Capital Risk

USA ECONOMIC OUTLOOK

Deflating Demand

Photo: Paul Teysen on Unsplash

America's bifurcated economy faces a long-dormant specter, inflation. The challenge for investors is determining whether this nefarious outcome is a temporary or permanent feature of the post-Pandemic landscape. The answer lies in assessing its root cause. The Pandemic's onset brought a health policy-induced retrenchment of service demand. With the consumption of services off the table, consumers transferred spending to goods. The fiscal response amplified this decision by increasing incomes broadly. The reality of just-in-time supply chains was that they depend upon stable demand. The resultant supply bottlenecks delivered inflation. Adaption will occur in time and provide higher supply while incomes lower with fading stimulus payments. As business adapts, this too will pass.

"

An abrupt switch in consumption baskets during the Pandemic conspired with slow-moving supply chains to deliver goods inflation.

This temporary event is already fading. Housing prices and goods consumption will continue to moderate as the economy rebalances. Inflation hawks take heed: this time is not different.

- *Jason Prole*

"

Highlights

- **Growth** for the year may approach **6.0%** as from stimulus measures.
- The **fourth quarter** will begin to show the rebalancing of goods and services.
- The **Leisure** sector is rebounding yet has much further to go.
- **Exports** will need to rebound to offset import growth.
- **Government** is the only component that can offset declines elsewhere.
- **Inflation** will temporarily reach **above 5%** as housing and commodities surge.

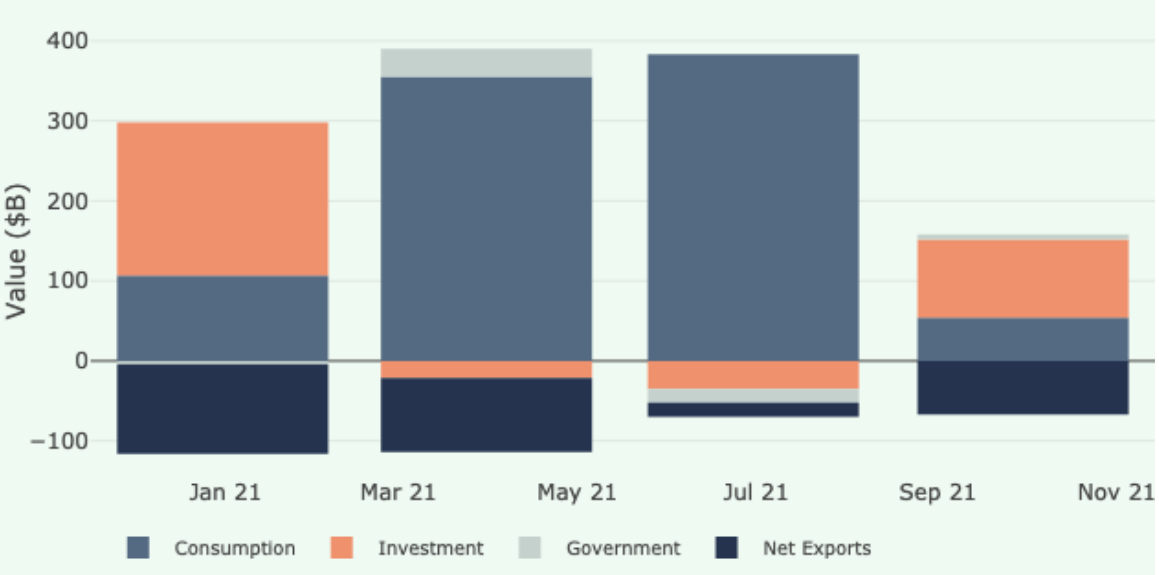
The Macro View

A **demanding policy.** The government delivered monetary and fiscal stimulus in the face of a cataclysmic economic retreat brought on from health policies enacted to prevent an eye-watering death toll. The challenge of all macro policies is their lack of precision, which leads to unintended consequences. A demand gap in services was a forgone conclusion as a Pandemic permeates the economy. The policy response delivered saving surpluses that enabled an unprecedented goods expansion to offset the services gap. As is always the case with too much money chasing too few goods, prices rose. The follow-on problem that the U.S. economy faces from its Pandemic policies is inflation and whether it is structural or transitory.

The boom in consumption also delivered an expanding trade deficit as imports increased faster than exports (exhibit 1). With hindsight, these events are obvious, yet they were not contemporaneously evident. Hawks spoke of *government* deficits, not *export* deficits, and *lower* demand as the government crowded out private spending, not *higher* demand. While global supply changes are dynamic, the *increased demand* overwhelmed them. This economic outlier is a unique event. As the current quarter shows, goods consumption *brought forward future demand* and will ensure *future goods demand lowers*.

Consumption is slowing.

Exhibit 1. GDP Contribution by Component



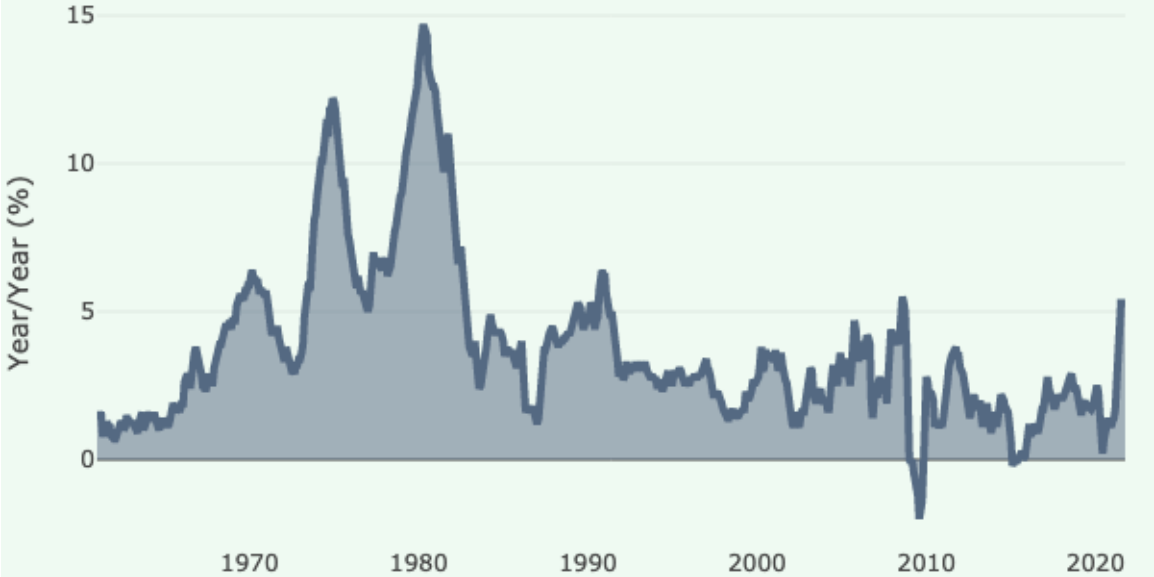
Source: Federal Reserve Economic Database, CRM Calculations.

The Macro View

Up, Up, and Away. That inflation is occurring in the economy is unquestioned (Exhibit 2). Its durability is uncertain, even as it reaches rates unseen in 30 years. The duration of inflation is a function of its root cause, the convergence of excess demand from *temporary* policy decisions with modestly constrained supply. The former is transitory, while the latter involves dynamic global supply chains not designed for *jumps in demand*. There is little debate that demand will fade as stimulus checks disappear and monetary stimulus recedes. The economy will endure the drag of this loss consumption over the next few years, which is *disinflationary* on its face.

A three decade high of inflation.

Exhibit 2. U.S. Consumer Price Index (Annual Change, %)



Source: U.S. Bureau of Labor Statistics, retrieved from FRED. CRM Calculations.

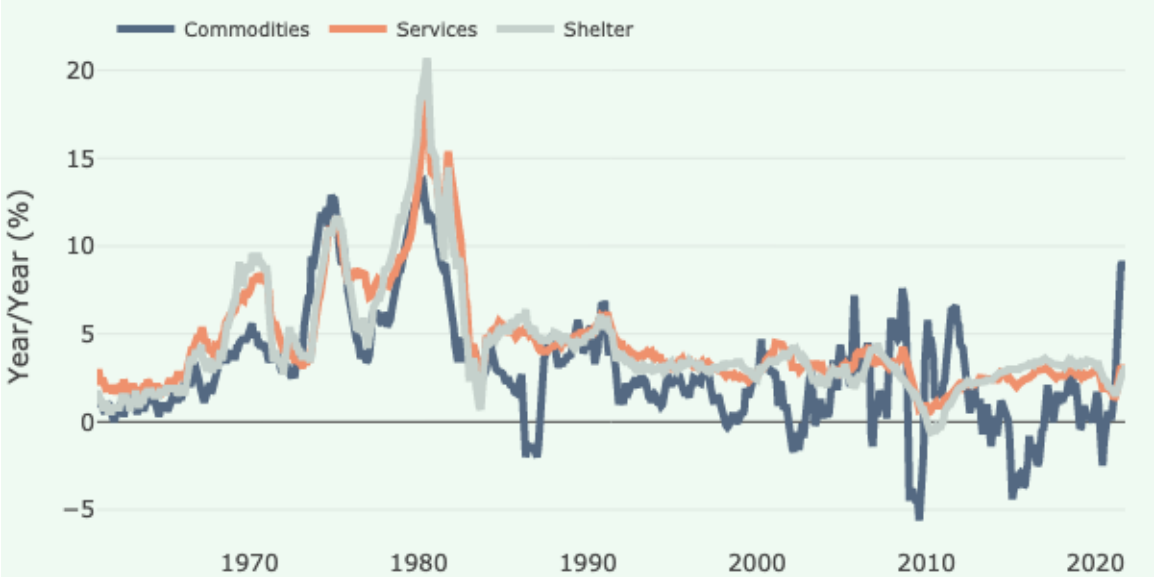
The supply constraints appear burdensome as ships litter American harbors and containers stack up in their ports. Yet, this hides the fact that goods consumption is materially above the prior trend. This situation is critical to understanding the current inflationary pressures. Supply chains are dynamic and global. This situation requires operational planning with lead times that can stretch to a year to deliver goods from one place to another. The accelerated *goods* demand overwhelmed the supply chain, as evident from the dramatically higher level of goods consumption. Thus, goods inflation should *not be surprising*.

The Macro View

Do not touch. As the Pandemic spread across the world, the economy shuddered as consumers retreated. While trite, it is evident that consumers would not spend money on services that involved contact with other people. The expectation was for losses in leisure activities, hotels, and dining. A surprise at the time was the *fall of medical service during a pandemic*. In hindsight, people avoiding discretionary health services where the virus is likely is rational. The data is clear on these outcomes: commodity prices (e.g., goods) rose, while services and shelter moderated (exhibit 3). The law of supply and demand remained intact.

Commodity prices are growing at 40-year highs

Exhibit 3. U.S. Consumer Price Index Major Components (Annual Change, %)



Source: U.S. Bureau of Labor Statistics, retrieved from FRED. CRM Calculations.

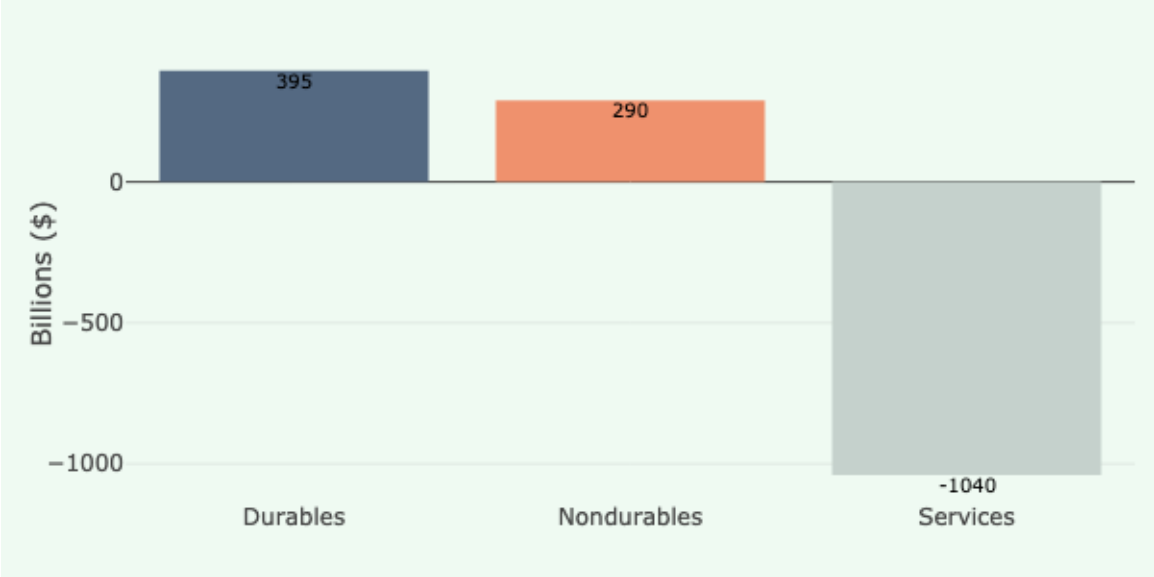
While unemployment rose sharply in the affected sectors, rebates and other support helped fill the income gap. Yet, most remained fully employed and possessed disposable income from rebates, mortgage refinancing, and their services spending void. Demand rapidly moved to a goods supply chain that was unable to adapt quickly *by design*. As the polemic in Washington centers around the failures of the supply chain, the root cause was the increased demand meeting inflexible supply. The supply chain was the *symptom*, not the cause, while goods inflation was the follow-on outcome.

The Macro View

Boom and Bust. The divergent economy is evident in the difference in consumption since the onset of the Pandemic (Exhibit 4). Durables and non-durables goods have exceeded their prior trends by a cumulative amount of nearly *$700 billion*. In comparison, services fell over *$1 trillion* below previous trends. Herein lies the challenge for the future. The goods sector is pulling workers from the languishing services sector with the enticement of higher wages. Yet, it is doubtful a worker would switch into a sector where the job may disappear as the transitory demand fades without a material incentive. This action brings current wage inflation at the cost of future wage *deflation*.

Goods filled the services gap.

Exhibit 4. U.S. Consumption Surplus/Deficit by Component (Billions, $)



Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis. Cumulative difference from prior trend, 2020Q2 to 2021Q3.

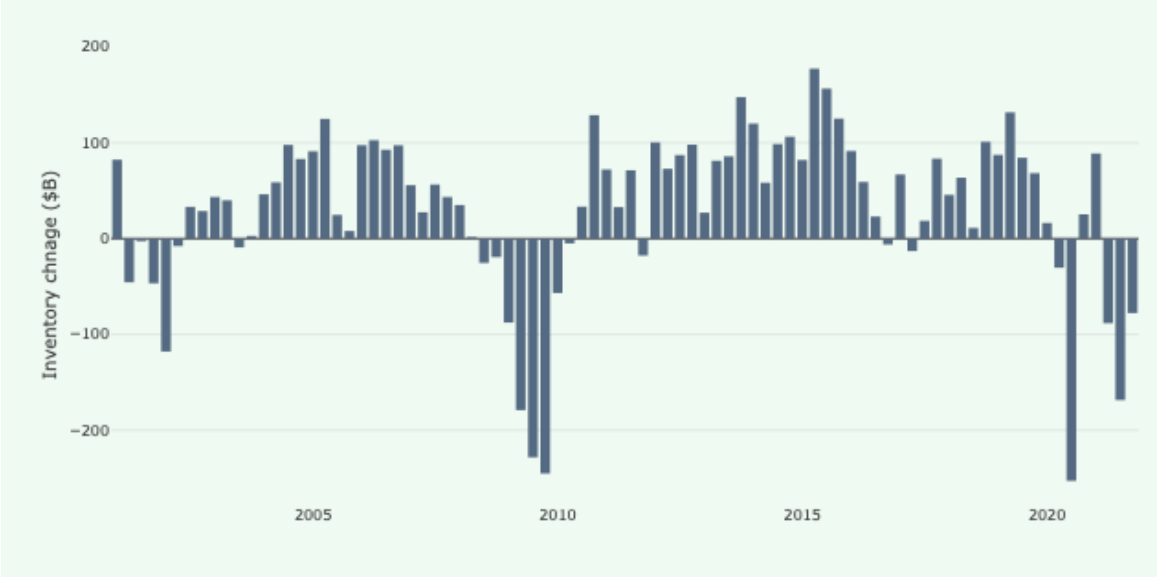
The wage outcome should be evident. Higher wages entice an employee to the goods sector from the services sector. The employee is a price-maker. When the tide turns and the employee terminated, they return to an overflowing employment market. The service economy is now the price-maker on its primary input, *labor*. They need not deliver the inflated goods wages, particularly when further stimulus policies are limited. Thus, both sides of the consumption bucket deflate as demand wanes and supply expands in this environment. Inflation becomes deflation.

The Macro View

Drawdown. As the economy exceeds its prior heights with frantic goods consumption, inventories continue to drawdown and reflect *recessionary behavior* (exhibit 5). This perplexing artifact does not foreordain a deflationary spiral. As goods demand fades, the sector will need to restock its drawn-down inventories. This outcome provides a means to moderate the blow from the dearth of demand that will arrive. Yet, it is likely not sufficient as the demand increase was about four times the inventory drawdown. While the extent is uncertain, this arithmetic suggests that goods inflation will return to more deliberate rates.

Excess demand is drawing down inventories.

Exhibit 5. U.S. Inventories Change ($, Billions)



Source: U.S. Census Bureau, retrieved from FRED, Federal Reserve Bank of St. Louis

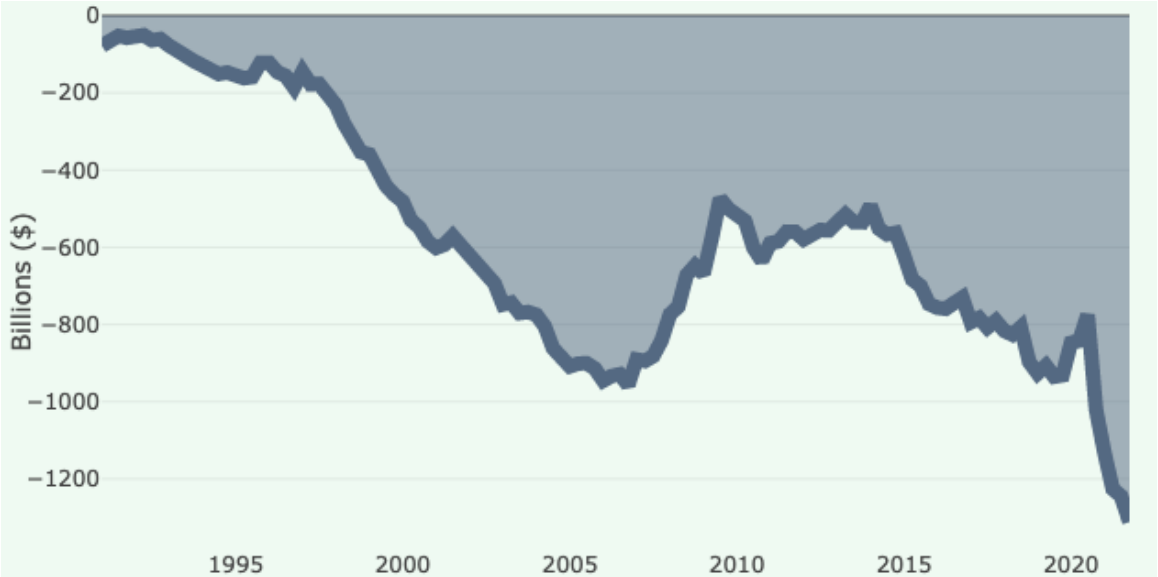
Moderation of steroidal goods demand evinced by the economy will deliver material short-term implications, which may have already begun to arrive. This force may reach its nadir in the first quarter next year. As the holiday season and its annual highs in consumption passes, goods companies will hold late-arriving merchandise that will require liquidation. This prospect suggests the new year could start on a depressed note as seasonal factors conspire with supply chain disruptions to deliver the confluence of excess supply and receding demand. This situation portends *further pressure* on goods to deflate.

The Macro View

Unbalanced. There is no more evident sign of the evolution of the U.S. to a services-based economy than the trade deficit, which has plummeted during the Pandemic (exhibit 6). The surge of spending on goods drove imports upward while feeble global demand constrained exports. The result was an expansion of over 25% in the net trade deficit to about *$1.3 trillion.* This outcome would usually signal a decline in the U.S. dollar. Yet its level remains consistent with the pre-Pandemic level. This outcome *moderates* the inflationary impact of increased import goods purchases.

Net exports are too low.

Exhibit 6. U.S. Net Exports



Source: U.S. Census Bureau, retrieved from FRED, Federal Reserve Bank of St. Louis.

The other perplexing outcome is the rise of commodity prices with no offsetting decline in the U.S. dollar. Commodities are priced in U.S. dollars globally; thus, price increases usually result in a *drop* in the U.S. dollar. Disentangling the drivers of these outcomes is complex, yet there is one clear implication: U.S. dollar demand is high.[1] This situation highlights a material inflation threat for U.S. policymakers.

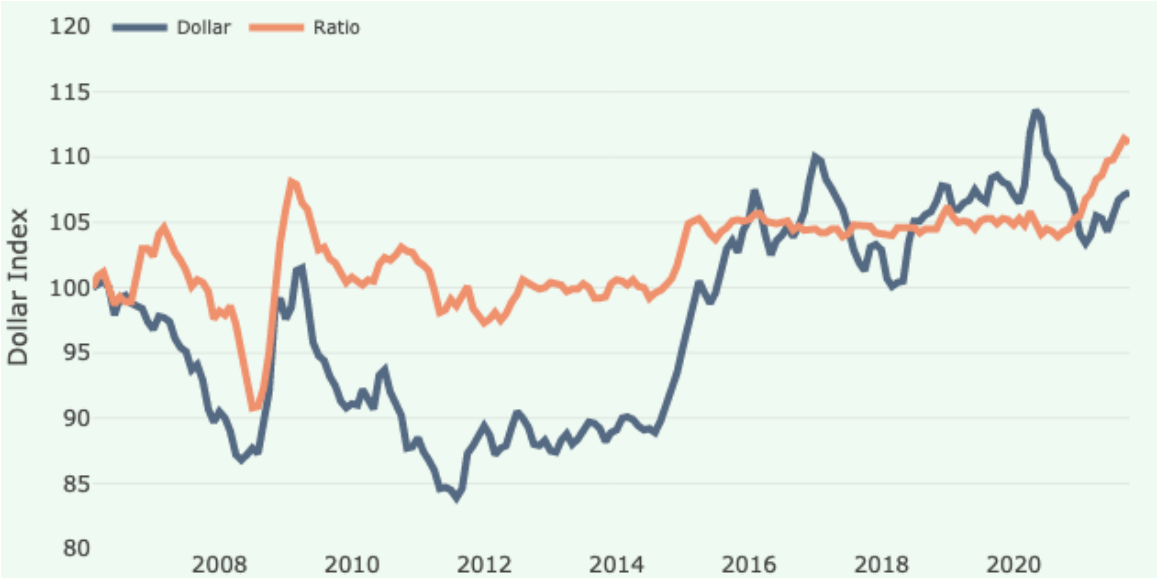
[1] This is occurring despite no material change in foreign holdings of U.S. Treasuries over the last year. https://ticdata.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt

The Macro View

Dollar Divergence. The driver for currency levels is a combination of growth and inflation differentials, which reflect the nominal interest rate. Higher levels in one country entice investors to buy the currency and lead to currency appreciation.[2] This relationship would suggest support for the U.S. dollar as domestic inflation accelerates faster than its foreign comparable, a situation that is now occurring. Thus, there is a theoretical and fundamental argument for the strong U.S. dollar despite the rise of commodities prices.

The U.S. Dollar should be higher.

Exhibit 7. U.S. Real Trade Weighted Dollar & Ratio of Export/Import Price Indices



Source: Board of Governors of the Federal Reserve System, retrieved from FRED. The ratio is Export & Import Price Indices of Commodities (End Use). CRM Calculations.

Another anomaly further supports a higher U.S. dollar: export prices are rising materially faster than import prices (exhibit 7). After nearly six years of *no movement* in the ratio of the price indices, exports prices are *ten percent* higher versus import prices. Yet, the real trade-weighted dollar is effectively *unchanged*. This situation presents *two outcomes*: U.S. disinflation as the U.S. Dollar appreciates or inflation as export prices fade. Caveat emptor.

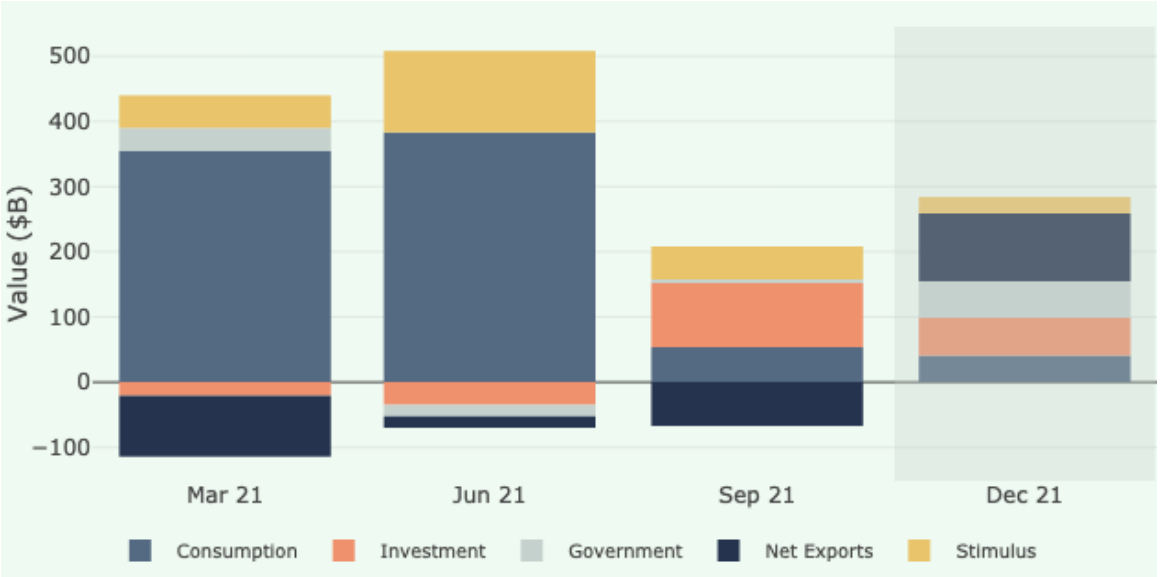
[2] This relationship is the *International Fisher Effect,* and there is a debate on its validity.

The Macro View

Diminished Demand. The goods demand boom that accompanied the fiscal stimulus is waning and portends a future demand drought. A rebound of services could overcome this pullback. Yet it must also contend with low vaccination rates that moderates its rebound. As the recent GDP numbers show, this outcome is beginning to show up *sooner than anticipated*. Herein lies the problem for the world and the U.S.: future growth will require more stimulus because of the Pandemic policy response. If not, *higher debt with lower interest rates and growth* is the outcome.

A 6.0% rise is forecast for 2021.

Exhibit 8. Forecast for US GDP Growth



Source: CRM estimates. Amounts are annualized rates. Shaded area is forecast.

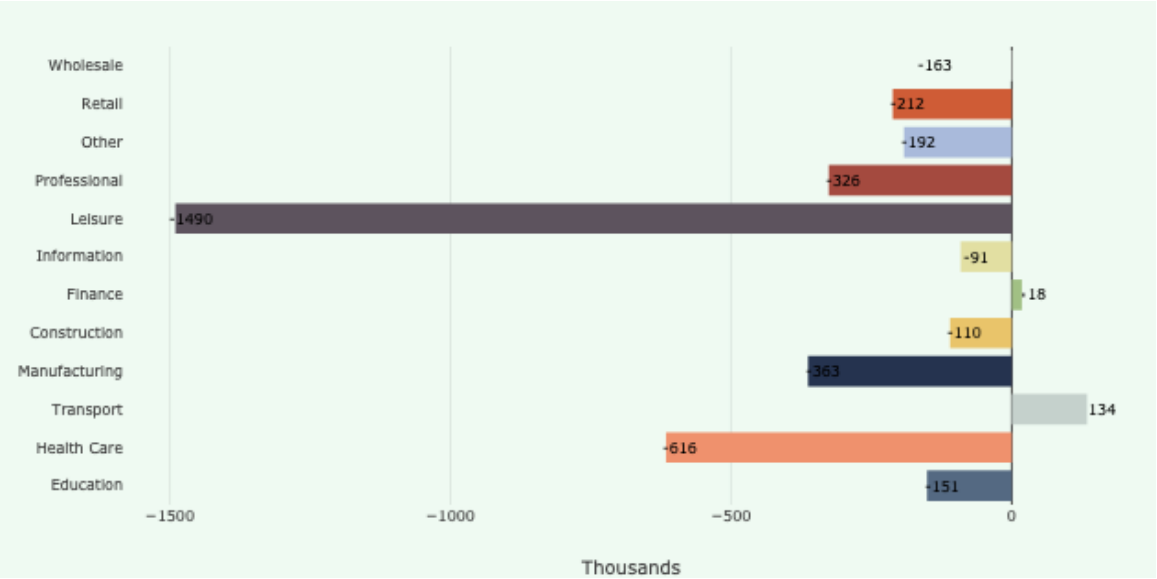
For 2021, growth will approach 6.0% (with 1.3% from the stimulus) and achieve a rate not seen in forty years (exhibit 8). Two key risks remain: exports do not rebound due to continued uncertainty from the Pandemic, and investment declines rather than slows. Both risks are *probable* outcomes and could lower annual growth 0.3-0.5%. Our inflation expectation is a revised 5.6% rate (year/year). With inflation running well ahead of expectations, *fiscal policy is the antidote* to help cure the nearly four million unemployed people. The risk is 1970s stagflation, rather than 1940s demand-pull inflation and growth.

Consumption

There are telling signs that this version of inflation is demand rather than supply-led inflation. Increased demand overwhelmed a rigid global supply chain and brought follow-on inflation. An evident sign is *higher* employment in the transportation sector than before the Pandemic started (exhibit 9). As ships litter U.S harbors and ports remain filled with shipping containers, the sector is pulling labor in to meet demand. This outcome is not a failure of supply but an artifact of the increased *demand*.

The leisure sector's recovery awaits.

Exhibit 9. U.S. Private Employment Change by Sector (Thousands)



Source: Federal Reserve Economic Database. Change from December 2019 to September 2021.

Little doubt exists to the carnage marking the sectors most affected by the Pandemic. The leisure sector remains nearly $1.6 million people below its prior peak. In comparison, the health care sector is still down over 600 thousand people. The worry is not whether these sectors will recover; instead, it is if consumer behavior changed during the Pandemic.[3] A behavior change *may endure for a generation,* thus limiting the return to full employment. Of course, some sectors don't let a crisis go to waste. Finance sector employment is above its prior peak. Economic epidemic indeed.

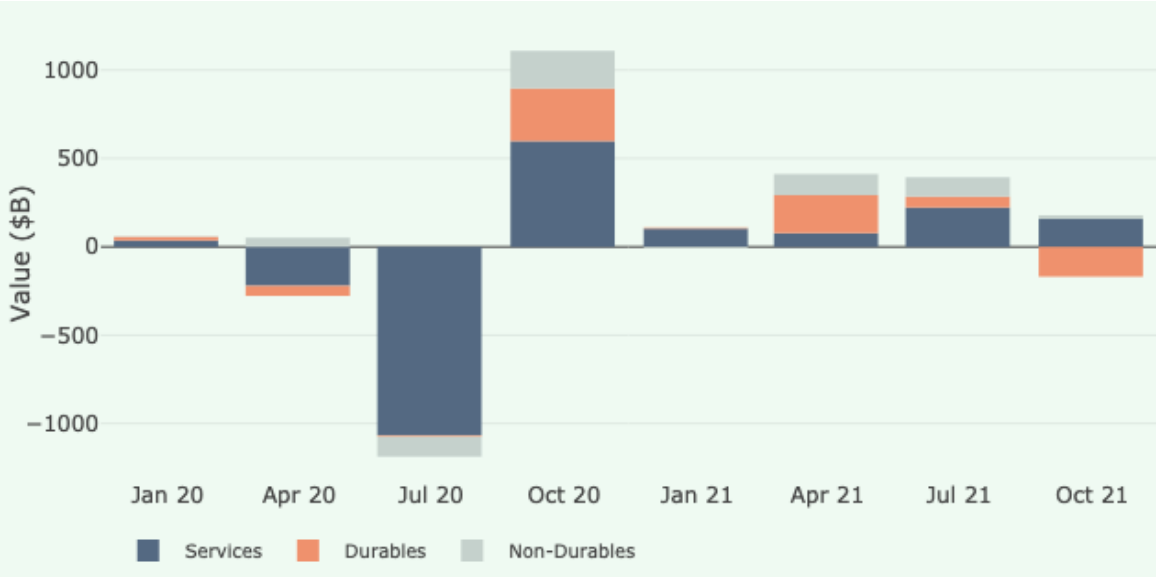
[3] Capital Risk highlighted this risk in its pandemic series, **Economic Epidemic**, April 2020.

Consumption

Demanding Goods. Policy decisions are blunt tools, which are a feature rather than a constraint because they can enable quicker action during uncertain times (i.e., during a global pandemic). The drawback is unintended consequences, like the jump in goods demand as rebate checks arrive. While helpful when filling a public health policy-induced demand slump, it also moves demand across time. The durable goods demand brought forward during the Pandemic is now turning into a constraint on growth (Exhibit 10). Indeed, there are only so many recreation vehicles one needs to buy.

Durable goods are contracting.

Exhibit 10. Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

Herein lies the consumption challenge. Due to the consumption's size in U.S. GDP, a pullback in goods consumption *requires* expanding services to avoid a recession. Yet, the return to normalcy remains elusive, with about one-third of the eligible population remaining unvaccinated. This outcome is critical to the services sector that needs consumers to return to restaurants, hotels, sporting activities, and health care. A service rebound is needed quickly, or two risks may materialize. First, it may bring recession in the first quarter. The second and more significant risk is a permanent change in consumer behavior that may *lower growth for a generation*.

Consumption

A Stalled Car. The makeup of goods consumption highlights the challenges ahead (exhibit 11). First, the magnitude of the rebound was about *$600 billion above* the prior trend rate. Second, the expected refresh rate of durable goods is generally more than three years. This logic suggests that the jump in durable goods *brought forward future purchases*. In the absence of an external event where income or credit expansion inflates demand again, reduced future growth is in play for purchases, including vehicles, furnishings, and recreation goods.

Car sales are declining.

Exhibit 11. Goods Consumption Contribution by Component

Source: Federal Reserve Economic Database. Values annualized rates.

The latest reading for vehicles & parts was a material decline. Certainly, some of this decline is from constrained inventories with new cars sales currently about 4 million below the prior trend rate.[4] Yet, the high prior consumption rate during the Pandemic also indicates that some of this decline is from demand retreating. People only need so many cars. This outcome is apparent in the numbers, as this quarter's decline merely *returned to the prior trend level*. The challenge lies ahead because cars are a *quarter* of durable goods.

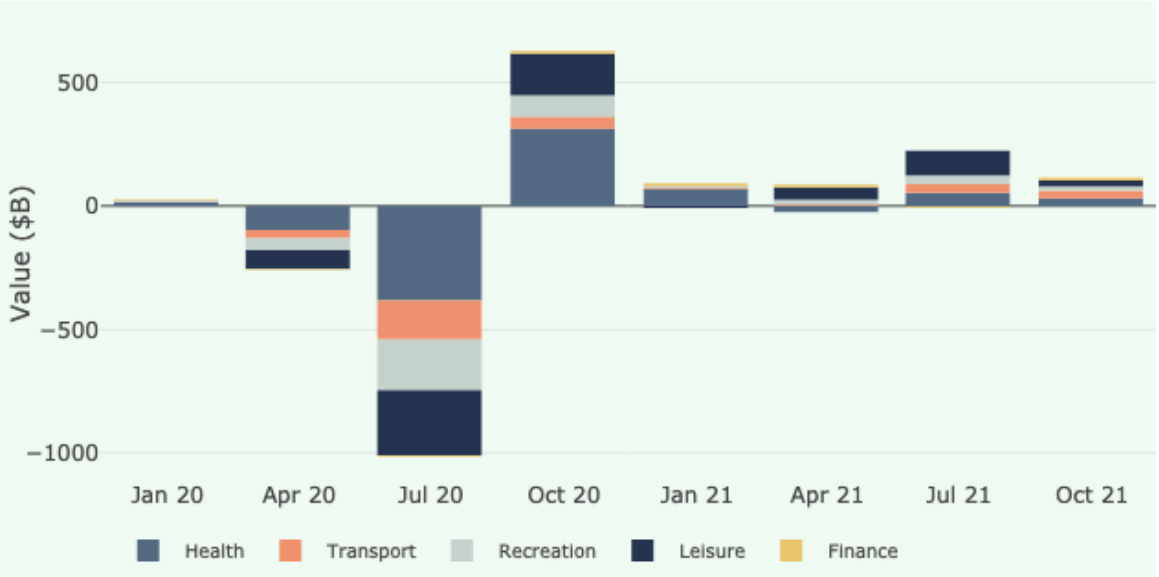
[4] See Light Weight Vehicle Sales: Auto and Light Trucks https://fred.stlouisfed.org/series/ALTSALES

Consumption

A Healthy Recovery. The Pandemic wrought havoc on the service sector, which is now nearly back to its prior peak (exhibit 12). If goods consumption continues to fade, then services are the main avenue to growth and is where the path becomes unknown. With Health Care, Professional Services, and Education *still a million jobs below their prior level*, there is room for growth. Yet, their output is back pre-Pandemic levels with *fewer* employees. Indeed, some of this cyclical and employment will return as demand increases.

Services return to trend.

Exhibit 12. Service Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

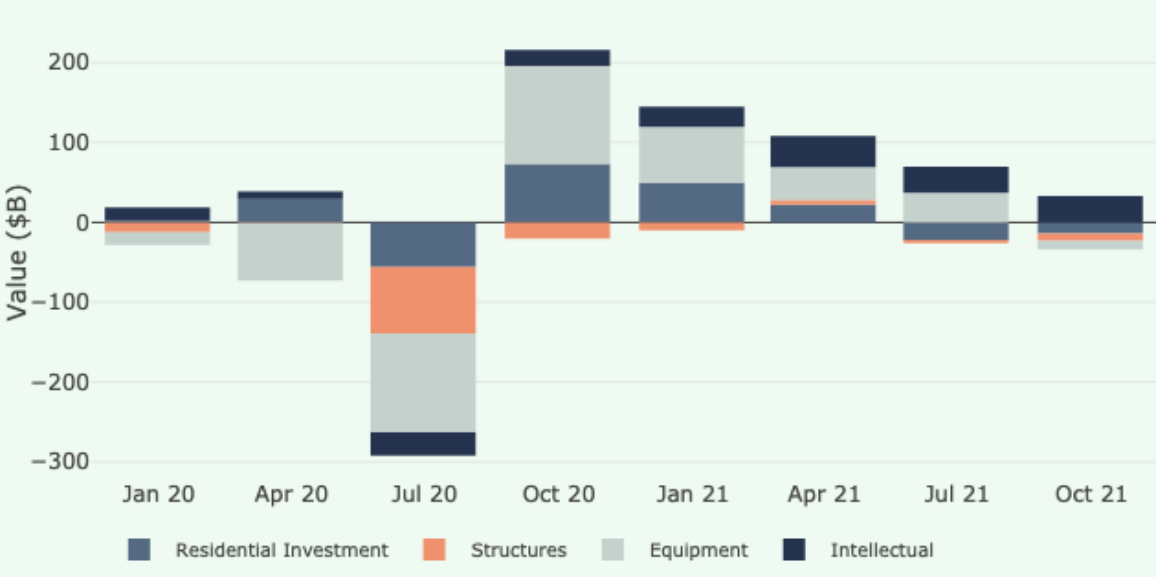
The structural challenges are significant. Education faces the demographic headwind of declining students for *two decades*. In contrast, demographics are somewhat supportive of health care services as society ages. Yet, a significant component of health care was discretionary services that may not return to prior levels. Still, the notorious inefficiency of health care may have adopted some best practices that obviate the need for some jobs. Further, some professional business services were contingent on commercial real estate, which is now receding. These jobs may only return very slowly, if at all. The implication is that future growth in services may not immediately return to prior rates, inhibiting growth.

Investment

The investment boom is becoming a bust, with only intellectual property showing gains (exhibit 13). This is significant along a couple of dimensions. First, investment is by nature a long-lived decision. The heightened investment that occurred during the Pandemic will not need immediate replacement. Second, moderating consumption needs another component to expand otherwise the *risk of recession will grow*. Third, the threat of higher inflation suggests now is the time to finance investment before marginally higher interest rates raise the cost. Yet, fixed investment is *fading in every component*. With abundant savings driving low financing costs, the dearth of investment is unfathomable.

Investment is a risk.

Exhibit 13. Investment Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

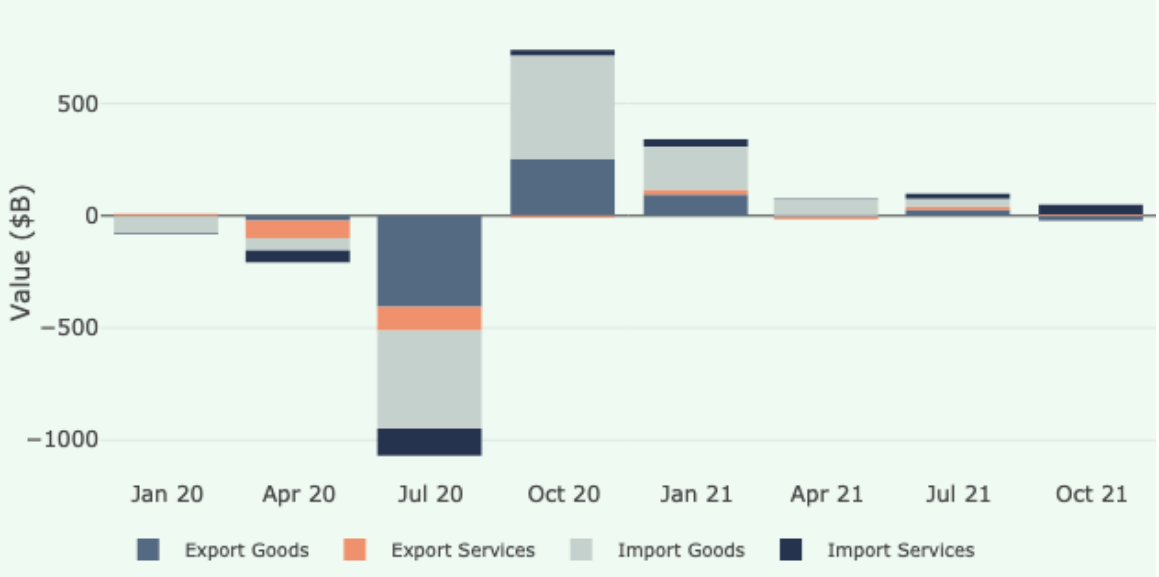
Businesses must assess future demand to align current investment. The contraction of investment suggests that recent investment can meet future demand, or they expect a more favorable investment environment in the future (i.e., lower interest rates). The latter is the most likely driver as the confluence of abundant savings, and low investment should deliver *lower interest rates*. The absence of further fiscal stimulus (i.e., the Build Back Better program) would *further magnify* this outcome.

Exports & Imports

The U.S. consumer's conspicuous is world renown. Yet, their thirst for goods is satiable as imports didn't expand for the first in over a year (exhibit 14). The trouble is that *import services* are now expanding as international travel resumes. The dissidence between imports and exports is unmatched in the last *50-years.* Indeed, some of this divergence is a result of varying policy responses across the world. Yet, the challenge is that consumer behavior is changed and permanently ingrained. The result of addressing the supply chain issues could be a *more import-dependent economy and less domestic investment*. This outcome is counter to the *public policy goals*.

Export growth is *zero.*

Exhibit 14. Net Exports



Source: Federal Reserve Economic Database. Values are an annualized rate.

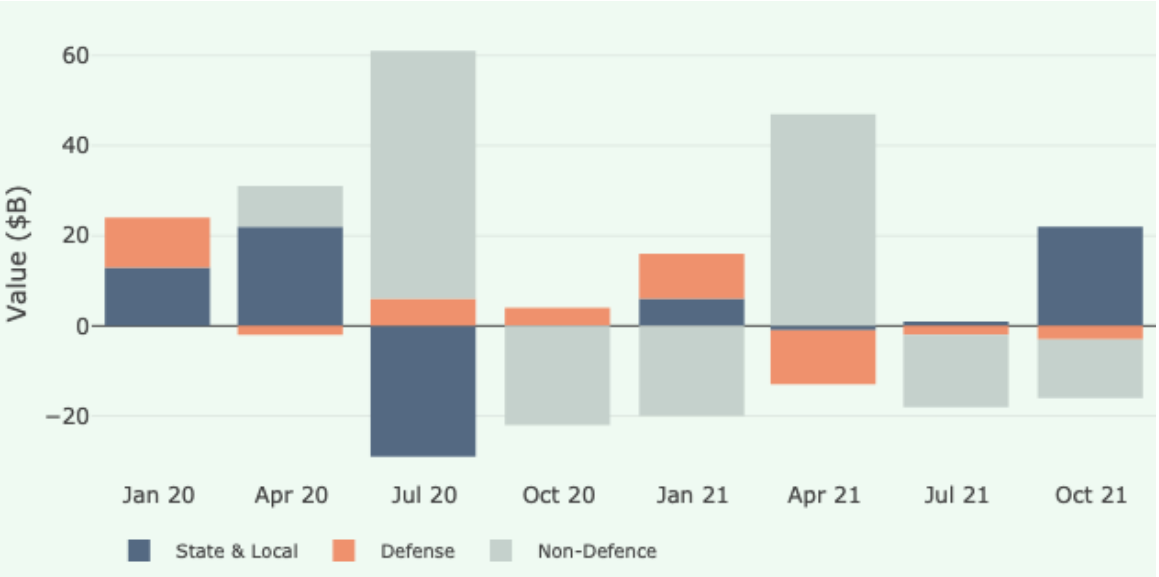
The decline of the trade balance highlights the challenge facing policymakers (exhibit 6, p. 7). Higher inflation raises interest rates, which draws capital to increase the U.S. dollar. This action depresses exports as they become more expensive and make imports cheaper. The result is a continued net export deficit that *cannot offset* the other components of GDP that are slowing or contracting. Herein lies the non-intuitive challenge of the moment: the Pandemic policy response may require a further investment-focused reaction to *counter the follow-on effects of the initial policy*. Indeed, up is now down.

Government

Federal fiscal policies attempted to offset a demand deficit with fiscal stimulus and rebates, which the data shows were largely successful. Unfortunately, it may have brought too much demand forward, particularly for durable goods that must now revert. The net impact on government spending in GPD was mostly *unchanged* at all levels, despite the unrivaled size of the fiscal packages with past responses (exhibit 15). That the largest demand contraction in a century was met with *little change in government spending* is a non-intuitive outcome.

Government spending is unchanged.

Exhibit 15. Federal and State Government



Source: Federal Reserve Economic Database.

The reality of government spending is nuanced. Most fiscal policy spending was direct cash outlays that materialize in the budget deficit and expanding debt, not in the GDP accounting numbers. This artifact serves to diminish the impact of government spending in the GDP accounts. The reality is that government spending is a service that was largely shutdown during the Pandemic and highlights the remarkable outcome that it *did not fall* during the period. Further, it supports the contention that a world of deficient consumption, investment, and exports, government investment might be the sole means to help the economy avert a recession. Build back better, indeed.

Forecast

The GDP forecast for *2021 is 6.0%* (Q4/Q4), with a current consensus estimate of 5.5%.[5] These new growth rates account for the slowing of investment and exports. The forecast is contingent upon a rebound in exports (or alternately declining imports) during the fourth quarter. The challenge for the current data is that the jumps in stimulus throw off seasonal adjustment models used in GDP. Due to this feature, the forecast was modestly adjusted for the final quarter of 2021. The expectation is that some of the third-quarter numbers will be augmented as new data arrives. Critically, the 2022 outlook continue to suggest a significant slowing of GDP growth to under *two percent*.

The expected headline CPI Inflation for *2021 is 5.6% (prior 3.9%), and core CPI is 4.0% (prior 3.7%)* versus a revised consensus rate of 5.8% and 4.5%, respectively. The main driver of the divergence from consensus is the belief that commodities will drive the headline number lower by year end as supply constraints fade and demand wanes. The expectation is that this occurrence will return inflation to the Fed's target of *two percent* during 2022.

Modestly off consensus growth and inflation forecasts.

Exhibit 16. Annual Forecast Versus Actual (%, y/y)

	2021	2020	2019	2018
Real GDP				
Forecast	**6.0**	-3.5	2.5	2.5
Actual		-3.5	2.8	2.3
Consensus	**5.5**	-5.6	2.7	2.9
CPI				
Forecast	**5.6**	1.2	1.0	2.2
Actual		1.3	2.3	1.9
Consensus	**5.8**	0.5	2.3	2.4
Core CPI				
Forecast	**4.0**	1.8	2.3	2.1
Actual		1.6	2.2	2.2
Consensus	**4.5**	1.5	2.4	2.2

Note: all rates are percent change year/year. Consensus is the Survey of Professional Forecaster's.

[5] Survey of Professional Forecasters, *November 2021*. https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/

Exhibit 17. GDP Component Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	19,465	0.5	4.9
Personal Consumption Expenditures	13,719	0.4	7.0
Services	8,371	1.9	7.1
Goods	5,512	-2.4	6.9
Durable Goods	2,147	-7.3	5.7
Non-Durable Goods	3,399	0.6	7.6
Investment	3,604	2.8	6.9
Fixed Investment	3,586	-0.2	8.1
Non-Residential Fixed Investment	2,886	0.4	9.0
Residential Investment	694	-2.0	5.5
Federal	1,340	-1.2	-0.7
State & Local	2,040	1.1	1.4
Defense	795	-0.3	-0.8
Non-Defence	544	-2.4	-0.5
Research	664	2.0	7.8
Exports	2,290	-0.6	5.7
Imports	3,601	1.5	13.0

Capital Risk

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