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Stonebridge Economic Outlook and Forecast Update

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Summary

The headline statistics for the U.S. economy performed very much as expected in the second quarter and seem to be on track to do the same in the third quarter, even though some of the underlying details of the forecast missed expectations. For example, overall real output growth was very much in line, yet various components were not. Consumer spending in the second quarter was much stronger than expected, offset by more imports and a sharper drawdown in inventories than anticipated earlier. Regarding the other aspects of the forecast in the second quarter, the unemployment rate, consumer price inflation, the trade-weighted dollar and short-term interest rates were in line with expectations. In contrast, corporate profits and longer-term interest rates were not. More importantly, despite the misses in the forecast for the second quarter, the outlook for the second half of 2021 remains roughly the same as it was in June. Real output growth should be solid albeit about half as fast as it was in the first. Inflation is expected to slow from its spike in the second quarter but remain at a level that could be troubling to the Fed. The unemployment rate will continue to drift lower on average. In addition, since most of the headline economic statistics are little changed, the asset allocation implications favoring risk remain the same as well. Of course, forecasting is always risky. In this case, the most widely advertised risks currently are the variants of the coronavirus, the uncertainty of infrastructure spending legislation and the growing prospect of the Federal Reserve tapering its bond purchases later this year. The assumptions underlying the forecast are that the variants of the virus will have a limited impact on the economy as more people get vaccinated. A sizable infrastructure spending program is approved. The Fed begins tapering its purchases of mortgage-backed securities sometime in the fourth quarter but not its purchases of U.S Treasury obligations, at least not yet.

Tracking the Economic Outlook

Although the headline statistics for the second quarter shown in the June forecast were roughly in line with expectations, the details differed dramatically in some cases. For example, according to the Bureau of Economic Analysis, real gross domestic product (GDP) climbed 6.6 percent at an annual rate in the second quarter, in line with the June forecast of 6.0 percent, which followed an increase of 6.4 percent in the first quarter. That said, the various sources of growth in the third quarter were considerably different than expected, led by real personal consumption expenditures (PCE) surging a whopping 11.9 percent at an annual rate. This was far better than the 7.2 percent increase projected in June and a tad stronger than the upward revised gain of 11.4 percent in the first quarter.

As noted last time, the stellar performance of real PCE in the first half of the year was not expected to continue in the second half, slowing to an average pace of about 3.2 percent at an annual rate (see Table 1). Based on the data reported so far, it increasingly looks as if the previous projections of real GDP (4.0 percent) and real PCE (3.4 percent) for the third quarter are still valid. In this regard, the September 2 update to the Federal Reserve Bank of Atlanta's GDPNow model estimated current-quarter real GDP growth at 3.7 percent at an annual rate, down from 6.1 percent at the end of July. The 3.7 percent estimate is now more in line with Stonebridge's third-quarter estimate of real GDP growth shown in the June forecast, suggesting that it may still be appropriate.

That said, some of the factors contributing to real GDP growth in the third quarter are far different from those in June. For example, the change in business inventories could add nearly 2.0 percentage points to real GDP after detracting an average of nearly 2.0 percentage points in the first half. On the other hand, real PCE is now expected to contribute far less to real GDP growth than anticipated earlier, as a decline in spending on goods (led by a plunge in motor vehicle sales) due to supply shortages offset the upturn in spending on services. Despite the major revisions to some of the components, the estimate of overall real GDP growth in the third quarter has changed very little the June forecast.

Table 1

*Forecast Details of Real Gross Domestic Product, 2021 **

	Q1	Q2	Q3*	Q4*	Q4/Q4*	Annual*
Personal Consumption Expenditures	**11.4**	**11.9**	3.4	3.0	7.4	7.9
Nonresidential Fixed Investment	**12.9**	**9.3**	2.5	5.4	7.7	8.6
Residential Investment	**13.3**	**-11.5**	0.0	3.0	0.8	10.6
Government Spending	**4.2**	**-1.9**	4.0	3.2	2.4	1.3
Exports	**-2.9**	**6.6**	9.2	3.5	4.1	4.5
Imports	**9.3**	**6.7**	12.5	6.0	8.8	14.3
Final Sales	**9.1**	**7.9**	2.3	2.9	5.6	5.5
Gross Domestic Product	**6.3**	**6.6**	4.0	3.0	5.0	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.*

For now at least, it appears that real GDP growth in the fourth quarter may slow a bit further to roughly 3.0 percent at an annual rate. This estimate is not only identical to the June forecast but the factors contributing to growth are roughly the same as well. Most of real GDP growth in the fourth quarter most likely will come from a rebound in real final sales, which means that the change in business inventories is expected to contribute far less to overall real GDP growth in the fourth quarter than expected in the third quarter.

Of course, economic forecasts are not without risks. The most widely advertised risks currently are the spread of the Delta variant of the coronavirus, the uncertainty around the passage of infrastructure spending legislation and the growing prospect of the Federal Reserve tapering its bond purchases later this year. The assumptions underlying the forecast are that the variants of the virus will have a limited impact on the economy as more people get vaccinated, a sizable infrastructure spending program is approved, and the Fed begins tapering its purchases of mortgage-backed securities sometime in the fourth quarter but only marginally with no tapering of U.S Treasury bonds.

The Latest on Jobs

According to the Bureau of Labor Statistics, nonfarm payroll jobs in August increased 235 thousand from a month earlier and 6.04 million from a year earlier. Several market participants claimed that this report signaled weakness in the labor market because the increase in payroll jobs fell short of expectations. Market participants had the same response to the April employment report, which saw a 269 thousand increase in payrolls, also below expectations. However, the unemployment rate from the household survey fell 0.2 of a percentage point to 5.2 percent in August versus the 0.1 percent uptick in the April unemployment rate. From that perspective, the August employment report actually was better than April.

An examination of the other details of the report confirms that the August employment report was solid, including average hourly earnings in the establishment survey, which rose 0.6 percent from a month earlier. Even total hours worked registered solid gains through the first two months of the third quarter (if September hours worked were unchanged from the August level, total hours worked by private workers would be up 4.3 percent at an annual rate for the quarter). Recall that total output is the combination of hours worked and output per hour (or labor productivity). Based on my forecast of 4.0 percent real GDP growth for the third quarter, it would be no surprise if total hours worked for September came in below the consensus but still good enough for U.S. economic growth to remain above potential in the third quarter and most likely again in the fourth quarter.

With unemployment benefits expiring for many in September, there is hope that many of the recipients of these benefits will once again return to work. If that happens, it should boost jobs but have little effect on the labor force participation rate, since anyone receiving unemployment benefits was already counted in the labor force. On the other hand, if a worker stops looking for employment for whatever reason (discouraged, retired, childcare), then they are no longer in the labor force. During the pandemic, some parents had to stop working to care for their children at home. The hope is that with students returning to school in person, these parents will be free to return to the labor force, causing the participation rate to rise. Moreover, the federal tax credit for childcare has been raised and expanded for 2021 to ease the financial burden of childcare expenses. On balance, I suspect there will be a modest uptick in the labor force participation rate in the fourth quarter but not enough to prevent the unemployment rate from falling a tad further by the end of the year.

As a result, as shown in Table 2, the estimate of the civilian unemployment rate for the third quarter has been revised downward to 5.3 percent from 5.4 percent in the June forecast, while the forecast for the fourth quarter remains at 5.0 percent. The underlying assumption here is that the participation rate edges up a bit over the next few months for various reasons, including the end of unemployment benefits or the weekly supplement to benefits for millions of people earlier this month. Clearly, there is no shortage of demand for labor given that businesses were able to fill only 6.7 million of the 10.1 million job openings in June (latest data available). As a result, it should be no surprise that average hourly earnings continue to climb, as employers search for qualified workers to fill their openings. One way to do so on short notice is to entice experienced workers away from competitors with higher wages rather than absorb the cost of hiring and the risk of training new employees. This strategy only works so long as the higher wage is less than the cost of hiring and training new employees. Indeed, in some cases, employers will increase wages of valued employees to discourage them from leaving for another job. I doubt this ends anytime soon.

Table 2

U.S. Economic Forecast

	2021 Q1	2021 Q2	2021 Q3f	2021 Q4f	2020	2021f	2022f
Real Gross Domestic Product	6.4	6.6	4.0	3.0	-2.3	5.0	2.1
Consumer Price Index, All	3.7	**8.4**	**4.4**	2.7	1.2	**4.8**	2.4
Consumer Price Index, Core	1.2	**8.1**	**4.4**	2.4	1.6	**4.0**	2.5
GDP Chain-Type Price Index	4.3	**6.0**	2.4	1.9	1.3	**3.6**	2.2
Civilian Unemployment Rate	6.2	5.9	5.3	5.0	6.8	5.0	4.2
Price of WTI crude oil ($/bbl)	57.0	66.1	68.8	69.0	42.4	69.0	58.0
Trade-Weighted Dollar	112.6	112.1	113.0	112.3	114.2	112.3	108.0
S&P 500 Operating Earnings	47.4	**52.0**	**45.1**	42.1	122.4	**186.6**	190.5
Percent vs. Year Ago	143.1	**94.1**	8.2	10.3	-22.1	**52.4**	**2.1**
91-Day Treasury Bill Rate	0.1	0.1	0.1	0.2	0.1	0.2	1.0
10-Year Treasury Note Yield	1.3	1.6	**1.3**	2.0	0.9	2.0	2.5
30-Year Mortgage Rate	**2.9**	**3.0**	**2.9**	3.4	2.8	3.4	4.0
Bank Prime Rate	3.2	3.2	3.2	3.2	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.

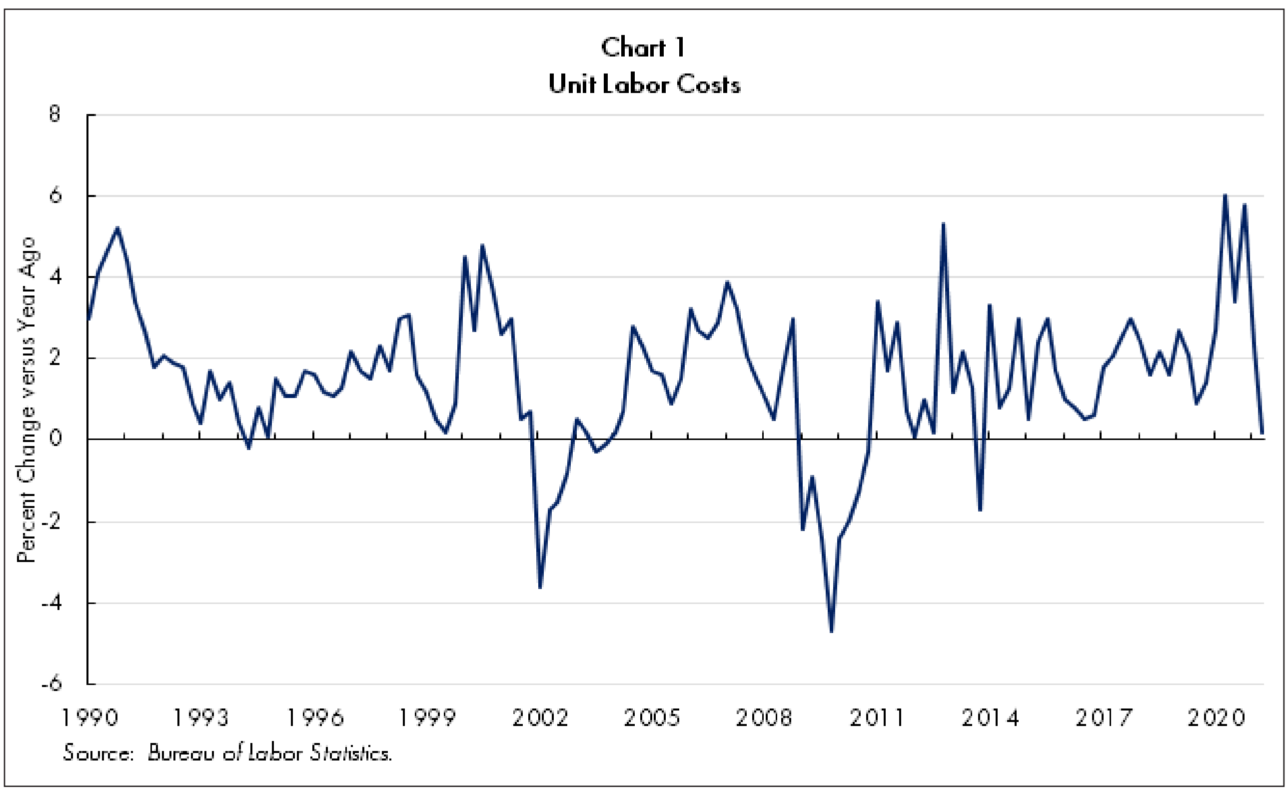
Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are 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—**green** if revised upward and **red** if revised downward*

The Latest on Inflation

Without a doubt, consumer price inflation skyrocketed in the second quarter and seems to be on pace to register another solid gain in the third quarter, raising the question of just how temporary (transitory is the word used by Federal Reserve officials) inflation may prove to be. Many market participants have focused on the relatively sharp rise in average hourly earnings in the monthly employment report as evidence of so-called "cost-push" inflation. In other words, higher wages will require higher prices on products produced. Actually higher wages do not always lead to higher consumer prices, especially if higher wages are being offset by higher labor productivity. This is best illustrated by unit labor costs, which is the cost of labor per unit of output produced. Unit labor costs go up when the increase in output per hour lags the increase in labor compensation per hour. Of course, unit labor costs go down when output per hour increase faster than compensation per hour. As shown in Chart 1, the percent change in nonfarm business unit labor costs from a year ago slowed sharply in the second quarter to a mere 0.2 percent, down from 2.3 percent in the first quarter and 5.8 percent over the four quarters of 2020.

Hourly compensation in the second quarter was up only 2.0 percent from a year ago, while productivity was up 1.8 percent over the same period. Apparently the increase in compensation was almost completely offset by the increase in productivity, suggesting that labor costs are not an inflation issue, at least not yet. Strong demand in the wake of supply bottlenecks may have more to do with price increases than labor costs.



Two inferences might be made from the sharp slowdown in unit labor costs in the second quarter. First, this could be the statistic the Federal Reserve is looking at to support its claim that inflation pressures are temporary and will subside. The hope is that higher prices will induce more supply, pushing prices lower again and that any further rise in wages will continue to be absorbed by improvements in productivity.

The second inference is that lower unit labor costs combined with strong output growth suggests solid profit growth. If companies can pay higher wages to a more productive labor force and at the same time raise prices, profits should do very well. And they did. According to the Bureau of Economic Analysis, after-tax corporate profits from current production in the second quarter were up a whopping 51.3 percent from the same quarter a year ago. Also, in the second quarter, S&P 500 operating profits were even better, spiking 94 percent from a year earlier. Do not expect such year-over-year gains to continue. Recall that the shutdowns owing to the coronavirus occurred in the second quarter of 2020, causing corporate profits that quarter to suffer markedly, which has distorted the year-over-year comparisons for the second quarter considerably. Nevertheless, such a stellar performance from corporate profits, regardless of how they are measured, suggests that cost-push inflation was not a factor. Hence it should be no surprise that the Federal Reserve is waiting for further evidence of inflation being a sustainable threat to the economy before it starts to taper.

The Latest on Interest Rates and the Fed

What does "Fed tapering" really mean? Currently the Federal Reserve is purchasing about $80 billion of Treasury securities and about $40 billion of mortgage-backed securities a month to provide liquidity to bond markets and help keep long-term interest rates low. When the Fed says it is discussing tapering late this year or early 2022, it most likely is referring to its purchases of mortgage-backed securities. According to the latest budget projections from the Congressional Budget Office (CBO), the Federal Reserve is expected to continue to expand its holdings of Treasury debt at least through 2025.

More importantly, how much tapering of mortgage backs is the Fed likely to do? Probably very little if the past is any guide. The problem is that financial markets have become addicted to the Fed's purchases, suggesting that any tapering will be small and surprisingly short-lived. Indeed, any tapering of mortgage backs may be offset to some degree by additional purchases of treasuries. After all, the Fed will be under considerable political pressure not to increase the cost of the federal government's penchant for deficit spending. With interest rates historically low, many suffer from the illusion that deficit spending is practically free money.

This same political pressure will most likely force the Fed to be very slow about hiking short term interest rates. For the Fed to successfully defend the decision to hike rates, both to politicians and market participants, it will need evidence that its economic mandate is being compromised. The only way that mandate can be compromised in my view is if inflation appears to be more than transitory. Achieving full employment without inflation clearly would not be accepted as justification for a shift by the Fed to a less accommodative policy stance.

What type of political pressure can Congress impose on the Fed? It is not Mr. Powell's reappointment as Chairman. Instead, I contend that it is the same old issues of independence and credibility. The Fed is considered independent only because it does not rely on Congressional appropriations for operating expenses. Indeed, the Federal Reserve System generated net income (revenue after expenses) of an estimated $114 billion at an annual rate in the second quarter, which is returned to the Department of the Treasury to offset the budget deficit. That said, legislation enacted by Congress created the Fed, which means that legislation enacted by Congress could do away with the Fed. Congress has used this threat on occasion.

For this reason, the Fed is very sensitive to maintaining its credibility, which is far more difficult to do under the increased transparency the Fed is trying to achieve. In other words, please do not say you will do something unless you are certain it is the right thing to do. At the moment, the Fed seems to be waiting for certainty before it makes a move. In defense of the Fed, monetary policy can impact demand but has far less influence (if any) over supply. To the extent that the current inflation is due to supply constraints, the Fed may be justified to wait to see how quickly the constraints are overcome.

Asset Allocation Implications

Strong earnings, along with the hope that interest rates will remain low longer, clearly have helped push the stock market to a steady string of new highs since the June forecast. As such, I suggest that the stock market still is priced for perfection, which means that it remains vulnerable to even a small disappointment. The question is what will disappoint—inflation, employment or growth. I contend that inflation, albeit less spectacular than the surge in the second quarter, will remain above the Fed's so-called target over the next year or more. The question is whether inflation will settle at a level high enough to push the Federal Reserve to hike short-term interest rates. I expect that it will.

Job growth may slow somewhat but it still will be enough to lower the unemployment rate further in 2022. The question is whether a lower unemployment rate will translate into more wage and income gains sufficient to keep aggregate consumer demand strong. I suspect it will but an even tighter labor market may also encourage businesses to implement productivity enhancing technology to help keep unit labor costs subdued.

Overall economic growth is expected to remain solid in the second half, albeit far less impressive than the growth rate in the first half. Moreover, growth in the third quarter may be more transitional than fundamental. In particular, real final sales most likely will slump considerably in the third quarter before rebounding to a more sustainable pace in the fourth quarter. The implication is that the change in inventories, which was a meaningful drag on growth in the first half, will make a large contribution to growth in the third quarter, followed by a much smaller contribution in the fourth quarter.

Hence, investment risk is still in favor and is expected to remain so for the foreseeable future. Nevertheless, there will be times when this assessment seems inappropriate but such episodes of doubt most likely will be temporary. Stay tuned.