

Q2 Productivity (Preliminary)

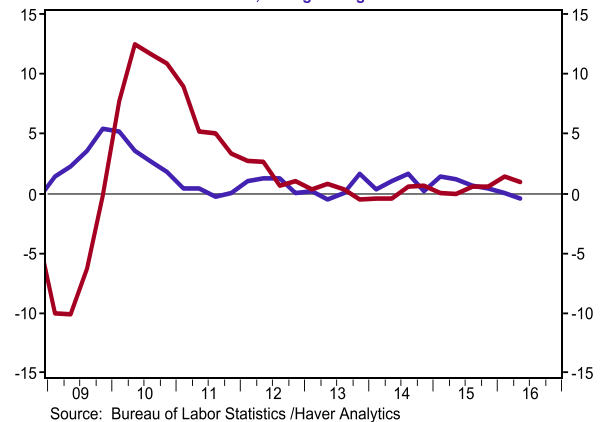
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- Nonfarm productivity (output per hour) declined at a 0.5% annual rate in the second quarter versus a consensus expected gain of 0.4%. Nonfarm productivity is down 0.4% versus last year.
- Real (inflation-adjusted) compensation per hour in the nonfarm sector declined at a 1.1% annual rate in Q2 but is up 0.6% versus last year. Unit labor costs increased at a 2.0% annual rate in Q2 and are up 2.1% versus a year ago.
- In the manufacturing sector, productivity was down at a 0.2% annual rate in Q2, better than among nonfarm businesses as a whole. The smaller drop in manufacturing productivity was due to a decline in hours. Real compensation per hour rose at a 0.4% annual rate in the manufacturing sector, while unit labor costs increased at a 3.1% rate.

Implications: According to the official data, nonfarm productivity declined at a 0.5% annual rate in Q2, the third straight quarter of declines. The good news was that output rose 1.2%, but hours climbed faster, growing 1.8%, so output *per hour* fell. The official measure of productivity is down 0.4% from a year ago. Part of the stagnation in measured productivity may be due to the retirement of Baby Boomers, who are taking some of their know-how with them. But we also suspect the government is underestimating output in the service sector, which means economic growth and productivity are higher than the official data show. There are many examples, in every area of the economy, but productivity in the service sector is particularly hard to measure. Drivers used to buy road atlases, and then GPS devices to help them navigate; now they download free apps that are more accurate and provide optimal routes through real-time traffic patterns. Travelers used to guess, hit-or-miss, where to go for a meal. Now they can use free services to tell them what restaurants are close and provide reviews. The figures from the government miss the value of these improvements, which means our standard of living is improving faster than the official reports show. Still, even on the manufacturing side, where it's easier to measure output per hour, productivity is up only 0.9% in the past year. In spite of the problems with measurement, we anticipate faster productivity growth over the next few years as new technology increases output in all areas of the economy. The key part of today's report for investors was that unit labor costs – how much companies have to pay workers per unit of output – increased at a 2% annual rate in the second quarter and are up 2.1% in the past year, signaling the kind of compensation pressure that should get the attention of the Keynesians at the Federal Reserve. That's why we still think the Fed will raise rates at least once this year, with the chances of two rate hikes exceeding the odds of none at all. In the meantime, the declining unemployment rate and faster growth in wages should create more pressure for efficiency gains, while the technological revolution continues to provide the inventions that make those gains possible. Look for productivity growth to soon accelerate out of the doldrums of the past several years.

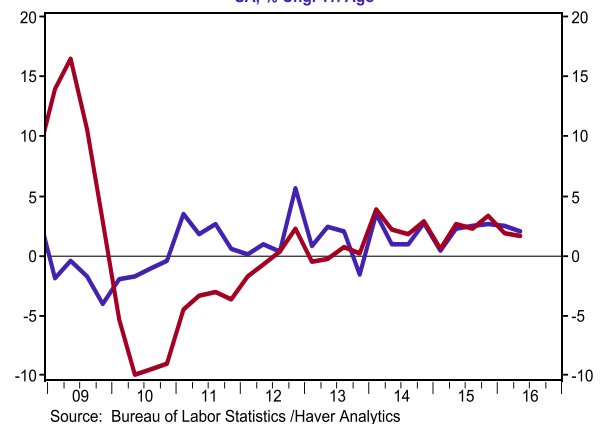
Manufacturing Sector: Real Output Per Hour
 SA, % Chg. Yr. Ago

Nonfarm Business Sector: Real Output Per Hour
 SA, % Chg. Yr. Ago



Manufacturing Sector: Unit Labor Cost
 SA, % Chg. Yr. Ago

Nonfarm Business Sector: Unit Labor Cost
 SA, % Chg. Yr. Ago



Productivity and Costs (% Change, All Data Seasonally Adjusted)	Q2-16	Q1-16	Q4-15	Q3-15	Y to Y % Ch. (Q2-16/Q2-15)	Y to Y % Ch. (Q2-15/Q2-14)
Nonfarm Productivity	-0.5	-0.6	-2.4	2.0	-0.4	1.2
- Output	1.2	0.7	0.8	1.8	1.1	3.7
- Hours	1.8	1.4	3.3	-0.2	1.5	2.5
- Compensation (Real)	-1.1	-0.4	2.3	1.5	0.6	3.5
- Unit Labor Costs	2.0	-0.2	5.7	0.8	2.1	2.3
Manufacturing Productivity	-0.2	1.5	-1.1	3.7	0.9	0.0
- Output	-0.8	0.7	-0.5	1.9	0.3	1.2
- Hours	-0.7	-0.8	0.6	-1.7	-0.6	1.2
- Compensation (Real)	0.4	-4.3	7.4	3.0	1.5	2.6
- Unit Labor Costs	3.1	-5.9	9.5	0.7	1.7	2.6

Source: US Department of Labor