ECONOMIC UPDATE

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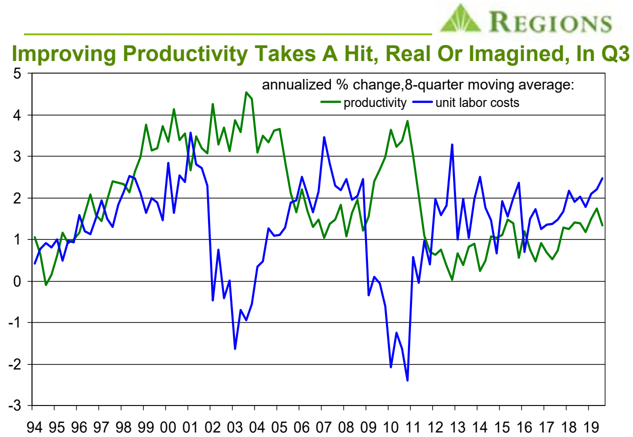
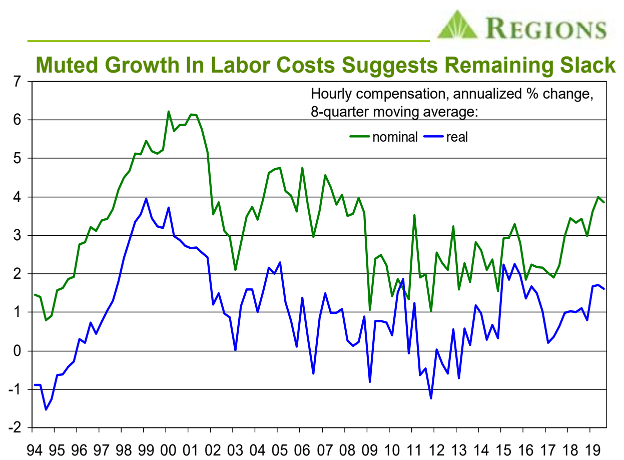
Q3 2019 Labor Productivity And Costs: Improving Trend Takes A Hit In Q3. Or Does It?

- Nonfarm labor productivity fell at an annualized rate of 0.3 percent in Q3; unit labor costs rose at an annualized rate of 3.6 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 1.3 percent and unit labor costs are rising at a rate of 2.5 percent.

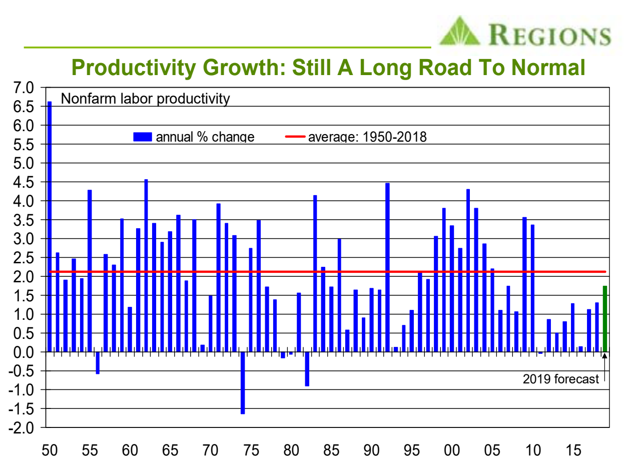
Labor productivity in the nonfarm business sector fell at an annualized rate of 0.3 percent in Q3, badly underperforming the 0.9 percent growth the consensus expected and lagging even further behind our forecast of 1.3 percent growth. That's quite a miss, and we can point to the source of that miss, at least in terms of our forecast. From the GDP data, it was already known that real output in the nonfarm business sector rose at an annualized rate of 2.1 percent in Q3. What was unknown to us and others when we made our forecasts of productivity growth was growth in aggregate hours worked, at least as reported in the productivity data which, as we noted in our weekly *Economic Preview*, is somewhat of a mystery. The BLS reports aggregate hours worked grew at a 2.4 percent rate in Q3, significantly faster than what we and, apparently, most others expected. Data from the monthly employment reports show aggregate private sector hours worked grew at an annualized rate of 0.92 percent in Q3, and while aggregate hours worked by the self-employed grew at a 17.4 percent rate, that is not, given the weightings, sufficient to push total hours worked up to that extent. The other component of hours worked as measured in the productivity data is the measure of hours worked by unpaid family members, which had to have increased at quite a pace in Q3 in order to go from 0.92 percent growth in private sector hours worked, far and away the largest block of hours worked, to the 2.4 percent growth reported by BLS.



We're not going through all of this to somehow explain away a missed forecast, even as bad of a miss as this. Instead, we do so to highlight the flighty nature of the productivity data. This is why we tend not to focus on the data in any given quarter, whether it is really good or, as in this case, really lousy. But, there do tend to be significant quarter-to-quarter swings in the data, making the underlying trend of much more significance. That said, a sufficiently large swing in any quarter can distort the trend, which we think is the case with the Q3 data. As shown in our top chart, the 8-quarter moving average rate of productivity growth, our measure of the trend rate, fell sharply in Q3 – from 1.74 percent as of Q2 to 1.34 percent as of Q3.



It is not just productivity growth that is impacted by measure of aggregate hours worked, with growth in unit labor costs (or, the per-unit labor cost of nonfarm business output) also impacted. For instance, hourly labor compensation grew at an annual rate of 3.3 percent in Q3, matching our forecast. Given the reported decline in productivity growth, however, this translated into annualized growth of 3.6 percent in unit labor costs, well ahead of our forecast of 2.3 percent growth, the difference again being that our forecast of growth in hours worked was much lower than the 2.4 percent growth reported by BLS. The Q3 data leave the 8-quarter moving average of growth in unit labor costs at 2.48 percent. Trend growth has been gently accelerating but remains fairly tame given an unemployment rate as low as what we've seen over the past several months.



We routinely stress the significance of productivity growth as one of the two main determinants, the other being the rate of labor force growth, of the economy's "speed limit," or, the rate at which the economy can grow on a sustained basis without igniting inflation pressures. Given the demographic trends, it is critical that what has been a rising trend rate of productivity growth be sustained, and our view is that the rates of business investment in equipment, machinery, software, and research and development are the main drivers of productivity growth. This is why we are so concerned about the recent pullback in business investment. Even without seeing the surprisingly weak Q3 data on labor productivity, we worried that the improving trend rate of productivity growth was at risk. The reported jump in aggregate hours worked is, aside from any questions about the validity of that number, a useless diversion away from the far more important question of whether or not the recent weakness in business investment will be reversed in time to preserve what we still believe to be an improving trend rate of productivity growth.

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