BULL & BEAR BULLETIN

November 2019

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An on-line publication by The Investment Committee

Demystifying 1.9% Trend GDP Growth

The Federal Reserve projections for the change in real economic output growth as of September, 2019 are 2.0% for 2020 and 1.9% in the longer run (after 2022).[1] Recalling that the U.S. economy grew at 2.9% for 2018, these near and longer term projections are observably lower than the past year. We are currently in a backdrop where we are possibly slowing towards this trend rate after what may have been a higher than normal growth rate due to regulatory and tax reform effects as well as a slightly increasing labor force participation rate, as tight labor markets drew in underutilized workers.

Investors likely are interested in the details around growth in an attempt to understand how accommodating the environment is and what, if any, implications are there for prices. From there, they can focus their views around revenues and earnings growth outlooks for specific companies in specific sectors of the economy.

A recent economic letter out of the Federal Reserve Bank of San Francisco written by John Fernald and Huiyu Li discusses two factors contributing to a normal GDP range.[2] First, demographics or population dynamics deliver a workforce to companies. How this population is growing year over year is one input. Second, productivity growth dynamics dictate how much more output can be produced per hour of work. Measuring this important number year over year can possibly tell us how well investment into things like new equipment, software and training is paying off with increased production and higher wages.

Simply looking at a rough approximation of working age population projections from the Congressional Budget Office and how that dataset grows over time, shows that we are averaging out around 0.50% growth. For comparison, in the 40 years prior we topped around 2.5% growth and bottomed out slightly just below 1.0%. Takeaway #1: The size of the labor force is not growing as fast as in the past.

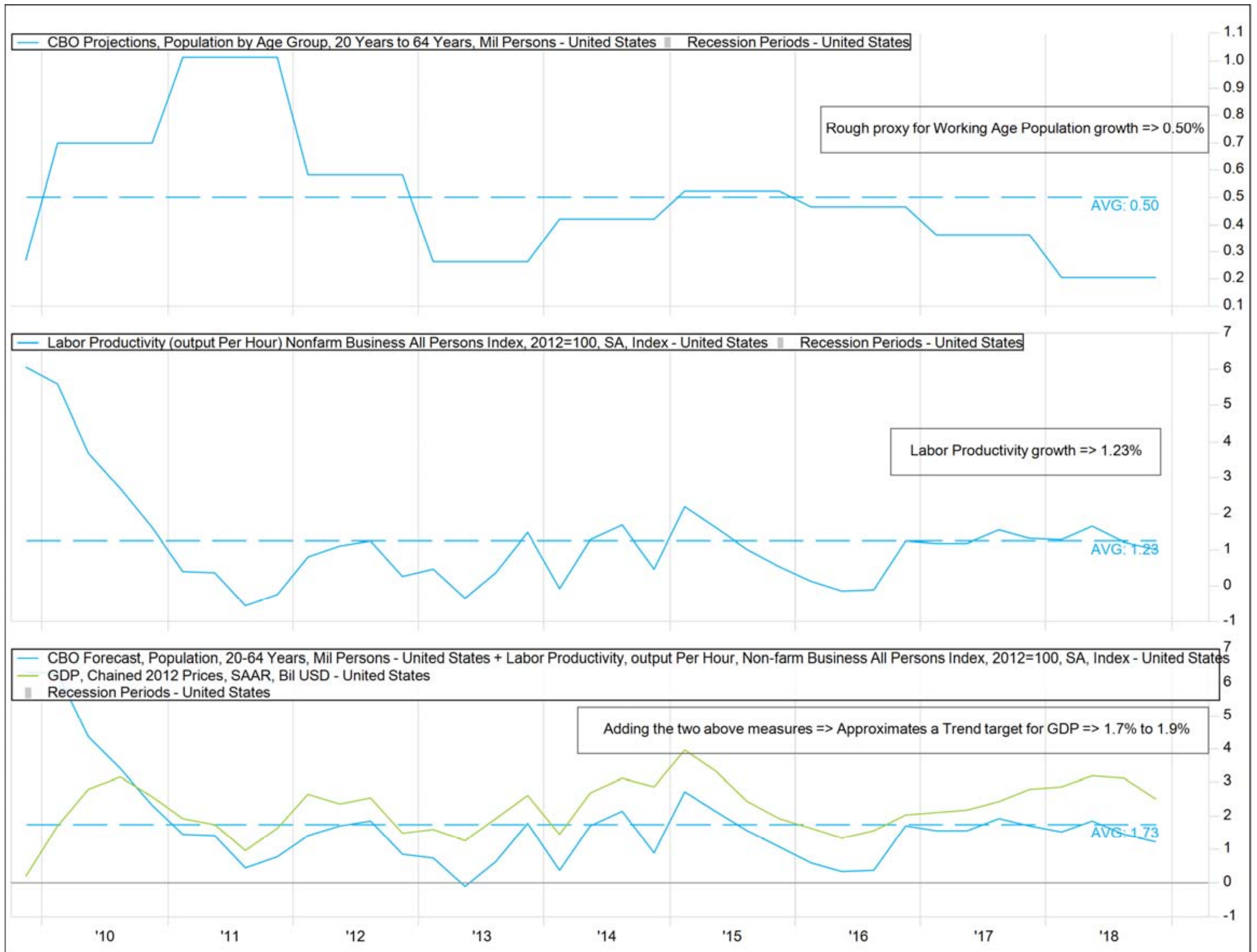
Next, looking at labor productivity shows that in the last 10 years we have been in the 1.2% growth range. From the mid 1990's up until the Great Financial Crisis, the U.S. economy was experiencing productivity growth numbers as high as the 2.0% to 2.5% range. Takeaway #2: Broadly speaking, productivity growth is coming in at lower levels than the last 25 years.

Looking at the graph provided for the prior 10 year period and adding the two factors, one demographic and the other productivity related, gets us to around a 1.7% normal rate of growth in this simple model. Overlaid against this is real GDP output for linear comparison (see chart).

Bulls could look at the present world of technological innovation and change yet slower growth and remain optimistic about prospects. They see a world of possible future gains full of opportunities for investment built around emerging technologies and catalysts not yet imagined. They need to track secular growth stories in order to find out where those opportunities may be coming from. Bears may argue that the demographic and population growth slowdown is a headwind to higher growth levels and, given that business investment in fixed capital has slowed a bit recently, there may be less of a rosy picture around productivity in the future. Either way, whether 1.9% is the correct and normal target of potential GDP, let's consider the factors around it which are now slightly demystified.

[1] https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20190918.htm

[2] https://www.frbsf.org/economic-research/publications/economic-letter/2019/june/is-slow-still-new-normal-for-gdp-growth/



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