Sluggish Long-Term Prospects for U.S. Economic Growth

Despite Recent Improvements in Jobs and Growth

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Navega Strategies LLC.

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Why This Matters?

This note puts recent positive developments in US real GDP growth in the context of factors affecting long-term real growth. It argues that long-term trend growth has declined in the US, driven by declines in Total Factor Productivity and Labor Force growth. Consequently, growth forecasts should be dampened until there are signals that TFP growth and Labor Force growth have improved.

Who Should Read This Paper?

The issues in this paper are important for assessing long-term returns on assets. Consequently, this paper should be of interest to investment strategists and asset allocators.

Sluggish Long-Term Prospects for U.S. Economic Growth

Despite Recent Improvements in Jobs and Growth

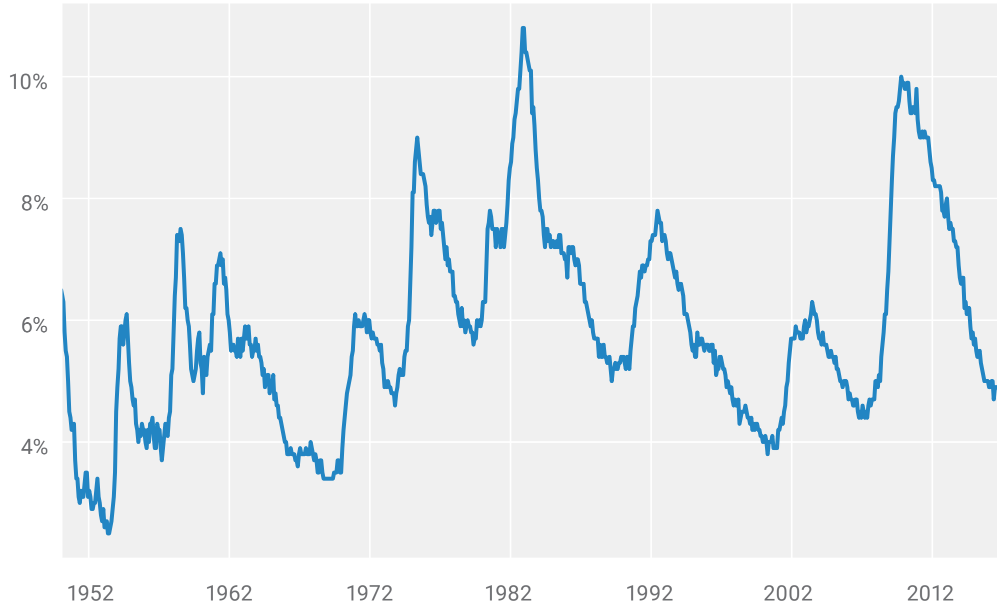
Despite stronger-than-expected second quarter growth (estimated to be 2.5%) and decreases in unemployment (4.3% in July, a 17-year low), our models still project sluggish real growth in the year ahead. While the recent releases bring comfort, **investors should stay focused on the long-term drivers of growth**. Labor is only one of three major contributors to output. Our models show that the two other major components of output, namely capital and total factor productivity (TFP)[1], continue to grow slowly, well below longer term average[2]. In turn, U.S. economic growth is projected to remain sluggish over the next 3 years, despite continued improvements in the labor market. And our forecast for the year ahead remains broadly unchanged at 1.6%.

Future prospects for economic growth matter for investors, both institutional and individual, as they drive the evolution of future asset returns and outcome driven allocation strategies. They also matter for evaluating the costs and benefits of fiscal and monetary policy changes.

[1] Technically, total factor productivity (TFP) is the residual part of growth after the impact of labor and capital have been accounted for. An economic interpretation could be that TFP measures the impact of growth in research and technological innovation, and of additional improvements in economic efficiency.

[2] In this note we will focus on the real growth rate of labor and total factor productivity (TFP). Over the last 4 quarters, the average growth in capital was about 1.7%, well below its historical average of about 3.5% since 1947.

Exhibit 1 - U.S. Unemployment Rate Has Reached a 10-Year Low



The Exhibit shows the historical, monthly evolution of unemployment rate in the U.S. from 1950. The unemployment rate was 4.1% in August, a 10-year low.

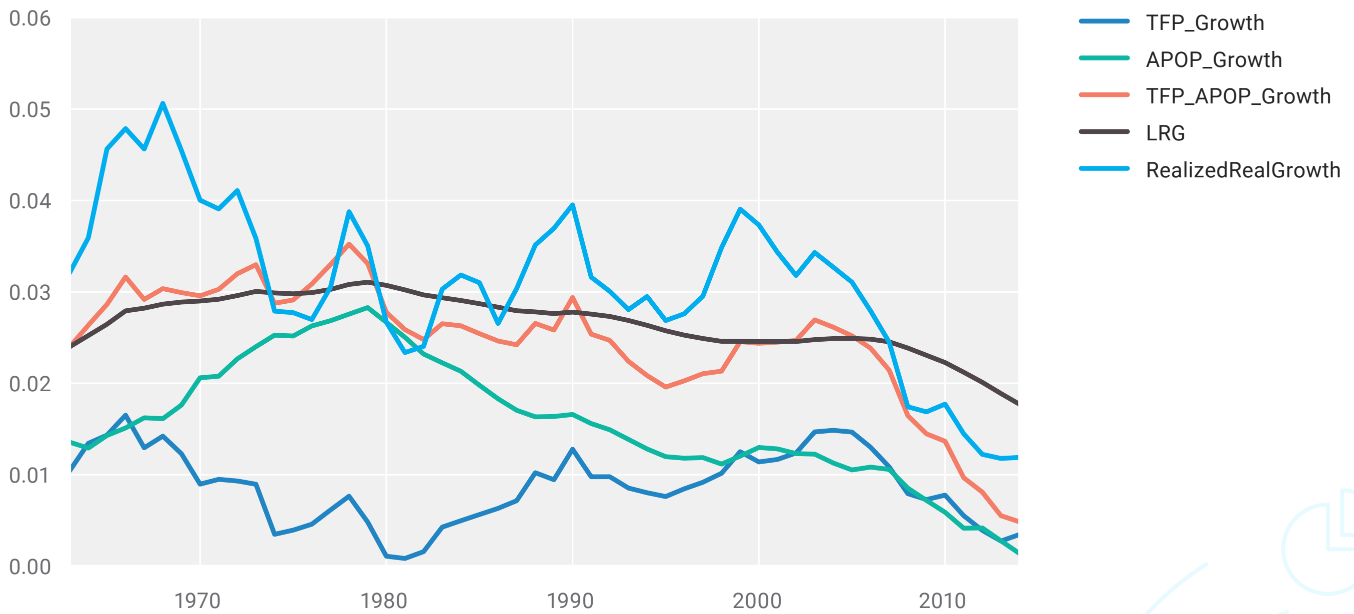
SOURCE: U.S. BUREAU OF LABOR STATISTICS

Exhibit 1 plots the evolution of the U.S. unemployment rate, and shows the decline from June to July. While declines in unemployment can be associated with economic expansion, the current rate is close to the historical one-standard deviation lower bound. In the last 50 years, there have only been three episodes of rates getting close to or breaching this lower bound: from September 1965 to February 1970, from August 1999 to March 2001, and from October 2006 to May 2007. The first episode ended with a decade of stagflation with low growth and significantly higher inflation. The second one with an economic recession and the TMT bubble crash. And the third one with the 2008 economic and financial crisis.

Is this time any different? More jobs do not always mean higher growth in output nor income. Indeed, as Exhibit 2 shows, growth in TFP -a major contributor to output capturing technological innovation and economic efficiency- remains low at 0.5%, a rate which is well below the long-term average of 1.3%.

As Exhibit 2 illustrates, this slow pace of growth in TFP is not new- improvements in TFP have been continuously slowing down on trend since 1999. Our models suggest that a prolonged period of slow growth in TFP is likely to result in the continuation of slow growth in real GDP. In particular, the recent improvements in the labor market are not enough to compensate for the persistent two-decade long decline in TFP growth. Indeed Exhibit 3 shows that real output growth is likely to remain sluggish at 1.6% over the next 3 years, according to our models. This growth rate falls short of the 3% rate assumed by the U.S. Treasury to support an aggressive fiscal plan that includes excessive tax cuts and spending in infrastructure and defense.

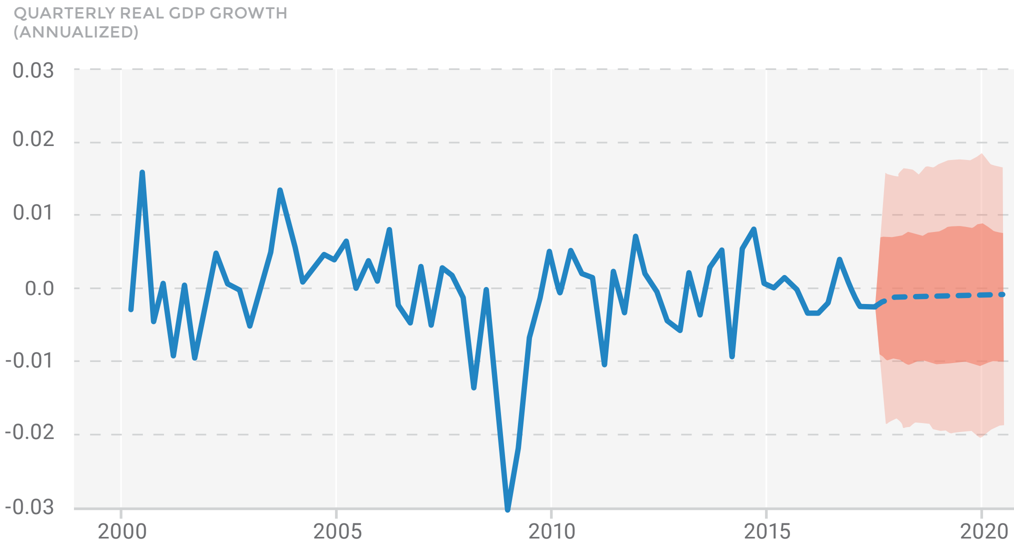
Exhibit 2 - U.S. Total Factor Productivity Growth Has Been Slowing Down Since 1999



The Exhibit shows the historical evolution of U.S. real GDP growth (Realized Real Growth), total factor productivity growth (TFP Growth), active population growth (APOP Growth), total factor productivity growth adjusted for changes in active population (TFP APOP Growth), and our model forecast for long-term real GDP growth (LRG) from 1947. Total factor productivity growth (TFP growth) and the labor force are two major contributors to real GDP growth in the long-term. All growth rates are quarterly, annualized rates.

SOURCE: FEDERAL RESERVE BANK OF ST. LOUIS, U.S. BUREAU OF ECONOMIC ANALYSIS, NAVEGA STRATEGIES LLC RESEARCH

Exhibit 3 - Our Models Forecast a Continuation of Slow Economic Growth in the U.S.



The Exhibit shows the recent evolution of U.S. real GDP growth from 2000 to June 2017, and our model nowcast at September end, and forecasts for the next 5 years. All growth rates are quarterly, annualized rates.

SOURCE: U.S. BUREAU OF ECONOMIC ANALYSIS, NAVEGA STRATEGIES LLC RESEARCH

Long-term prospects for economic growth in the U.S. are grim, relative to historical standards. What about inflation? Investors are increasingly concerned with stagflation (a combination of lower growth and higher inflation) being a possible outcome. These concerns are due to the possibility of delayed renormalization of interest rates and improved labor income, or unbalanced fiscal expansion. The next paper in this series of four papers will examine the prospects for inflation. The last three papers in the series will explore the implications of our outlook for growth and inflation for asset returns, and allocation strategies for pension funds and individual investors.

Navega Strategies LLC.
www.navegastrategies.com

NewYork, USA
info@navegastrategies.com

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