ECONOMIC OUTLOOK

REGIONS
August 2021

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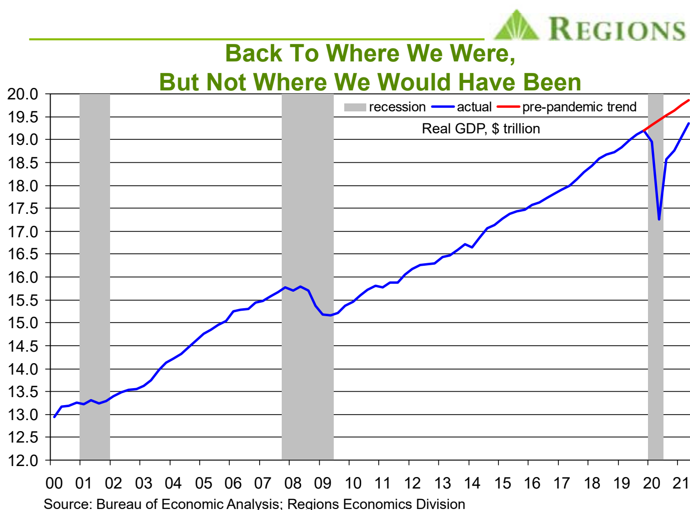
Back To Where We Were, But Not Where We Would Have Been . . .

According to the initial estimate from the Bureau of Economic Analysis, real GDP grew at an annualized rate of 6.5 percent in Q2 2021, putting the level of real GDP at just over $19.358 trillion. If the significance of this escapes you, it is that the level of real GDP is now above the pre-pandemic peak of just over $19.202 trillion reached in Q4 2019. To be sure, there are no historical precedents for what the economy has gone through since the onset of the pandemic, but after the epic contraction in real GDP in Q2 2020 – an annualized decline of 31.4 percent that left the level of real GDP 10.1 percent below the pre-pandemic peak – it seemed unlikely that loss would be fully recouped this soon.

Upon the release of the Q2 GDP data, more than one commentator noted that the U.S. economy was now larger than it was prior to the pandemic. Sure, in terms of simple math, the level of real GDP is now higher than it was prior to the pandemic; for those scoring at home, as of Q2 2021 the level of real GDP was 0.81 percent above the pre-pandemic peak. But, with the level of nonfarm employment 5.702 million jobs below the pre-pandemic peak, the labor force substantially smaller, and other indicators such as industrial production yet to regain their pre-pandemic peaks, it isn't clear whether the economy is actually "larger" than it was prior to the pandemic. And even aside from that point, even with the level of real GDP now above the pre-pandemic peak, that is by no means the same as saying that all of the damage done by the pandemic and the efforts to stem its spread has been undone.



The chart above is one way of making that point. The blue line shows the actual level of real GDP, while the red line shows what the level of real GDP would have been had the pandemic not happened and the economy continued to grow at the average rate seen during the prior expansion (annualized quarterly growth of 2.286 percent). We think it will take two, possibly three, more quarters to fill in this gap, or, for the level of real GDP to be as high as it would have been as of Q2 2021 had the pandemic not happened. It will take considerably longer to close the remaining gap in nonfarm employment, which reinforces our point that, while the U.S. economy is healing, it is far from healed.

As for the Q2 GDP data, the 6.5 percent annualized growth came in well short of the consensus forecast, which anticipated growth of 8.5 percent, but was more in line with our forecast of 6.9 percent growth. That our forecast diverged so widely from the consensus forecast mainly reflected differing views on nonfarm business inventories, government spending, and residential fixed investment, each of which we expected to be a meaningful drag on top-line growth, which proved to be the case. As it turned out, however, the drag from government spending was not as large as our forecast anticipated and the drag from residential fixed investment was larger, while a wider than expected trade deficit also played a hand in growth coming in below our forecast.

Of more significance, however, is that the Q2 GDP data are the perfect embodiment of the predicament facing the U.S. economy, which is that the supply side of the economy has simply been unable to keep pace with demand, thus fostering significantly faster inflation. To that point, real private domestic demand, or combined household and business spending adjusted for inflation, grew at an annualized rate of 9.9 percent in Q2, and growth would have been even faster had it not been for the steep decline in real residential fixed investment.

In this context, that anyone expected inventories to make a contribution to Q2 real GDP growth is more than a little curious. Supply-side constraints and shipping bottlenecks have for some time now been acting as drags on growth in business output in a time of robust growth in demand, which has contributed to sharp declines in inventory-to-sales ratios across the board in the manufacturing, wholesale trade, and retail trade sectors. With the supply side of the economy unable to keep pace with robust growth in demand, something has to give, and that something is prices. The sharp acceleration in inflation captured in the higher frequency measures such as the Consumer Price Index (CPI) and PCE Deflator is reflected in the broader GDP Price Index. After having risen at an annualized rate of 4.3 percent in Q1 2021, the GDP Price Index rose at an annualized rate of 6.0 percent in Q2, the largest such increase since Q4 1981.

Perhaps the best way to put the imbalance between supply and demand into perspective is to note that on a nominal basis, i.e., not adjusted for price changes, GDP grew at an annualized rate of 13.0 percent in Q2. Aside from Q3 2020, when the economy was rebounding after having been largely shut down in the previous

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quarter, this is the fastest quarterly growth rate since Q3 1981. While a significant drawdown in nonfarm business inventories, which deducted 1.1 percentage points from top-line real GDP growth, helped facilitate rapid growth in consumer and business spending in Q2, that is not something that can be sustained over a prolonged period. For instance, our August baseline forecast anticipates a significant decline in inflation adjusted spending on consumer durable goods such as motor vehicles, appliances, and home furnishings in Q3, thanks in part to limited supplies holding down sales. To that point, with the global semiconductor chip shortage leading to sharp cuts in vehicle production, unit motor vehicle sales have fallen sharply over the past two months; July's annualized sales rate of 14.750 million units is 12.5 percent below Q2's sales rate of 16.859 million units. As such, after accounting for higher vehicle prices, a decline in consumer spending on motor vehicles will act as a drag on real GDP growth in Q3.

If there is a silver lining here it is that, with nonfarm business inventories so far below what firms would consider optimal levels, there will be a transition from inventory drawdowns to inventory restocking. As this occurs, rather than acting as a drag on top-line real GDP growth as was the case over the first half of 2021, inventories will become a support for growth. When that transition will occur, however, remains most uncertain given the persistence of the supply chain and logistics bottlenecks, which are global in nature, that have been weighing down output growth. We have for some time looked for the transition to restocking to begin in Q3 2021, and while we still anticipate that will be the case, the Q3 inventory build in our August baseline forecast is considerably smaller than those in our prior forecasts. Indeed, it may not be until 2022 that there is a meaningful and sustained build in nonfarm business inventories, particularly with the Delta variant of the COVID-19 virus impacting manufacturing and shipping activity across much of Asia.

"Transitory" Gives Way To "Temporary," What Comes Next?

To the extent the supply chain and logistics bottlenecks noted above do linger, they will act as a source of persistent inflation pressures. With the same dynamic playing out in the labor market, i.e., demand outpacing supply and driving up prices – in this case wages – at a faster rate, that is another avenue through which rising input costs may be passed along in the form of higher prices for goods and services. Firms do of course have an alternative, which is to absorb higher costs for inputs, shipping, and labor and live with smaller margins. While firms may at some point make that choice, particularly those already having pushed through more than one round of price increases, it seems unlikely they would do so during a time in which demand is growing so strongly.

When inflation began to accelerate sharply in the spring, many were quick to dismiss faster inflation as transitory and, as such, nothing to be concerned over. As we now enter the dog days of summer, headline CPI inflation is running at over 5.0 percent and inflation measured by the PCE Deflator, the FOMC's preferred measure, is running at over 4.0 percent. As such, many are citing uncertainty as to just when inflation will begin to recede and are now characterizing inflation as being temporary, which we surmise is longer than transitory but shorter than forever. Our view on this has not changed; from the start we have argued that inflation would be stickier than many were assuming to be the case, and we have seen nothing to make us change that view.

It is interesting that upon the release of each set of inflation data many of those in the transitory/temporary camp spend a good deal of effort massaging, or in some cases brutalizing, the data to illustrate their point. Take out the price increases of all of the components tied to the economy reopening and take out the outsized price increases of a few components, such as used motor vehicles, that carry a low weight in the price index and, next thing you know, inflation is nothing to worry about. Sure, and if you took out every item for which prices are rising, inflation would be zero and we could all just get on with our lives.

Okay, that's obviously an exaggeration, but sometimes it doesn't seem like too much of one. Others point to various "trimmed mean" measures of CPI or PCE inflation, which remove, or, trim, the upper and lower tails of the distribution of price changes, as more reliable gauges of the underlying trend rate of inflation. To be sure, the trimmed measures have been yielding lower rates of inflation than the headline CPI and PCE measures. But, with the Dallas Fed's measure "trimming" as many as 129 of the 178 components of the PCE Deflator in a given month, that raises the question of just what these measures are really telling us about inflation.

Another way some dismiss concerns over present-day inflation is by conjuring up the bad old days of the late-1970s/early-1980s. Double-digit inflation was the norm during this period, and there was even a 26-month run from March 1979 through April 1981 in which CPI inflation was 10.1 percent or higher in every single month. It isn't uncommon for those dismissing concerns over the current acceleration in inflation to equate the expression of any such concerns as an alarmist warning that 1970s stile inflation is on the way. We have yet to hear anyone actually making such a prediction, rendering this nothing more than a straw man argument that settles absolutely nothing.

And, under the heading of "oh by the way," were the CPI constructed today as it was constructed back in the late-1970s and early-1980s, we could easily be looking at double-digit inflation. Unlike back then, house prices do not directly enter into the CPI, having been replaced by the concept of owners' equivalent rent in 1983. Owner's equivalent rent in essence asks homeowners what they believe the monthly rent would be on their home were it placed on the rental market, the premise being that this captures the cost of shelter and thus does away with any "house as an investment" distortions in the measurement of housing costs. But, with the recent run of double-digit house price appreciation – the CoreLogic HPI was up 17.2 percent year-on-year in June – measured inflation would be much higher if house prices directly entered into the calculation. Another difference in how the CPI is constructed at present is that hedonic adjustments for quality improvements tend to hold down measured inflation, with such adjustments not introduced into the CPI until 1999.

In any event, inflation as measured by the CPI is now running at a better than 5.0 percent pace and, while not a double-digit pace, it feels plenty bad considering that in the eight years prior to the

pandemic CPI inflation averaged 1.6 percent. CPI inflation is likely to remain at or above 5.0 percent through year-end, while the PCE Deflator, the FOMC's preferred gauge of inflation, is running at 4.0 percent and could remain at or above this pace through year-end. It has almost become trite to characterize inflation pressures as transitory, or temporary; it isn't whether so as much as it is when inflation pressures will begin to subside. On that question, no one has the answer at this point.

Moreover, repeatedly hearing inflation characterized as being "transitory," or "temporary" for that matter, can lead some to think that at some point prices will begin to reverse. And while this would bolster the argument that the acceleration in inflation is not something to be overly concerned about, anyone thinking that falling prices are on the other side of this period of faster inflation will be in for a rather rude awakening. Inflation settling back at the FOMC's 2.0 percent target or thereabouts doesn't leave us with falling prices, it leaves us with prices rising at a slower rate than is at present the case. We can make the same point about labor costs; while an easing of the labor supply constraints that have been acting as a drag on the pace of job growth would lessen the degree of upward pressure on wages, that isn't the same as saying wages will begin falling. They won't. As such, firms will still be left to figure how to contend with rising labor costs.

As noted above, we've been consistent in our view that inflation was likely to be more persistent than many have been assuming. This doesn't mean we think inflation will remain at current rates forever, and neither does it mean we're sounding the alarm over a return to the bad old inflation days of the 1970s. We've found it useful to identify some of the main factors behind the acceleration in inflation over recent months, which we think helps in laying out a plausible path for inflation in the months ahead. Specifically, we've pointed to base effects, the normalization of services prices, higher costs for raw materials and other non-labor inputs, higher shipping costs, higher labor costs, and a period of a declining exchange value of the U.S. dollar as contributing to the recent acceleration in inflation.

Clearly, base effects and the normalization of services prices are transitory factors, the effects of which will fade from the data in the months ahead. Higher input costs and higher shipping costs are likely to be with us for some time still, which is where the above discussion of the global nature of supply chain and logistics bottlenecks comes into play. When these bottlenecks start to clear, it could well be that input prices will fall, and shipping costs could also ease. Higher labor costs, however, will not reverse, though the rate at which labor costs are rising could slow as labor supply constraints begin to ease. As to the exchange value of the U.S. dollar, which figures heavily into the prices we pay for imported consumer goods, there are arguments to be made either way, and at present we don't see significant, sustained moves in either direction in the months ahead.

Keep in mind, however, that there are two factors with the potential to add to inflation over coming months as these other adjustments are taking place. First, rent growth took a beating during the pandemic but is showing signs of firming, as would have been expected with the economy reopening and the labor market healing. Given the relative weightings, faster rent growth would be a significant support for core CPI inflation, as rents account for over 40 percent of the core CPI, and would have a lesser but still noticeable effect on core inflation as measured by the core PCE Deflator. Second, medical care costs have been notably restrained over the past several months, thus acting as a drag on inflation. Should medical care costs begin to behave more in line with pre-pandemic norms, they would become a support for inflation.

Where we think all of this leaves us is with inflation receding from current elevated rates, but not until we get into 2022, and we see inflation remaining above the FOMC's 2.0 percent target through 2022. Obviously, inflation may prove to be less, or more, persistent than our forecast anticipates, but simple math suggests that at the very least headline CPI inflation will remain at or above 5.0 percent through the end of this year. If so, that would make it a run of at least eight consecutive months with inflation at or above 5.0 percent, making it increasingly difficult for consumers to see higher inflation as being merely transitory.

Indeed, one can question whether we've already passed that point. Survey-based measures of consumer expectations, such as those produced by the University of Michigan and the Federal Reserve Bank of New York, show consumer expectations of inflation have risen meaningfully over recent months. Where this could cause problems for the broader economy is if consumers start to act on these expectations, in terms of their spending decisions and/or wage demands. Many have been quick to dismiss rising inflation expectations amongst consumers, on the grounds that consumers are constantly expecting inflation that never appears. We think such criticisms are way off the mark. Consumers are not being asked to predict the path of the CPI or the PCE Deflator, but instead are answering these questions based on their experiences with their particular consumption bundle. As such, an outside observer has no way of knowing whether or not the inflation consumers expect actually appears. To be sure, thus far market-based measures of inflation expectations are more in line with the view that current inflation pressures are transitory, but we're not willing to simply dismiss survey-based measures.

Clearly, there are lots of moving parts here, but it will take months before a clear-cut trend emerges from the inflation data. In the interim, inflation will erode at least some of the benefit accruing to workers in the form of faster wage growth. One question yet to be answered is how much longer the FOMC will stand pat in the face of elevated inflation amid clearly improving conditions in the labor market and the broader economy.

July Employment Report: Setting The Stage?

Total nonfarm employment rose by 943,000 jobs in July, with private sector payrolls up by 703,000 jobs and public sector payrolls up by 240,000 jobs. As was the case in June, however, the large increase in public sector payrolls in July is nothing more than seasonal adjustment fiction stemming from layoffs in the education segment of state and local government being smaller than is typically case for the month. On a not seasonally adjusted basis, education payrolls amongst state and local governments fell by 923,000 jobs in July. While this is a large number, it is nonetheless smaller than the average July decline of 1.182 million

jobs in the twenty years prior to the pandemic. As such, the seasonal adjustment factors overcompensated, hence the outsized increase in state and local government education payrolls reported in the seasonally adjusted data.

Be that as it may, the real story of the July employment report is how strong the underlying details are. In addition to July's hefty increase in private sector payrolls, the initial estimate of private sector job growth in June was revised up by over 100,000 jobs. At the same time, the initial estimates of average hourly earnings and average weekly hours worked in June were revised higher. As a result, aggregate private sector wage and salary earnings are now shown to have risen by 1.02 percent in June, rather than the 0.56 percent increase originally reported. June's increase was followed by a 0.93 percent increase in July. Why this matters is that private sector labor earnings are far and away the largest component of personal income, and with generous fiscal transfers having largely run their course, private sector wage growth will return to its role as the key driver of growth in total personal income.

Though leisure and hospitality services continue to post the largest monthly increases, job growth remains broad based across private sector industry groups. While the breadth of job growth is impressive, the intensity of job growth is less so. This, however, is a labor supply story, not a labor demand story, as evidenced by there being over nine million open jobs across the U.S. economy. The labor force remains over three million people smaller than was the case prior to the pandemic. There are a few main factors behind this gap, including lingering fears over the COVID-19 virus that are making people hesitant to return to a physical work setting, increased child care responsibilities that continue to hold down labor force participation amongst females, and supplemental unemployment insurance benefits. Skills mismatches and mobility constraints are also holding down job growth.

One factor that is somewhat overlooked, however, is the rising number of people exiting the labor force, the vast majority of whom are employed when they leave the labor force. To some extent, this reflects retirements amongst those in the Baby Boom cohort, and this drain from the labor force is likely to intensify over the next few years. As such, even though inflows into the labor force have risen rapidly over recent months, they are outpacing outflows by only a narrow margin, hence the somewhat stagnant labor force participation rate. While other labor supply constraints will ease in the months ahead, the elevated number of exits from the labor force will remain a drag on labor force participation and will push the unemployment rate down faster than would otherwise be the case. The drop in the unemployment rate from 5.9 percent in June to 5.4 percent in July is in part a function of only modest growth in the labor force.

Still, the broader point is that the July employment report is clear evidence of the "substantial further progress" in the labor market the FOMC has laid down as a marker for making any adjustments to their current policy stance. As a general rule, one never wants to put too much emphasis on any single data release in any given month. Not only do the economic data stubbornly refuse to move in perfectly straight lines, but revisions to the initial estimate can change the look and feel of a given data release. For instance, the June employment report looks better a month after its initial release than it did at the time. With that caveat duly noted, the July employment report raises the possibility that the FOMC may start tapering the Fed's monthly asset purchases sooner than many had been expecting.

It would perhaps be more accurate to say that it is the July employment report in conjunction with recent public comments by several FOMC members on top of maybe not-so-transitory inflation that may have shifted the timing of tapering. Many had been looking to the November FOMC meeting as the timing for the FOMC to lay out its plans for tapering the Fed's monthly asset purchases ($80 billion in U.S. Treasury securities, $40 billion in agency mortgage-backed securities), which was widely expected to begin in Q1 2022. It is now reasonable to think that the FOMC may lay out their plans for tapering at their September meeting and commence tapering in either November or December.

While some are looking to the annual Jackson Hole Symposium (August 26-28), which has in the past been a venue used by the FOMC to signal shifts in policy, for the tapering playbook to be revealed, we do not think this will be the case. After all, the July FOMC meeting was the start of in-depth discussions of tapering (the timing, the composition, and the pace), and we see it as unlikely that any concrete plans would be formulated without at least one additional meeting for discussion, which in this case would be the September FOMC meeting.

We'll know soon enough whether we're correct on this point. More broadly, however, it would seem to be increasingly difficult for the FOMC to continue providing the same high degree of monetary accommodation in the face of clear and substantial improvement in the labor market and the broader economy. That inflation is likely to remain significantly above the FOMC's 2.0 percent target for some time to come could make things quite uncomfortable for the FOMC. Keep in mind that the FOMC will almost surely not begin to raise the Fed funds rate until they have completely halted the monthly asset purchases. In that context, the sooner they begin tapering, and ultimately pull the plug on, the monthly asset purchases, the more latitude they will have to respond to inflation should it be more persistent than they now believe will be the case. Indeed, our thought is that tapering the monthly asset purchases sooner rather than later is a low-cost way for the FOMC to hedge their bet on inflation.

After the experience of the 2013 "taper tantrum," the FOMC is being very deliberative in their communications around tapering this time around. The longer they wait, however, the greater the risk that the FOMC touches off a different sort of taper tantrum, a "reverse taper tantrum," if you will. In other words, the longer inflation remains elevated, the greater the risk that market-based expectations of inflation become unmoored, which would result in potentially sharp increases in market interest rates. While that is perhaps a low-probability outcome, is almost surely is not a zero-probability outcome, and it is an outcome the FOMC could hedge against by pulling forward the timing of tapering. As it is, the FOMC will take care to not catch anyone off guard, and it could be that the start of tapering will have little, if any, impact on market interest rates, particularly as the financing needs of the federal government will be diminishing – okay, at least for now. In any event, improving labor market and economic conditions along with elevated inflation may be forcing the FOMC's hand by making it increasingly difficult to justify standing pat.

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Q1 '21 (a)	Q2 '21 (p)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)		2018 (a)	2019 (a)	2020 (a)	2021 (f)	2022 (f)
6.3	6.5	7.4	5.6	4.5	3.9	2.7	2.0	Real GDP[1]	2.9	2.3	-3.4	6.2	4.7
11.4	11.8	3.4	4.5	3.9	3.9	2.7	2.1	Real Personal Consumption[1]	2.9	2.2	-3.8	8.2	4.2
12.9	8.0	6.9	7.1	5.5	5.2	5.5	4.9	Real Business Fixed Investment[1]	6.4	4.3	-5.3	8.1	6.0
14.1	13.0	8.0	6.8	4.5	3.7	4.9	4.2	Equipment[1]	6.4	3.3	-8.3	15.0	5.7
15.6	10.7	9.5	8.4	6.7	5.8	5.3	5.2	Intellectual Property and Software[1]	8.1	7.2	2.8	9.7	7.1
5.4	-7.0	-2.3	4.1	5.2	7.7	7.6	6.1	Structures[1]	4.0	2.0	-12.5	-7.8	4.0
13.3	-9.8	2.5	4.5	5.1	3.4	2.9	1.8	Real Residential Fixed Investment[1]	-0.6	-0.9	6.8	11.3	2.9
4.2	-1.5	1.0	1.6	2.6	2.5	1.6	1.5	Real Government Expenditures[1]	1.4	2.2	2.5	0.9	1.8
-1,226.1	-1,259.0	-1,279.0	-1,250.0	-1,271.4	-1,277.5	-1,303.4	-1,319.1	Real Net Exports[2]	-864.2	-905.3	-942.7	-1,253.5	-1,292.9
1,156	1,104	1,105	1,124	1,143	1,160	1,172	1,185	Single Family Housing Starts, ths. of units[3]	871	889	1,004	1,122	1,165
443	464	440	427	420	419	419	419	Multi-Family Housing Starts, ths. of units[3]	376	403	393	444	419
10.2	15.1	17.1	14.5	11.2	6.4	3.1	2.9	CoreLogic House Price Index[5]	5.7	3.9	5.7	14.3	5.8
16.8	16.9	14.9	15.3	15.6	15.8	16.0	16.2	Vehicle Sales, millions of units[3]	17.2	17.0	14.5	16.0	15.9
6.2	5.9	5.2	4.9	4.6	4.4	4.3	4.1	Unemployment Rate, %[4]	3.9	3.7	8.1	5.6	4.4
-5.6	8.5	4.7	4.5	4.7	4.1	2.8	2.2	Non-Farm Employment[5]	1.6	1.3	-5.7	2.8	3.5
57.6	-30.6	-4.2	-5.8	1.0	3.7	3.3	3.5	Real Disposable Personal Income[1]	3.4	2.3	6.2	2.3	-2.5
2.0	4.0	4.2	4.6	4.1	3.1	2.5	2.1	GDP Price Deflator[5]	2.4	1.8	1.2	3.7	2.9
1.8	3.8	4.3	4.9	4.5	3.5	2.6	2.1	PCE Deflator[5]	2.1	1.5	1.2	3.7	3.2
1.9	4.8	5.5	5.9	5.5	3.8	2.5	1.9	Consumer Price Index[5]	2.4	1.8	1.2	4.5	3.4
1.7	3.4	3.7	4.4	4.3	3.4	2.8	2.3	Core PCE Deflator[5]	2.0	1.7	1.4	3.3	3.2
1.4	3.7	4.4	4.9	5.3	3.9	2.8	2.6	Core Consumer Price Index[5]	2.1	2.2	1.7	3.6	3.6
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
1.32	1.59	1.34	1.54	1.65	1.68	1.76	1.83	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.89	1.45	1.73
2.88	3.00	2.87	3.09	3.23	3.33	3.45	3.52	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.12	2.96	3.38
-3.6	-3.3	-3.1	-3.3	-3.4	-3.3	-3.4	-3.4	Current Account, % of GDP	-2.1	-2.2	-2.9	-3.3	-3.4

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2021 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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