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Q3 2018 Labor Productivity And Costs: Trend Productivity Growth Grinding Higher

- > Nonfarm labor productivity rose at an annualized rate of 2.2 percent in Q3; unit labor costs rose at an annualized rate of 1.2 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 2.0 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 2.2 percent in Q3, with unit labor costs rising at an annualized rate of 1.2 percent. Productivity growth fell short of our forecast of 2.7 percent, as aggregate hours worked rose by more than our forecast anticipated, and as we missed on our forecast of productivity growth our forecast of 0.6 percent growth in unit labor costs proved too low (consider it two misses for the price of one). As we routinely note, however, the quarter-to-quarter productivity growth numbers tend to be highly volatile, and what is of far more significance is the trend rate of productivity growth (these same comments apply to growth in unit labor costs). We see the eight-quarter moving average rates of growth in productivity and unit labor costs as the best gauges of the trend rates, and as seen in our top chart productivity growth is clearly trending higher. As of Q3, the eight-quarter moving average rate of productivity growth stood at 1.3 percent, with unit labor costs advancing at a 2.0 percent clip. While the upward trend in productivity growth is encouraging, the reality is that over the course of the current economic expansion productivity growth has been anemic, and the relevant question is the extent to which the rising trend rate of growth can be sustained. As we show in our bottom chart, at 1.3 percent the trend rate of productivity growth leaves us a good bit away from the historical average, and even further away from "productivity miracle" territory, i.e., the annual average of 3.0 percent growth seen over the 1996-2005 period which to a large extent reflected rapid technological advances over that period.

As we knew in advance from the GDP data, real nonfarm business output advanced at an annualized rate of 4.1 percent in Q3. The productivity data show 1.8 percent annualized growth in aggregate hours worked which, in conjunction with growth in output, yields the 2.2 percent (annualized) rate of productivity growth. Hourly compensation rose at an annualized rate of 3.5 percent in Q3, but this follows annualized growth of just 1.9 percent in Q2, and it is worth noting that as of Q3 hourly compensation costs were up 2.8 percent year-on-year, right in line with the rates of wage growth seen in the monthly employment reports and the Employment Cost Index. As our middle chart shows, growth in hourly compensation costs has picked up, whether looked at on a nominal or real (i.e., inflation adjusted) basis, but growth remains shy of the rates seen in past cycles. This is another illustration of a point we frequently make, which is that despite a prolonged period of improving labor market conditions and an unemployment rate below 4.0 percent, there is still a good deal of labor market which has yet to be pared down.

We have for some time argued that the main culprit behind what has been notably weak productivity growth over the course of the current expansion has been underinvestment on the part of firms. Investment had been so weak for so long that not only is the size of the capital stock an issue, but so too is the age of the capital stock, with each factor spawning inefficiencies that hold down productivity growth. The data show a reversal in this pattern beginning in early-2017, i.e., prior to the 2017 tax bill, and our thought is the tax bill only adds to firms' incentives to upgrade their capital stocks. While a weak print on business investment in the Q3 GDP data has led some to declare the tax bill "a bust" – a nonsensical statement founded on something other than actual analysis of actual data – we think there is still further upside room for business investment. Moreover, firms have stepped up spending on R&D activities which typically lead improvements in productivity growth by several quarters. Again, the key question is the extent to which spending on equipment, machinery, and R&D will lead to a sustained increase in labor productivity growth. It is simply too soon to know that, at least for us. We'll add that another wild card in the mix is that bursts of technological innovation, which enhance labor productivity, are virtually impossible to forecast, but nonetheless we vehemently disagree with those who think innovation is done. Weak productivity growth is not destiny, as some argue to be the case, but neither is it something that changes quickly. With less and less slack remaining in the U.S. economy, sooner would be better in terms of improved productivity growth.

