Weekly Market Insights

August 2, 2021

A Productivity Boom or the Solow Paradox?

Equity Markets

U.S. equity markets slowed their torrid advance this past month. Although Friday's close was down, they ended the month with gains. As always, the culprit was uncertainty, the enemy of investors and businesses alike. We wrote last week about some causes of these uncertainties—mixed economic signals, COVID's resurgence, and continued confusion about China.

As you will read, my colleague Ryan does a fine job analyzing the mixed economic signals. He goes into some detail explaining why we feel they should be interpreted a bit differently than in the past.

We think the economy and equity markets remain in good shape.

The S&P 500 closed the week up 0.52%, the Dow up 0.30% and the NASDAQ up 0.57%.

The Economy

In the past, we have discussed the idea that after a long period on slow growth in productivity, the U.S. may be in for a productivity boom. What inspired us to discuss it again is that two well-known analysts[1] have been working on this same thought.

The thesis is that during the COVID recession, many companies have invested heavily in new technology. New technologies and innovations tend to lie dormant until something spurs them into use. The current dormant technologies may be about to change and the COVID crisis may be that inspiration. The most robust investments have been made by the large industry leaders. This also is likely to change. Competition drives innovation and investment. This change will come at a cost and may be frightening to some. Certain changes will obviously substitute capital for labor and have an employment effect.

As we see it, the sectors/industries most likely to benefit first are healthcare, information technology, construction, retail, and banking.

As we wrote earlier, productivity booms do not come without a cost. For this to take place there must be a public/private sector effort to soften the harsh side.

What can prevent this from happening? The Solow Paradox. In the past, there has often been a long delay between innovation and adoption, and another between adoption and economic impact. Robert Solow summed up these apparent discrepancies in a 1987 article in the New York Times Review of Books writing, "You can see the computer age everywhere but in productivity statistics."[2] No one really knows why.

Another reason may be some governments' misguided attempt to save jobs in the short run rather than help those affected.

---

[1]James Manyika, Chair and Director of the McKinsey Global Institute and Michael Spence, winner of the 2001 Nobel Prize in Economics.
[2]A Better Boom, Manyika and Spence, Foreign Affairs, July/August 2021.

Weekly Market Insights (cont'd)

This is interesting to think about. Will it occur? No one knows, but it may and it will be exciting. Investors can be certain that there will at least be some movement in the direction described above. These changes will alter the economic landscape to a lessor or greater degree. It should be fascinating to watch.

July Economic Update

Despite positive reopening momentum in recent months, July's economic indicators were mixed, as COVID-19 continues to play a disruptive role in the U.S. economic recovery.

The 2nd quarter GDP print came in below consensus at a real annualized rate of 6.5% compared to forecasts for an 8.5% increase. While U.S. GDP growth of this magnitude would be celebrated in the pre-COVID world, it instead points to an economy struggling to readjust after 2020's lockdown-driven recession. Consumer spending contributed meaningfully to growth in the 2nd quarter, while residential investment and inventories were significant detractors. The takeaway is that economic growth was hurt by supply-side disruptions rather than a lack of demand. Supply chain bottlenecks have negatively impacted production, and depleted inventories signal that businesses are struggling to keep up with consumer demand. Similarly, despite a strong demand for housing, residential investment detracted from GDP, as builders struggled to obtain the necessary supplies for construction. Supply chain disruptions should improve over time, and a natural ease in demand as reopening continues will allow firms to work through backlogs, increase production, and replenish inventories.

Inflation continues to make headlines with another month of "largest since" headlines. CPI[3] came in at 5.4% year over year, the largest since August 2008, and the PCE[4] inflation index increased 4.0% over the same period. While used car prices accounted for one-third of the CPI increase, shelter prices, a stickier inflation component, has begun to turn higher. As we have stated previously, more attention should be given to the duration and composition of inflation rather than the magnitude. Core measures excluding items like food and energy are more subdued, and alternate measures of inflation like the Cleveland Fed's median CPI, the Dallas Fed's trimmed mean PCE price index, and the Atlanta Fed's Sticky Prices measure offer further reassurance. With readings of 2.2%, 2.0%, and 2.7%, respectively, these less volatile inflation gauges offer a less worrisome inflation picture. "Transitory" has been the often-associated term with the inflation discussion. While initially interpreted to be months, transitory may turn out to be longer as the global economy takes more time to work through COVID-related frictions.

July's employment report was promising, with employers adding 850,000 jobs over the course of the month. The reading beat forecasts and eclipsed the prior month's increase handily. Despite strong employment gains, the unemployment rate ticked higher to 5.9%, while the labor force participation rate held constant. A higher unemployment rate is seldom a good thing, however, more people entered the labor force and are in search for work. Furthermore, the average workweek declined, signaling that existing employees are getting more help and are no longer required to work as long hours. With labor

[3]Consumer Price Index.
[4]Personal Consumption Expenditures.

shortages continuing to plague businesses look to hire, more available workers can certainly be interpreted as a positive. Labor market frictions are slowly easing, and employment numbers continue to trend in the right direction. Expectations are for another strong employment report next month, which would provide further confidence in the labor market recovery.

COVID-19 continues to be a disruptive force in the world and is making for an uneven U.S. economic recovery. However, absent further headwinds on the health front, employment gains, pent up savings, fiscal support, and improved supply chains act as catalysts for future growth.

Michael Olin Clark
Senior Advisor
moclark@1919ic.com

Ryan Schutte
Investment Associate
rschutte@1919ic.com

Abigail McKenna
Senior Portfolio Associate
amckenna@1919ic.com

The views expressed are subject to change. Any data cited have been obtained from sources believed to be reliable. The accuracy and completeness of data cannot be guaranteed. Past performance is no guarantee of future results.

Please visit us at 1919ic.com Follow us