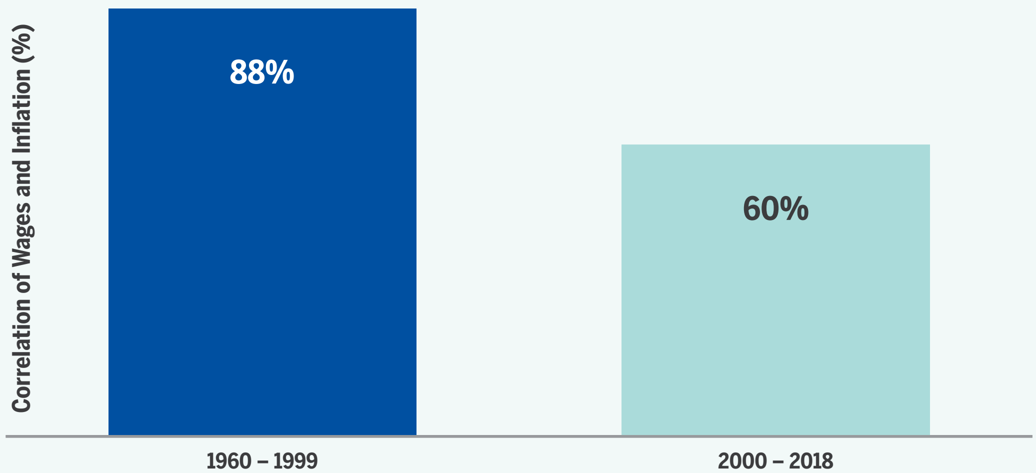
What Economists Are Missing

Economists and market pundits have clear beliefs regarding how the economy works. In the view of many, growth peaks when the economy is fully utilizing resources. For example, historically labor force employment increases lead to wage growth, resulting in higher inflation and ultimately higher interest rates. This leads to a slowing economy, and the cycle begins anew. Interestingly, today's U.S. economy is not working in this fashion.

Wages No Longer Driving Inflation to Same Extent



Source: Alger analysis, U.S. Bureau of Economic Statistics and U.S. Bureau of Labor Statistics. Wages are year-over-year change in unit labor costs and inflation is year-over-year change in PCE price deflator ex-food and energy.

- In the past companies were able to pass on higher wages in the form of increased prices, creating a strong correlation between wages and inflation. In recent years, however, that correlation has materially declined and now the economy is able to operate with low unemployment and low inflation. What is driving this change?
- While traditional economists are mystified, it seems that the answer may lie in the rapidly changing technological landscape in the U.S. First, increased pricing transparency due to wide availability of inventory online is weighing on prices. Second, new business models that eliminate the middleman are reducing costs and lowering prices. Third, increased automation is making prices less dependent on wages.
- The downward price pressure from technology may cause lower U.S. Inflation than traditional economic models would imply. Structurally lower inflation would in turn support equity valuations and potentially extend economic expansions due to subdued interest rates.

Inspired by Change, Driven by Growth.

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