ECONOMIC UPDATE
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Q4 2015 Productivity And Costs: Anemic Trend The Bigger Issue

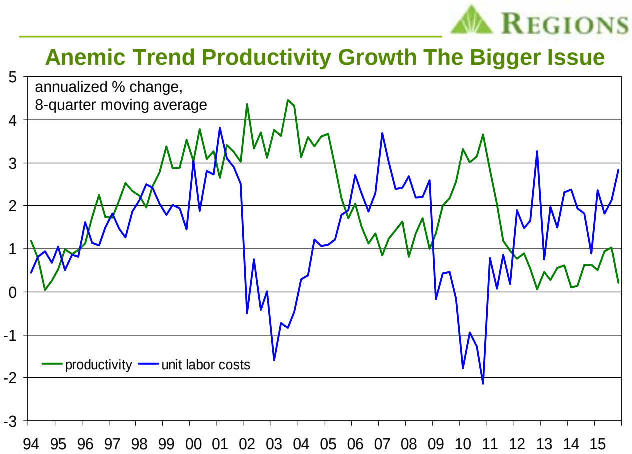
- Nonfarm labor productivity fell at an annualized rate of 3.0 percent in Q4; unit labor costs rose at an annualized rate of 4.5 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.22 percent and unit labor costs are rising at a rate of 2.83 percent.

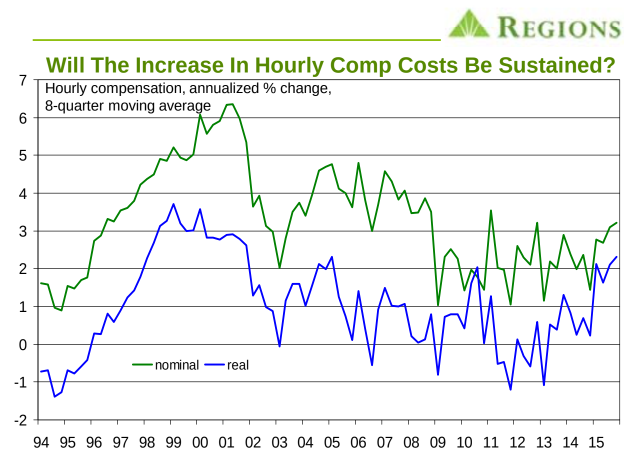
Labor productivity in the nonfarm business sector fell at an annual rate of 3.0 percent in Q4 2015 according to the initial estimate by BLS, which also shows that for 2015 as a whole productivity grew by 0.58 percent. Unit labor costs, which represent the labor cost of producing each unit of output, rose at an annualized rate of 4.5 percent in Q4 and rose by 2.39 percent for 2015 as a whole. As we routinely note, the productivity data can be quite volatile from quarter to quarter and therefore the underlying trend is far more relevant than the headline number in any given quarter. On this basis, however, the news isn't much better as the 8-quarter moving average (our preferred means of looking at the productivity data) rate of productivity growth is just 0.22 percent in the 8 quarters ending with Q4 2015. Unit labor costs, which are in essence the flip side of productivity growth, have trended higher with the 8-quarter moving average showing 2.83 percent growth.

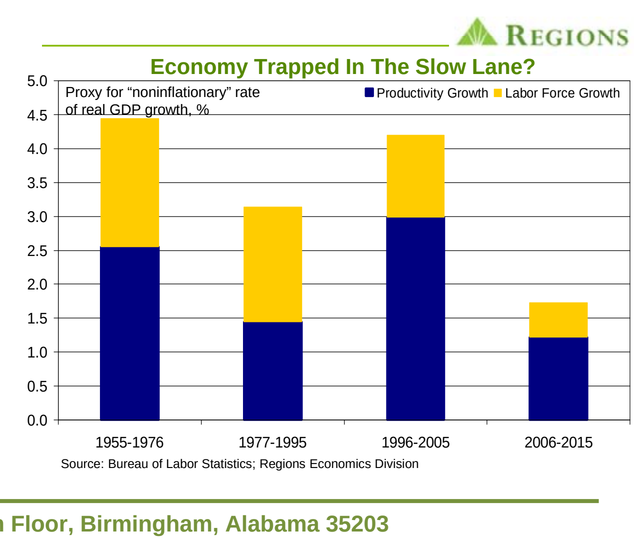
The initial estimate of productivity growth in any given quarter is based on the BEA's first estimate of real GDP growth. In Q4 2015 that first estimate puts real GDP growth at 0.69 percent but growth in real nonfarm business output – the metric on which productivity growth is based – grew at an annualized rate of just 0.14 percent in Q4. We look for both of these numbers to be revised lower, however, which will mean productivity growth fell more in Q4 than reflected in today's initial estimate. Aggregate hours worked are reported to have grown at an annualized rate of 3.3 percent in Q4, which implies a significant increase in hours worked by the self-employed as data from the monthly employment reports show aggregate hours worked by those on nonfarm payrolls rose at an annualized rate of 2.0 percent in Q4.

While we are not wild about using the unit labor cost metric as an indicator of wage pressures, the productivity data do contain useful detail on hourly compensation, on both a nominal and real basis. In Q4 2015 hourly compensation costs rose at an annualized rate of 1.3 percent, considerably slower than the average rate of 4.8 percent over the prior two quarters. On a real, or, price adjusted basis, hourly compensation costs rose at an annual rate of 1.1 percent in Q4. As seen in the middle chart, on our preferred 8-quarter moving average basis hourly compensation costs are clearly trending higher. As labor market conditions tighten further in the months ahead there will be additional upward pressure on hourly compensation costs but, we would argue the rate of increase seen in the middle chart is a bit overstated by the jump in Q2/Q3 2015. Either way, however, further upward pressure on compensation costs will only exacerbate downward pressure on corporate profit margins, already struggling in what is a very weak revenue growth environment (nominal GDP growth is a good proxy for top-line revenue growth).

As we routinely stress, the most important takeaway from the productivity data is what it tells us about the economy's "speed limit," i.e., the rate of sustainable noninflationary growth. Along with the rate of labor force growth the rate of productivity growth sets the economy's speed limit. The bottom chart shows the economy's speed limit over various time frames – we segment these periods on the basis of productivity cycles, not calendar decades. As seen in the chart, anemic trend productivity growth and what has been significantly slower labor force growth set the economy's speed limit at a distressingly slow rate. Keep in mind the running 8-quarter trend is at present considerably below the average for the 2006-15 period shown in the chart. We don't harbor much hope for productivity growth, which is in part based on what is at present an aged capital stock and what we contend has been underinvestment on the part of businesses over the course of the current cycle. One relationship typically missed by analysts and policy makers is, over time, wage growth is largely governed by productivity growth. Wage growth in excess of productivity growth forces firms to choose between accepting lower profit margins and raising output prices. This is but one of many implications, none of them good, of a weak trend rate of productivity growth such as that which now prevails.







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