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Pence Perspectives, Q3 2017

Bottom Line Up Front:

If there is one thing that investors dislike more than bad news, it is uncertainty. As we stated in our April newsletter, the US economy is currently in the **Implementation Stage**, where financial markets eagerly await Congress to enact President Trump's policy agenda. The objective is simple: move the economy from an anemic 2% gross domestic product (GDP) growth rate to a more meaningful 3% or higher. We believe it is achievable if the government passes pro-growth fiscal policies such as tax reform and deregulation.

On the bright side, the major indices have started the year strong, extending the post-presidential election rally.[1] The earnings of companies in the S&P 500 Index are expected to increase about 12% this year.[2] This could continue to support the current equity rally even if nothing gets done in Washington this year. Elsewhere, the economic expansion has strengthened and synchronized around the globe, which we believe could further benefit US-based multinational companies.[3]

With major stock indices trading well above their historical average, investor sentiment can quickly change depending on macro factors such as politics or the US economy. This is why we remain cautiously optimistic. As we stated in our earlier newsletters, sector picking in this type of environment will continue to be a key factor in building and managing portfolios.

Understanding Economic Growth: Is 3% GDP Growth Achievable?

We think it is and that is really important because a 3% GDP growth rate is the equivalent of growing an economy which is the size of Argentina or Sweden every year. Going forward this should be positive for equity markets.

Between 1960 and 2000, the economy grew at an average annual 3.6% rate—but starting in 2001 has averaged only 1.8%.[4] There has been a long debate whether the US economy can reach and sustain a higher growth rate than it is currently achieving. Some economists argue that achieving sustainable 3% growth is difficult because structural forces that cut productivity growth are here to stay. Others believe that government interventions such as tax reform and deregulation can unleash private investment, encourage job creation, and fuel productivity growth while increasing prosperity for all.

[1] *The S&P 500 Index is up 10% year to date.*
[2] *According to FactSet: The S&P 500 companies that reap more than 50% of their revenue from outside the US has already recorded over 20% in earnings growth in the first quarter.*
[3] *According to IMF, the global growth is expected to rise to 3.7% this year after slowing down to 3.2% last year.*
[4] *Source: FRED*

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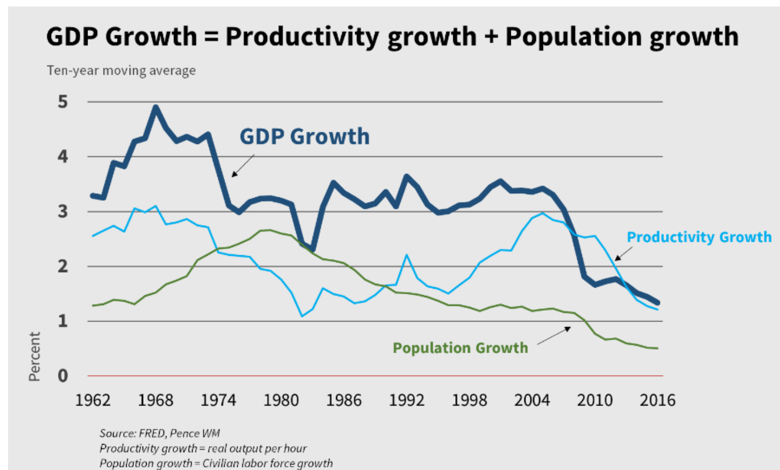
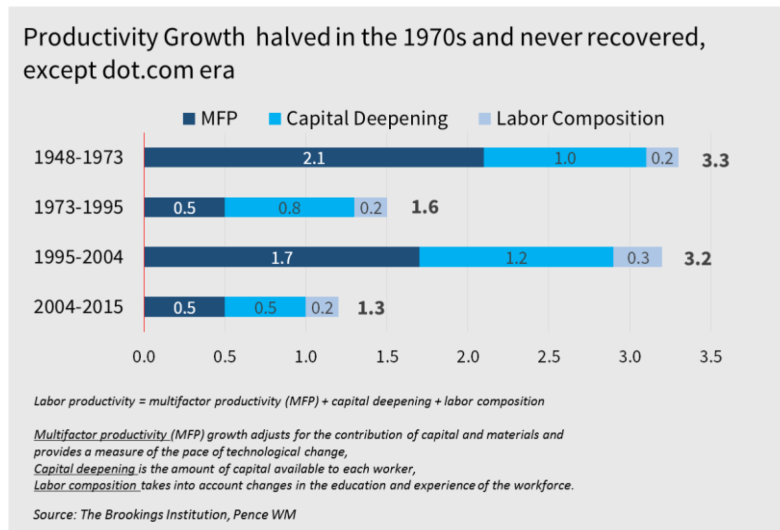
There are two ways we can grow the economy. We can either increase population (working-age people) or increase productivity. Both trends have been declining for decades (see chart below).



Slow productivity growth gets most of the blame for slow economic growth and there are several theories explaining why it has declined. Productivity has grown at only a 1.3% annual rate since 2004, compared to 3.3% from World War II to 1973 (see table below)[5].



Among the factors explaining slow productivity growth, the most optimistic group believes that we are **mismeasuring productivity** because the work place (and the economy) has transformed itself from the manufacturing sector to a service sector-orientation. Over seven decades, the share of total employment attributable to the manufacturing sector has declined from 30% to 8.5% today. It's also harder to measure productivity in service industries than in physical output industries. The optimistic group argues that mismeasurement is a serious problem because of the treatment of new products and the lack of quality adjustment in existing products. For example, Deloitte Global estimated that in 2016, 2.5 trillion photos were shared or stored online, about 31 times the volume taken (let alone shared) in the 1990s, when about 80 billion were taken every year. This represents a huge increase in the productivity of photo-taking technology and was brought about by the fact that the price per photo has declined from around 50 cents to almost zero as consumers use their phones to take pictures. While the whole productivity slowdown may not be explained by mismeasurement, most economists stress the overall importance of mismeasurement and the potential for understating long run growth.[6]

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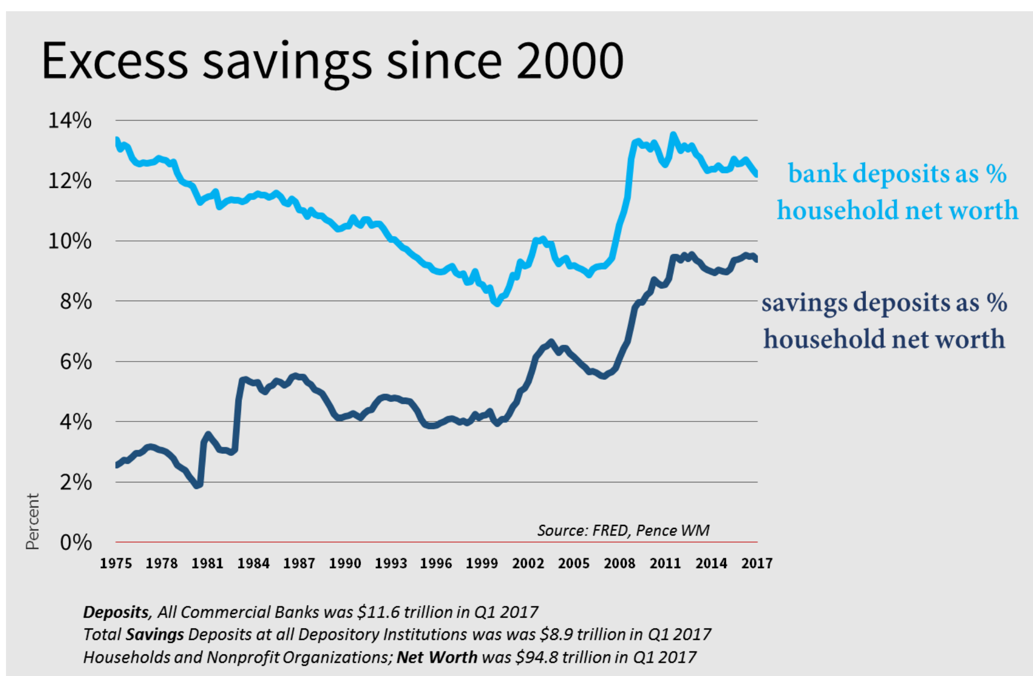
[5] *If we ignore 1995-2004, dot.com era when computer and electronic products had an enormous 11% growth rate. Productivity is defined as the efficiency at which inputs are turned into outputs. The simplest productivity measure is output per hour worked (labor productivity).*

[6] *See the Brookings productivity conference, Hal Varian, Google's Chief Economist and Emeritus Professor at Berkeley: https://www.brookings.edu/wp-content/uploads/2016/09/wp22_baily-montalbano_final4.pdf*

The most pessimistic group, led by a Northwestern economist Robert Gordon, believes that slow productivity growth is the result of the **exhaustion of major innovations** and current technological advances are not great enough. They believe that historical innovations had a far greater impact on productivity growth and we won't see a similar wave of innovations anytime soon. They claim fewer new ideas or new innovations mean there is no need for new machines, because they do the same thing as the old machines, and no need for new investment that could propel productivity. For example, the flight time from New York to Chicago hasn't drastically changed over 60 years but the impact of flying in the 1950s is far greater than it is today. In fact, we spend more time getting through the airport than in the air flying. Critics of this group argue that technologies can take a long time to conceive, perfect and commercialize, and an even longer time to create growth and value. Many of the transformative innovations in the past were conceived a few decades before they transformed a way of life. So, we may now be on the cusp of another surge in productivity.

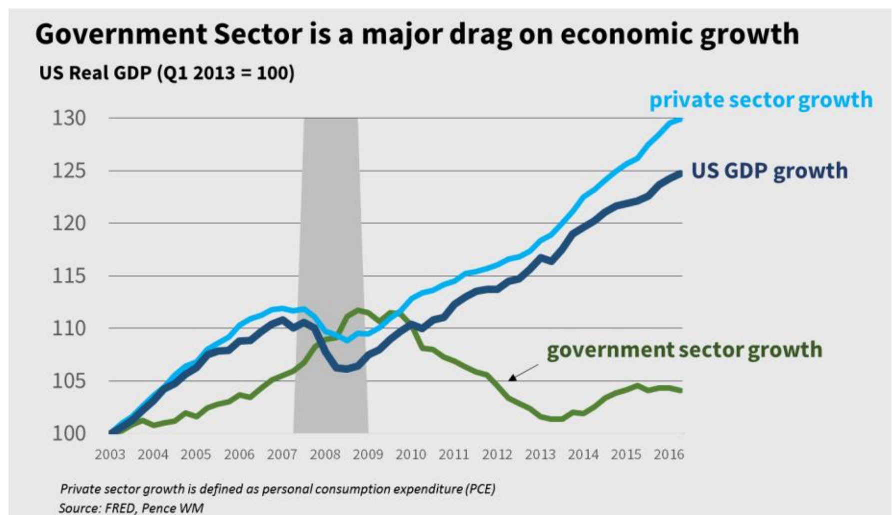
The less optimistic but more hopeful group, led by Harvard economist Larry Summers, believes that the economy is out of balance because of an excess propensity to save relative to a lower propensity to invest, the so-called "**secular stagnation**" hypothesis. Excess savings (see chart below) means slowing consumption and diminished investment, which limit aggregate demand. Summers frames it as an inversion of "*Say's Law*," the notion that supply creates its own demand. In this case: "Lack of demand creates lack of supply." According to this group, primary responsibility for addressing secular stagnation should rest with government. Expansionary fiscal policy such as lowering tax rates, deregulation, and expanding investment in infrastructure can reduce national savings, raise neutral real interest rates, and stimulate growth.



Government's Role

Although measuring government productivity may not be as straightforward as in the private sector, government can affect productivity directly and indirectly. Government can slow productivity by overspending, overregulating, or underspending in some sectors. During 2011-2014, the government sector was a major drag on economic recovery because of underspending (see chart below).

Supply-side economists argue that producers and their willingness to create products set the pace of economic growth. **Tax reform** has the potential to have an enormously positive impact on small businesses. They think pro-growth tax reforms that lower rates on saving and investment can unleash private investment and fuel economic growth. But the financing of tax cuts also matters. The historical evidence suggests that tax cuts that are financed by increasing **government debt** may have little positive impact on long-term growth. In fact, by overspending and running a budget deficit, government can also crowd out private investment and choke off productivity by absorbing private savings. Total **public debt** as a percentage of GDP has gone up from 62% in 2007 to 104% of GDP today. During the same period, gross private domestic investment as a percentage of GDP has declined from 18.5% to 15.7% of GDP. This represents over $500 billion that is **not** invested in the US economy today.



There is a general consensus that US manufacturing has the highest economic multiplier effect of any sector on the economy. And **overregulating** that sector is a massive undercut to productivity. The National Association of Manufacturers estimate that for every $1 spent producing manufactured goods, $1.81 in additional value is added to the US economy. A 2012 report[7] found that the burden of federal regulations on US manufacturers has more than doubled since 2001 – increasing from an estimated $80 billion in 2001 to more than $164 billion in 2011. According to the Mercatus Center at George Mason University study that covers 1977 through 2012, federal regulations amounted to an average annual reduction in GDP growth of 0.8%. A 2014 report[8] finds that federal government regulations **cost** an estimated $2 trillion in 2012 (in 2014 dollars), an amount equal to 12% of GDP. On January 30, 2017, Trump signed an executive order stating that all federal agencies must cut two or more regulations for every new one they introduce. He said that he wanted to eliminate 75% of regulations.

The US needs to step up infrastructure investment significantly, nearly 1.1% of GDP, or about $200 billion, which is the amount needed every year until 2030. The good news, there is a political will from both sides of the aisle for an increase **infrastructure spending**. Today, more than half of government spending goes into social security, healthcare, and labor compared to decades ago and citizens can argue that the benefits they received have not exceeded the cost they have paid for them. Yet, since 1964, spending on public nonresidential infrastructure as a portion of GDP has been declining steadily and is now at record lows. Freight and passenger delays on the nation's congested railroads cost the economy an estimated $200 billion a year, according to American Society of Civil Engineers.[9] Trump has told Congress his infrastructure plan will be "financed through both public and private capital." However, it is expected to focus heavily on public-private partnerships (PPPs). According to a report by McKinsey, "PPPs can bring the discipline of the private sector to risk assessment, evaluation, and construction. Many PPPs also entail a 20- to 30-year concession that includes operations and maintenance. That long-term responsibility encourages the partnership to optimize the total cost of ownership, so there is no cutting back on maintenance. In this sense, PPPs have enormous potential. However, they need to be managed carefully, with recognition of their limits."

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[7] *Commissioned by the Manufacturers Alliance for Productivity and Innovation*
[8] *Commissioned by the National Association of Manufacturers*
[9] *http://www.ustrust.com/UST/Pages/rebuilding-america.aspx*

Conclusion

Growth is the engine of wealth. We believe the US economy can grow at a 3% GDP growth rate or higher but to do so, we need a functioning government that enacts key legislation. The economy has shown that it can bump along at a 2% GDP growth rate regardless of Washington. So, to get to a 3% growth rate, lawmakers don't have to pass all of the key fiscal policy initiatives, just one or two of the following:

- increase labor force participation by cutting some of the entitlement programs
- boost labor productivity by immigration reform that brings in skilled immigrants
- boost consumer spending (and aggregate demand) by income tax reform and healthcare reform
- boost private investment by corporate tax reform and deregulation
- boost private investment (not crowding out) by cutting the budget deficit through entitlement reform
- create more jobs by fixing the nation's infrastructure
- shrink the trade deficit by a border tax adjustment

We believe at least one of these initiatives can get passed this year and one or two more next year as long as Congress can find even the smallest path through gridlock. We state we are cautiously optimistic because we are cautious about Congress but fully optimistic about the potential of improving economic fundamentals and the market.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

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