Economic Outlook March 2022

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Overview

Inflation has unnerved the public and policy makers alike, leaving the Federal Reserve prepared to tighten monetary policy. Normally, strong inflation implies an overheated economy that strains productive capacity, giving sellers stronger pricing power. This time, however, analysis of economic demand suggests that supply shortages may be a bigger part of the inflation problem.

The 7.0% real GDP growth the economy achieved in the 4th quarter seems well above anything that could be considered a sustainable rate. Drilling down, however, we find that 4.9% of the 7% came from inventory build. That probably has more to do with concerns about unreliable supply chains than the strength of final demand. In other areas of the economy, a 2.1% personal consumption contribution to growth was strong, but not extraordinarily so. Exports did contribute a strong 2.4% to GDP growth, but economically that was offset by a 2.4% rise in imports. Investment and government spending had only minor effects on total growth. Net of inventory growth, therefore, 2.1% GDP growth in the other areas does not suggest an overheating economy.

Yet despite relatively modest GDP growth over much of the economy, inflation raged. The Consumer Price Index (CPI) rose 7.9% over the last year, which is the highest rate of consumer inflation in almost 40 years. As is often the case, some of the prices buyers notice most, such as food and fuel, rose even faster. While the data suggest the inflation rate may have stopped accelerating, the current level is still almost four times the Federal Reserve's 2% target.

The so-called inflation pipeline also points to an extended challenge. While the Producer Price Indexes (PPI) show some signs of decelerating rates of gain, levels remain high. The PPI for processed goods at the intermediate stage of production rose 24% over the last year, while the PPI for finished goods increased 12%. Those numbers suggest producers may have absorbed some of the pipeline pressures, but there are limits to how much businesses can absorb. While prices may no longer be accelerating, 12% increases are certainly well beyond the Fed's 2% target.

Given the strong inflation, it seems odd that demand in most areas of the economy does not seem to be significantly higher than it was prior to the pandemic. Most areas have grown within what would historically be considered a normal range of growth. That suggests supply constraints may have played a larger role than has typically been the case.

Originally, many economists thought inflation would ease as pandemic supply-chain disruptions ended, but the economic effects of the virus lasted much longer than

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expected. Moving forward, if world societies can finally normalize, supply-chain improvement may take pressure off global inflation rates.

Labor has also proven to be a serious supply constraint. The nonfarm payroll numbers show that even after having added 6.1 million jobs in 2021, the number employed still falls 2.1 million short of the peak prior to the pandemic. And allowing for the real growth of GDP since then, it appears the economy could actually need as much as 4.8 million new workers to be equivalent with the pre-pandemic level. An unemployment rate of 3.8% suggests it would be hard to find a total of 6.9 million more workers.

If a limited labor supply has been an important part in inflation this time, then the Federal Reserve will need to reduce demand by enough to fit economic activity more comfortably within the existing pool of labor. Clearly, reducing labor demand by the equivalent of several million workers would seem to require more than a light tap on the monetary brakes. Moreover, a large pipeline of government spending and well-funded consumers may make overall economic demand less sensitive to interest rates than has historically been the case, particularly given the low level of current rates. Thus, while the Fed is ready to begin raising rates, it may take more tightening than many economists expect to reduce inflation to an acceptable level.

Consumers

Clearly, last year was a tough year. Just when the public thought vaccines would vanquish Covid-19, the Delta variant inflicted a whole new wave of infections. And while jobs have been widely available, inflation has outdistanced wage gains. Now, war in Europe threatens global security, economic growth and higher prices for important commodities.

Consistent with that backdrop, the University of Michigan survey shows extremely low results in the most recent consumer sentiment poll. Compared against responses back to the year 2000, the current level ranks at only the 8th percentile. Politically, too, sinking approval ratings for the President's handling of the economy and expectations of heavy losses for his party in the next election offer another measure of the public's concern with current conditions.

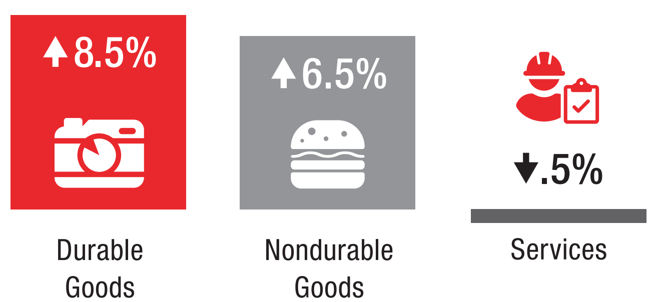
And yet despite broad concerns about current conditions, consumers have continued to spend. Net of inflation, personal consumption rose 6.9% in 2021. Over the last economic cycle, inflation-adjusted consumption rose an annualized 2.3%. Off the pre-pandemic peak, consumption has increased almost exactly in line with the historical rate.

As the pandemic raged, consumers focused their spending more heavily on goods than on services. From the previous peaks, inflation-adjusted spending on durable goods rose 8.5% ar (annualized rate), spending for nondurables goods was up 6.5% ar while spending on services fell 0.5% ar. Over the last economic cycle, the three categories of spending increased more in line with each other. Therefore, as pandemic restraints ease more fully, economists expect services will account for a greater share of spending growth. That should help to ease any pressures that may have developed on the productive capacity for goods.

Retail sales were volatile over the last year, but off the high in January of 2020, spending has been strong. This January, nominal retail spending stood 23% higher than it was just prior to the pre-pandemic peak. The annualized gain of 11% since then is over twice the 4.3% ar growth of spending over the last economic expansion. Adjusting for price changes, retail spending peaked this past April, roughly 15% above the pre-pandemic top. Currently, inflation-adjusted spending stands about 2% below the April peak.

While the consumer spending recovery has been relatively strong, income gains have covered most of the spending increase. Nominal personal consumption rose 13% ar over 2021, with a 21% gain in the first half of the year and a 6% gain over the second half. Wages and salaries rose 10% for 2021 as a whole, increasing 9% over the first half and 11% in the second half. Thus, while consumers probably dipped into savings to fund some of the first half spending, second half spending was more fully funded by sustainable cash flow. Notably, too, a large part of the "excess savings" reserve the public seemed to build through the pandemic appears to remain intact.

Consumer spending during the pandemic



Business activity

CEO Magazine's survey of CEO confidence in the business outlook has improved marginally over last fall's low, but still indicates significant worries. Supply chain problems and labor shortages drew special comment in the latest survey, although interest rates, inflation, threats to consumer spending and political instability were also cited. At the margin, while CEOs have become less optimistic about the general outlook, 81% still expect their own firm's revenue to improve and 69% project improving profits. Moreover, 62% of the firms plan to increase capital spending, while 72% project increased hiring. CEO Magazine notes that "a considerable proportion of CEOs see opportunity despite headwinds and hope that persistent issues in the supply chain and labor market, as well as the effects of inflation, will resolve."

Smaller businesses operators seem less optimistic. The National Federation of Independent Business (NFIB) reported that the percentage of owners expecting higher real sales declined 11 points to a net negative of 4 percent. Moreover, a net 13% do not expect profit trends to improve. The survey reported that 30% of the owners say supply chain problems significantly disrupted their businesses. And while 61% of businesses reported trying to hire more help, 57% of the firms reported they see few or no qualified applicants for open positions. The report concluded that owners were losing confidence in the strength of the economy. Thus, although capital investment might seem an important solution to chronic labor shortages, only 55% of firms reported making investments over the last six months, a number the NFIB notes is not particularly strong.

Although industrial areas grew a little faster in 2021 than they have historically, production levels were not far above prior peaks. In nominal prices, manufacturing grew close to 4% last year, a little stronger than its long-term growth rate of roughly 1.5%. Oil and gas extraction grew a little over 7%, which was close to its long-term growth rate of 6%. Energy drilling's 55% growth was well above its 1.4% historical rate, but drilling activity remained 14% below its pre-pandemic peak. Energy extraction ended the year about 5% below its prior top and manufacturing was just a little more than 2% over its prior peak.

Nonresidential investment posted a little stronger growth than the industrial economy. In 2021, the investment in structures, equipment and intellectual property all grew close to 10%, roughly twice their historical growth rates, which ranged from about 4% to 6%. In the 4th quarter, however, the equipment and intellectual property areas stood only 2% to 3% above their prior peaks, while investment in structures remained almost 14% below its peak. Unless supply disruptions have a major impact on industrial production and investment activity, most areas of the business economy should have ample capacity.

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Exports and international economies

Exports were a strong positive for the U.S. economy in the 4th quarter, adding 2.4% to overall GDP growth. But imports were also strong, reducing GDP by 2.4%. Netting the two, trade was flat for the quarter.

Given relatively high vaccination rates and a less-lethal variant of the coronavirus, most countries of the world have moved toward normalizing activities in ways that should benefit their economies. Yet before most countries could fully ease viral restrictions, inflation began to pose problems. Now, the global community must deal with the human tragedy and economic fallout from war. The fact that Russia is a major energy supplier, and that together Russia and Ukraine account for 30% or more of global wheat production suggest the conflict could have far reaching economic effects.

Even before the war, the Eurozone was struggling economically. That region did not weather the pandemic as well as some other countries. It finally posted solid GDP growth in Q3 and Q4, only to decelerate sharply in Q4 as the Omicron outbreak took hold. A Manufacturing PMI (Purchasing Managers Index) of 58.4 and a rebound in the Services PMI to 55.5 suggest an improving near-term outlook, but those numbers do not reflect the impact of Ukraine. War is always economically disruptive, but even more so when the conflict is close. It also doesn't help that Russia has provided 40% of Europe's natural gas. The current conflict could push the Eurozone's inflation rate of 5.8% much higher.

The United Kingdom has staged a stronger recovery. Growth in Q3 and Q4 of 2021 ran close to 4% on an annualized basis, roughly twice as fast as the U.K. was growing prior to the pandemic. But it was primarily an exceptionally strong Q2 that made 2021's growth the strongest the country has seen in decades. The PMIs suggest a strong outlook, scoring 58.0 for Manufacturing and an even stronger 60.5 for Services. Yet while the U.K. is not quite as enmeshed with Ukraine as other parts of Europe, the conflict may disrupt the U.K. economy as well. A 5.5% inflation rate has prompted two rate hikes so far, but Ukrainian uncertainties may encourage U.K. authorities to proceed more slowly from here.

Japan avoided major COVID-19 outbreaks until the Olympics in July of last year. The virus and the restrictions implemented to halt its spread caused the Japanese economy to contract in the third quarter. The number of infections and public restrictions eased in time to spur fourth quarter growth, but an Omicron wave has again dampened the outlook for the 1st quarter. Concerns about the virus has apparently weakened the outlook for services substantially, as the Services PMI declined from a 52.1 reading in November to February's very weak 44.2 reading. The Manufacturing PMI's decline was not as severe, as it fell to 52.7, which forecasts modest growth. Rising inflation is not a problem, but 2021's 0.7% GDP growth was disappointing and 2022's growth seems off to a slow start.

China faces a number of shorter-term and longer-term challenges. The country reports relatively few COVID cases. But even if those numbers are absolutely accurate, outbreaks and the associated lockdowns have had significant economic impacts at times. Until the Chinese ease their zero tolerance COVID policy, the economic disruptions may continue. Also shorter term, problems in the housing markets risk both political and financial instability, as well as robbing China of what had been a major source of economic growth and government revenue. Reflecting the shorter-term challenges, economic growth fell from 5.8% just prior to the pandemic to 4.0% for 2021. The near-term outlook also seems mediocre, with a modest Manufacturing PMI of 52.7 and a barely growing Services PMI of 50.2. Longer term, with a population that is no longer growing, even a 4% growth rate would seem difficult to sustain.

Purchasing Managers Index
4th Quarter

	Manufacturing	Services
Eurozone	58.4	55.5
United Kingdom	58.0	60.5
Japan	52.7	44.2
China	52.7	50.2

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About Bruce McCain

Bruce McCain serves as a consultant providing perspectives on the economy and the market to both investors and business operators. He has appeared regularly on CNBC and Bloomberg providing market perspectives and has been quoted in The Wall Street Journal, Investor's Business Daily, and MarketWatch as well as published articles on Forbes.com. He retired from KeyBank in 2019 after 32 years.

Acknowledgment: The author wishes to express appreciation for the research and opinions of Cornerstone Macro and Tim Duy at the University of Oregon that were used as background information in preparing this piece, as well as to numerous government and other public information sources that provided data and economic updates.