Capital Risk

USA ECONOMIC OUTLOOK

Asymmetric Inflation


Photo: Shelly Collins on Unsplash

America is on the road to recovery. Fiscal and monetary stimulus is brewing a magnanimous concoction to lift the economy. While the stimulus ingredients are similar globally, the paths are diverging. This outcome reflects the policy choices made a year ago in America, which pre-funded vaccine development for preferential access. Most of the world lags America in distribution because of their position in the vaccine queue, not their policy response. The result is a multi-speed global recovery that reduces the variability of global growth. The greater challenge is diminished growth in the long-term as tax increases and debt service crowd out other fiscal programs. Fortunately, America faces this global challenge with higher growth prospects as the Millennial generation workforce proportion increases. *Carpe diem*.

"

Rapid enactment of the American Recovery Plan has brought growth forward from the second and third quarters. The summer travel season may be the best quarter in a generation.

The direct payments help in the short run. The lack of focus in the rebates requires sacrificing other programs in the long run. As always, everything has a cost.

\- *Jason Prole*

Highlights

- **Growth** for the year may approach **4.7%** as stimulus buoys growth.
- The **second quarter** will experience peak growth that may set records.
- The **Leisure** sector is rebounding smartly and has further to go.
- **Exports** will return in the second half of the year as vaccines propagate.
- **State & Local government** need to maintain their employment levels.
- **Inflation** will return to the **mid-2s** as housing and commodities lift prices.

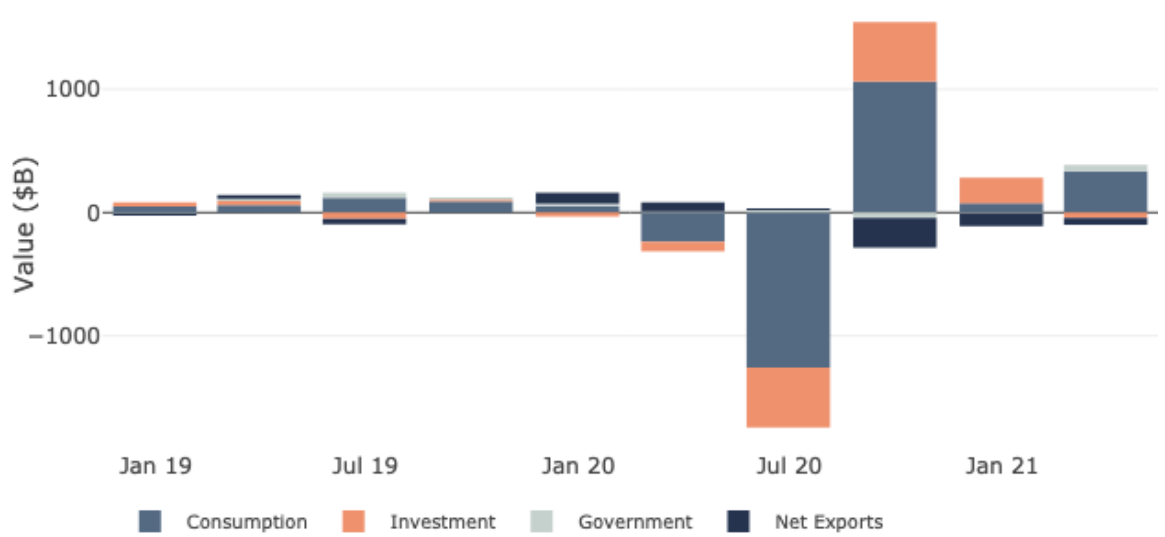
The Macro View

The balloon is inflating. In response to one of the most sudden and catastrophic economic events in a century, governments worldwide flooded the world with fiscal and monetary stimulus. The Pandemic required a material response. While the US sits on the cusp of normalcy as the vaccine's distribution pushes forward, consumption growth reaches unheard of levels despite unemployment levels reminiscent of the Great Recession. This economic contrast highlights the uneven policy response that is magnifying one of the secular trends of the times: inequality.

The US is on the vanguard of the recovery, which is evident in the recent GDP data (exhibit 1). While consumption and investment recovered their losses from last year, exports continue to drag. The latter point highlights that the recovery is primarily an American phenomenon, not a global one. This situation leads to an asynchronous recovery that may smooth global growth while permitting varying leaders and laggards. Critical to the outcome is the fiscal policy response, which America addressed overwhelmingly. The challenge is that the ebullient summer may lead to *sluggish growth starting in the fourth quarter*.

Exhibit 1. GDP Contribution by Component

Consumers will lead the recovery.



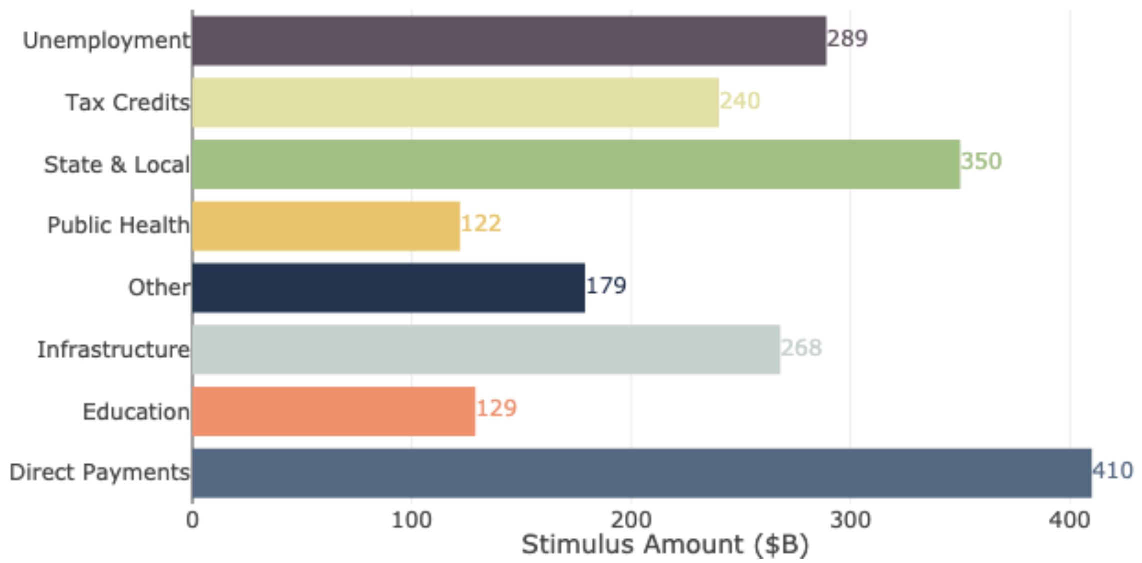
Source: Federal Reserve Economic Database, CRM Calculations.

The Macro View

A sword, not a scalpel. The size of America's policy response to the Pandemic was unseen since the World War II. There is little doubt that the situation called for dramatic policy action. Economic theory leaves little room for debate on whether to support deficient demand. In contrast, there is a material discourse on *where and how*. The fiscal stimulus evaded the discussion by adding something for everyone (exhibit 2). Indeed, the absence of targeted programs ensures one beneficial outcome: there should be little debate that politicians didn't try to assuage the concerns of *all constituents*.

A bit of everything in the stimulus.

Exhibit 2. American Rescue Plan



Source: Joint Committee on Taxation. Capital Risk calculations for categories. https://www.jct.gov/publications/2021/jcx-13-21/

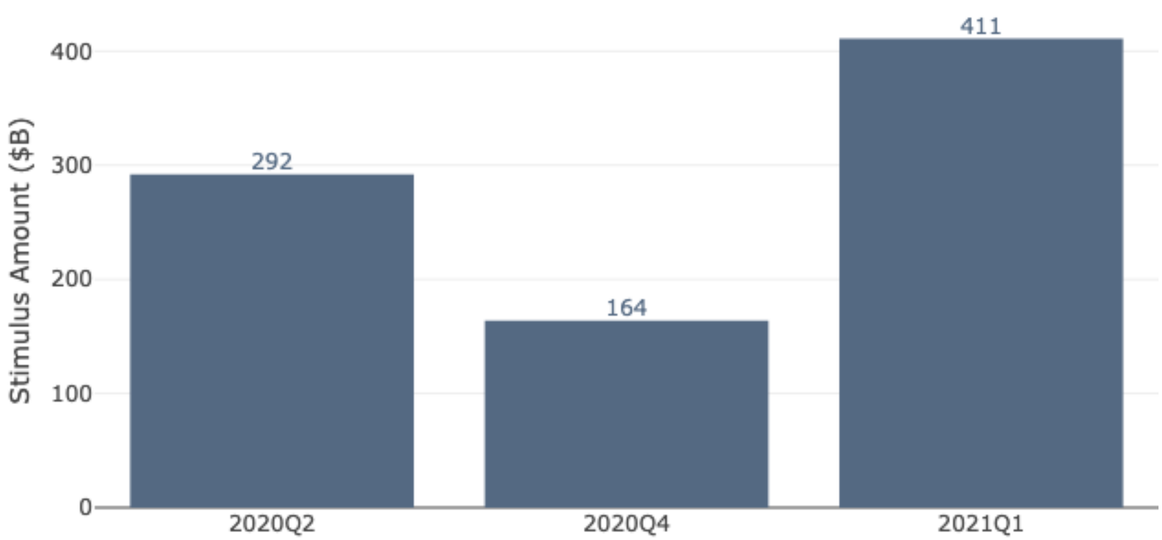
The programs addressed the major deficiencies of the moment: extended employment benefits, support for State & Local governments, education, and public health concerns. These were all programs that addressed specific needs. The primary concern is the largest disbursement, the direct payments to everyone below a certain income threshold. This stimulus was helpful during the collapse of demand *early* in the Pandemic. The need for a further stimulus of this type is not evident *after* the recovery of consumption to near its prior peak. Supporting consumption now *reduces* future consumption and requires higher future taxes that will also impair *future* consumption.

The Macro View

The first direct payments did help address a need. Demand plummeted during the shutdown in March and April of 2020. The direct payments of $292 billion helped moderate the deficient demand (exhibit 3). The trouble was the inability to spend the money due to these shutdowns and consumer frugality from the uncertainty of the shutdowns' length. The unspent money delivered savings that skyrocketed to the highest amount on record. While this outcome was arguably inefficient in timing, it did permit consumers to hoard savings until the Pandemic passed.

Exhibit 3. Direct Stimulus Payments ($, Billions)

Direct payments were *backloaded*.



Source: Congressional Budget Office estimates.

The subsequent direct payments are the more perplexing decision. In the face of evidence that the first stimulus was largely unspent, the response leading into the election was for another payment to the woebegone consumer of $164 billion. With payrolls still *eight million* below their peak, this action has some economic justification. A further dose of $411 billion that nearly equaled the prior two programs is the mystery. With savings still abnormally high, this is ineffective means to stimulate *employment*. The price of the inefficiency will result in a burden for *future* generations that did not necessarily help the *current* generation in need.

The Macro View

The second and third direct payments hit the pockets of 11 out of 12 people who were still *employed*. The benevolence resulted in nearly a *two trillion-dollar* expansion of household savings in America (exhibit 4). This outcome is beneficial to driving demand for Treasury bonds as people park the money in their bank accounts. The trouble lies in the application where the people in need, the unemployed, do not have a viable path to employment through this action. Yet, their liabilities (e.g., rent) remain the same.

High savings indicate a change in consumer behavior.

Exhibit 4. US Household Savings

Source: Federal Reserve Economic Database. Four-quarter moving average.

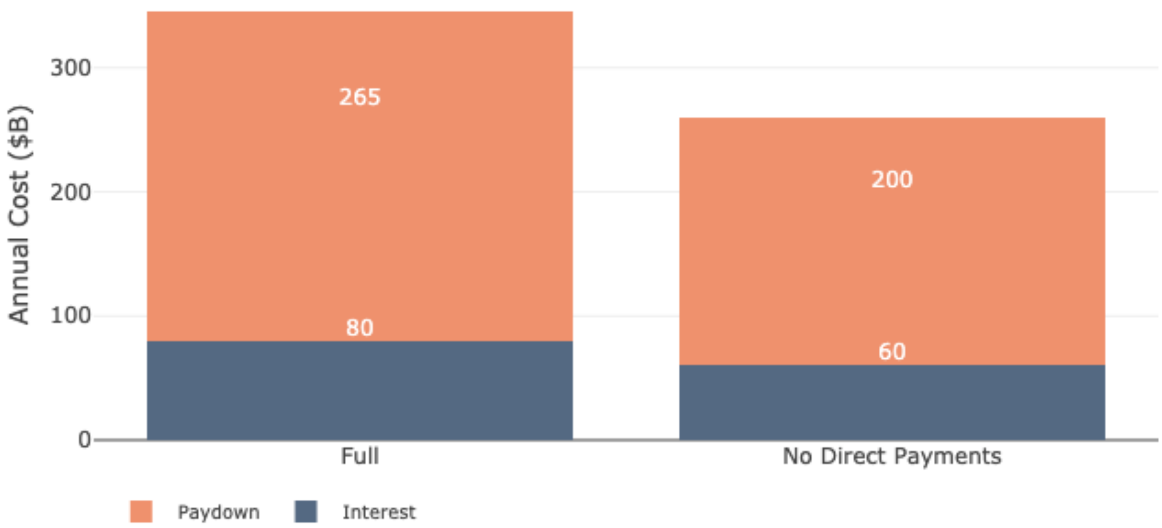
The challenge is the distinction between *aggregate* demand and *marginal* demand. For the economy to return to its prior employment peak, the marginal employees (e.g., the unemployed) must return to active engagement in the workforce. The direct payments are an indirect tool of *aggregate demand* that is susceptible to changes in consumer behavior. The Great Depression caused a generation of consumers to save for a rainy day. The current evidence suggests a parallel dynamic is occurring now. If this situation continues, then the recovery will endure longer than required because of misdirected resources, with future generations bearing the cost via higher taxes.

The Macro View

The secular view is no less disconcerting. First, the wealth inequality in America is exacerbated by this policy choice as the fortunate gain at the expense of the unfortunate. While progressive taxation addresses some of this burden, it still permits the fortunate to leverage their *capital and income* advantage. They can turn their current income (i.e., direct payments) into capital for the expected future tax increases. In effect, they are borrowing at zero cost with the ability to invest (e.g., equities) at a higher rate of return. This *intertemporal arbitrage* may further magnify wealth inequality while not enabling current employment growth.

Exhibit 5. Estimated Service Cost and Paydown Amount of New Federal Debt

The service cost of new debt is material.



Source: Capital Risk calculations based on $4 trillion of new debt at 2% interest rate amortized over 15 years. No Direct Payments excludes the direct stimulus checks from all the fiscal stimulus programs.

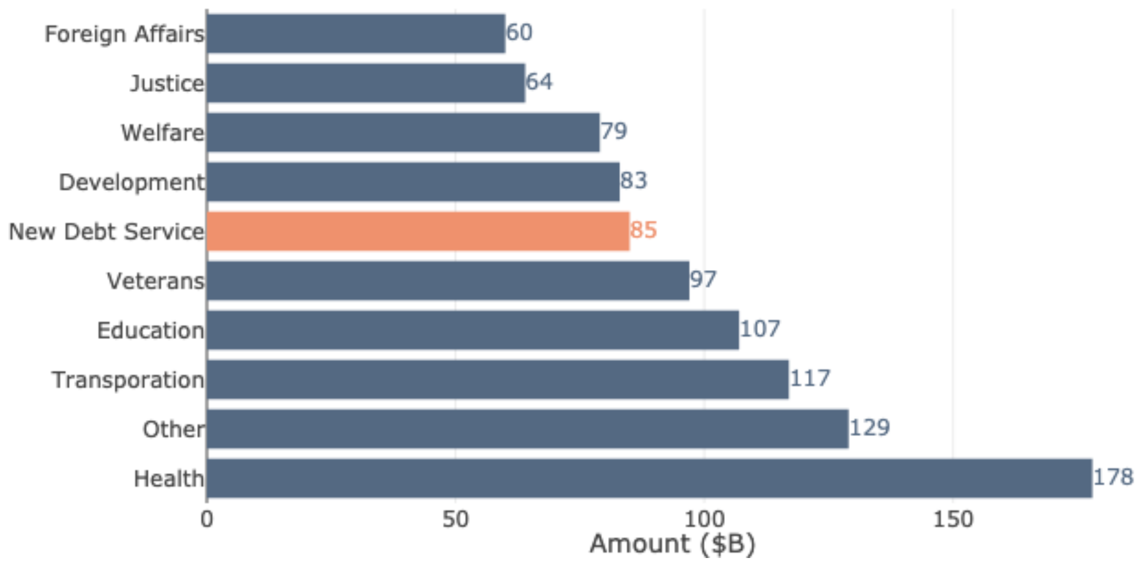
The direct payments cost is material with a marginal debt service of *$85 billion per year* for the next fifteen years. While we can regale in the *fourteen million* jobs that returned from the abyss of the shutdown, it's not evident that any of the returning jobs were the result of the direct payments. Thus, these future payments are a burden that will weigh on consumers for a generation. Critically, they will weigh on future policymakers as they determine *what* fiscal policies to reduce or *who* pays higher taxes.

The Macro View

The $85 billion marginal debt service from the direct payments will exceed some social programs costs, including Welfare and Development (exhibit 6). Higher than expected interest rates could deliver future costs that approach the annual outlay of the Veterans and Education programs. The marginal cost of these programs will deliver either higher taxes or cuts to future programs. In the latter case, *heightened wealth inequality* would decrease programs that diminish intergenerational inequality (e.g., Education and Development).

The stimulus rebates may limit *future spending*.

Exhibit 6. US Federal Non-Defense Discretionary Spending



Source: Congressional Budget Office, April 2021. CRM estimate of debt service for direct payments.

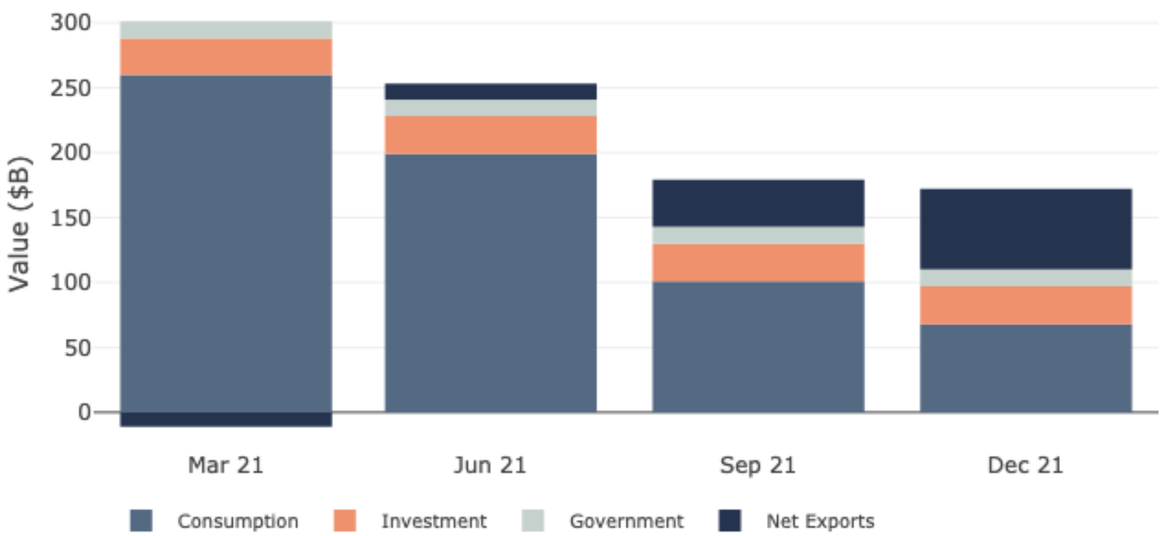
The design of fiscal programs during an economic contraction is complex. This challenge is even more so during a once-in-a-century Pandemic. While no program is perfect during these periods, sacrificing the future for the present seems incoherent. This choice is particularly acute because of *whom* the decision affects. The people most likely impacted by the Pandemic-induced closures (e.g., retail) are the citizens with the lowest wages and who would benefit from the programs that might face future cutbacks. Thus, the choice seems myopic in the long run because it exacerbates growth challenges in the present from *investing* the payments rather than *spending* them, and in the future by delivering less *productivity growth* from a less-educated workforce.

The Macro View

Fiscal policy choices must account for competitors' actions. While the direct payments may be gratuitous and unfocused, they are not a strategic threat to the US because most developed countries and regions followed a similar path with their fiscal stimulus. *All* developed countries will face the same burdens. The question is how *future* fiscal policy will address the challenges when they arrive. Thus, the suggestion that the fiscal response will lead to higher interest rates, higher taxes, and a lower US Dollar is incoherent with the situation.

Exhibit 7. Forecast for US GDP Growth

A 4.7% rise is forecast for 2021.



Source: CRM estimates. Amounts are annualized rates. Forecast composition altered with consumption frontloaded to the first quarter from the third. The annual growth rate forecast is unchanged.

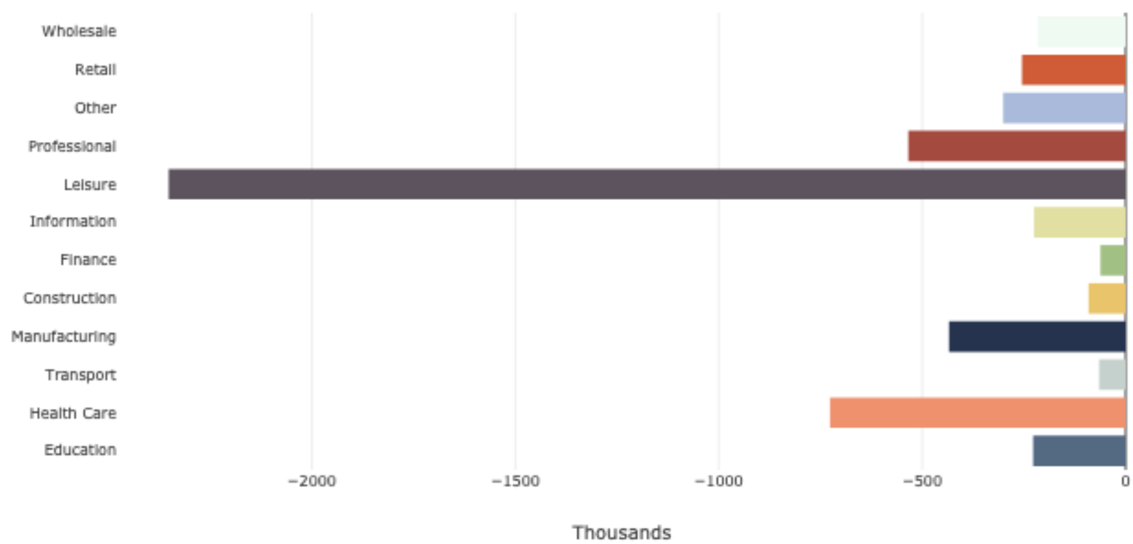
The direct payments will provide a material lift to growth, with most of the benefits arriving in the first and second quarters. The previous forecast had the benefit beginning in the second quarter. For the full year, growth may approach 4.7% and achieve a rate not seen in twenty years (exhibit 7). Exports should climb in the second half as the laggards in vaccine distribution recover. This action should marginally offset the pullback from the domestic consumption boom in the first and second quarters. The *future* moderation of domestic consumption is the price of *current* consumption.

Consumption

The leisure sector bore the brunt of the employment catastrophe that occurred during the Pandemic. While the initial lockdowns hit all sectors, the enduring theme was the lack of leisure activity. The hallmark of these sectors was conducting their business inside with consumers near each other, which are a prime breeding ground for virus transmission. The employment damage to this sector is now more than all other sectors combined (exhibit 8). A *global pandemic* resulted in a *local economic epidemic.*[1] That may endure through the end of the year or even longer if consumer behavior is changed.

Exhibit 8. US Private Employment Change by Sector (Thousands)

The leisure sector awaits more vaccine distribution.



Source: Federal Reserve Economic Database. Change from March 2020 to March 2021.

The vaccine's continued distribution will alleviate some of the carnage in the leisure sector with the locus of activity in the late second or early third quarter. This fulcrum point may be the lever that brings the *eight* million unemployed people back to the workforce and may result in the busiest quarter ever in dollar terms, given latent demand and the pricing power. The challenge is later in the year when the economy approaches normalcy.

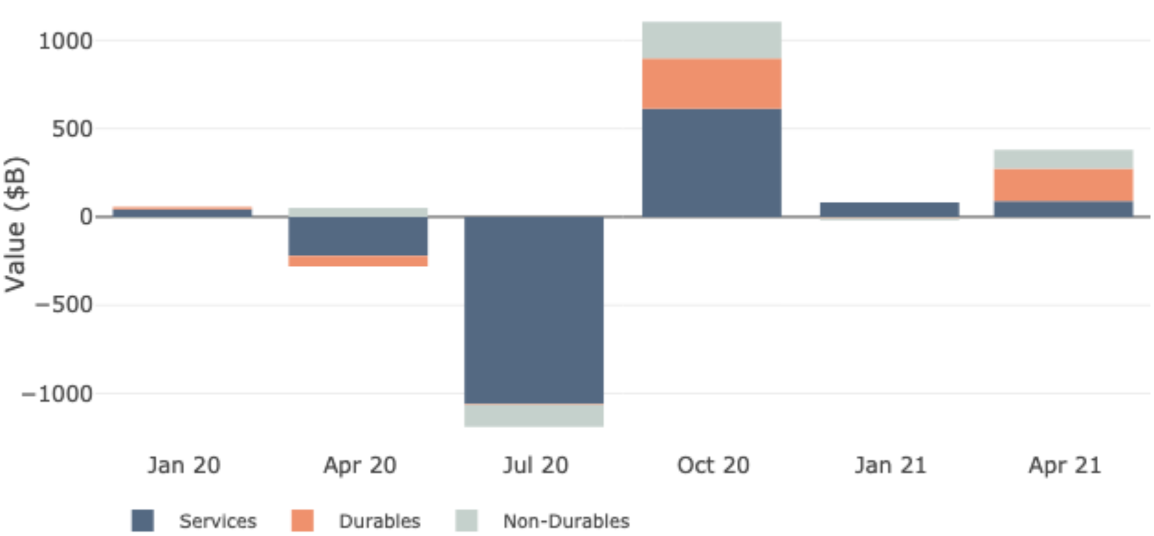
[1] See Capital Risk's **Economic Epidemic** (March 2020) for more details on sector impacts and the risk to consumer behavior over the long term.

Consumption

A Past Future. The economy faces two challenges. First, saving the unprecedented fiscal and monetary stimulus may occur as consumer behavior changes. The frugality of the Great Depression followed the excess of the Roaring Twenties as consumers saved for an uncertain future. Second, businesses may downsize their operations as the need for commercial space and marginal workers diminishes. Indeed, the current political environment precludes letting workers go in a restructuring. This constraint will change as the Pandemic recedes and businesses study their operations for alignment with future needs. These decisions will generate a material number of structurally misaligned workers and require a *different* policy response.

Service consumption is not yet back.

Exhibit 9. Consumption Contribution by Component



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

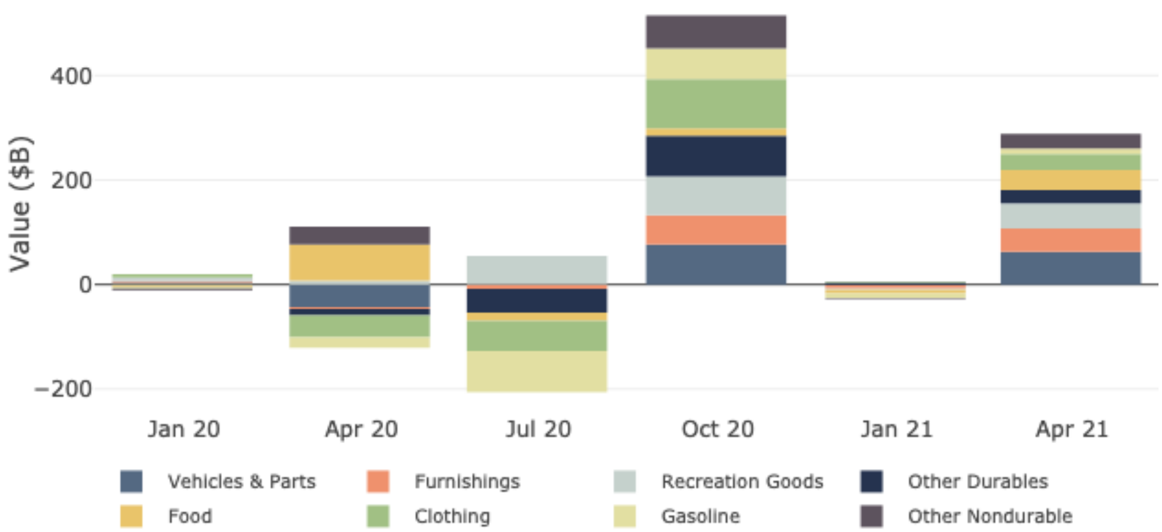
The short-term risk is the regression of consumption as fiscal and monetary stimulus fades. Durable goods orders are a material component of the current rebound, whether driven by rebate payments or household refinancing (exhibit 9). Even non-durables exhibited a material jump greater than the drop during the initial closures. This dynamic ensures that future consumption will most likely not return to pre-pandemic levels because *nothing is left to buy*. For the first time in a generation, the American consumer may pause.

Consumption

A closer look at goods consumption highlights the disconnect (exhibit 10). It is evident that the consumption rebound was greater than the loss. What is surprising is the composition of the rebound. Car and vehicle sales more than doubled their loss. Furnishings achieved a similar result. Recreation goods are in a never-before-seen boom. Indeed, the stimulus payments drove some of these results, while cheap financing enabled others. The trouble is that neither of these drivers is *repeatable*.

Stimulus brings goods consumption.

Exhibit 10. Goods Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values annualized rates.

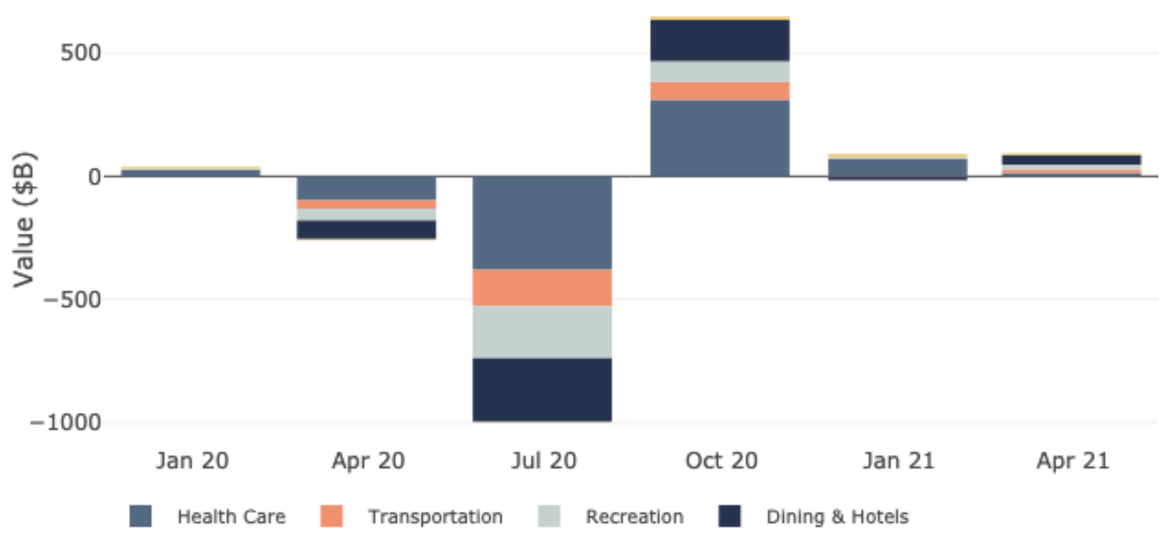
The other challenge is mathematics. A material portion of the rebound was merely a return to form (e.g., gasoline, food, clothing). This trend will not continue unless there is employment growth. Even then, the change is incremental. The combination of the durable goods orders brought forward, and the unlikely probability of further stimulus payments or lower interest rates implies that goods consumption will return to *trend levels at best*. This outcome is disheartening because the Millennial generation is entering their prime household formation years, augmenting demand. Thus, a momentary fiscal policy benefit and consumer behavior changes may conspire to imperil a beneficial secular trend.

Consumption

The more significant service sector continues its modest recovery, yet it remains *five percent below* its prior peak (exhibit 11). Critical to the recovery is health care expenditures, which are the largest single consumption sector outside of housing. The rebound is promising despite transportation, retail, and food services below their prior peaks. A complete return during the second and third quarters could add *two percent* ($380 billion) to GDP. This potential is the primary reason the second and third quarter will show strong growth and will alleviate some of the employment pressure.

Exhibit 11. Service Consumption Contribution by Component

Waiting for the leisure sector.



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

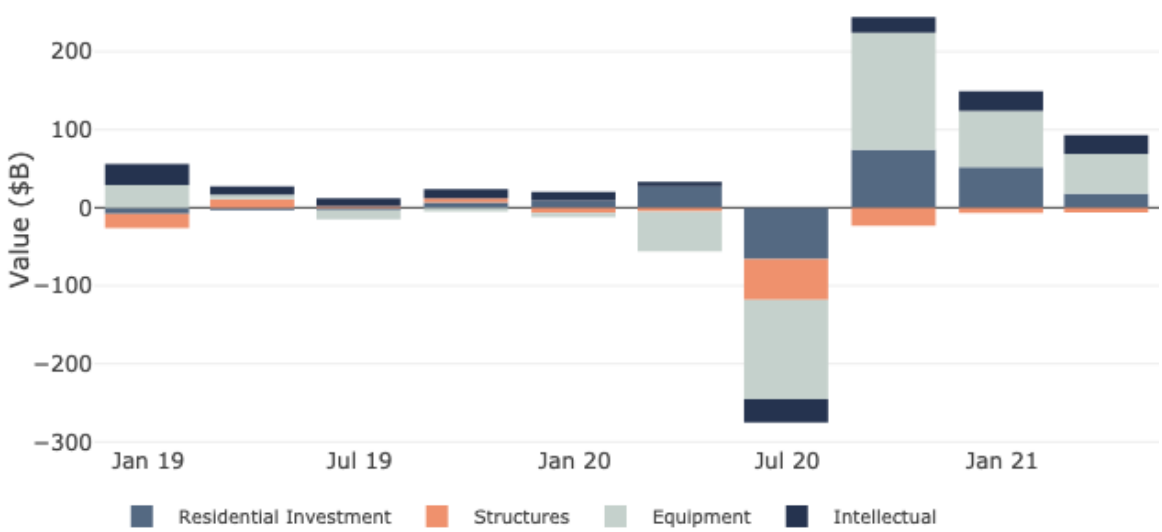
Indeed, returning two million people to the leisure sector would boost GDP by about $20 billion from their wages. While the direct economic impact is small, the multipliers are greater than average because of the inclination for lower-income levels to spend all their wages. More importantly, returning people to work is a humane action, and its benefit is immeasurable. One challenging outcome remains: nearly one million people in professional services and manufacturing remain unemployed. This data is the canary in the coal mine: businesses create cost efficiencies that have implications for employment *and investment*.

Investment

The investment boom is slowing, with commercial structures still deflating. Currently, equipment and residential structures drive investment (exhibit 12). This insight may foretell future weaknesses, particularly for the equipment sector. The rebound of equipment over the last year was about $150 billion in real dollar terms. The problem is that the entirety of the increase is from the information processing sector, with the amount equal to the gain over the *prior eight years*. While this event is largely unrepeatable and will moderate future investment growth, the greater threat is to employment as it signals companies are adopting automation at the *expense of people*.

Equipment investment is a risk.

Exhibit 12. Investment Contribution by Component



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

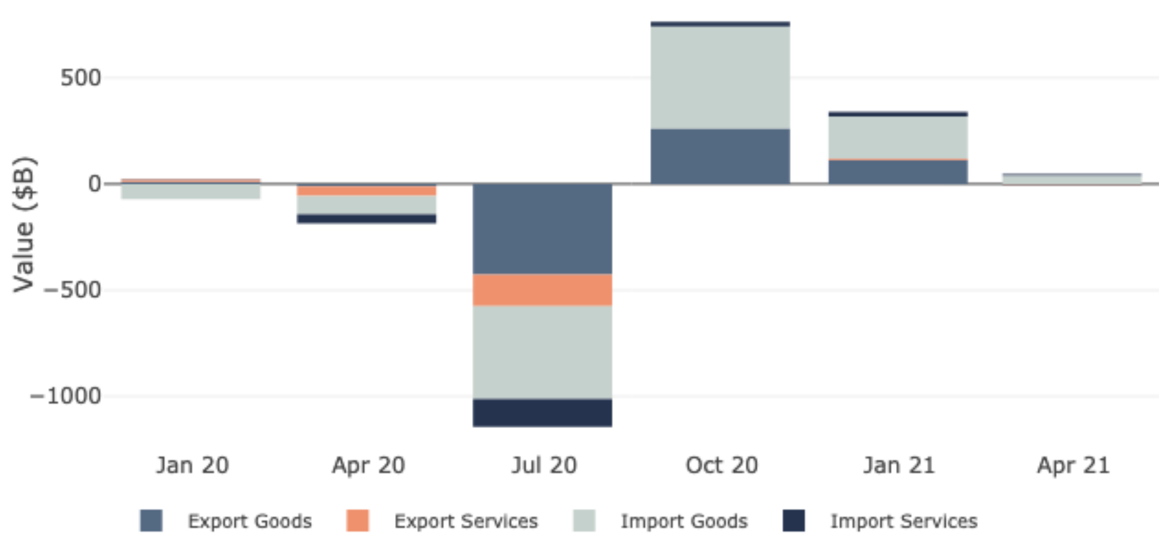
The return of residential investment is welcome. All-time lows of interest rates and the benefit of employment for most of the workforce permit homeowners to upgrade with a renovation or to a hew house altogether. The challenge is that price appreciation brought on by a dearth of supply (i.e., listing volumes are about one-half prior levels) leaves renters out of the virtuous capital cycle. This situation occurs because they cannot afford the new price level as house prices increase more than their wages. This dynamic then results in *less demand for new housing* and lower investment overall.

Exports & Imports

The uneven global distribution is impacting net exports as some economies enact closures to slow the virus. The result is lower foreign demand for American goods and a continual decline of the trade balance (exhibit 13). The export drag is material at nearly 1.7 percent of GDP ($330 billion), with services accounting for two-thirds and goods the remaining portion. It remains worrisome that the trade deficit is at its lowest level in history because it suggests that US demand has run ahead of the rest of the world. The good news is that the deficit should reduce as external demand revives and US consumption moderates in the latter half of the year. The bad news is that it's not clear when the export services will return.

Export growth is *zero.*

Exhibit 13. Net Exports



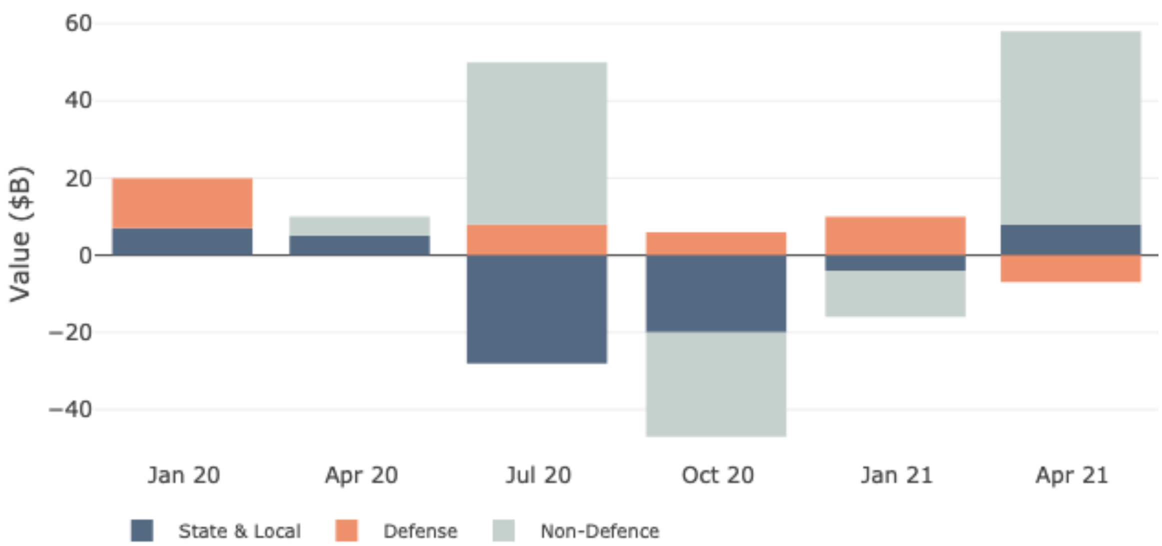
Source: Federal Reserve Economic Database. Values are an annualized rate.

Another troublesome issue is the US Dollar which is at a three-year low and should support US exports. A softer Dollar should lead to more competitive US exports. This situation highlights the impact of low foreign demand for American exports. Until the rest of the world achieves a sufficient level of vaccination rates, global demand and US exports will remain diminished. A global recovery will mirror *vaccination rates*.

Government

Federal fiscal support is all-in to revive the economy, with State & Local expenditures now joining the effort (exhibit 14). A sign of the changing narrative in Washington is also evident in the most sacred expenditure category, defense spending, which contracted modestly in the most recent quarter. This outcome hides a material detail: defense spending is up for the year, so one data point does not make a trend. More significantly, State & Local government expenditures remain *below their peak*.

Exhibit 14. Federal and State Government



Source: Federal Reserve Economic Database.

The Federal Government leads the way.

State & Local governments' balanced budget mandates make this situation a threat to the recovery. Local governments receive a material proportion of their revenues from property taxes, while States generate revenue with some combination of property and income taxes. This threat may force further employment cuts to meet their fiscal year-end targets in June. This situation is material because State & Local governments account for *ten percent* of the economy. If they were to cut the workforce (the dominant cost item in government expenditures) by merely *five percent*, it would *reduce* aggregate growth by *0.5 percent*. This outcome is avoidable with targeted fiscal policy.

Government

The most recent Federal fiscal response, the American Rescue Plan Act, met most of the policy objectives that Capital Risk highlighted in prior reports. While there remains divergent opinion on the need for further direct payments, most of the other policies targeted those most impacted by the Pandemic. Risks remain to future consumer behavior as indicated in the dramatically higher savings rate (exhibit 5). Nonetheless, the Federal stimulus appears well targeted.

Highlighted below are the convergence of Capital Risk's prior policy suggestion and the American Rescue Plan Act (ARP).

A balanced fiscal response.

- **Health Care:** mandate a temporary national health care program for all the unemployed and those that don't have coverage. *ARP $122B. Focused on vaccine distribution and low-income health care.*
- **Retail Sector:** expand unemployment with full compensation of prior wages until the US reaches herd immunity. *ARP $289B. Focused on extended and increased unemployment benefits through year-end.*
- **Leisure Sector:** mandate a national job retraining program for the hotels, bars, and restaurants to ensure future readiness. *ARP $129B. Focused on job retraining programs.*
- **Mobility**: ensure the full tax deductibility of moving expenses for relocation to new jobs and a further tax deduction as an incentive. *ARP $240B. Mobility tax credits were a minor portion of the Act.*
- **Housing**: provide government-subsidized interest-free loans for housing to those who enter job retraining programs or move for employment. *ARP $0. Monetary policy supported lower interest rates.*
- **State & Local Government**: remove the balanced budget constraints or provide federal government-backed bonds to prevent further cuts. *ARP $350B. Focused on expanded debt support and direct payments for some programs (e.g., welfare).*

Forecast

The GDP forecast for 2021 is for 4.7% with a current consensus estimate of 4.0%.[2] A material rebound of consumption that is driven by stimulus payments underlies this forecast. The initial expectation was this effect to occur in the second and third quarters as rebates unfolded. Prompts enaction of the stimulus bill and expedient delivery of the vaccine changed the calculus. While the annual growth forecast is unchanged, the timing changed with the consumption moved forward to start in the first, rather the second quarter.

The expected headline CPI Inflation for 2021 is 2.8% and core CPI is 1.8% versus a consensus rate of 2.0% and 1.9% respectively. The main driver of the divergence from consensus is the belief that commodities will drive the headline number higher as supply constraints meet an abnormal demand increase. The expectation is that this occurrence will fade as demand returns to trend and supply bottlenecks alleviate with inflation returning to the Fed's target of 2% during the following year.

Out-of-consensus growth and inflation forecasts.

Exhibit 15. Annual Forecast Versus Actual (%, y/y)

	2021	2020	2019	2018
Real GDP				
Forecast	**4.7**	-3.5	2.5	2.5
Actual		-3.5	2.8	2.3
Consensus	**4.0**	-5.6	2.7	2.9
CPI				
Forecast	**2.8**	1.2	1.0	2.2
Actual		1.3	2.3	1.9
Consensus	**2.0**	0.5	2.3	2.4
Core CPI				
Forecast	**2.5**	1.8	2.3	2.1
Actual		1.6	2.2	2.2
Consensus	**1.9**	1.5	2.4	2.2

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

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

Exhibit 16. GDP Component Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	19,088	1.6	0.4
Personal Consumption Expenditures	13,334	2.6	1.6
Services	8,094	1.1	-3.2
Goods	5,413	5.4	12.5
Durable Goods	2,206	9.0	25.9
Non-Durable Goods	3,250	3.4	5.8
Investment	3,495	-1.3	4.8
Fixed Investment	3,543	2.4	5.0
Non-Residential Fixed Investment	2,808	2.4	2.7
Residential Investment	716	2.6	12.3
Exports	2,272	-0.3	-8.9
Imports	3,448	1.4	5.0
Government	3,372	1.5	0.7
Federal	1,376	3.3	5.4
State & Local	1,998	0.4	-2.1
Defense	813	-0.9	2.0
Non-Defence	562	9.7	10.4

Capital Risk

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