The Tug of War between Inflation and Productivity

There are two contending forces in the U.S. economy that present a "fork in the road" analogy to describe our growth outlook. One route is greater capex investment which boosts productivity; an enhancement of real output relative to costs. The other route is rampant inflation; the unfettered rise in the general price level which contributes greatly in ending our period of expansion.

A rise in productivity is necessary to extend the U.S. economy's real output without succumbing to the retrograde effects of rampant inflation. We at BigSur believe that the metrics that measure productivity understate the reality that a more tangible improvement in efficiency has taken place. We also believe that productivity can be further supported by growing business confidence, subsequent capex investments, and stimulation via government tax-cuts. Inflation fears on the other hand are overstated and fail to convincingly present rampant inflation as an approaching hurdle.

Debunking Run-Away Inflation

In considering the threat of inflation, greater deregulation and tax-cuts have sparked fears among investors. Some argue that the benefits of greater investment, fiscal stimulus, and growing demand and wages, could lead to an abrupt overheating of the economy rather than lasting growth and greater productivity. Although the U.S. economy is no longer in a "Goldilocks" state and is experiencing diminishing labor capacity, strained systems, and commodity reflation, run-away inflation is not necessarily going to arise.

Those who see inflation as a force to be reckoned with point towards the Fed's Balance Sheet tightening, the US Manufacturing ISM Prices Paid Index (shown below), and the US Manufacturing ISM Index reaching multi-year highs as evidence of a tightening environment.

The Thinking Man's Approach

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Ignacio Pakciarz | CEO
Gabriel Bendaña | Research Intern

- Soft data depicts greater consumer and business confidence rather than run-away inflation.
- To an extent, wage-inflation has been positive considering its absence as the economy grew and unemployment rates fell.
- A rise in productivity is necessary to extend the real economic business cycle. Productivity has picked-up in 2017. Metrics also most likely understate the reality of improving efficiency.
- We believe that Tax-cut benefits will likely create greater productivity, cushion margins, and extend the growth cycle.
- Evident short-term risks are present. However, we believe they do not have the disruptive capability to derail this bull market and the mature U.S. growth cycle.
- A correction in the bull market does not mean the commencement of a bear market. The signals that herald a bear market remain absent.
- Financial conditions are tightening. However, we at BigSur believe that run-away inflation will not kill this bull market and that productivity will likely extend the real U.S. growth cycle.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

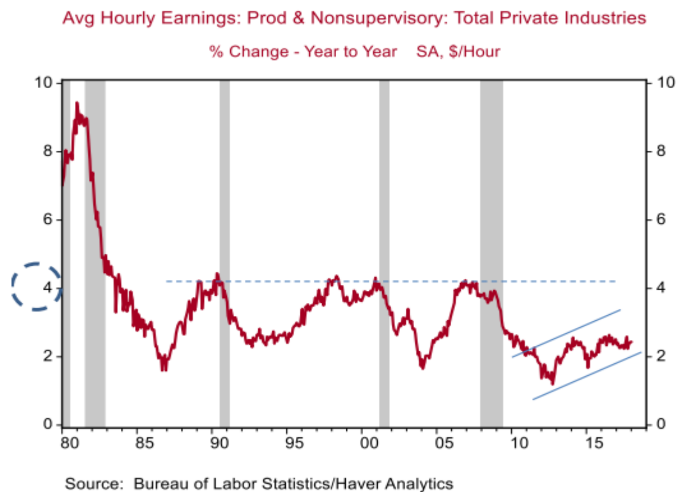
ideas@bigsurpartners.com

Moreover, Strategas' research on average hourly earnings depicts rising wages reaching new highs.

Up until recently, wage inflation remained dormant while the U.S. economy achieved one of its lowest levels of unemployment in quite some time. Rather than be a cause of concern, this development is something many have been waiting for. Understanding the positive significance of wage inflation is the first step in debunking fears that rampant inflation is around the corner.

The second step is not to be biased against contradictory data. Whereas the indices mentioned above imply rising inflation, other indices such as Core PCE Deflator Index (seen right), the National Financials Conditions Index, and the GS US Financial Conditions index are at historical lows and point to the contrary.

There are also important deflationary elements in the U.S. that contribute as counterweights towards inflationary forces. As seen in Japan, with time demographics change so as to have more elderly individuals comprise the overall population. An older population with more sedentary habits translates to waning aggregate demand and therefore stronger deflationary forces. A more concrete argument is that deflation is supported by greater globalization. As outsourcing opportunities for firms become more abundant, costs of production fall in tandem with the general price level. The greater integration of industry and access to cheap capital stems inflation globally.



From a historical perspective, during the 8 years of Janet Yellen's Fed chairmanship, the Fed consistently underperformed the 2% target. More importantly, U.S. wages typically hit 4% y/y before we see significant pressure on corporate margins. Given that U.S. average hourly earnings are still below 3%, the U.S. growth cycle's expansion may logically still have time. Although there has been some concern that even 2-3% wage growth could undermine margins, the very likely rise in productivity in 2017-18 could boost a later-cycle environment and extend expansion.

Therefore, the run-away inflation argument still has a few holes to address, namely contradictory data, failing to recognize that even some inflation, such as wage inflation, is positive, and ignoring the entry of greater productivity in the economy.

Productivity Extending the U.S. Growth Cycle

The other side to this coin is productivity outweighing the disrupting effects of inflation. A more productive economy is achieved via the optimization of technologies that lower production costs and leverage greater overall real output. Although productivity is set to grow 1.3% this year, below pre-crisis rates, it nevertheless has turned back up in 2017. Last year also saw the bullish "Trump effect" stir up animal spirits as the White House adopted an increasingly supportive pro-business environment for firms. In conjunction with recent tax-cuts, we believe that perhaps these developments may improve productivity, cushion companies' margins, and subsequently extend the U.S.'s mature growth cycle.

The aforementioned research on average hourly earnings argues that rising wages are sustainable only if there is sufficient capex investment to increase productivity. Greater investment in innovation would impede the general price level from rising to exorbitantly high levels. Such high levels would diminish real purchasing power and offset wage gains. The effects of growing productivity are perhaps witnessed in future growth projections becoming increasingly favorable, the y/y growth rate of the S&P 500's forward 1-year EPS already registering at 9.2%. Strategas expects wages to pick up in a sustainable fashion as greater business confidence boosts capex and thus improves productivity. Rampant inflation would become less likely as result.

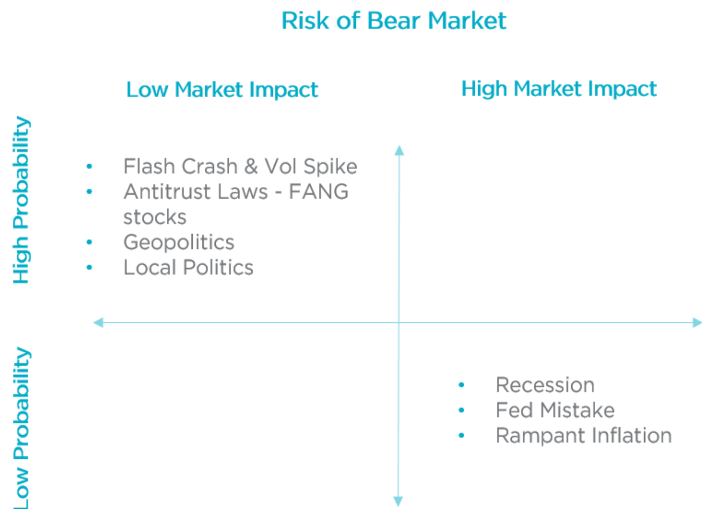
In answering the critical "what if" question on whether business confidence will translate to greater capex and thus productivity, all business indicators, from consumers, and even stronger from businesses, are showing STRONG soft data. As evidenced by manufacturers' new orders for nondefense capital goods (shown right), capex investment may very well continue rising given that relative to other cycles, cumulative capital growth has been lower and slower. Moreover, tax reform has the potential to extend the mature U.S. business cycle and likely cause a late-cycle reacceleration in PMIs.

It is also important to consider the shortcomings of measuring productivity. As explored in Goldman Sachs' 2017 Outlook report, as technologies become cheaper and more powerful, consumer surplus is created (benefits consumers derive from various activities over and above the price they pay). These benefits to the economy brought about by more powerful IT and communications systems are more difficult to factor in. For example, GDP does not account for the export of intangibles such as software and design despite their very tangible contributions to growth and value. Because the real value created by technology sectors is inaccurately measured, current productivity metrics most likely lowball the real degree of growing efficiency throughout the economy.

BSP View

From a fundamental standpoint, it is imprudent to ignore that financial conditions are indeed tightening. Despite this, inflation is not becoming a rampant and uncontrollable force that will halt our current expansion. A period of normalization is underway as the U.S. economy positions itself to confront inflationary influences from a gradual stance. Not only has the Fed announced its plans to gradually introduce 4 rate hikes this year, but it has also begun to tighten its balance sheet by diminishing the frequency at which it renews its holdings of Treasury bonds. This monetary policy would provide the Fed ample room to lower rates in a post-expansionary downturn.

We also must recognize that there are some short-term risks that merit attention. Trump's Plans to impose a 25% tariff on imported steel and a 10% tariff on imported aluminum saw stocks fall. In the long-run, the prices Americans will have to pay for a variety of products may increase, thereby possibly exacerbating inflation.



This issue could also lead to retaliation from other trading partners and undermine the U.S.'s export industry. The effects of the rising tide of populism in Europe could also heighten tensions. Geopolitics however, represent high probability events with low market impacts as they will not single-handedly halt our period of economic expansion. The same can be said for the effects of local politics, the recent resignation of the head of Economic Advisors Gary Cohn evoking a mildly disruptive windfall that the markets may likely shrug off.

Bad is Good

There is a wide difference between a late cycle stage of a bull market and a commencing bear market. The recent corrections, although daunting to some, are normal in a bull market. 5% drawdowns, more often than not, signal the continuity of the uptrend. A lead-up to a correction sees U.S. stocks outperform, credit yields tighten, and yields rise slowly. However, the rise of a bear market sees a melt-up of 20%+ in the final 12 months of a bull market, US 10-year yields rise 110bp on average, credit spreads widen, and crude oil peak. These criteria, derived from observation of past signs that heralded bear markets, are not present in the market we currently find ourselves in.

We at BigSur believe that rampant inflation arising any time soon is an exaggeration. Moreover, productivity is inaccurately measured and its real contributions in extending the U.S.'s mature growth cycle are likely understated. All the international and domestic issues mentioned above have the potential to create corrections in the markets. However, they will not deter this bull market from continuing its course. We reiterate that the U.S. economy and its markets still have legs to run and it is therefore too soon to de-risk portfolios.

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