NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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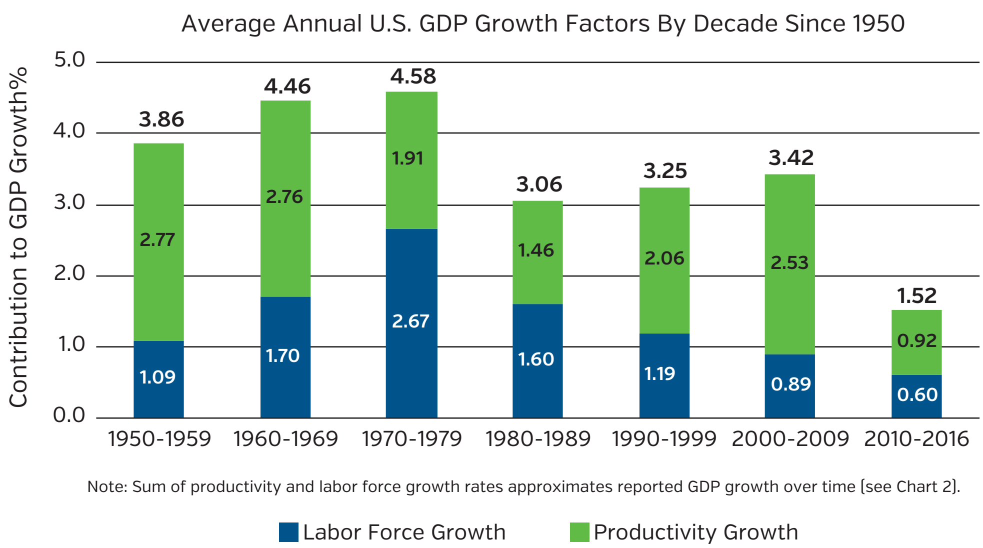
3%+ GDP Growth in the U.S.: Achievable or Just Wishful Thinking?

President Trump and several of his cabinet members and advisors have stated that real U.S. GDP growth over 3%, even 4%-5%, is achievable. ***NEAM believes 3% growth is certainly possible but would be difficult to sustain without some very significant catalysts. We believe the 4%-5% growth numbers bandied about during the campaign are mathematically infeasible when all relevant facts are taken into account.***

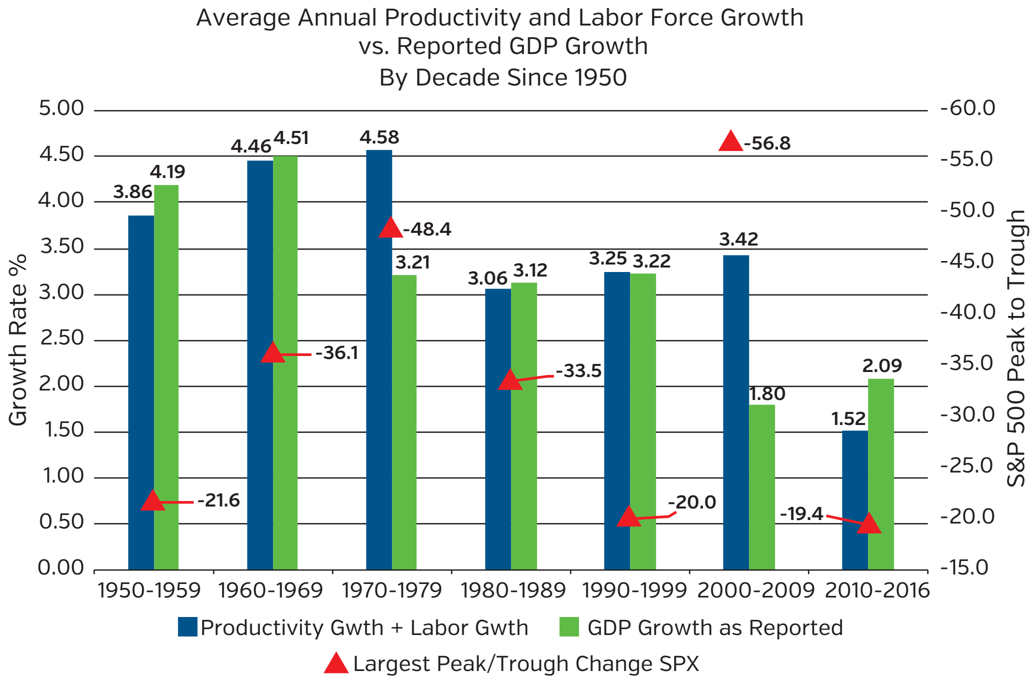
To begin with, GDP growth can be reasonably approximated by summing the growth in the labor force and the growth in worker productivity. Historically, a ~1+% growth rate in our labor force, combined with productivity growth of ~2+% have combined to create a real growth rate for the U.S. economy (until fairly recently) of ~3.0%-3.5% (see Chart 1). This simple "rule of thumb" has squared quite well with reported GDP growth since 1950, with few exceptions (see Chart 2). In both of the decades in which the relationship deviated, interestingly enough, extreme economic shocks were involved (Arab oil embargo of the 1970s and the "Great Recession" of 2008/2009) and resulted in extreme bear markets in equities. In any case, over long periods of time GDP growth equates directly to growth in the size and efficiency of the U.S. labor pool.

Chart 1. U.S. Productivity and Labor Force Growth by Decade



Source: Bureau of Labor Statistics

Chart 2. U.S. Growth Factors vs. Reported GDP Growth



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Yardeni Research Inc.

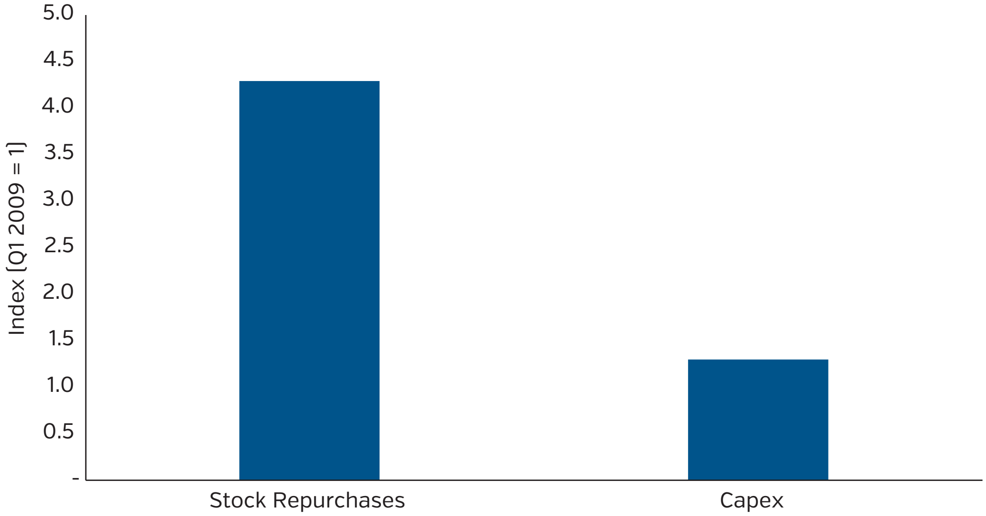
Our past immigration policies, the Civil Rights movement of the 1960s, and the Women's Rights movement of the 1970s all contributed to increasing the size of the U.S. labor pool over the last several decades. Meanwhile, technological advancement in the post-war period along with the information technology revolution of the 1990s were among the key drivers providing tremendous fuel for productivity growth. The decade beginning in 2010 has unfolded far differently than historical precedents of GDP growth, leading many to wonder why achieving historical levels of real GDP growth has become so elusive.

Let's begin with what we know. Our labor force is growing more slowly than it has historically and it is aging. In addition, major social changes–including those noted above–brought tens of millions of new workers into the labor pool. The changes were transformational but unfortunately *not repeatable*. Additionally, and somewhat ironically, today's posture toward immigration is shifting us in a direction that will make it even *more* difficult to achieve the faster growth that the current administration has promised.

With regard to productivity, the remarkable deceleration since the last crisis has bewildered economists. Productivity actually surged during and immediately following the recession in 2008/2009. At a time when layoffs were pervasive, many attributed the spike in productivity to the fear of losing one's job in a very difficult environment or to the Darwinian notion that employers fired their least productive workers first. Whatever the catalyst for the surge, it proved unsustainable as annual productivity growth has averaged less than 1% since 2010.

Two things seem very likely to us. First, the incredibly low interest rate environment both here and abroad has made financial engineering versus long-term investment a relatively easy choice for many companies (see Chart 3). This may very well be a contributing factor to diminished productivity. Second, since wage increases have been fairly tepid post the financial crisis, companies have likely concluded that paying a bit more for labor as opposed to making large investments in new equipment makes the most sense, given the current backdrop.

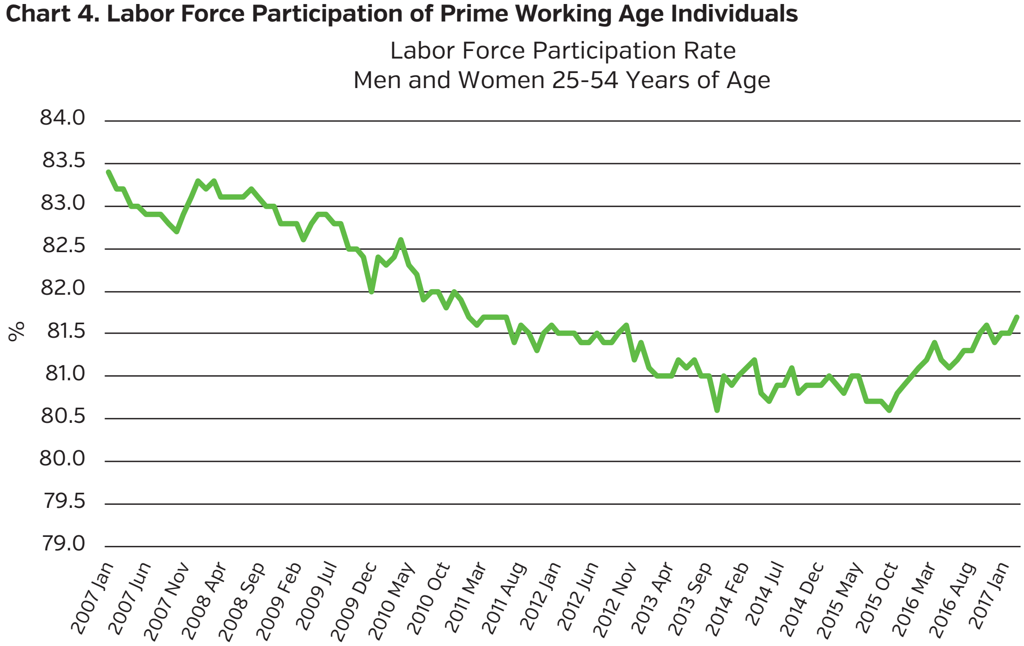
Chart 3. Growth of Stock Repurchase Relative to Capital Expenditures, Q1 2009 – Q4 2016



Source: BEA and Bloomberg

President Trump, and indeed all presidential candidates, made faster growth a rallying cry during their campaigns. The reality, however, of achieving that growth is more difficult than just giving it lip service. With an aging population, a heavy debt load and an annual budget that is 60% non-discretionary spending (over 75% if one includes defense spending), we face a very stiff headwind. Tax cuts, infrastructure spending and other fiscal measures are certainly the right type of medicine, but those remedies are limited by a debt-to-GDP ratio of over 100%. Even if those stimulative measures find their way into law to some degree, they ultimately need ***to directly influence the workforce, productivity or both***. There **is** some evidence to suggest that the participation rate of parts of the labor force has begun to move higher, indicating that workers who have been sidelined for some time are once again seeking jobs (Chart 4). If this continues AND we get some degree of fiscal stimulus to either add jobs or bolster productivity (in the case of increased capital spending on new more efficient equipment, software, etc.), then we'd conclude that 3% growth is certainly achievable at least for some period of time.

Chart 4. Labor Force Participation of Prime Working Age Individuals



Source: Bureau of Labor Statistics

As for growth of 4% or higher, that is simply not realistic. Such a growth rate has scarcely existed for any extended period since the Vietnam War. Given demographic changes, debt loads and the lack of any obvious catalysts, there is no reason to believe that such high growth rates are plausible in an economy as mature as ours, absent an event or series of events that changes the demand side of the economic equation.

KEY TAKEAWAYS:

- GDP growth can be reasonably approximated by summing the growth in the labor force and the growth in worker productivity.
- Aging demographics, a heavy debt load and financial engineering have been (and will continue to be) impediments to GDP growth. Fiscal stimulus, which either adds jobs or bolsters productivity, could enable 3% growth but the sustainability of that rate is questionable.
- Consequently, we believe interest rate movements will remain benign in the short to intermediate term. As such, we continue to maintain a benchmark duration posture with a flattening curve bias.

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