WHITE PAPER

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The Holy Grail of Economics-Growth

What have been recent trends in economic and corporate profit growth, and what can we expect going forward?

Microsoft Word and similar programs have a function that searches for and highlights a word or phrase inputted by the user. I'm willing to bet that going through this exercise for the word "growth" in virtually any economic or financial article or report as well as many political commentaries would yield a large number of hits. Politicians frequently tout proposed legislation as "pro-growth." Market strategists obsess about the rate of growth in corporate earnings, and stock analysts base their recommendations on a given company's projected growth versus its current valuation. And of course, all three of these are interrelated.

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So, why is growth important? What have been recent trends in economic and corporate profit growth, and what can we expect going forward? Finally, what are the implications for investing?

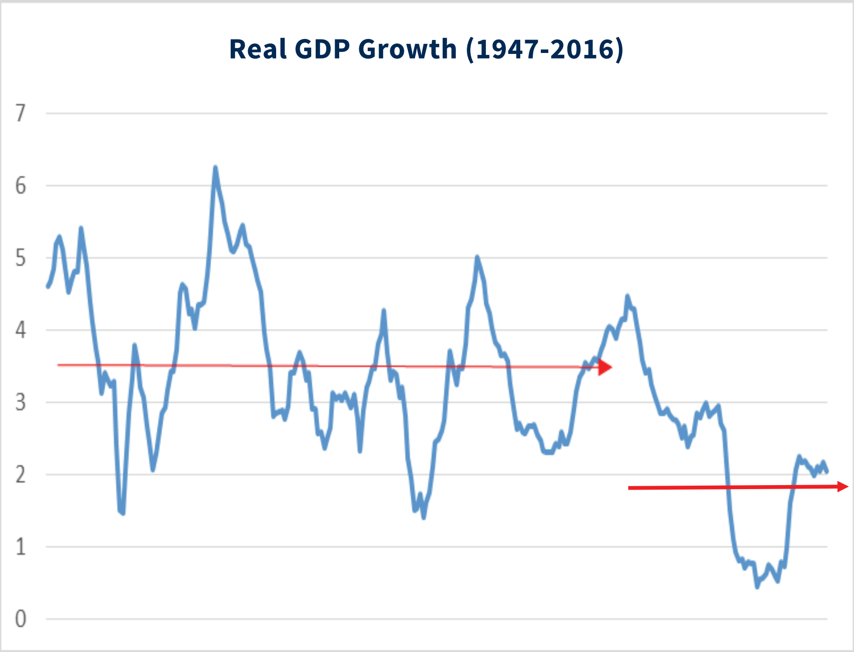
Why Do We Care About Growth?

While it seems a little like Motherhood and Apple Pie, at a high level, economic growth is important because our collective living standard only improves when incomes grow faster than inflation. A key component of this desirable outcome is growth in the number and quality of jobs that result from an expanding economy. And, with regard to financial markets, the long run return on stocks is equal to the beginning dividend yield plus the rate of growth in dividends which is a function of overall economic growth as well as factors specific to individual companies. So, the outlook for both our income and financial assets is importantly influenced by the expected rate of growth in the economy.

Trends in Economic Growth

A short history of economic growth represents the proverbial “good news, bad news” story. As depicted in the following chart, following the recovery from the Global Financial Crisis, overall economic growth has been stuck in a range of 1-2% as compared to a longer term average of about 3.5%. During the first quarter of 2017, the annual rate of growth was a mere .7%! That’s the bad news.

Now for the good news!



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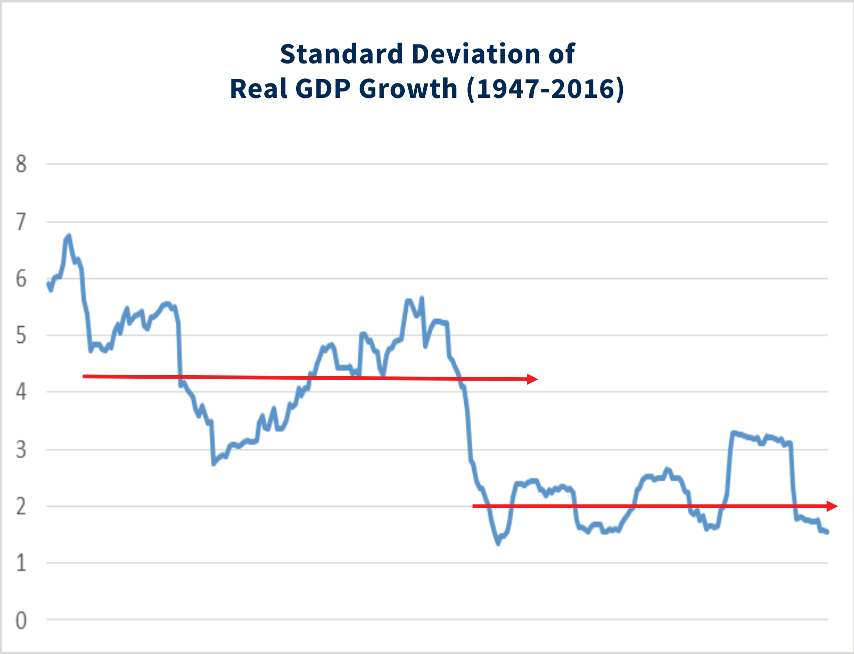
While growth has been modest, the volatility of that growth has been declining. In other words, the economy is much more stable. That could be a result of luck, or more optimistically, a function of better monetary and fiscal management. Similarly, both the rate of inflation and the volatility of inflation have been quite low by historical standards. And finally, corporate profits have recently been growing at approximately a 3% annual rate as compared to the longer term average which is north of 7%. To sum it up, we seem to be in a world characterized by low growth and relative stability. Investors and voters do not seem to particularly value the relative stability of the economy so we are left with considerable angst regarding the lack of growth. We certainly are not political analysts, but it seems safe to argue that President Trump won the election largely on the basis of his promise to create jobs and reaccelerate growth. Before we step into the political fray, let's focus on the fundamentals of economic growth.



The Sources of Growth

From year to year, growth can vary considerably based on a large number of factors including the business cycle, consumer and business sentiment, government policy, and so on. But, over longer periods, economic growth is a function of two basic factors: growth in the population of working individuals, and growth in the output per hour worked, also known as productivity. As mentioned earlier, long term growth in real GDP has been approximately 3.5% annually which resulted from population growth of about 1.2% and productivity growth of roughly 2.3%. More recently, the picture is very different. For the last five years, population growth has been about .9% and productivity growth has averaged .5%; hence GDP growth in the 1-2% range. As an aside, productivity actually fell .2% in 2016! What about the future? Let's look at population growth first.

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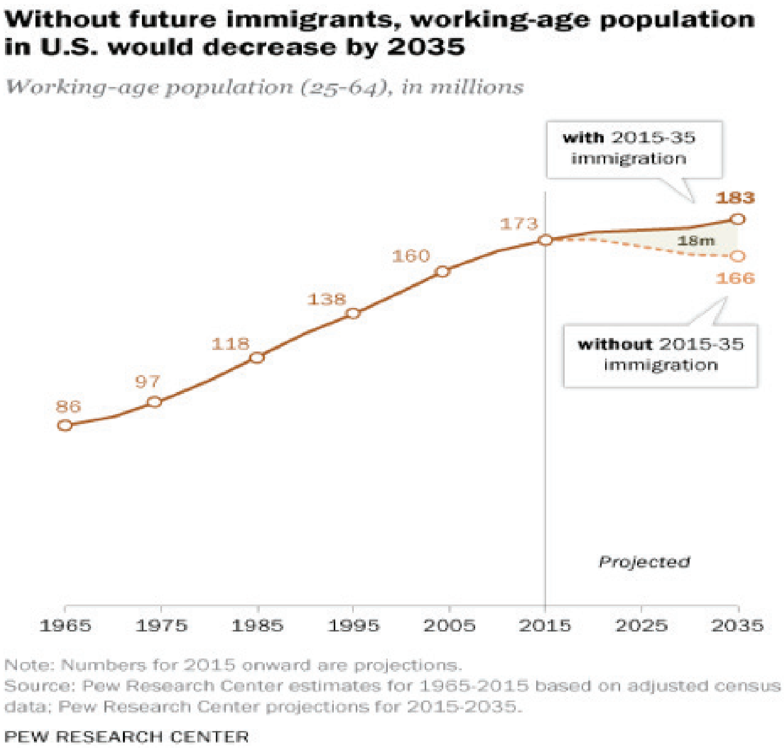
The following chart depicts expected growth in the working age population in the U.S. As you will note, the Pew Research Center forecasts growth in the number of workers from 173 million to 183 million over the next twenty years which represents a growth rate of .3% annually. Interestingly, they forecast a decline of seven million workers absent immigration. We won't wade into the current debate regarding immigration policy, but will only note that working age population growth is likely to be quite modest at best, and any policies that result in a significant decrease in immigration will have an important impact on potential economic growth.



How about productivity growth? This is a complex subject on which there is great debate and considerable disagreement. Specifically, there is no definitive answer as to why productivity growth has been slow in recent years, and there are even a few economists who question the underlying data. What drives productivity growth? Five factors are frequently cited:

- **Investment in physical plant and equipment**
- **Innovation-new technology, new techniques, and so on**
- **Skills-worker health, training, etc.**
- **Competition-drives the need for cost control**
- **Organization-workplace, employee cooperation, teamwork, etc.**

Many of these factors are soft and somewhat difficult to measure. The major exception is investment in plant and equipment which has grown at a 3.9% annual rate during the past five years as compared to the long run average of 6.7%. Why have companies not been investing in plant and equipment, particularly given the fact that borrowing is relatively cheap and companies are flush with cash? Once again, this is a controversial topic on which economists disagree. One oft cited explanation is that companies are currently operating at about 76% of their capacity versus a long run average of about 80% – why should they spend money on plant and equipment?

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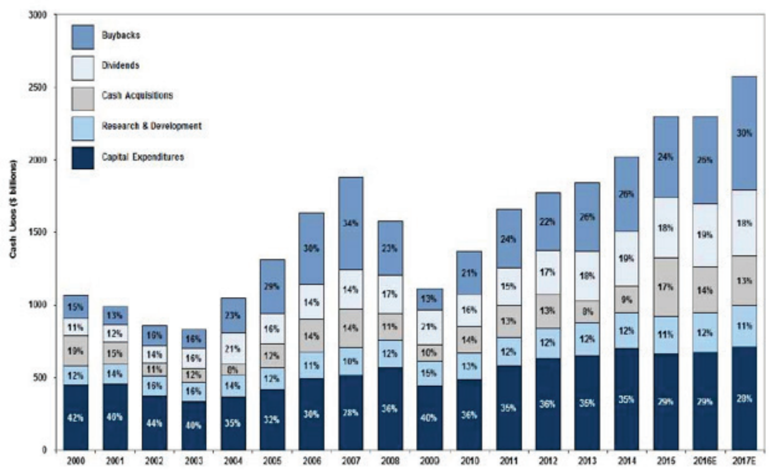
Exhibit 1: S&P 500 use of cash, 2000-2017E
as of November 17, 2016



Use of cash:	2000	2001	2002	2003	2004	2005	2006	2007	2008	2000	2010	2011	2012	2013	2014	2015	2016E	2017E
Invest for Growth (capex + R&D + M&A)	74%	75%	70%	68%	57%	56%	55%	52%	60%	65%	62%	60%	60%	56%	56%	58%	55%	52%
Return to Investors (buybacks + dividends)	26%	25%	30%	32%	43%	44%	45%	48%	40%	35%	38%	40%	40%	44%	44%	42%	45%	48%

Source: Compustat, Goldman Sachs Global Investment Research

This chart provides another important explanation which is that companies have dramatically increased the amount of money returned to shareholders through dividends and stock buybacks while decreasing investment in R&D, capital expenditures, and so on. Of course, we love receiving cash and benefiting from buyback support of stock prices. But, there is a legitimate concern that this is occurring at the expense of future competitiveness.

Tying all of this together, growth rates in population are relatively fixed so an improvement in long term economic growth is largely tied to a resurgence in productivity growth which leads to the current political discussion regarding tax cuts and infrastructure spending.

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The Magic Bullet?

Since the election, the U.S. stock market has risen more than 11% based on the expectation that President Trump's promises to cut taxes, reduce regulation, and increase infrastructure spending will in fact result in renewed productivity growth. Various administration figures have argued that Real GDP growth will accelerate to 3 or even 4%. Earlier this year, I wrote a paper called It's Complicated which asserts that economics is much more complex than suggested by popular headlines because there are always secondary and tertiary effects as well as unintended consequences. In this case, we are optimistic that the proposed policies, if enacted, will have a salutary effect on productivity growth, and ultimately economic growth. But, consistent with It's Complicated, we feel compelled to present the other side of the argument:

- **There is no guarantee that consumers will stimulate the economy by spending tax cuts. Consumer spending did not materially change in response to lower gasoline prices in 2015 which was in essence a tax cut.**
- **As discussed, corporations have not been spending on capital and equipment despite huge cash balances. Will a tax cut motivate them to do so?**
- **At an unemployment rate of 4.5%, the economy is already operating at what many economists consider full employment.**
- **Tax cuts and infrastructure spending may have negative implications for the U.S. Budget Deficit, and ultimately, interest rates.**
- **Finally, some economists argue that these policies will have at best a temporary effect on growth, and they point out that the rate of economic growth did not change significantly following either the Reagan tax cuts or the Clinton tax increases.**

The bottom line is that we are hopeful but appropriately skeptical.

Implication for Investing

Our portfolios have a full allocation to equities which has yielded nice returns in the past year. But, given relatively full valuations as well as very modest economic growth, further gains will be dependent on the enactment and success of the proposed tax cuts and infrastructure spending, neither of which is a slam dunk. As a result, we continue to forecast moderate portfolio returns and balance our equity allocation with some exposure to fixed income and a significant emphasis on diversifying strategies.

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