Standard Life Investments

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"Productivity isn't everything, but in the long run it is almost everything."

- Productivity levels and growth rates differ sharply between countries and regions.
- OECD economies need structural reforms to compete with the developing world.
- Productivity trends have important investment implications, including for profits growth and bond spreads.

Global Perspective

STANDARD LIFE INVESTMENTS

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Productivity is a key issue for global investors, affecting such issues as the growth/inflation trade-off, real wage trends, equilibrium interest rates, or the relative balance between emerging and advanced economies. Government efforts to stimulate innovation and technological adoption could have significant pay-offs. Long-term investors need to consider the investment implications of changes in recent trends.

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Introduction

To quote the famous US economist Paul Krugman: “‘Productivity isn't everything, but in the long run it is almost everything”. It is understandable that governments are currently focused on cyclical issues, such as how to reduce unemployment or the exit strategies from unorthodox monetary and fiscal policies. However, global investors should look ahead to the shape of the forthcoming business cycle. Productivity trends will largely determine medium-term economic growth rates. This has considerable implications, for example the ability of countries to grow successfully out of their debt burdens, or the ability of the corporate sector to generate profits in a slow economic growth environment.

It is easy to define productivity in broad terms, such as the amount of output delivered per unit of input. Total Factor Productivity (TFP) is the most comprehensive measure, but as calculations are difficult the most common measure is labour productivity, i.e. output per worker or per hour worked. In practice, there are considerable problems with measuring productivity, say in relation to the size of the capital stock in a sector or economy, and hence revisions to historic data can be significant.

Productivity is cyclical, typically improving during the early stages of an economic recovery as growth in the labour market lags the improvement in activity. Hence, US productivity grew 6.3% in the year to Q1 2010; the fastest rate since the early 1980s. This reflected the speed with which labour was shed - unemployment rose from 5% to 10% - while nominal GDP grew 3% in the year to Q1 2010. National differences in productivity often matter less at corporate level. For example, even though unit labour costs in 2009 appeared rather poorer in Europe than the US, our analysis shows that companies in each area were equally disciplined in controlling labour costs. Global companies are usually equally subject to global issues. This helps explain the similar earnings performance of such firms despite their different domiciles.

Different countries, different levels of productivity

Cyclical changes in productivity are important drivers of company profits, helping to explain how firms are generating very strong earnings growth at this stage of the cycle. It is necessary also to look at productivity trends over the course of one or more business cycles to help make longer-term investment decisions. As demographics usually change slowly over time, i.e. net migration and births vs deaths, then an economy’s long-term potential rate of economic growth largely reflects changes in its productivity.

In recent years, productivity growth rates have differed noticeably between countries. For example, the US Conference Board has estimated that output per person employed is growing about 6% a year in the developing economies while it has decelerated to only 1% p.a. in the advanced, either side of the global average of 2.5% p.a. TFP trends have been similar.

There are several reasons for such divergence. Emerging economies, such as China, are in the process of transferring millions of workers from less productive sectors, such as agriculture, to higher value-added sectors such as manufacturing, finance and construction, significantly raising their productivity. One feature of faster-growing economies is the rapid creation but also destruction of companies, and the trend towards replacing less efficient state-owned organisations with more efficient private sector companies.

Despite much faster rates of productivity growth in emerging economies, it is important to note that their productivity levels are still comparatively low versus the level in more devloped economies. On some estimates average levels of productivity in developing economies, measured as output per worker, are only 10-30% of the levels seen in more advanced nations. Indeed, the contrast between advanced economies is not unimportant: for example, on some measures productivity levels in much of Europe are only 80% or so of US levels.

OECD economies have seen slower productivity growth rates in recent decades, even in the US, which experienced a relative productivity boom in the late 1990s before easing again in the 2000s. Some areas have suffered more than others. Hence, potential growth in the Euro-zone has steadily slowed from 2.5% p.a. in 1974-81 to 1.7% p.a. in 2002-08, largely caused by a slowdown in TFP. While there were benefits from deeper economic integration within the region, and some success with the Lisbon reform agenda, it appears much of Europe has lost comparative advantage from the surge in globalisation which interacted with still too rigid product and labour markets. Not all OECD economies have suffered in the same way, though; it is noticeable that productivity trends have been much stronger in Finland, Norway and Sweden than say, in the UK.

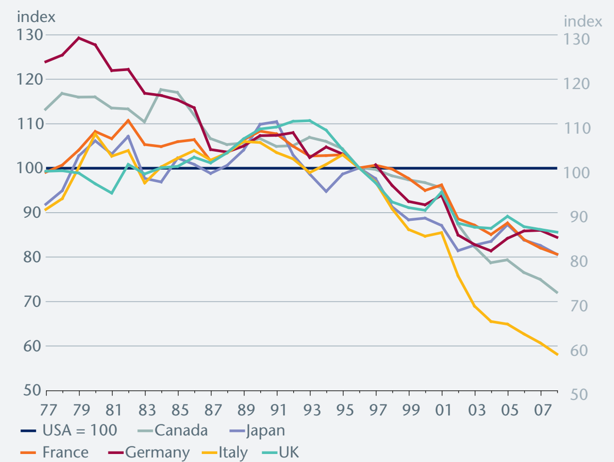
Table 1
Labour productivity growth

	USA	Japan	EU15	UK	GEM
1988-1995	1.2%	3.2%	2.2%	1.8%	5.5%
1995-2005	2.4%	2.1%	1.5%	2.2%	4.1%
2005-2009	1.5%	0.8%	0.5%	0.9%	5.9%
2009 forecast	3.0%	2.7%	2.0%	1.7%	5.1%

Annual average % change. GEM = average of Brazil, China, India, Indonesia, Mexico, Russia, Turkey from 1995, Brazil, China, India and Russia only for 1988-95. Labour productivity = growth in GDP per hour for the advanced economies, GDP per person for the developing economies, UK 1988-95 = output per head.

Sources: US Conference Board, ONS, UBS

Chart 1
Foreign productivity relative to US



Source: Bureau of Labor Statistics

Projecting productive potential

Trends can change. How might productivity develop going forwards? We suggest two different scenarios. Under a positive one, Europe and North America could profit from the export potential of Asia and Latin America, using the benefits of their considerable R&D and innovation expertise. One helpful factor is the strong balance sheets of many companies, enabling them to fund innovation and invest in new technology. At the same time, the emerging economies might see slower rates of productivity growth, as the benefits of their labour transfer and industrialisation become less marked. China, for example, is already promoting the benefits of domestic consumer spending rather than a reliance on manufactured exports. Indeed, there is a question mark about whether the infrastructure spending being seen in some emerging economies is sensible, or whether they are imitating Japan in terms of unproductive investment. Under a negative scenario, however, companies might face ever growing competitive pressures from emerging competitors. In a period of slower growth firms reduce investment and structural unemployment remains high, while governments put up restrictive policies such as trade or environmental barriers to shield their industries. Not all the pressures are on OECD economies. Populations in some Asian economies such as Korea and Singapore will age as fast in the coming 5-10 years as their counterparts in Italy or Germany. Productivity gains will need to fill the gap or sustainable economic growth rates will dip sharply.

The OECD currently forecasts that potential output growth for its members is only 1.7% p.a. from 2011-2017. Only a few countries such as Australia, Mexico and Norway are close to 3% a year, while some such as Germany and Italy are closer to 1%. Projections are uncertain at the best of times, even more so following a financial crisis. Academic research suggests that such events can have a long-lasting impact on future growth. A prime example would be the weak productivity seen in Japan, where capital was misallocated during and after the 1990s banking crisis; conversely, there appears to have been a limited long-term impact from the Nordic crisis in the 1990s. The risks include sudden shocks forcing many firms into bankruptcy, causing premature scrapping of plant and equipment. Damaged credit channels can inhibit business formation and capital spending. Hence bodies such as the IMF and OECD have emphasised the need for structural reforms such as product market de-regulation and more active labour market policies.

To raise long-term productivity trends, companies and governments need to invest in high-quality inputs, with more skilled workers, more efficient processes and more use of technological innovation. Public sector policy making could have an important influence; for example, in many countries there are sensitive fiscal decisions when tackling the debt/GDP burden, as resources are transferred from public to private sectors. Do governments focus more on the household than the corporate sector when raising taxes? Do public spending cuts unduly affect support for business, whether R&D grants and allowances or investment in research, technology and the science base? In the short term government actions can limit productivity; support for companies in financial difficulties has distorted competition by preventing the exit of less efficient producers, say in the car industry.

Investment implications

Our Focus on Change analysis suggests investors need to monitor the success of different companies and countries in raising their productivity. At a company level, one trigger would be the success of businesses in implementing structural change in order to prosper in the new environment. A key question is which companies can cut costs and raise productivity in the face of modest top-line sales growth. At a national level, the House View will assess whether the financial crisis lowers the pace at which economies can sustainably expand. This will be important in several respects, such as their ability to fund high debt/GDP ratios, to produce a better balance between growth and inflation, or the equilibrium levels of government bond yields. For example on current OECD projections, aggregating potential GDP growth and the relevant inflation target suggests government 10-year bond yields would average 3-4% in 2017 in the major economies, showing the currently expensive nature of such markets for a long term holder. At a stockmarket level, investors should look for exposure to those parts of the world where productivity trends can hold up best. For example, about two thirds of the sales exposure of European stock market indices such as the Stoxx 600 is to the slow growing Europe region. More focused indices, such as the FTSE 100 Index, the Helisinki OMX or the German MDAX have a sizeable exposure to the Asian and other emerging market economies.

Productivity is important for society. The benefits of faster productivity growth are seen in a range of areas: wages, profits and prices, or the tax base, public spending and environmental protection. As the next business cycle begins, companies and governments face difficult decisions about identifying their areas of competitive advantage and how best they can foster long-term productive growth.

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House View

The following portfolio is based upon a global investor with access to all the major asset classes.
For regional versions of the House View, please contact your Standard Life Investments representative.

Risk	The Global Investment Group has concluded that portfolios will take on moderate levels of risk, focusing on assets with high, yet sustainable yield, looking for relative value opportunities, in view of continued economic and market volatility.	
Government Bonds		
US Treasuries	Yields are supported by a backdrop of muted inflation pressures, which will limit any interest rate increases into 2011, but valuations and fiscal pressures are becoming more of a concern	MOVED TO NEUTRAL
European Bonds	Still well supported by an environment of moderate economic growth and restrained inflation, but safe have flows about European debt servicing problems have pushed some markets to expensive levels	NEUTRAL
UK Gilts	Concerns about the economy's fiscal position and sizeable gilt supply in the years ahead make us cautious, but interest rate increases remain unlikely for some time.	NEUTRAL
Japanese Bonds	Low Japanese government bond yields mean this asset class is increasingly being used as a funding source for other investments including other government bond markets.	NEUTRAL
UK Inflation-Linked Debt	There are inflation risks in the medium term from central bank quantitative easing, but valuations of inflation-proofed debt need to be examined carefully.	NEUTRAL
Corporate Bonds		
Investment Grade	Spreads over government bonds are still historically wide, although not as attractive as last year. Improving corporate cashflow supports a peak in bond default rates.	VERY HEAVY
High Yield Debt	Benefiting from an attractive carry, improving corporate cashflow and a peak in the default cycle as the global economy recovers. Investors still need to be aware of selective default risk and periodic risk aversion.	MOVED TO VERY HEAVY
Equities		
US Equities	Supported by improving corporate cashflows into 2010 on the back of strict cost control, however, the upside is limited by the consumer debt and housing market overhangs restraining domestic demand.	NEUTRAL
European Equities	Profitability is restrained by less cost-cutting than seen in the US and UK, plus the impact of tight fiscal policy on economic growth, albeit some sectors are supported by their exposure to emerging market economies.	LIGHT
Japanese Equities	Helpful exposure to the Asian and US economies offset by weak domestic dynamics and tighter fiscal policy; government action unsuccessful so far in stimulating consumer spending or ending deflation.	LIGHT
UK Equities	The market can make headway supported by valuations and the benefits of sterling's depreciation on overseas earnings, but it faces headwinds from weak real income growth and fiscal tightening.	NEUTRAL
Developed Asian Equities	Cautiously selective on Asian economies, benefiting from strong Chinese growth but wary of inflation pressures building in some countries unless central banks take firm action to dampen liquidity.	NEUTRAL
Emerging Market Equities	Some are benefiting from the upturn in commodity demand and upgrades to sovereign debt ratings, others still facing external financing problems awaiting a strong recovery in export growth.	NEUTRAL
Property		
UK & European	Selectively Heavy with a particular focus on supply-constrained office markets, e.g. London & Paris, and higher-yielding Central European logistical property.	HEAVY
North America	Significant property debt maturities present risks for US commercial property, but Canada's lower leveraged property markets should fare better.	NEUTRAL
Asia Pacific	Excessive supply in certain markets in Asia, e.g. China & Singapore, will hold back growth but higher-yielding Australian markets look more attractively priced.	LIGHT
Other Assets		
Foreign Exchange	Interest rate differentials, divergent growth prospects, political and regulatory drivers are becoming important differentiators for global capital flows.	HEAVY \$ and £ vs LIGHT € and ¥
Global Commodities	Strong demand for industrial commodities will be led by infrastructure projects in emerging economies, but oil and soft commodities will eventually see new supply come on stream.	NEUTRAL
Cash		
	Central banks in the major economies will keep monetary policy very loose into 2011 as inflation pressures remain weak due to excess capacity and high levels of unemployment.	VERY LIGHT

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