibrium point. Outcomes that should be predictable by heuristic rules or general economic theories can be unsuspectingly shattered by sudden external shocks. Unfortunately, the economy is not a simple mathematical toy-model. Think of flowing water. It can produce unpredictable turbulence, even though the millions of molecules are obeying simple physical laws.

It is indeed intriguing that cost-push pressures steaming from tightening labour markets have not found their way into higher inflation. Running economic history forward is not an easy task when the laws of supply and demand are not functioning in a normal manner to properly bring about a state of equilibrium. The reason is that there is an

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overabundance of resources and a rise in productivity. This unique combination is upsetting the apple cart. It may be surprising for some that producer prices for industrial commodities are as weak and that productivity is as strong at this late stage of the economic expansion. History is full of examples which defied economic logic and we just might be in one of those periods.

On Producer Prices Trends:

Except for a brief rebound after the Great Recession, the performance of industrial metals, agricultural commodities and precious metals has been lacklustre either because of sluggish demand in some sectors or supply gluts in others. As a matter of fact, the Thomson Reuters CoreCommodity CRB Index peaked at 465 in 2018 and has trended downward ever since. It currently stands at 183 - a staggering decrease of more than 60%.

On Productivity Trends:

The output of goods and services for each hour of work increased 2.4% in Q1 from a year earlier. As mentioned in last week's commentary, the upward trend in productivity which began in 2016 has been on a tear since the first quarter of 2017.

Most investment strategists are cautious about declaring a productivity breakout. I'm not. There are reports showing that a growing number of owners are spending significant time and money on training new employees, managing workers governed by algorithmic software, employing sophisticated technology to track the efficiency of workers, automating fully their plant and using cameras to supervise the habits and behaviour of employees. Data compiled by the Information and Technology Foundation along with new research by the McKinsey Global Institute and the Brooking Institute, show that digital technologies have been a major enabler of productivity growth.

Findings in the Metro Program's new analysis show that industries are investing a growing proportion of their capital in software and R&D - 35% in 2018 versus 23% in 2017. This is resulting in rapidly changing the digital influence on 545 occupations--covering 90% of the U.S. workforce on all industries. Digitalization is far from being over because most companies are surprisingly still under-digitalized, leaving ample room for future productivity gains - thus ending the 10-year productivity slump. Studies by Chad Syverson of the University of Chicago explain that productivity changes are global in nature and productivity shifts tend to play out over long periods of time. The course of productivity since the end of World War II through 2018-including both expansions and recessions--ran at the average annual rate of 2.1%. In the previous economic cycle, from 2000 to 2007, productivity rose at a 2.7% annual rate.

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U.S. Monetary Policy as of May 9, 2019

If the productivity slump has indeed run its course, the implications will be very serious to the point that it will alter the direction and management of monetary policy. In a nutshell, soaring productivity could solve the puzzle that's been vexing the Fed for years: the reason why inflation remains stubbornly low at this late stage of the game when the unemployment rate is low, and hiring is strong. Additionally, wage growth, long stuck in neutral, has at last found a higher gear. Average hourly earnings in April were 3.2% higher than a year earlier, the ninth straight month in which growth topped 3 percent. Productivity gains bring in many benefits. They keep profit margins healthy and inflation low even as wages rise. It also means that the economy can still grow without the help of more employment, can run hotter for longer without inflationary pressure and can sustain a growth pace without the help of the Fed. It's not that the Fed officials are missing out on what is going on with productivity. Powell observed that it seems to move in the right direction. They are just not ready to throw a party, yet. It partially explains why they decided not to pause and wait for more proof that productivity is eating away the inflationary pressures coming from rising wage rates. Nevertheless, the Fed admitted last week that it is ready to take into consideration that we just might be on the cusp of a sustained improvement in productivity.

Why is it that the market anticipates that a rate cut is a 50% probability when the economic outlook is promising, unemployment rate is declining, wage rates are rising and economic data points defy expectations? It's because productivity is making it is as good as it gets as long as the trade tensions don't turn into a futile trade war.

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