



# Weekly Market Commentary



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## New Ideas Are Not Just for Europe

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#### Highlights

The weaker pace of productivity in recent years could mean slower profit growth ahead for S&P 500 companies.

Fortunately, business spending on research and development (R&D) has improved, and patent grants are now on the rise. It typically takes about three years for patent grants to result in improved productivity for businesses.

We believe that productivity and innovation are due for a comeback, helping to support profit growth.

Developing new solutions to battle the debt problems in Europe has been important to making substantive progress toward a long-term solution. Last week's European summit produced progress in the form of a landmark agreement to strengthen budget rules. While the accord addresses the long-term problems facing Europe, the spending cuts are likely to slow growth and produce a mild European recession in 2012. The breakthrough finally opens the door for the European Central Bank (ECB) to intensify its efforts to stimulate growth and stabilize the debt markets beyond last week's rate cut.

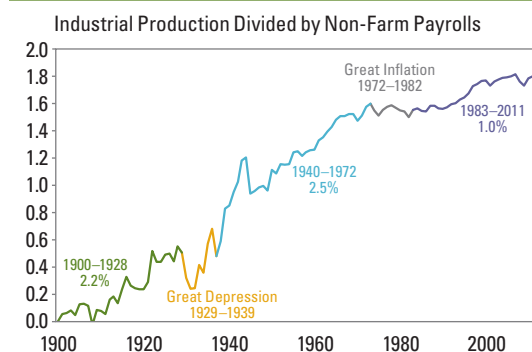
While the headlines on Europe continue to garner nearly all of the market's attention, it is worth noting the changes in the trend of innovation since developing new solutions to drive productivity will be important to generating profits in the years ahead for the benefit of investors.

Developing new products and finding new, more productive ways to employ resources to create them is critical to sustaining the growth of a business. The ingredients for innovation are often in the form of patents, copyrights, and licenses to support economic interest in developing new technologies and processes. Competition intensifies companies' push for cost-saving productivity enhancements through implementation of new technologies and processes.

Post-World War II economic growth has averaged 3.2% on a real (net of inflation) basis annually. Most of this growth has come from increasing productivity rather than using more resources. Productivity growth, measured by industrial production per worker, has averaged 2.2% over the past 100 years. The only notable pauses in this trend were the result of the Great Depression and the inflation spiral of the 1970s, in the latter case, rapidly rising prices masked the benefits of improving efficiency.

New successful consumer products, such as smart phones and internet search engines, are often what come to mind when we think about innovation. It is the broad implementation of new technologies by businesses that accounts for many of the recent advances in productivity. A key component of rising productivity in the 1980s and 1990s was the implementation of just-in-time inventory management systems. The advent of radio frequency identification (RFID) tags allowed the trend to extend further. Putting RFID tags on products enables many types of companies to manage their inventory more efficiently through real-time integration with suppliers. Advanced asset tracking enhances operational efficiency.

#### 1 Long-Term Productivity Trend Rates



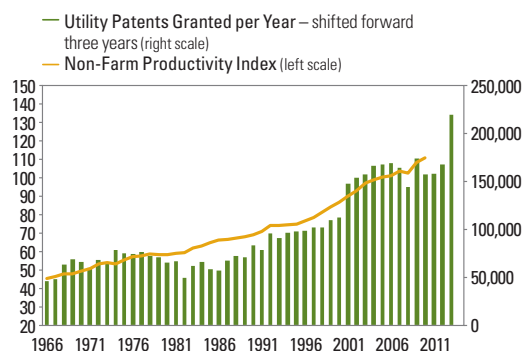
Source: LPL Financial, Factset Data Systems, Bloomberg 12/09/11



Supply chains can be optimized, thereby reducing the risk of input shortages without holding excess (and potentially perishable or obsolescent) critical supplies. This is especially valuable for health-care and manufacturing companies. For retailers there are additional benefits, such as the potential to eliminate the traditional checkout areas, reduced customer wait times, and improved theft detection. This is just one of the new technologies that help to drive productivity.

Productivity is critical to sustaining growth in profits. Over the long-term, S&P 500 company profits have risen by about 7% per year, on average. This rate also happens to be our forecast for profit growth in 2012 (for more details on earnings growth and other aspects of what we envision for 2012 see the *2012 Outlook* publication). However, during the past decade, there has been a slowdown in productivity to less than half the historical trend rate. Weaker productivity could mean slower profit growth for S&P 500 companies in the years ahead. The reasons for declining productivity include: the slower pace of business spending, lower tolerance for risk-taking in corporate America, and the stall in patent grants.

## 2 Patents Tend to Lead Productivity by Three Years



Source: LPL Financial, U.S. Patent and Trademark Office, Bloomberg 12/09/11

One way to measure the potential pace of productivity and innovation in the coming years is to look at spending on research and development (R&D) and the growth in patent grants. Growth in spending in these areas tends to support ongoing productivity growth. After surging in the late 1990s amid the technology boom, business R&D spending as a percentage of gross domestic product (GDP) peaked in 2000. Patent grants soon began to fade and business productivity slumped starting in late 2004.

Fortunately, spending has since improved and patent grants are now on the rise. It typically takes about three years for patent grants to result in improved productivity for businesses [Chart 2].

During the next 10 years, innovative business operations are essential for creating investor wealth. We believe productivity both in and outside the United States will rise in the coming years. Keeping up with the pace of change will be a challenge facing individual companies. The period of competitive advantage offered by a better mousetrap is shrinking. Faster development of products and services means companies must constantly innovate to stay on top. For instance, automobiles go from the design stage to production and the showroom floor in much less time than they did 10 years ago. Companies—and countries—must adapt or face extinction.

Technology and communications have made it cheaper and easier than ever before for someone with an idea to disseminate and develop it. Access to credit was severely curtailed during and after the financial crisis of 2008–09; however, credit and capital to finance new ideas have now become more abundant. And, while funding for the patent office had been in doubt as part of reducing overall spending, a November 2011 compromise secured funding through the end of the 2012 fiscal year. We believe that productivity and innovation are due for a comeback in the years ahead.



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