ECONOMIC OUTLOOK
REGIONS
June 2021

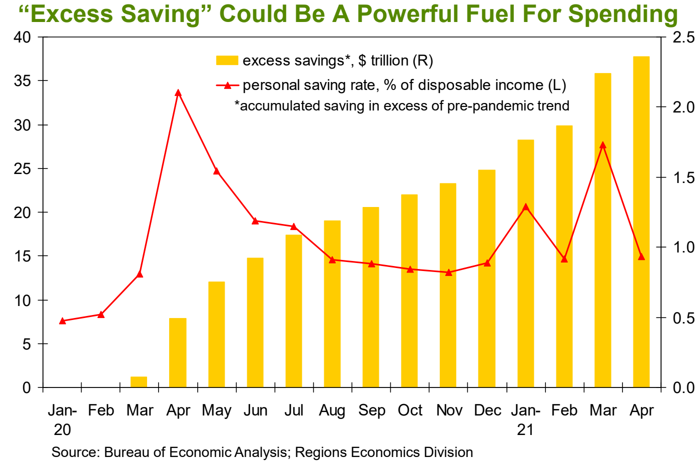
Services Spending Ready To Launch?

As of April, the level of total consumer spending was 4.6 percent above the pre-pandemic peak. That total, however, masks some stark differences amongst the individual components of consumer spending. For instance, spending on consumer durable goods (such as motor vehicles, appliances, furniture) was 33.8 percent above the pre-pandemic peak, while spending on nondurable consumer goods (such as clothing, groceries, gasoline) was 10.8 percent above the pre-pandemic peak. In contrast, consumer spending on services (such as travel, dining out, entertainment, recreation) was 1.9 percent below the pre-pandemic peak, which largely reflects the extent to which the services sector has been impacted by limitations on economic activity and changes in consumer behavior over the course of the pandemic. But, with increasing numbers of Americans being vaccinated, remaining restrictions on activity being lifted, and a sizable pool of "excess saving" in household accounts, expectations are that coming months will see a significant burst in services spending.

That burst in services spending is a key component of what many, us included, expect to be a continuation of the robust real GDP growth seen in Q1 (annualized growth of 6.4 percent) through the end of 2021 and possibly into Q1 2022. Based on the April data, however, the "burst" in services spending got off to a somewhat uninspiring start. Total consumer spending on services increased by 1.1 percent in April, considerably smaller than the 2.1 percent increase in March. Moreover, almost one-half of April's increase is a function of higher prices for services, as real (i.e., inflation adjusted) spending on services rose by 0.6 percent. While coming months will surely see further growth in consumer spending on services, how strong that growth will be and how long it will persist are very much open questions.

The answers to these questions will have meaningful implications for top-line real GDP growth, which simply reflects the GDP math. Services account for roughly two-thirds of all consumer spending as measured in the GDP data, and consumer spending in turn accounts for just over two-thirds of GDP. Clearly, a resurgence in consumer spending on services would provide a powerful boost to top-line real GDP growth and, just as clearly, the ingredients for a significant increase in services spending are in place. Again, though, what is less clear is the extent to which services spending will increase in the months ahead, and whether any such increase will come in the form of a brief but powerful burst or a more gradual and sustained increase.

One key ingredient is the magnitude of "excess saving" in the household sector, a topic we first discussed in our March *Outlook*. By "excess saving," we simply mean the level of household saving in excess of what that level would be had pre-pandemic trends prevailed over the past fourteen months. As of April, our estimate puts the level of excess saving at just over \$2.4 trillion, and while the personal saving rate fell from 27.7 percent in March to 14.9 percent in April, that nonetheless leaves it well above the pre-pandemic trend rate of around 7.5 percent.



One of the main sources of this excess saving is the magnitude of the Economic Impact Payments (EIP) which were the foundation of the fiscal policy response to the pandemic and the efforts to stem its spread. The three EIP distributions are evident in the spikes in the personal saving rate seen in the above chart in April 2020, January 2021, and March 2021. As seen in the chart, each spike in the saving rate reversed in the subsequent month, but the addition to the pool of excess saving remained. Another main source of excess saving is what can be thought of as "involuntary saving," in the sense that what would have been normal spending on services did not take place over the course of the pandemic due to restrictions on economic activity and/or changes in consumer behavior. To be sure, some of this spending was diverted to spending on goods, but some of it likely made its way into household saving, with some used to pay down debt or invested (however loosely we may need to use that term).

As noted above, consumer spending on goods is far above pre-pandemic levels, while spending on services has yet to recapture the pre-pandemic peak. With more and more people vaccinated and fewer and fewer remaining restrictions on activity, it follows that there is more room for growth in spending on services in the months ahead. One question is whether, or to what extent, consumers will pull back on spending on goods to facilitate any greater spending on services. A glance at the above chart showing the level of excess saving in the household sector may seem to suggest it isn't an either/or choice, and to some extent that is true,

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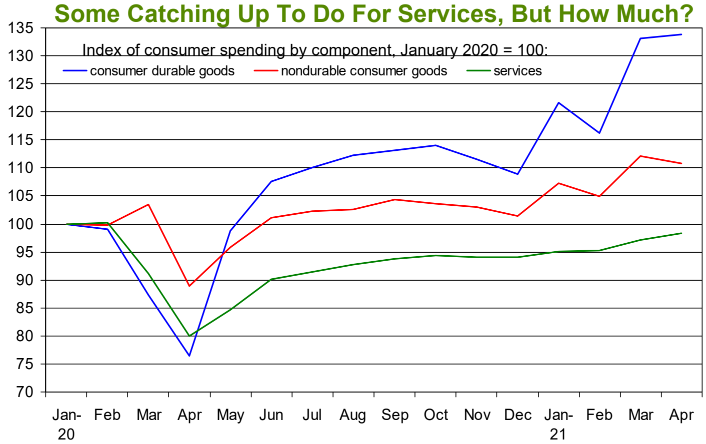
but there are other reasons to think spending on goods may drift lower in the months ahead.

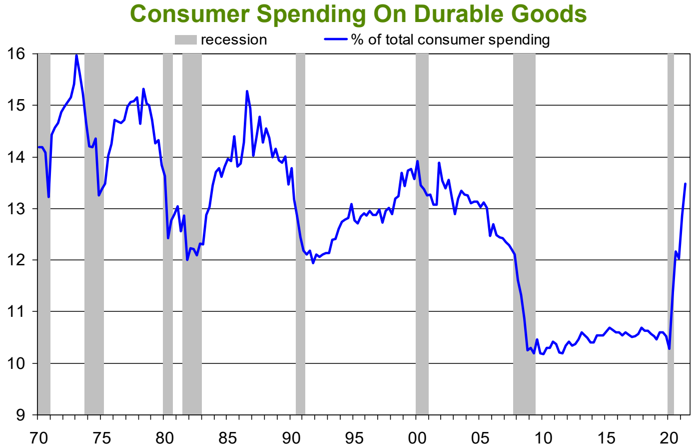
Some Catching Up To Do For Services, But How Much?



Source: Bureau of Economic Analysis; Regions Economics Division

The above chart shows the paths of the three components of total consumer spending over the course of the pandemic, indexed to the level as of January 2020. The combination of substantial fiscal transfers, mainly in the form of three rounds of Economic Impact Payments and supplemental unemployment insurance benefits, low interest rates, and much of the services sector being shuttered helped fuel strong growth in spending on consumer durable goods. This reflects spending on things such as motor vehicles, furniture, appliances, computers and electronics, and recreational vehicles. Recall that in the early days of the pandemic there was a strong burst of spending on home exercise equipment to compensate for gyms being shut down, and there was also a strong burst of spending on furniture and communications/computer equipment to accommodate working from home and at-home learning.

Consumer Spending On Durable Goods



Source: Bureau of Economic Analysis; Regions Economics Division

As seen in the above chart, past recessions have seen sharp declines in consumer durable goods' share of total consumer spending, which makes sense given that consumer durables reflect discretionary spending on big-ticket items. Not only did we not see such a decline during the recession triggered by the pandemic and the efforts to stem its spread, but the share of consumer spending accounted for by consumer durables shot up and, as of April, was higher than at any time since July 2005. By the nature of consumer durable goods, which carry an expected life of at least three years, such spending tends to not be repetitive, i.e., buy a new car or a new sofa or a new refrigerator, and you're good for a while. This suggests limited upside room for spending on consumer durables.

So, while there may yet still be some element of pent-up demand for consumer durable goods, such goods are likely to account for a smaller share of total consumer spending going forward, particularly should the pace of home sales slow in the months ahead, which would take some of the steam out of spending on home furnishings and appliances. Another factor which could weigh on spending on consumer durable goods in the months ahead is the lack of consumer durable goods to spend on. Indeed, we're already seeing supply-side effects, with notably lean physical inventories and increasing lead times (order-to-delivery) of motor vehicles, household furniture, and appliances, which is already impacting spending.

In contrast to consumer durable goods, there is ample upside room for consumer spending on services. In March, the share of total consumer spending accounted for by services fell to the lowest since January 2006. While the increase in service spending in April fell short of our expectations, coming months are likely to see much larger increases. For instance, spending on dining out, lodging, and recreation rose in April, but with more people, particularly more children, being vaccinated and school years ending, spending in these areas is likely to rise sharply over the summer months. Additionally, spending in areas such as personal care and elective medical care procedures, which plummeted with the onset of the pandemic, is likely to rebound strongly.

It is worth noting that, while the level of total spending on services is not too far from the pre-pandemic peak, as seen in the earlier chart, there is a stark difference between spending on necessity and discretionary services. For instance, spending on housing and utilities, which accounts for just over one-fourth of consumer spending on services, increased throughout the pandemic, as would be expected. It is also no surprise that spending on discretionary services fell sharply and remains far below pre-pandemic levels. Spending on lodging rose by 10.3 percent in March and by 8.4 percent in April (though higher prices account for much of these increases), but as of April was still 43.9 percent below where it was in January 2020, while spending on recreation services was 19.7 percent below the level of January 2020.

Even with strong growth over the summer months, it could take some time for spending on discretionary services to recapture pre-pandemic levels. Just how strong that growth may be, however, remains to be seen. As with consumer goods, there are also capacity constraints in the services sector which, at least at present, are likely weighing on spending. Labor shortages are particularly acute in the services sector, to the point that while the limitations on capacity that were imposed during the pandemic have mostly been lifted, many restaurants and hotels are still operating at less than full capacity due to staffing issues. To the extent these issues persist, it could limit growth in spending on discretionary services over the summer months. And, even should labor supply constraints ease as we head into the fall, as is widely expected to be the case, that raises a timing issue, at least in terms of travel and tourism, as that would bump against the start of the new school year.

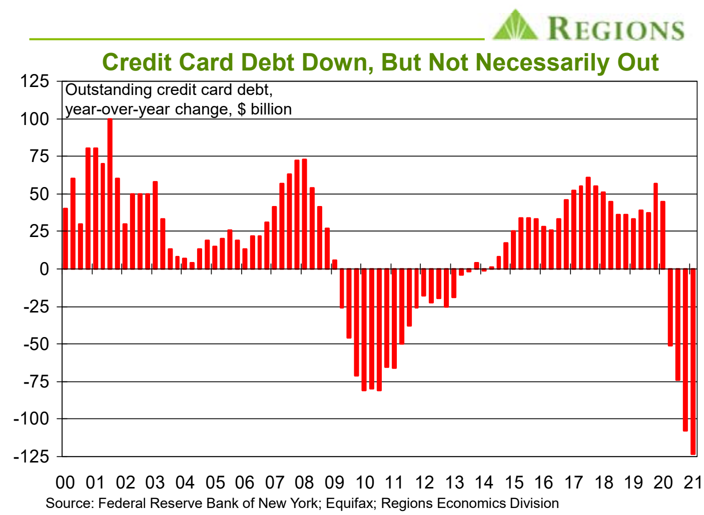
So, as with consumer goods, demand for consumer services is strong but supply/capacity constraints may act as a drag on growth in spending. The imbalance between supply and demand is helping push prices higher, and we have for some time noted that there would be a "normalization" of services prices as demand started to pick up. This was most visible in the April CPI data, with air fares rising by 10.1 percent, rental car rates rising by 16.2 percent, and lodging costs rising by 8.8 percent. While increases in subsequent months may not be as large, there is much further to go in terms of the normalization of services prices.

While it is reasonable to think that higher prices will begin to erode demand, that may not be the case during this cycle, particularly for consumer services. While services prices are normalizing, in many cases they remain well below pre-pandemic levels for services such as travel and lodging. In that sense, consumers, particularly those who have not even considered taking a trip over the past year, won't be thinking of the rate at which prices are rising but instead will be thinking of prices today relative to where they were prior to the pandemic, which is the last time many people traveled. In other words, while the normalization of services prices will be quite visible in the inflation data, it may be less so in terms of consumers' perceptions of services prices.

It could also be that consumers are more tolerant of higher prices at present than has typically been the case. A strong desire to get back out and about and now being free to do so may also be making consumers less sensitive to higher prices. At the same time, a financial cushion, in the form of excess saving, could be blunting the impact of higher prices, thus making consumers less sensitive to higher prices than they otherwise might be. To the extent that is the case, however, as excess savings are pared down that cushion gets thinner and thinner, thus making consumers more sensitive to higher prices.

There are other factors to consider when trying to assess the course of consumer spending, particularly services spending, in the months ahead. One factor is the distribution of the pool of saving across the household income cohorts, though the lack of timely, consistent data on this topic doesn't help. As noted above, while those in the highest income brackets were not eligible for the Economic Impact Payments, they nonetheless would have accumulated saving to the extent their normal spending on services was disrupted. It is reasonable to think that those in this group will more readily resume spending on discretionary services. Those in the lowest income brackets may be less likely to engage in such spending and could instead be more focused on how to stretch the saving at their disposal. To the extent that necessities such as shelter, food, clothing, and transportation comprise a greater share of total expenditures for lower-income households, and that prices for such necessities have risen, that suggests less discretionary spending going forward. Moreover, to the extent lower income households have accumulated liabilities, such as rent/mortgage payments and loan payments, through forbearance programs, knowing that these bills will ultimately come due will be a deterrent to these households engaging in discretionary spending. This isn't to say that this group of households has not engaged in any discretionary spending over the past year, but rather that there is likely to be little, if any, such spending going forward.

It is also worth asking whether, or to what extent, the experience of the pandemic has led to lasting changes in consumer behavior. For instance, one thing that stood out amid an unprecedented degree of fiscal transfers was that surveys consistently showed overwhelming shares of consumers reporting that the primary use of the Economic Impact Payments would be either saving or paying down debt, and this was true of consumers across income brackets, with increased spending coming third on the list of priorities. To be sure, had the services sector not been largely shut down, spending may have been reported as a higher priority. Nonetheless, the personal saving rate is far above the pre-pandemic trend rate, which we put at around 7.5 percent, and there has been a notable reduction in outstanding non-mortgage debt in the household sector, particularly credit card debt.



Whether these changes will persist remains to be seen. The level of outstanding credit card debt has declined in four of the past five quarters, the only exception being Q4 2020 and, even then, the increase was much smaller than the typical Q4 increase. The $49 billion decline in credit card balances in Q1 2021 is the second largest quarterly decline in the life of the New York Fed's data series, which goes back to 1999, and as of Q1 the level of credit card debt outstanding was $123 billion below that of Q1 2020. Obviously, the extent of fiscal transfers has played a key role, such as leading to a greater reliance on debit cards and a lesser reliance on credit cards in consumer spending transactions, while balance paydowns have been significantly larger than had been the case prior to the pandemic. As conditions normalize, i.e., transfers run their course and household savings are pared down, it could be that consumers begin utilizing credit cards more intensively. There is no question that they can do so; at 20.07 percent in Q1 2021, the credit card utilization rate (i.e., balances as a share of available lines) was the lowest in the life of the New York Fed's data.

There is also the question of whether the "equilibrium" personal saving rate in the post-pandemic world will be higher than or lower than the pre-pandemic rate of around 7.5 percent. Even without being a two-handed economist, one could make an argument to support both cases. It could be that seeing massive and sudden job losses on the order of those seen at the onset of the pandemic and seeing how quickly businesses can go under would lead people in the post-pandemic world to maintain higher levels of precautionary saving. And, for lower-income households, the degree of transfer payments received over the last year may have provided a foundation for a higher level of saving than had been possible prior to the pandemic. Then again, seeing how rapid and how aggressive the fiscal policy response to the pandemic was could lead people to believe that will be the template going forward, even in recessions not as sudden and severe as that seen last year. To the extent they believe this to be the case, it could lead people to question why they should maintain as high a level of saving as they did prior to the pandemic. Our view is that the post-pandemic saving rate will settle somewhere above the pre-pandemic rate, and that households will be more disciplined in the use of debt, but experience suggests that we not work up too high a degree of conviction in our view.

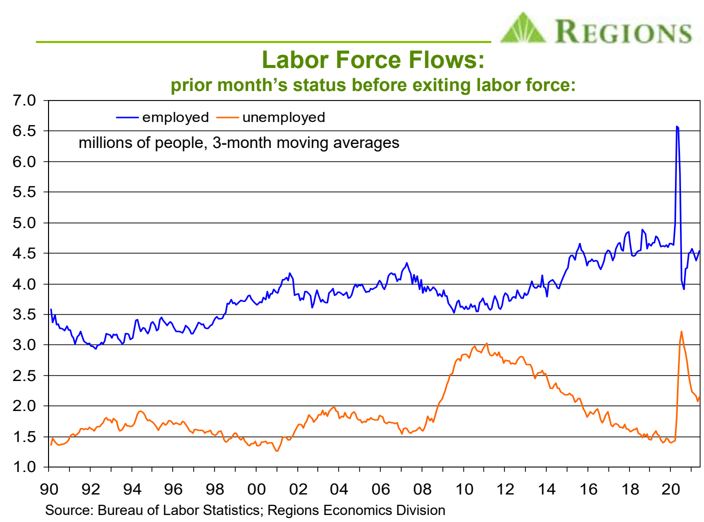
Obviously, it will take time for the answers to these questions to emerge. The point here, however, is that while it is reasonable to expect a rebound in consumer spending on services in the months ahead, that rebound may be less robust or may play out over a longer time than many are now anticipating, while spending on goods may taper off. We've cited a number of factors that will help set the path for consumer spending; how this plays out will have an impact on top-line real GDP growth over the next few quarters.

May Employment Report

It says a lot about the world as it now is that nonfarm payrolls rising by 559,000 jobs in one month is seen as a disappointment. Be that as it may, despite showing job growth that in normal times would not even be imaginable, the May employment report was widely panned, with "at least it's better than the April report" about the most charitable thing many could find to say about it (nonfarm payrolls rose by 278,000 jobs in April). Then again, "disappointing" is in the context of expectations, and expectations were that April and May would see significantly larger increases in nonfarm payrolls than proved to be the case. So, for a second month in a row, we're left to try and explain a much smaller than expected increase in nonfarm payrolls which, as of May, leaves them 7.629 million jobs below the pre-pandemic peak.

It wasn't unreasonable to expect that further reopening of the economy and increasing numbers of people being vaccinated would prompt much larger job gains in April and May than we actually saw, particularly with over eight million open jobs waiting to be filled. In some cases, such as motor vehicle production, input shortages are curbing production to the point that firms have put workers on furlough until supply chains are functioning more smoothly, thus holding down nonfarm payrolls. Other factors behind the smaller than expected job gains revolve around labor supply; as of May, there are more than 3.5 million fewer people in the labor force than there were prior to the pandemic. Inclusive of the supplemental benefits being paid by the federal government, the level of unemployment insurance benefits is for many recipients who had previously worked in lower-wage industry groups equal to or greater than their labor earnings, making not working a rational choice. While the supplemental benefit payments are slated to expire in September, a number of states – 25 so far – have announced that they are withdrawing from the program, with supplemental benefits ending over June and July.

Coming months will help assess the role these supplemental benefits are playing in labor supply constraints, but they are hardly the only factor. Another factor is that labor force participation amongst females has fallen significantly over the course of the pandemic, as females have shouldered a larger share of the burdens of day care and at-home schooling. To the extent this is a factor, this constraint should ease considerably in the fall with the start of the new school year and what presumably will be a higher level of day care services than is now available. It could also be that those whose previous jobs are no longer there due to their former employer having gone out of business either do not have the skills required to land a new job or are held back by mobility constraints (i.e., being either unable or unwilling to move), such that landing a job is more difficult. Finally, there are those who, out of concern for their health, simply do not yet feel comfortable returning to a physical work environment.



Another factor, although often overlooked, contributing to labor supply constraints is the rate at which people are transitioning from being employed in one month to being out of the labor force in the next month. This is a trend that was well in place prior to the pandemic, which largely reflected the onset of what is expected to be a sizable wave of retirement amongst those in the Baby Boom cohort. Like virtually every other element of the economy, this trend was disrupted by the pandemic, but recent months have seen an uptick in the number of people making this transition. There are of course other factors behind these exits, but retirements amongst those in the Baby Boom cohort are a significant driver, and the steady upward trend in the number of exits will likely resume in the months ahead.

Again, there are a number of factors contributing to labor supply constraints. But, when coupled with demand for labor running hot, these supply constraints are pushing up wages at a rate that would otherwise seem at odds with the remaining degree of labor market slack. While it is reasonable to think that these supply constraints will ease over the next several months, that does not mean we should expect wages to fall as that happens, as wages are inherently sticky, at least to the downside. As such, while wage growth will slow, the level of wages will be higher than otherwise would be the case, which could have implications for inflation in the broader economy.

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Q4 '20 (a)	Q1 '21 (p)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)		2018 (a)	2019 (a)	2020 (a)	2021 (f)	2022 (f)
4.3	6.4	6.8	6.1	6.2	5.1	3.4	3.0	Real GDP[1]	3.0	2.2	-3.5	6.1	4.8
2.3	11.3	9.4	3.2	5.4	4.7	4.2	3.0	Real Personal Consumption[1]	2.7	2.4	-3.9	7.5	4.5
13.1	10.8	9.7	7.1	6.8	6.3	5.3	5.4	Real Business Fixed Investment[1]	6.9	2.9	-4.0	8.8	6.3
25.4	13.4	11.6	7.4	5.9	5.6	5.2	4.8	Equipment[1]	8.0	2.1	-5.0	15.3	6.0
10.5	16.9	9.0	8.3	8.4	7.1	5.6	5.2	Intellectual Property and Software[1]	7.8	6.4	1.7	9.6	6.9
-6.2	-5.8	5.3	2.7	5.4	6.2	4.6	7.4	Structures[1]	3.7	-0.6	-11.0	-6.0	5.6
36.6	12.7	4.4	0.9	7.2	5.8	3.7	1.2	Real Residential Fixed Investment[1]	-0.6	-1.7	6.1	14.3	4.1
-0.8	5.8	-4.9	0.4	2.4	2.9	1.8	1.2	Real Government Expenditures[1]	1.8	2.3	1.1	0.0	1.4
-1,122.0	-1,193.9	-1,196.7	-1,214.4	-1,227.4	-1,248.3	-1,262.8	-1,265.4	Real Net Exports[2]	-877.7	-917.6	-926.0	-1,208.1	-1,265.4
1,220	1,156	1,135	1,156	1,184	1,203	1,206	1,212	Single Family Housing Starts, ths. of units[3]	871	889	1,004	1,157	1,210
356	446	470	440	425	418	416	418	Multi-Family Housing Starts, ths. of units[3]	376	403	393	445	418
16.1	16.9	17.6	16.9	16.8	16.8	16.8	16.8	Vehicle Sales, millions of units[3]	17.2	17.0	14.4	17.0	16.8
6.8	6.2	5.8	5.2	4.9	4.6	4.4	4.2	Unemployment Rate, %[4]	3.9	3.7	8.1	5.5	4.3
-6.0	-5.6	8.5	4.2	4.0	4.3	3.7	2.9	Non-Farm Employment[5]	1.6	1.3	-5.7	2.5	3.3
-7.6	61.7	-28.6	-11.5	-4.6	3.2	3.4	3.4	Real Disposable Personal Income[1]	3.6	2.2	6.0	2.6	-2.6
1.3	1.9	3.8	3.7	3.8	3.3	2.5	2.1	GDP Price Deflator[5]	2.4	1.8	1.2	3.3	2.5
1.2	1.8	3.8	3.9	4.1	3.8	2.7	2.2	PCE Deflator[5]	2.1	1.5	1.2	3.4	2.7
1.2	1.9	4.5	4.3	4.3	3.8	2.5	2.1	Consumer Price Index[5]	2.4	1.8	1.2	3.8	2.6
1.4	1.6	3.3	3.3	3.6	3.5	2.6	2.3	Core PCE Deflator[5]	2.0	1.7	1.4	2.9	2.7
1.6	1.4	3.4	3.3	3.5	3.8	2.8	2.5	Core Consumer Price Index[5]	2.1	2.2	1.7	2.9	2.9
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
0.86	1.32	1.62	1.71	1.81	1.95	2.03	2.09	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.89	1.61	2.05
2.76	2.88	3.00	3.11	3.23	3.39	3.52	3.60	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.12	3.05	3.55
-3.5	-3.3	-3.2	-3.3	-3.4	-3.4	-3.3	-3.4	Current Account, % of GDP	-2.2	-2.2	-3.1	-3.3	-3.4

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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