If Productivity Rebound is Done, Fed is Done

The Q3 productivity data is not yet available, but we can make a good guess on what output per hour did last quarter based on the data we already have. This is important because underlying productivity is the key input into underlying trend GDP growth which is necessary for properly estimating R-star, or the natural rate of interest.

While R-star is highly uncertain and not directly observable, it is an important factor in determining the broad stance of monetary policy. Fed policymakers use it as a guidepost for action, and Chair Powell will likely be asked about R-star in tomorrow’s post-meeting press conference. If the fed funds rate is below R-star, monetary policy is accommodative. But if the funds rate is above R-star, and we believe it is well above R-star, monetary policy is restrictive.

Nevertheless, with real GDP rebounding, some investors are wondering whether the Fed needs to hike again or push out the timing of interest rate cuts. We believe this would be a mistake because underlying productivity growth is still weak. This means that trend growth is still weak, which means the natural rate of interest is still low, or at least on the lower range of economists’ estimates. We project that R-star is between 2% and 2.5%.

As we can see in the chart below, the growth in the ratio of real GDP to nonfarm payrolls is nearly identical to the growth in productivity. Our productivity-proxy grew 3.1% last quarter after declining 1.8% at an annualized rate over the previous six quarters. But it is up less than 1% over the past year. Essentially, productivity has rebounded near its post-financial crisis average of 1%, after unusually large declines associated with pandemic-related distortions. But the productivity rebound may have run its course.

Current quarter real GDP growth is projected to slow markedly while job gains persist. This means that productivity should weaken noticeably, thus capping further year-over-year gains. Going forward, if trend economic growth remains in line with its 2010 to 2019 rate, then today’s 5.5% fed funds rate is plenty restrictive. We hope monetary policymakers take note.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko. It does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals, and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents, other research materials, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.

© 2023 SMBC Group. All rights reserved.