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MICRO AND MACRO INTERSECTIONS

Exploring Causes of Fleeting Productivity

March 19, 2018

Michael Parker, CFA
Chief Investment Officer

The main culprit behind the inability to sustain expansionary real GDP growth since the last recession is productivity, or, more accurately, the absence of its sustainable contribution to growth since the 2008-2009 downturn.

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We frequently read headlines that point to anemic economic growth in the US following the 2008-2009 downturn, with politicians quick to assign blame to the opposite side of the isle. As intense the battle is to pin on one party, the main culprit behind the inability to sustain expansionary real GDP growth since the last recession is productivity, or, more accurately, the absence of its sustainable contribution to growth since the downturn.

Since the market's March 2009 bottom we have only seen a handful of quarters break 3% year-over-year real GDP growth. Since a wide chasm exists between those creating economic output and the economists who study top-down methodologies, it can be tough to connect underlying trends at the company-specific level that aggregate themselves into macroeconomic effects. Such is the case in attempting to source our absence of productivity gains. As we tie together insights from quarterly updates of the publicly traded universe over the prior few weeks, we can begin to formulate a construct that might help explain the reasons why we've witnessed this lack of sustained productivity growth while providing glimpses of a potential roadmap to prolonged economic expansion.

How Did We Get Here?

Every U.S. recession has entailed an impairment to factory capacity utilization, as companies respond to lower demand and/or over-supply environments by scaling back production. The 2008-2009 downturn was no different. Historically, at some point during the recovery period post-recession, the economy returns to an optimal 80% of factory utilization. In fact, this has happened in every recovery period since the Federal Reserve has been tracking factory utilization, that is, until the expansionary period following to the 2008-2009 downturn *(see figure 1 below)*. In these prior recoveries, it took 15 months on average *(see figure 2 below)* for factory utilization to recover back to 80% utilization levels following the preceding six recessions. However, in the 104 months since the end of the last downturn—and counting—we have yet to breach the 80% mark.

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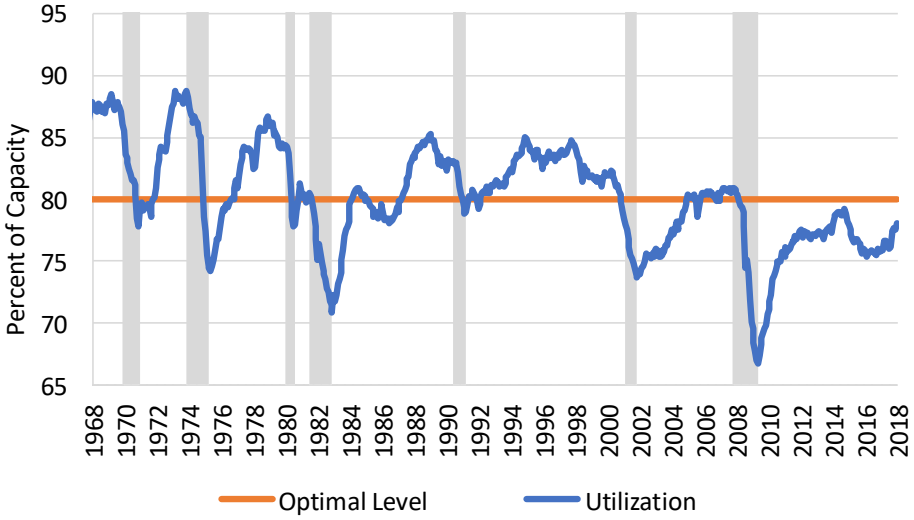
Figure 1: Capacity Utilization, Total Industry



Source: FactSet; US Federal Reserve Board of Governors. Shaded areas indicate U.S. recessions.

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Figure 2: Months for Utilization Recovery to 80%

Last Recession:	**No. of mos.**
Dec'07 - Jun'09	104
Prior Recessions:	
Mar'01 - Nov'01	39
Jul'90 - Mar'91	3
Jul'81 - Nov'82	16
Jan'80 - Jul'80	4
Nov'73 - Mar'75	17
Dec'69 - Nov'70	11

And Counting

Source: FactSet; U.S. Federal Reserve Board of Governors.

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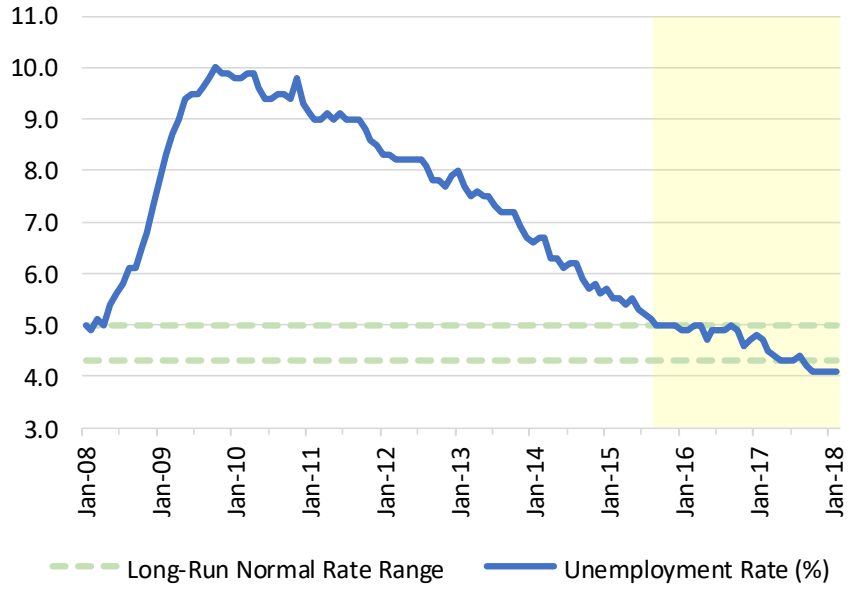
Labor Supply: Forcing the Issue?

A readily available supply of labor has made the ability to throw cheap labor at the problem as an easy band-aid.

One potential explanation for the delay in utilization recovery could be the readily available supply of labor, which, up until late 2015, made throwing cheap labor at the problem an easy band-aid. Since hitting the upper bound of the Fed's normal unemployment target in September of 2015 *(see figure 3 below)*, that approach has reached its limitations, forcing management teams to turn to solutions that will make their labor forces more efficient. Corporations are realizing that they can no longer prolong capital expenditure ("capex") modernization efforts because of the tighter labor markets, nor do looming threats of faster moving competitors allow for them to take their time to increase operational efficiencies.

Since hitting the Fed's target unemployment range in 2015, management teams have been forced to turn to solutions that will make their labor forces more efficient.

Figure 3: U.S. Unemployment



Source: FactSet, US Bureau of Labor Statistics. Highlighted region indicates latest period at/below the Fed's long-run "normal" unemployment upper bound.

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For some U.S. domiciled companies, the opportunity exists to plow tax savings from a lower corporate tax rate back into efficiency seeking capex projects, providing some mitigating impacts to their bottom line. Such a dynamic is unfolding with Lowe's Companies [ticker: LOW] in its 2018 spending plans. The company intends to step up capex to enable mobile computing capabilities and training of its on-floor associates in efforts to increase traffic conversion and enable in-store pickup for online orders. Lowe's management believes that this spending will help thwart declines in in-store transactions despite experiencing increases in store foot traffic. Lowe's, as well as most brick-and-mortar retailers, are facing increasing pressure to optimize omnichannel go-to-market efforts in an attempt to stem continued demand shift to the online retailers.

Tesla, Inc. sees an opportunity for a 5x increase in vehicle assembly speed largely due to its opportunity to look at manufacturing automation on a fresh sheet of paper.

Other industries face pressures to modernize from innovative competitors breathing down their necks, challenging the manufacturing efficiency of the incumbents. Such is the case unfolding among the automotive manufacturers. Tesla, Inc.'s [ticker: TSLA] quarterly commentary highlighted how its strategic playbook hinges on the assumption that many incumbent auto OEMs designed their factory automation efforts primarily around the replacement of human labor and its ergonomic limitations. Since Tesla is currently scaling Model 3 manufacturing to 2,500 cars per week, and eventually to 5,000 per week by mid-2018, the legitimacy of these claims has yet to reveal itself fully. However, the company sees an opportunity for a 5x increase in vehicle assembly speed largely due to its opportunity to look at manufacturing automation on a fresh sheet of paper—lithium ion battery pack bottlenecks aside. This is largely why CEO Elon Musk categorizes its factory, rather than the slate of vehicles that it produces, as its real product and source of competitive advantage long-term.

Where Do We Go From Here?

As we take a step back and plot our course on the economic map, we see an equity market that has recovered three-fold since its March 2009 market bottom. Despite the fact that valuations have recovered to levels more consistent with a healthier economy, we still have areas for improvement in the underlying fundamental and economic drivers. The most noticeable needed remedy has been productivity's contributions to the economic output equation. Sentiment and certainty can recover much faster than labor force productivity, even though it's taken nearly a decade for the latter to show signs of improvement. We believe that the conditions are in motion for relief to be delivered—exogenous risks aside, such as the potential for trade wars following tariff implementations—as companies across various sectors now face increasing intensity to make their operations more efficient. This, in turn, makes for a ripe environment to uncover relative winners and losers among publicly traded companies attempting to create shareholder value, which we believe allows for active managers to exploit opportunities for alpha generation.

About the Author

Michael Parker, CFA
Chief Investment Officer

Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS).

He leverages over fifteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today.

Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania in 2002 and is a CFA® charterholder.

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https://swspartners.net info@swspartners.net (614) 670-5733