MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Are We Destined for Stagnation?

Over the span of decades, growing stock markets need growing economies. But what explains economic growth in the first place? Widely accepted classical economic thought suggests it is the combination of growing labor inputs and rising productivity. Output can increase either by existing workers producing more (higher productivity), or by adding more workers. If labor inputs grow by 1%, and productivity grows by 1%, then economic output should grow by 2%, roughly speaking.

Labor force growth is influenced by population growth, changes in the makeup of the population (i.e., the share that is of working age), and by the participation rate (the share of the population that chooses to work). Longer term, the first item is the most important, the most predictable, and the most glum. Across major economies worldwide, fertility rates (births in relation to the number of women of childbearing age) have been below "replacement" levels and declining for years. Although it takes decades for this to play itself out in declining populations, it is inevitable. US fertility rates have tumbled in the last decade and reached a record low last year. The phenomenon is especially visible in Japan, whose population has already been declining since 2011, in eastern and southern Europe, and even in China, whose population is guaranteed to begin declining by the early 2030s as the lagged effect of their one-child policy kicks in.

Because its fertility rate held up better than most, the US population will continue to grow over the next 40-50 years, but at ever-declining rates – the Census Bureau estimates it may be growing by just 0.4% annually by mid-century. Only countries in the Middle East and Africa are growing their populations sustainably.

Focusing on the US: how do we grow our economy with a diminished tailwind from a growing population? First, the US has been accepting of immigrants, and this will likely continue. In this respect, our future is much brighter than that of China or Japan, where immigration is nearly nonexistent. Of course, economists will be watching for populist pushback against legal immigration, already a prominent feature of the political scene in western Europe. Second, workers likely will remain in the labor force for longer, pushing up the participation rate – possibly as much out of need for income as out of opportunity. Third, the drive for private sector productivity improvement will remain relentless, and here is where there is an offsetting potential source of optimism.

Productivity growth has the potential to be the magic elixir that keeps the US economy humming. Economist Paul Krugman has noted that "productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker." And while there is no strong consensus among economists about what causes high or low productivity, most believe that investment – in tangible assets (including technology), in research and development, in public infrastructure, and in human capital (especially education and training) – drives subsequent productivity improvements (albeit with an inconsistent lag). In this respect, an economy can "control its own destiny" even without help from population growth, and investment spending as a share of GDP (including R&D) in the US has grown steadily since the financial crisis. Although it will take years to "see it in the data", productivity measures have indeed begun to rise in the last three years, after declining steadily from a 2002 peak.

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So, will growth disappoint? It depends on one's expectations, but it is fair to say that long term GDP growth rates around the world are gradually slowing, including in the US. But slower is not negative, and a growing economy can still produce growing earnings and dividends. In a context of very low inflation, the stock market still offers wealth-building and wealth-sustaining return potential over time.

But it is important to reiterate that volatility is what one must accept to earn whatever returns the market has to offer, and the last 18 months' experience may be indicative of what we can expect. Since March 31, 2018, the S&P 500 Index total return was 16.2%, a reasonably good rate of return given the elevated levels from which this advance began, and the meager rates of return offered by low-risk fixed income investments over that same time period. But at any given point in time, an investor in the S&P 500 might have asked "how have I done lately" and it would have been a tossup between "doing well" and "not doing that well":

6-Month Period Ending	S&P 500 Total Return
3/31/2018	5.7%
6/30/2018	2.5%
9/30/2018	11.5%
12/31/2018	-6.9%
3/31/2019	-1.8%
6/30/2019	18.3%
9/30/2019	6.1%

In short, an environment where investors simultaneously experience good overall returns ***and*** frustration may be the "new normal". We may hope that this is not the case, but it is better to be prepared that it might be.

Sources: Pew Research; CNN; Bloomberg; US Census Bureau; Federal Reserve Bank of St. Louis; Paul Krugman, The Age of Diminishing Expectations