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Stonebridge Economic Outlook
Forecast Update

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Summary

With vaccinations available and the pandemic easing, the U.S. economy understandably improved sharply in the first quarter especially given the ongoing munificence of fiscal and monetary policy. Solid economic gains are expected as most sectors return to something closer to normal and consumers become more confident to spend. Indeed, this is apparent in the double digit percent gain in real personal consumption expenditures in the first quarter and the prospect based on high frequency data of another solid gain in the second quarter. It is doubtful that consumers can sustain such an impressive spending pace but it still could be stellar through the end of the year given the solid financial conditions of the household sector. Residential investment, which has been robust throughout the pandemic, should remain solid but not as spectacular as it was in the first quarter. Business investment and government spending most likely will continue to contribute to real economic growth over the remainder of 2021 but also less so than in the first quarter. Net exports most likely will detract a bit from growth going forward, as the trade deficit widens owing to imports growing faster than exports. The unemployment rate is still expected to fall to 5.0 percent by the end of the year, as the number of new entrants and reentrants into the labor force fall far short of job openings. Consumer inflation spiked in the first quarter and is expected to remain somewhat elevated over most of the year. Whether this upturn is transitory remains unclear. That said, the risk of inflation becoming a problem is probably higher than it has been for decades because of very strong demand in the face of widespread supply constraints. My best guess is that inflation has made a slight secular shift higher on average but will not be problematic for the Fed just yet.

An Impressive Opening Salvo to 2021

As shown in Table 1, the U.S. economy got off to a roaring start, registering a solid improvement in the first quarter by nearly all measures. Real gross domestic product (GDP) jumped 6.4 percent at an annual rate, the civilian unemployment rate fell to 6.2 percent, consumer price index climbed 3.7 percent, and corporate profits surged 144 percent from a year earlier while interest rates remained at or near historically low levels. With vaccinations becoming more widespread and the pandemic waning, the economy should continue to do very well. Nevertheless, it may be too much to expect all aspects of the economy to remain so stellar. As such, the economy is still expected to continue to grow over the remainder of the year, with the pace remaining very robust in the second quarter but less so in the second half. Higher consumer prices may hamper real GDP growth somewhat later this year, owing to a slight loss of consumer purchasing power as well as higher interest rates than now expected by the consensus. In particular, May's consumer price data has already sparked some discussion among policy makers about how long the extremely accommodative fiscal and monetary policies should remain in place.

Over the four quarters of 2021, real GDP growth is now expected to grow 4.9 percent, up slightly from the 4.4 percent estimate shown in the forecast three months ago. I contend that the risk to the forecast is skewed more toward a stronger rather than a weaker outlook. After all, an important assumption underlying the 2021 forecast is that the COVID vaccines effectively reduce the number of cases and deaths, allowing people to feel less threatened by the virus and providing local governments the confidence to remove all restrictive mandates on activity. For the most part, states have reopened much faster than anticipated only three months ago, which helps explain why the forecast for real GDP growth for 2021 is more front end loaded than in the previous forecast.

Moreover, the other aspects of the forecast that have been meaningfully revised from last time are the various price indices, including crude oil prices, and S&P 500 profits per share. With regard to prices and profits, the forecast now shows larger advances in the second quarter than shown previously. Other features of the current forecast for 2021 are little changed from the March forecast, including the unemployment rate, the broad measure of the traded-weighted dollar and interest rates.

Table 1
U.S. Economic Forecast

	2021 Q1	Q2F	Q3F	Q4F	2020	2021F	2022F
Real Gross Domestic Product	**6.4**	**6.0**	**4.0**	**3.0**	-2.4	**4.9**	2.1
Consumer Price Index, All	**3.7**	**6.2**	3.0	2.2	1.2	**3.8**	2.4
Consumer Price Index, Core	**1.2**	**5.9**	3.0	2.2	1.6	**3.1**	2.5
GDP Chain-Type Price Index	**4.3**	**3.3**	2.4	1.9	1.3	2.2	2.1
Civilian Unemployment Rate	6.2	5.9	5.4	5.0	6.8	5.0	4.2
Price of WTI crude oil ($/bbl)	57.0	**65.4**	**64.0**	61.0	42.4	61.0	58.0
Trade-Weighted Dollar	112.6	111.1	110.5	109.6	114.2	109.6	105.0
S&P 500 Operating Earnings	**47.6**	**45.7**	41.0	42.1	122.4	**176.4**	**187.5**
Percent vs. Year Ago	**144.2**	**70.6**	8.2	10.3	-22.1	**44.1**	6.3
91-Day Treasury Bill Rate	0.1	0.1	0.1	0.3	0.1	0.3	1.0
10-Year Treasury Note Yield	1.3	1.6	1.8	2.0	0.9	2.0	2.5
30-Year Mortgage Rate	3.5	3.5	3.8	4.0	2.8	4.0	4.5
Bank Prime Rate	3.2	3.2	3.2	3.5	3.2	3.5	4.0

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

f-forecast; bold type reflects a major change from the previous forecast

Consumer spending once again will lead the way (see Table 2), now expected to increase a solid 7.2 percent at an annual rate in the second quarter. This would be a remarkable performance if not for the double-digit surge registered in the first quarter. For all of 2021, real personal consumption expenditures are expected to increase 6.2 percent on a fourth-quarter to fourth-quarter basis and 7.0 percent on year-over-year. More jobs, higher wages and a substantial wealth effect should go a long way to provide consumers the wherewithal to increase spending as the virus wains and the economy continues to reopen.

Business fixed investment should improve markedly in 2021, as businesses increase spending on new technology designed to reduce labor intensity. Electronic kiosks and self-checkout facilities will become more widely available, as well as the ongoing acceptance of online shopping for both pickup and delivery. For example, the drycleaners I use now offers 24-hour pickup and drop-off services, thanks to their automated system. Over time, I would not be surprised if a majority of their sales business is conducted via automation, assuming it becomes more user friendly over time.

Residential investment jumped 12.6 percent at an annual rate in the first quarter, continuing its impressive performance during the pandemic. Although housing is expected to hold up reasonably well going forward, it could come under some pressure late this year due to rising home prices and slightly higher mortgage interest rates in the second half of 2021. Moreover, with most schools likely returning to classroom instruction and many workers returning to their offices, it is unclear that demand for housing will be as strong this year as it was last year.

Government spending on consumption and investment is also expected to hold up reasonably well this year, owing to strong gains in infrastructure and education spending. The year got off to a solid start with real government spending climbing 5.8 percent at an annual rate in the first quarter. After a slight deceleration in the second quarter, government spending is expected to reaccelerate in the third quarter and end the year on a solid basis. This outlook assumes that the Biden administration is successful at getting an infrastructure spending initiative enacted, even though it may not be as generous as the original proposal. In addition, state and local government spending on education and safety as the economy reopens also should increase markedly this year.

Table 2
Details of Real Gross Domestic Product Forecast, 2021
(Annual Percent Change) *

	Q1	Q2	Q3	Q4	Q4/Q4	Annual
Personal Consumption Expenditures	**11.3**	**7.2**	**3.5**	**3.0**	**6.2**	**7.0**
Nonresidential Fixed Investment	**10.8**	8.9	8.0	5.4	8.4	9.2
Residential Investment	12.7	8.0	5.0	3.0	7.2	15.3
Government Spending	5.7	2.0	4.0	3.2	3.8	1.9
Exports	**-2.9**	7.0	7.0	3.5	**2.4**	**3.6**
Imports	**6.7**	10.0	8.3	6.0	7.9	13.6
Final Sales	**9.4**	**5.4**	**3.6**	**2.9**	**5.2**	**5.3**
Gross Domestic Product	**6.4**	**6.0**	**4.0**	**3.0**	**4.9**	**5.5**

Quarterly data are percent changes from the previous quarter at annual rates. Q4/Q4 is the percent change from the fourth quarter of 2020 to the fourth quarter of 2021. Annual is the percent change from all of 2020 to all of 2021.
**Bold numbers are actual estimates based on the latest report from BEA.*

On the other hand, net exports are expected to be a mild drag on real GDP growth this year, as imports rebound far more than exports. In the first quarter, real imports jumped 6.7 percent at an annual rate, while real exports declined at a 2.9 percent pace, detracting 1.2 percentage points from the annual growth rate of real GDP. This was the third consecutive quarter that net exports detracted from overall real GDP growth and the expectation calls for more of the same.

Finally, the change in business inventories, which subtracted a whopping 2.8 percentage points from real GDP growth in the first quarter, is unlikely to continue to do so over the remainder of the year. In fact, by the end of the year, the change in inventories likely will have very little impact on overall real GDP growth.

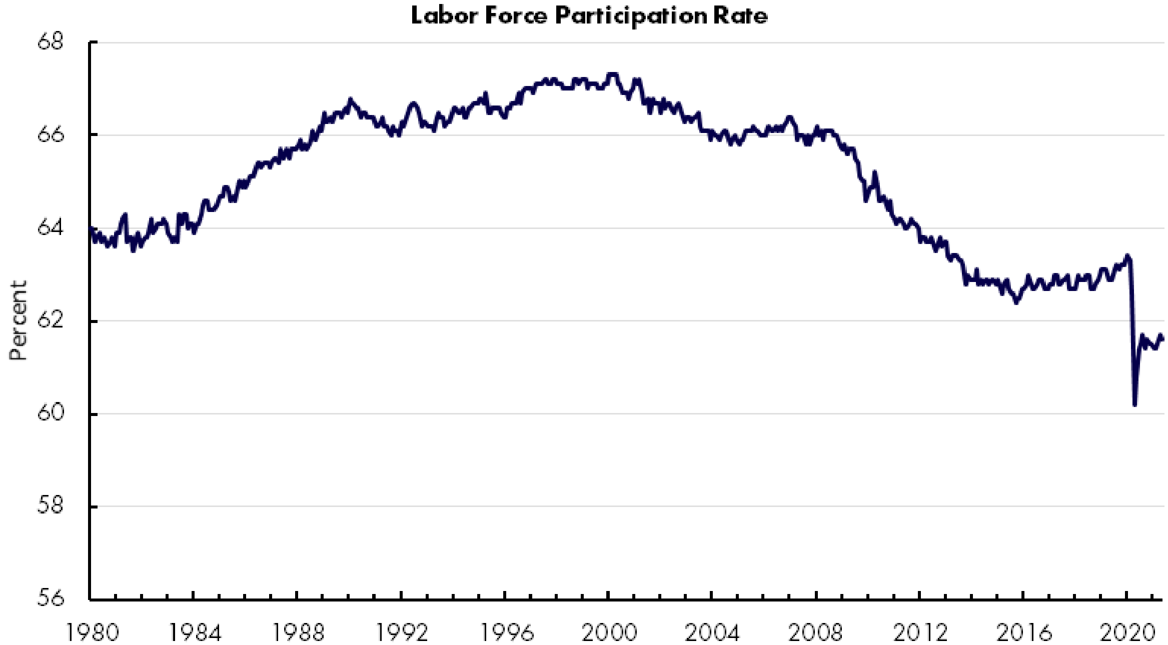
The Latest Jobs Report

According to the Bureau of Labor Statistics, nonfarm payroll jobs in May increased 559 thousand from a month earlier and 11.9 million from a year earlier. Several market participants claimed that this report signaled weakness because it fell short of expectations. I contend that such a claim is unjustified. It seems silly to identify half a million new payroll jobs in a month as a sign of weakness. Moreover, an examination of the other details of the report confirm that the May jobs report was rather impressive, including average hourly earnings and total hours worked. At an annualized rate, average hourly earnings are on track to increase at a 3.8 percent pace in the second quarter and hours worked are on track to climb 5.1 percent. Clearly, neither metric suggests economic weakness. In addition, the unemployment rate fell to 5.8 percent in May, down from 6.2 percent in April and from 13.6 percent a year earlier.

The strength of the labor market can also be assessed by other jobs data, including the monthly report on job openings and labor turnover also from the Bureau of Labor Statistics. This release includes estimates of the number of job openings, hires and separations for the total nonfarm sector. In April (the latest data available), job openings reached a series high of 9.3 million on the last business day of the month, suggesting that demand for workers was very strong. What was even more interesting was that the number of workers who quit their jobs reached a series high as well. The implication is that more workers either voluntarily left the labor force or found better jobs elsewhere. This tends to support the view that the demand for labor is strong and that any disappointing shortfall in hiring may be due to the lack of qualified candidates.

In that regard, the labor force participation rate, which is the percent of the civilian working-age population who are either employed or actively seeking employment, has been very slow to return to its pre-pandemic level, suggesting that the pace of new entrants and reentrants into the labor force has made it more difficult for businesses to find workers. As shown in Chart 1, the participation rate dropped dramatically early last year and despite an almost immediate rebound, it came up far short of where it had been. More interestingly, it has remained at this lower level far longer than most were expecting.

Chart 1
Labor Force Participation Rate



Source: Bureau of Labor Statistics.

This may help explain why job growth has been less stellar than the drop in the unemployment rate alone might suggest. Moreover, since I doubt that the labor force participation rate will return to its pre-pandemic level anytime soon, fewer new jobs will be needed to lower the unemployment rate to 5.0 percent, which is the level currently expected by the end of this year.

Inflation and Interest Rates?

Like most economic forecasters, I expect consumer price inflation to move higher this year but in part because it was so low last year. In fact, unlike many forecasters, I expect inflation to remain elevated in 2022 as well. Such an outcome could cause the Fed to move away from its overly accommodative policy stance by the end of this year but certainly not in any dramatic fashion. The reason is that inflation, although already higher on a year-ago basis than it has been since 2008, most likely will settle at a level only moderately above the Fed's long-range target.

The factors behind the inflation forecast are:
First, globalization is not dead but it is far less disinflationary than it was over the last several decades. In particular, China has lost some of its shine as the manufacturer for the world and I expect that it will continue to do so. If China must decide between their economy and their political system, the leaders have demonstrated by their actions in Hong Kong that they most likely will decide in favor of the latter.

Second, there has been a tremendous amount of stimulus delivered at a time when people were constrained to spend it, creating considerable pent-up demand. The release of this demand as the economy reopens will put considerable pressure on prices, a situation that will last far longer as more people return to work.

Third, household wealth has gone up markedly over the last year, reflecting asset prices rising much faster than household debt levels. As a result, there is a potentially meaningful positive wealth effect on consumer demand that could play out over the next couple of years and not just the next couple of months.

Finally, markets always clear but in the case of consumer products I think they will require higher prices in the future to do so. Again, it will depend on how quickly supply can adjust to stronger demand. Rising costs will lead to higher prices, which in turn will lead to higher costs, etc. The risk is that when faced with rising prices, people ask the government to do something about it. The hope always is that the government can somehow increase supply at a low or lower price. It cannot. It can only regulate markets or control prices, which puts even more upward pressure on prices or makes shortages even more likely.

Although I expect inflation to make a bit of a comeback over the next few years, there is no way it will be a repeat of the 1970s. However, even if inflation turns out to be more aggressive than I expect, it most likely will take more than a couple of years to unfold. Interestingly, even a moderately higher outlook for inflation is more extreme than the "it's all transitory" view of the Fed. Without a doubt, at least some of the spike in inflation in the first half of this year will prove to be transitory but for all the reasons mentioned there is no reason to expect that average price increases over this year and next will return to the low levels of the last decade.

As such, inflation expectations should start to move moderately higher over the remainder of this year along with inflation, causing upward pressure on interest rates across all maturities. Although the 10-year Treasury yield did climb to a high of nearly 1.75 percent earlier this year, it has since retreated to less than 1.5 percent, very much in line with the Fed's view that any near-term spike in inflation is "transitory" and hence does not require any policy response.

To the extent that consumer price increases do not decelerate as much as the Fed currently expects, inflation expectations may take a turn higher once again. The implication is that the Fed most likely will not need to slam the brakes of monetary policy but it may feel the need to take its foot off the accelerator sooner than the consensus and the Fed now expect.

Implication for Financial Markets

Longer-term interest rates, despite the recent pullback, are still expected to drift higher this year. Although how much higher is still unclear, my best guess is that the yield on the 10-year Treasury note hits 2.0 percent before the end of the year. If the Fed makes even a minor shift in policy, it would signal that not all of the spike in overall inflation is transitory after all. In addition, if the unemployment rate continues to decline as expected, the Fed's dual mandate of mild inflation and full employment will have been achieved, suggesting a more appropriate monetary policy stance under such a goldilocks scenario. In this regard, fiscal policy most likely will become less generous as well, especially if the Fed slows its purchases of government debt in the face of more spending programs.

Based on much better than expected S&P 500 earnings per share in the first quarter and a moderate upgrade to earnings for the second quarter, earnings per share for all of 2021 is now expected to be $176, still below the consensus estimate. Clearly, I have a less robust outlook for S&P 500 earnings in the second half than the consensus, begging the question of why take such a stance after being so wrong about the first half. The answer is that profit margins are likely to narrow somewhat going forward as labor costs increase faster than prices. In particular, a series high quit rate as reported in the April Job Openings and Labor Turnover data suggests that workers feel confident that they can find a better paying job. This puts even more pressure on labor intensive businesses to raise wages to attract new and reentrants to the labor force. Only if businesses can raise their prices will they be able to offset their higher labor costs. My bank serves as anecdotal evidence of this point. I went inside the bank recently for the first time in over a year to transact business only to discover that there were no tellers available. I had to either use the ATM or the drive-up window. When asked, the manager said that they are having difficulty finding people to fill those positions. In the near term, this could be considered a cost benefit to the bank because their payroll is lower but such a benefit is available only as long as their customers are willing to put up with it. During the pandemic, it was acceptable. That may not be the case now that the economy is open for business again. I suspect that at some point the bank may find that they need to offer a higher wage just to keep the tellers they have. In other words, I am convinced that S&P 500 profits will be as good as the consensus now expects in the second half of the year only if consumer price inflation comes in higher than even my above consensus forecast.

The stock market seems priced for perfection at the moment, which means that even a small disappointment could cause a substantial downdraft in the market. So far this year, the S&P 500 price index is up 13.1 percent. From a valuation perspective, operating earnings per share for the S&P 500 are expected to surge 44 percent this year, following a decline of 24 percent for all of 2020. If a price/earnings (PE) ratio of 25 (which was roughly the average PE ratio for all of 2020) is applied to the operating earnings estimate of $176.4 for all of 2021 shown in the forecast (see Table 1), it suggests a price level at the end of the year of 4400 for the S&P 500 stock price index. As mentioned above, there are several moving parts to this stock price index projection, including earnings, inflation, inflation expectations and interest rates. If I knew exactly what each of these four variables will do over the remainder of the year, I might have a chance of accurately predicting what the stock market index will be. Instead, my best guess is that the S&P 500 price index will hit a new high before the end of this year but not without considerable volatility along the way.