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Capital Advisors

Stonebridge Economic Outlook and Forecast Update

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Summary

The overall theme of the economic forecast is little changed from the September report, even though some of the details have changed markedly (see Table 1). First, the expansion, as measured by real gross domestic product (GDP) growth, is expected to continue at least through 2022, with the pace next year projected to be nearly half that for all of 2021. That said, the growth rates of real GDP for both 2021 and 2022 have been revised upward somewhat from their estimates shown in the September forecast, owing in large part to more robust consumer spending than anticipated earlier.

Real GDP grew at a somewhat surprisingly sluggish 2.1 percent annual rate in the third quarter, after climbing at an average of 6.5 percent over the first half. All of the surprise came from real final sales, defined as real GDP less the change in business inventories, which were flat in the third quarter after growing an average of 8.5 percent at an annual rate for the first half of the year. All of the uptick in real GDP in the third quarter could be attributed to business inventories. However, inventory accumulation alone cannot sustain the expansion. Real final sales will need to rebound quickly to prevent the expansion from stalling and at the moment it looks as if they have in the current quarter.

Second, regardless of how it is measured, inflation for 2021 and 2022 is now expected to be higher than shown in the September forecast. The consumer price index (CPI) is now expected to rise 6.4 percent over the four quarters of 2021 and 2.8 percent over the four quarters of 2022. Interesting, that the CPI has increased or is on track to increase at a pace well above the reported target of the Federal Reserve (Fed) in every quarter of this year. More importantly, although the inflation outlook for all of 2022 is expected to move down, it still may be high enough to be a concern for Fed officials and in turn market participants. The primary concern of the Fed seems to be that inflation expectations will ratchet higher, which in turn could make it easier for consumers to accept future price increases. In that regard, the Fed's contention that the recent spike in inflation was transitory may have been an attempt to restrain inflation expectations. The Fed's success at managing those expectations may explain why longer-term interest rates have not kept pace with the sharp upturn in consumer prices in 2021 or the forecast of further advances in 2022, at least not yet.

Third, the civilian unemployment rate, which plunged to 4.2 percent in November from 4.6 percent in October, is now expected to average 4.4 percent for the fourth quarter of this year. In the September forecast, the unemployment rate for the fourth quarter of 2022 was expected to average 4.2 percent. Given the the current level of the unemployment rate and the outlook for real growth next year, the unemployment rate most likely will fall further next year. As a result, the forecast for the fourth quarter of 2022 is now 3.8 percent. Although further improvement in the unemployment rate is expected, such improvement will be far more gradual than over the last 20 months. Recall that at the onset of the restrictions and limitations associated with the pandemic, the unemployment rate skyrocketed to 14.8 percent in April 2020 from the business cycle low of 3.5 percent in only two months. Although the improvement in the unemployment rate since then has been impressively quick, it most likely will be several months before it gets back to the February 2020 low of 3.5 percent.

Fourth, the bond market's response to expectations about monetary policy are very complicated. For example, the outlook for short-term interest rates remains the same as in the September forecast. In particular, the Fed is expected to hike its federal funds rate target over the four quarters of 2022 by a total of 75 to 100 basis points in response to the increased likelihood that the pace of the expansion will remain above potential, inflation will remain elevated and unemployment will remain low. Such a policy move could be viewed as a shift to a less accommodative stance rather than a shift to a tight monetary policy. After all, with inflation at 2.5 percent for all of 2022, the Fed would need to raise short-term interest rates at least 250 basis points for real rates to stop being negative. In contrast, the 10-year Treasury note yield is projected to end 2022 at about 2.5 percent, roughly in line with inflation.

Fifth, S&P 500 operating earnings per share for all of 2021 is now expected to be up a whopping 64.4 percent from a year earlier, due in large part to the sharp recovery in economic activity in the first half of the year and the likelihood that activity has rebounded again in the fourth quarter after pausing somewhat in the third quarter. In addition, pricing power seems to have improved in 2021, allowing businesses to raise prices in the face of higher costs and supply disruptions to preserve profit margins. For 2022, operating earnings per share are expected to rise 3.0 percent, which is roughly in line with the consensus bottom-up estimate of earnings per share after adjusting for the usual overestimation bias of such estimates.

Finally, the risks to the outlook are perceived at the moment to be mainly to the downside, which may explain why bond yields have retreated lower and why the stock prices of economically sensitive companies have declined far more than the aggregate indices suggest.

Table 1
U.S. Economic Forecast

	2021						
	Q1	**Q2**	**Q3f**	**Q4f**	**2020**	**2021f**	**2022f**
Real Gross Domestic Product	6.3	6.7	**2.1**	**7.4**	-2.3	**5.6**	**2.7**
Consumer Price Index, All	3.7	8.4	**6.6**	**7.0**	1.2	**6.4**	2.8
Consumer Price Index, Core	1.2	8.1	**5.3**	**4.5**	1.6	**4.8**	2.8
GDP Chain-Type Price Index	4.3	6.1	**5.7**	**2.5**	1.3	**4.6**	2.2
Civilian Unemployment Rate	6.2	5.9	5.1	**4.4**	6.8	**4.4**	3.9
Price of WTI crude oil ($/bbl)	57.0	66.1	70.6	**78.2**	42.4	**78.2**	**75.0**
Trade-Weighted Dollar	112.6	112.1	113.6	**115.4**	114.2	**115.4**	110.0
S&P 500 Operating Earnings	47.4	52.0	**52.1**	**49.8**	122.4	**201.4**	**207.5**
Percent vs. Year Ago	143.1	94.1	**37.5**	**30.4**	-22.1	**64.6**	3.0
91-Day Treasury Bill Rate	0.1	0.1	0.1	0.1	0.1	0.1	1.0
10-Year Treasury Note Yield	1.3	1.6	1.3	**1.5**	0.9	**1.5**	2.5
30-Year Mortgage Rate	2.9	3.0	2.9	**3.2**	2.8	**3.2**	4.0
Bank Prime Rate	3.2	3.2	3.2	3.2	3.2	3.2	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*

Flat Real Final Sales in Q3 Short-Lived

In the third quarter, real final sales of domestic product were disappointingly flat after growing at an average rate of 8.5 percent for the first half of the year. Larger-than-expected slowdowns in consumer spending and business fixed investment, combined with a decline in residential investment, a further deterioration in net exports and surprisingly little change in government spending, accounted for the disappointment in real final sales. Indeed, all of the 2.1 percent growth in real GDP in the third quarter could be attributed to a sharp rebound in business inventories. On balance, the sizable contribution to overall GDP growth from inventory accumulation was expected but the zero growth in real final sales was not.

Economic expansions cannot be sustained by inventory accumulation alone. Eventually real final sales need to rebound. Applying a term used by the Fed to describe inflation, the sluggishness of real final sales in the third quarter is expected to be transitory. According to the most recent data releases, it appears that real final sales will rebound markedly in the fourth quarter. In October, real PCE, which represent over 70 percent of real final sales, were already at a level 4.5 percent at an annual rate above the average for the third quarter. Hence, if real PCE simply remains at its October level on average for each of the final two months of the year, it alone is on track to add 3.2 percentage points to real GDP growth in the fourth quarter.

Moreover, new orders and shipments of non-defense capital goods excluding aircraft in October were already at levels well above their third-quarter averages, 7.3 percent and 5.8 percent at annualized rates, respectively. Even allowing for above-trend inflation, it appears that business spending on equipment is on track to register a solid gain in the fourth quarter as well. In addition, residential investment, net exports, and government spending may be on course to rebound as well. In summary, it appears that real final sales growth will not disappoint again in the fourth quarter. By the way, it also appears that business inventories will add to overall GDP growth in the fourth quarter. According to the current-quarter estimate from the Atlanta Fed (GDPNow) based on the latest available data, real GDP is on track at the moment to grow a whopping 9.7 percent in the fourth quarter, with real final sales leading the way with 8.0 percent growth. Although the direction is correct, it may be a bit too early, especially with the introduction of the omicron variant of the coronavirus, to be that optimistic about real GDP in the fourth quarter.

Table 2
Forecast Details of Real Gross Domestic Product, 2021♣

	Q1	Q2	Q3*	Q4*	Q4/Q4*	Annual*
Personal Consumption Expend.	**11.4**	**12.0**	**1.7**	6.6	7.9	7.9
Nonresidential Fixed Invest.	**12.9**	**9.2**	**1.5**	3.8	7.0	8.4
Residential Investment	**13.3**	**-11.7**	**-8.3**	1.3	-1.8	9.2
Government Spending	**4.2**	**-2.0**	**0.9**	3.0	1.5	0.8
Exports	**-2.9**	**7.6**	**-3.0**	8.5	1.7	3.2
Imports	**9.3**	**7.1**	**5.8**	4.9	6.8	13.3
Final Sales	**9.1**	**7.9**	**0.0**	5.5	5.4	5.4
Gross Domestic Product	**6.3**	**6.7**	**2.1**	6.4	5.7	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.

Despite the increased uncertainty about the potential impact of the new omicron variant of COVID-19 on the economy, I suspect that consumer spending will continue to climb in November before slowing some in December. The pattern of consumer spending over the last two months of the year will be influenced markedly by seasonal factors during the holiday shopping season—November is expected to be above normal, while December is expected to be less than normal owing to the likely impact from the omicron variant. On balance, the forecast expects real PCE to rebound to a 6.6 percent annual rate, which is more than three times faster than the third-quarter growth rate but apparently in line with the latest real PCE growth rate estimate from the Atlanta Fed's GDPNow model. I contend that the economic impact from omicron will be relatively minor given the anecdotal evidence that consumers are becoming increasingly fatigued with virus concerns or are increasingly adjusting their spending and behavior to balance the virus risk.

As a sidebar on this issue, real GDP is derived by adjusting nominal GDP for inflation. In the third quarter, the GDP Price Index used to such an inflation adjustment increased a whopping 5.7 percent at an annual rate, more than twice the 2.4 percent pace shown in the September forecast. This 3.3 percentage point error in the inflation forecast for the third quarter can account for all of the error in the real GDP growth forecast for the same quarter. Although inflation is likely to remain elevated and well above the Fed's target for inflation, it is unlikely to be as high as it was in the third quarter. As a result, a smaller portion of the increase in nominal GDP in the fourth quarter will be discounted by higher prices.

Inflation Looks Less Transitory

Consumer price inflation has slowed from its spike in the second quarter but to a level in the third quarter that was still considered well above expectations. According to the Bureau of Labor Statistics, the overall Consumer Price Index (CPI) rose 6.6 percent at an annual rate in the third quarter compared with the 8.4 percent advance in the second quarter. Although the September forecast was skeptical of inflation being as temporary as the Fed was suggesting at the time, the jolt in third-quarter inflation was still surprising.

More importantly, consumer price inflation is expected to remain high longer than the Fed had anticipated earlier. According to Fed Chairman Powell, "Most forecasters, including at the Fed, continue to expect that inflation will move down significantly over the next year as supply and demand imbalances abate. It is difficult to predict the persistence and effects of supply constraints, but it now appears that factors pushing inflation upward will linger well into next year. In addition, with the rapid improvement in the labor market, slack is diminishing, and wages are rising at a brisk pace." It seems that Fed officials are still convinced that inflation is transitory but that the transition lower will take longer than anticipated earlier. Of course, the risk is that the Fed waits too long to offset the inflation risk, if they have not done so already. After all, what is the appropriate interest rate for the Fed to target if inflation and inflation expectations remain elevated in the absence of any slack in the labor market?

In that regard, the overall CPI in October was up 5.4 percent at an annual rate from its third-quarter average. Energy and food prices accounted for a large share of this uptick given that the CPI excluding food and energy (core CPI) in October was up a more moderate 3.2 percent at an annual rate from the third-quarter average. Over the remainder of the year, the core CPI is expected to be the key driver of overall inflation, which means that core is expected to continue to drift higher while energy and food prices stabilize a bit.

As I have noted before, if prices are high solely because of temporary supply problems, then inflation most certainly will be temporary as well. However, if the problem is that demand is so strong that it continues to outpace supply even after the obvious adjustments to the supply chain, then inflation most certainly will not be temporary. In addition, given the sharp plunge in the unemployment rate to 4.2 percent in November, labor costs most certainly will rise, adding to inflation expectations. The key to whether higher wages are inflationary is productivity.

However, 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 the unit labor cost measure in the Productivity and Cost data released by the Bureau of Labor Statistics. Unit labor costs 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 increases faster than labor compensation per hour.

[1] Testimony by Jerome H. Powell, Chairman of the Board of Governors of the Federal Reserve System, Coronavirus and CARES Act, Before the Committee on Financial Services, U.S. House of Representatives, December 1, 2021.

Investment Implications

Since the overall theme of the economic forecast is little changed, the same is true of the investment 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 in 2021. Nevertheless, the stock market is still priced for perfection, which means it remains vulnerable to even minor disappointments. The question is what will disappoint—inflation, employment or growth. I contend that if inflation remains above the Fed's so-called target as expected, it most likely will push the Fed to hike short-term interest rates. The forecast continues to suggest that the Fed will begin to hike its federal funds rate target in 2022, which has now basically become the consensus.

Job growth will most likely slow, but it still will be enough to further lower the unemployment rate. The question is whether job growth and wage gains will translate into income gains sufficient to keep aggregate consumer demand strong. I expect that it will. The November employment report is a great example. The consensus was looking for nonfarm payroll jobs to increase over 500 thousand but the gain was only 210 thousand, triggering several analysts to conclude that the employment report was disappointing. However, the unemployment rate plunged 0.4 percentage points to 4.2 percent, the employment-population ratio jumped 0.4 percentage points owing to 1.136 million newly employed individuals, the index of hours worked in November rose 5.6 percent at an annual rate from the third-quarter average, and average hourly earnings of all private sector employees in November were up 4.5 percent at an annual rate from the third quarter. A simple application of the data suggests that the wages and salaries component of personal income is on track to increase over 10 percent at an annual rate in the fourth quarter before adjusting for inflation.

Hence, investment risk is still in favor and is expected to remain so for the foreseeable future. This is based on the view that an economic recession is not on the forecast horizon. Nevertheless, there will be times when this assessment seems inappropriate owing to the ongoing pandemic, higher interest rates, and slower corporate profit growth. Still, such episodes of doubt most likely will be temporary for now.