

## Fidelity Institutional Insights

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# A Strategic Allocator's Guide to Productivity and Profits

How a new regime with shifting trends and sometimes unexpected motives could influence productivity and fundamentally reshape the investment-decision process.



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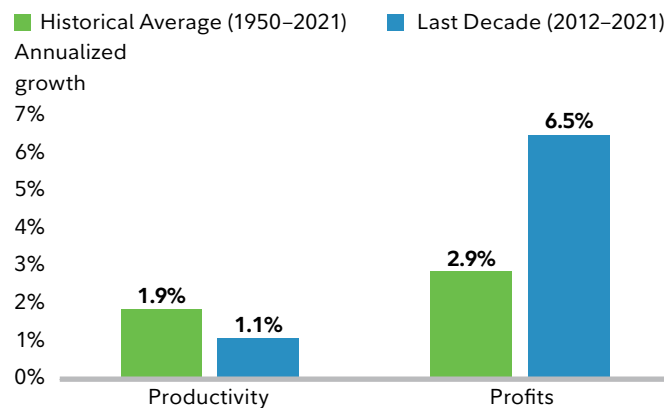
The U.S. experienced some of the fastest earnings-per-share growth in the post-war era over the past decade, but it did so amid the slowest productivity gains in modern history.

Today, we have transitioned to a more volatile world in which persistent inflation uncertainty will likely make some key investment drivers of the prior regime—such as financial repression and increasing leverage—less effective.

In this new world, the backdrop for global asset performance is likely to reattach to core fundamentals, such as productivity gains. Understanding the drivers of productivity—and their links to profits and asset-class returns—could hold the key to successful strategic asset allocation.

### Exhibit 1: Productivity growth diverged from profit growth.

Real Productivity Growth vs. Real Profit Growth



Productivity is real GDP per hour. Profits are real S&P 500 earnings per share. Chart compiled using annual data. Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Haver Analytics, Fidelity Investments (AART) as of 12/31/21.

## Opportunities

- **Greater investment spending in many developed and some emerging markets:** An upturn in public and private capital expenditures could potentially boost productivity and create an environment for winning companies to generate sustained profit growth. Potential winners include “non-aligned” emerging and frontier markets that can create a favorable investment environment; the U.S. amid its reshoring efforts and ample resources across multiple dimensions; and Europe, where a more cohesive trajectory may provide greater policy support for investments in areas such as energy security.
- **Innovation and shifting market leadership amid decarbonization efforts:** Climate mitigation and the transition to cleaner energy represents a technological transformation and may be a secular positive for both productivity and profits. Like prior transformations, there may be longer-term, underappreciated economic gains and an array of beneficiaries beyond industries at the center of the transition.
- **Global exposures to benefit from lower correlations:** If rising regionalization and self-sufficiency reduce the dominance of global cycles or trends, there may be greater opportunities to diversify portfolios according to geography.
- **Greater active opportunities and thematic portfolios:** A different backdrop for inflation, geopolitics, and monetary policy implies a broader range of winners and losers across multiple asset categories. Allocations could be tilted toward or away from exposures to big themes such as climate or globalization, and we suspect identifying industries and companies that may benefit from increased capital expenditures (capex) may be a good place to start.

## Challenges

- **Extrinsic X-factors present risks to corporations:** If these X-factors manifest as overly intrusive and significantly impair market-oriented mechanisms, expectations for profit growth may suffer. Geopolitical and domestic political risks are generally higher for many countries than during recent decades, implying a clear political framework is a necessity for asset allocators.
- **Rising temperatures will continue causing disruptions:** Damage from more frequent extreme weather patterns could be a regular feature of the economic backdrop for many countries and regions.
- **Inflation may be higher and more volatile:** Shifts in the supply side of the global economy may make it difficult for central banks to restore an era of low, stable inflation rates. The upside for asset valuations may be lower compared with the prior decade’s near-record highs.
- **Asset price volatility will likely be higher:** The many potential shifts listed above imply that uncertainty about many key trends will remain high and shifting investor expectations may generate more sustained asset-price fluctuations.

## Productivity and Profits: Trends and Drivers

### **Productivity is fundamental to the long-term economic and investment outlook.**

- Productivity is the main driver of economic growth and higher living standards, and it's also a key source of profit opportunities.
- Multifactor productivity is associated with technological advancements and efficiency improvements. It's the core driver of long-term growth and is not subject to diminishing returns.

### **Productivity slowed everywhere and still faces some structural headwinds.**

- Over the past decade, productivity growth exhibited a slowing secular trend around the world.
- A decrease in investment activity occurred as both public investment and private capex declined to levels not seen in post-war history.
- Our model-based, baseline expectation is for long-term productivity rates to remain subdued across most major economies relative to their long-term histories.

## Understanding the Divergence between Productivity and Profits

### **Productivity decoupled from profits over the past decade, but the structural trends that drove the divergence have peaked.**

- Annualized real profit growth averaged 6.5% from 2012 to 2021—or more than 5 times the growth in domestic productivity—versus about 1.5 times historically.
- The high profit-low productivity divergence can likely be attributed to falling business costs related to three trends: the unprecedented level of global integration, a sustained period of financial repression by the world's leading central banks, and high levels of industry concentration.
- Corporations enjoyed tremendous profitability due largely to the reduction in costs and financial engineering, despite falling rates of capex and productivity.
- We believe that the confluence of factors that drove surging profits to decouple from flagging productivity to such a large degree is unlikely to persist because the key drivers are either peaking or already in retreat.
- To break out of the slowing productivity trend, new technological advances and efficiency improvements are needed, which could lead to increased capital spending.

## Extrinsic X-Factors

### **Evolving considerations are increasingly affecting the behavior of corporations and policymakers.**

- The focus on greater global integration and hyper-efficiency is giving way to a greater domestic focus and the rising influence of X-factor considerations, such as geopolitics and climate.
- We suspect that, in some areas, extrinsic X-factors, including climate-related risks and geopolitics, will serve as important catalysts for new investments.

### **The costs of physical damage and the efforts to mitigate climate effects represent both potential opportunities and threats to economies and businesses.**

- Mitigation and decarbonization efforts may be a secular positive for both productivity and profits because they represent a technological transformation.
- Geographic locations facing the greatest risks have high physical and economic exposure and limited adaptation/mitigation capacity, while the biggest opportunities are in innovative countries with supportive regulatory backdrops and favorable business environments.

### **Geopolitics: Peak globalization and the less stable, multipolar world order may pressure profit margins, influence corporate incentives, and animate new beneficiaries.**

- Reshoring, onshoring, and near-shoring (regionalization) efforts have the potential to catalyze greater investments, particularly among developed economies.
- The biggest relative winners are likely the countries and industries that are less exposed to great-power rivalries, in addition to those with the economic and political systems that are best able to adapt without becoming overly interventionist.
- An inherently less stable geopolitical backdrop implies possible downward pressure on profit margins, upward pressure on inflation, and lower correlations among global assets.

## Outlook and Conclusions for Allocators

- We believe public investment and capex have the potential to rise from depressed levels, representing upside for productivity growth.
- Fading profit tailwinds from globalization, market concentration, and financial repression imply a slowing from the above-average pace of profit growth, with a potential rise in productivity growth to help offset that dynamic.
- Allocators face a different set of opportunities and risks than in past decades, which could require more nuanced diversification and nimbler investment strategies.

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*Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this report.*

To learn more about how your asset allocation strategy might be influenced by productivity and profits in the new regime, please contact your Fidelity representative or visit [i.fidelity.com/productivityandprofits](https://i.fidelity.com/productivityandprofits).



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