BUSINESS RESTRUCTURING AND A JOBLESS RECOVERY

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Summary and Major Conclusions:

The US economy appears to be on track for a jobless recovery, wherein growth in employment lags growth in GDP. The corollary is that a disproportionate share of GDP growth will be derived from growth in labor productivity, as opposed to growth in hours worked. This conclusion is consistent with the outlook for massive business investment in digitization and automation. This combination of developments would be favorable for corporate earnings. In a broad economic context, the percentage share of gross national income earned by the business sector should increase while the share earned by labor should decrease.

- The central theme of this analysis is that trends in company earnings can be best understood as a persistent struggle between labor and capital. Corporate profitability is maximized during periods of weak labor markets, when businesses earn a growing percentage share of the national income pie at the expense of labor.

- Economic conditions over the next several years are likely to favor capital over labor, as net job creation trails GDP and the number of unemployed workers remains in recession territory. The implication is that company earnings could surprise investors on the upside in 2021 and 2022.

- There are two broad economic forces at work, affecting wages and selling prices. First, unemployment is likely to remain high over the next several years. Second, record business failures could accelerate the process of industry consolidation, enabling the largest companies in each industry to exercise greater pricing power.

- The coronavirus pandemic has triggered a massive wave of restructurings among business firms aimed at maximizing labor productivity. With widespread utilization of digital technologies, companies are automating their operations, resulting in faster growth in output and sales with fewer workers.

- A combination of slow growth in labor compensation and rising productivity should exert downward pressure on unit labor costs. A rough economic proxy for company profit margins is the statistical relationship between selling prices and unit labor costs.

- Unit labor costs (ULC) are defined as the total cost of labor to produce one unit of output. ULC are calculated using total compensation of workers adjusted lower for productivity growth.

- My forecast for the next several years assumes a 3% rise in worker compensation and a 2% growth rate in productivity. If so, this combination of trends would yield growth in ULC of only 1.0% annually. A rise in unit selling prices in excess of 2% should contribute to a widening in company profit margins.

- The business sector is undergoing a transformation unlike anything seen in decades. The most significant changes will likely take place in the areas of staffing, workplace management, and technology and will likely result in radical changes in the relationship between management and workers.

- Management consulting firm Mckinsey & Company commissioned a survey of business executives from 800 companies across eight countries in order to gain more insight into how firms are responding to the crisis.

- The survey revealed that business firms are rapidly seizing the opportunity to transform their operations by taking advantage of revolutionary technologies in an effort to become more nimble, efficient, productive, flexible, and competitive in their industries.

- In response to the emergence of remote work, 85% of companies have adopted digital technologies to achieve greater interaction and connectivity among employees. Approximately 50% of companies have enhanced digitization of customer channels with the use of e-commerce and mobile applications.

- In addition to digitization, companies have accelerated their implementation of automation technologies, including robotics, autonomous vehicles, and artificial intelligence. These initiatives have been adopted in all industries surveyed, but companies in the financial services and technology sectors have been at the forefront.

- Equity market trends are determined by the level and direction of company earnings, with employment playing only a minor role. The equity market is indifferent to high unemployment, and responds directly to investor expectations regarding the future trend in company earnings.

- The US economy appears to be on track for a *jobless recovery*, which implies that net hiring will lag growth in GDP. The implication is that a disproportionate share of GDP growth will be derived from growth in labor productivity, which is consistent with rising business profits.

- In principle, accelerating growth in labor productivity is predicated upon rising business investment, most importantly in the areas of digitization, robotics, and other forms of automation. There is a strong correlation between labor productivity and company profitability.

- My forecast assumes that company earnings will increase by 20% in both 2021 and 2022. A combination of low bond yields and strong profit growth implies positive stock market returns during the next two calendar years.

- However, equity investors should exercise caution in the short term. Stock prices remain vulnerable in coming weeks and months because of apparent market complacency regarding imminent economic, political, and public health risks. The risk/reward equation at current equity market valuations appears unfavorable.

"COVID-19 has dramatically changed the way many jobs are performed, and employers are now planning how best to extract benefits from those changes as they prepare for business after the pandemic subsides. Greater digitization and automation, more demand for independent contractors, and increased reliance on remote work have the potential to deliver better productivity, lower costs, and enhanced resilience."

The Post-Pandemic Workforce
McKinsey & Company
September 23, 2020

The COVID-19 pandemic has resulted in unprecedented disruptions to the world economy, most notably in the significantly altered behavior of consumers and businesses. This week's *Economic Perspective* focuses on the seismic changes underway within the business sector and labor market, with a special emphasis on the relationship between workers and employers and the implications for corporate profitability.

LABOR MARKET CONDITIONS

The labor market has been the segment of the economy most profoundly impacted by the pandemic. The COVID-19 pandemic has thrown millions of individuals out of work, implying a sluggish recovery in net job growth. Moreover, the future composition of workers is likely to differ radically from the makeup that existed prior to the pandemic. An in-depth analysis of the labor market reveals the following notable trends:

- The strong recovery in employment in the spring and early summer has stalled. Both the unemployment rate (7.9%) and initial jobless claims (835,000) remain squarely in recession territory.

- A large segment of the workforce has been disrupted by the pandemic. Nearly one-third of workers have either lost their jobs, had their hours reduced, or experienced a reduction in their salaries.

- There are numerous crosscurrents with respect to hiring and layoffs. The persistently high level of initial claims means that businesses continue to *lay off workers* at a rapid pace. Conversely, the decline in continuing unemployment claims suggests that reopening businesses continue to rehire *furloughed workers*.

- Monthly employment data reveal a sharp slowdown in net job creation, implying very weak employment conditions for *permanent workers*. Permanent job losses are rising at a faster pace than during the Great Recession.

- *Service sector employment* has massively lagged the recoveries in the manufacturing and construction sectors. Because service workers comprise the vast majority of the total workforce — fully 85% — a healthy recovery in employment is not possible without more aggressive hiring in the service sector.

The bottom line is that the labor market remains weak and has recovered only half of its losses from earlier in the year. Wage growth slowed from 3.5% in 2019 to only 2.0% in the second quarter. There are three macroeconomic implications of a weak labor market:

- Businesses have solidified *bargaining power* versus labor and should be able to increase profit margins through tight control of labor expenses.

- The cyclical rebound in *consumer spending* is likely to lag the pace experienced in typical economic recoveries in the past.

- Any future rise in *consumer inflation* is unlikely to be triggered by an acceleration in wage inflation.

BUSINESS TRANSFORMATION

The business sector is undergoing a transformation unlike anything witnessed in many decades. The coronavirus pandemic has disrupted normal business operations and planning to the point where massive reforms have become necessary. The most significant changes are taking place in the areas of staffing and workplace management, thereby bringing about radical changes in the relationship between management and workers.

McKinsey Survey: Last month, management consulting firm Mckinsey & Company commissioned a survey of business executives from 800 companies across eight countries to gain more insight into how firms are responding to the crisis. Companies surveyed range in size from sales of $1 billion to over $10 billion. The main findings of the survey are as follows:

- In response to a sharp increase in remote work, 85% of companies have adopted digital technologies to achieve greater interaction and connectivity among employees.

- Approximately 50% of companies have implemented enhanced digitization of customer channels with the use of e-commerce and mobile applications.

- Nearly 35% have improved their management of supply chains by linking their suppliers with digital platforms.

- In addition to digitization, companies have accelerated their implementation of automation technologies, including robotics, autonomous vehicles, and artificial intelligence (AI).

- These initiatives have been adopted across all industries surveyed, but companies in the financial services and technology sectors have been at the forefront.

- The pandemic accelerated the ongoing trend toward outsourcing. In an endeavor to make labor a variable cost, 70% of executives surveyed expect to use more temporary workers and independent contractors on-site.

- The need for enhanced workplace safety, sanitation, data security, and efficiency will result in business demand for a new class of workers in the areas of health and hygiene, cybersecurity, and facilities management.

The bottom line is that business firms are rapidly seizing the opportunity to transform their operations to take advantage of revolutionary technologies in an effort to become more nimble, efficient, productive, flexible, and competitive in their industries.

CORPORATE PROFITABILITY

There are a number of reasons to be optimistic regarding the outlook for corporate earnings, and these fall into two broad categories: (1) The proven tendency for company earnings to increase at the fastest rate during the early years of an economic recovery; and (2) The observation that the coronavirus pandemic has sparked numerous significant structural changes pertaining to the labor market and business organization. As discussed in previous sections of this report, these structural changes should support higher levels of profitability in future years.

Classic Business Cycle: In principle, the first several years of a business cycle comprise the most dynamic phase of an economic expansion cycle. GDP growth typically exceeds that of the middle and later phases of an expansion, and corporate profit margins expand at the fastest rate, boosted by ***operating leverage***. My forecast assumes that 2021 and 2022 will be the years of fastest profit growth in the next expansion cycle.

Business Transformation: Corporate profit models used by most economists are based upon year-over-year growth in nominal (current-dollar) GDP. This model is predicated upon three primary assumptions:

- Stability in the composition of GDP
- Symmetrical growth in employment and GDP
- Equivalent growth in selling prices and unit labor costs

My assumption is that these three relationships are not static and are likely to shift over the next two years. First, I expect above-average growth in GDP to be derived from durable goods manufacturing and investment in business equipment, rather than services — a favorable shift in output mix for company profit margins. Second, I expect growth in employment to lag that of GDP, which should also benefit profit margins. Finally, as discussed previously, average selling prices are likely to rise at a faster pace relative to unit labor costs, also positive for margins.

INVESTMENT IMPLICATIONS

A combination of a weak labor market and a large-scale restructuring of US corporations has significant implications for the equity market. Common stock values are determined by the level and direction of company earnings, while employment is of only minor relevance. In principle, if a rising trend in corporate earnings comes about because of labor market weakness — and an opportunity for businesses to reduce labor costs — the equity market will respond positively. Stated differently, the equity market is indifferent to high unemployment, and responds directly to the trend in company earnings.

The US economy appears to be on track for a jobless recovery, defined as an economic recovery in which growth in employment lags growth in GDP. The corollary is that a disproportionate share of GDP growth in coming years will be derived from growth in labor productivity, as opposed to growth in hours worked. This conclusion is consistent with the outlook for massive business investment in digitization and automation, including robotics, autonomous vehicles, and artificial intelligence. It is also consistent with business caution in adding to payrolls.

In a broad macroeconomic context, the percentage share of gross national income earned by the business sector should increase, while the share earned by labor should decrease. My forecast assumes that company earnings will increase by 20% in both 2021 and 2022, while annual wage growth could remain below 3%. A combination of solid earnings growth and historically depressed bond yields implies positive stock market returns over the next two years.

However, stock prices remain vulnerable in the short term because of apparent market complacency regarding imminent economic, political, and public health risks. The economic recovery has stalled in recent months, while the risk of a second wave of the pandemic remains elevated. Notwithstanding the prospects for solid profit growth in 2021 and 2022, the S&P 500 appears overvalued. The risk/reward equation appears unfavorable in the short term: Long-term investors should maintain an overweight position in common stocks versus bonds and cash, but should await a more attractive entry point to augment current stock holdings.

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S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.