STONEBRIDGE
Capital Advisors

Stonebridge Economic Outlook and Forecast Update

March 15th, 2022

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Overview

Consumer price inflation over the last year has proven to be far more persistent than the consensus and policymakers expected initially, putting considerable pressure on the Federal Reserve (Fed) to relax—if not remove—its overly accommodative monetary policy stance. Indeed, a small group of market analysts argues that the Fed has seriously underestimated the inflation pressures and may need to hike its target rate by 50 basis immediately, while an even smaller group still believe that inflation is transitory and will subside without the need of a policy response by the Fed. Based on the recent comments by Fed officials in view of the recent surge in geopolitical risks, I expect the Fed will hike its federal funds rate target by 25 basis points at the next policy meeting this month.

Rather than inflation, the trend in consumer price changes for decades has been described by labels such as disinflation or deflation. Any uptick in prices during that period was usually due to one-off changes in relative prices more so than widespread price increases and were always transitory. Not the case this time. Over the 12 months ending in February 2022, the overall consumer price index (CPI) skyrocketed 7.9 percent, following a 7.5 percent advance in January. Not only was the February advance in the CPI the fastest year-ago percent change since 1982, but it was also more widespread than at any time during the last 40 years. As a result, the inflation label has returned, but more importantly, it has been reinstated as an issue in the policy debate.

A new development now reflected in the forecast is the intensified geopolitical risks due to the Russian invasion of Ukraine orchestrated by Russian President Vladimir Putin. The lives lost by Putin's reckless military aggression are are disturbing and frustratingly unnecessary. The fact that he has no intention of stopping his recklessness continues to haunt financial market participants. From an economic perspective, the impact on Ukraine is devastating. For the rest of us, the primary impact at the moment is sharply higher petroleum prices, raising the question of whether the higher prices will slow U.S. consumer spending and economic growth. The most likely answer is yes, it will but not enough to remove the risk of inflation remaining elevated above the level preferred by the Fed. Most analysts harken back to past energy price shocks to support their argument of a quick and sharp retrenchment in real growth. I am skeptical of such a comparison. Inflation pressures were already embedded in the U.S. economy for various reasons, increasing the likelihood that inflation may have some staying power. An important factor to consider in this regard is that household balance sheets are in excellent shape, suggesting that consumers have the wherewithal to withstand higher prices as long as interest rates do not restrain consumer debt. At the moment, I do not see any evidence that the Fed wants banks to stop lending to consumers.

Putin's justification for the invasion was to slow the expansion of NATO in Eastern Europe. Ironically, it may have the opposite effect, as more Eastern European countries express interest in joining NATO. How will Putin respond? How desperate will he become? Although the forecast assumes that the military conflict will be confined to Ukraine, Putin's threat of further recklessness will at best revive a Cold War scenario.

Undoubtedly, war results in a senseless waste of human and capital resources. It generally is very expensive, both financially and economically, for the countries involved. This begs the question of how Russia will finance its aggression. The only options available seem to be the revenue from government-owned operations or government debt. The primary source of government revenue comes from exporting crude oil and natural gas, which eventually could be disrupted by the war. Hence, debt issuance may be required to carry much of the financial burden.

Table 1
U.S. Economic Forecast

	2022f						
	Q1	Q2	Q3	Q4	2021	2022f	2023f
Real Gross Domestic Product	2.2	3.2	3.0	2.2	5.5	2.7	1.6
Consumer Price Index, All	5.5	5.0	4.0	3.7	4.6	3.0	2.2
Consumer Price Index, Core	5.4	4.8	3.8	4.0	5.0	3.3	2.8
GDP Chain-Type Price Index	3.0	3.0	3.5	3.9	5.5	2.7	2.2
Civilian Unemployment Rate	3.9	3.7	3.7	3.6	4.2	3.6	3.8
Price of WTI crude oil ($/bbl)	96.0	98.0	105.0	95.5	77.4	95.5	70.0
Trade-Weighted Dollar	115.7	116.1	115.6	114.0	115.0	114.0	110.0
S&P 500 Operating Earnings	51.4	53.2	54.5	55.3	202.8	214.4	209.5
Percent vs. Year Ago	8.4	2.2	4.8	5.1	64.6	5.7	-2.3
91-Day Treasury Bill Rate	0.3	0.8	1.6	1.8	0.1	1.8	2.5
10-Year Treasury Note Yield	1.8	2.0	2.2	2.3	1.5	2.3	2.7
30-Year Mortgage Rate	3.6	3.8	3.9	4.0	3.2	4.0	4.5
Bank Prime Rate	3.3	3.8	4.6	4.8	3.2	4.8	5.5

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.

Financing the Invasion

There is considerable attention given to Russia's foreign currency reserves of $680 billion to fund the cost of invading Ukraine. Reportedly, Russia may have access to only about $300 billion of those reserves due to the sanctions imposed. Russia may be hampered by the sanctions but apparently will not be stopped from continuing the invasion of Ukraine. Estimates of Russia's military costs vary considerably.

However, most of Russia's military equipment is produced domestically using domestic raw materials, so Putin may be able to cover the cost of the war by printing more rubles (issuing government debt denominated in rubles to the central bank). Exactly how committed to the war the Russian people will be if it continues to escalate and lasts longer than a few weeks is unclear, which may explain why Putin is applying considerable pressure on Ukraine to cease its resistance immediately.

Of course, Russia could leverage its foreign currency reserves by using them as collateral for debt issued in a currency other than rubles. That may be the only option for them, given that the pool of foreign investors willing to buy Russian bonds denominated in rubles may no longer exist. If Russia issues bonds denominated in another currency, what currency would that be, and at what interest rate? Many countries have already closed their capital markets to Russia, reducing the list of potential financial supporters to a very short list, with China possibly at the top.

Note that China did not join the U.S. and its allies in condemning Russia for invading Ukraine. Many argued that China and Russia were unofficially allied against the United States. However, that alliance may not be as strong as many suggest, given that it remains unofficial. My take is that China's leadership may find it difficult to condemn Putin's aggression when they have their designs on Taiwan. The failure to condemn aside, China still may be reluctant to provide financial support for a war of aggression by Russia, which shares 2,615 miles of China's border. Although the Sino-Russia border dispute was resolved some years ago, it may go the same way as the Cold War, which was thought to be resolved as well until recently.

Inflation

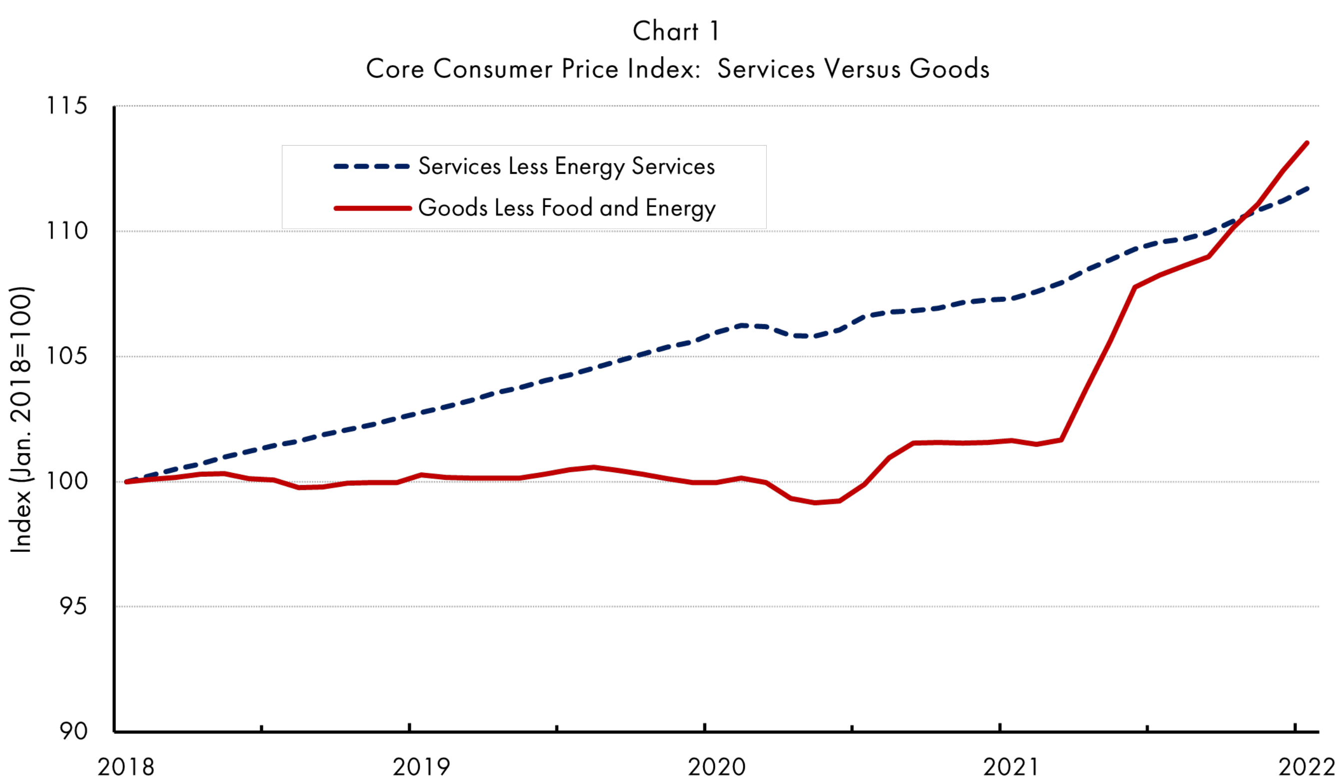
Consumer prices surged last year, following decades of very weak pricing power by businesses. Although last year's pricing action cannot and will not be sustained, the level of inflation still will require a Federal Reserve policy response. In fact, it may be that the only way to slow inflation in any meaningful way at this stage of the inflation cycle is for the Fed to do even more than most now anticipate, which in turn will probably be too much to engineer a soft landing for the economy.

What happened to suddenly cause consumer price inflation to reemerge at the forefront of the policy debate? Analysts have offered several factors to explain the recent surge in inflation, including the prolonged accommodative monetary policy by the Federal Reserve, supply-chain disruptions, the retreat of globalization, and a shift in demographics. Of course, it may be that all of the above factors have contributed, with the pandemic and the massive pandemic relief programs providing the catalyst to the long-anticipated shift in pricing behavior. As such, inflation pressures are not expected to dissipate without the Federal Reserve pulling its policy strings.

From January 1983 to January 2021, the overall CPI increased 2.7 percent at an annual rate, while core consumer prices (excluding the volatile food and energy components) advanced at a similar 2.8 percent annual rate. This demonstrates that economists use the core CPI not as a substitute for the overall CPI but rather as a near-term gauge of the underlying overall inflation trend by ignoring the very volatile prices of food and energy. For example, for the twelve months ending in January 2021, the overall CPI jumped 4.4 percent at an annual rate, while the core CPI advanced 3.7 percent at an annual rate. Food and energy price increases had a meaningful impact on overall inflation. Using the core CPI as a guide, the trend level of overall CPI inflation is currently expected to rise above the Fed target of 2 percent by a sizable margin.

Separating the core CPI into its two major components, services and goods, may provide a bit more insight into the debate about the recent uptick in consumer price inflation. In particular, from January 1983 to January 2021, CPI for services excluding energy services (core CPI for services) increased at a 3.5 percent annual rate, while the CPI for goods excluding food and energy (core CPI for goods) rose a mere 1.1 percent at an annual rate. Hence, the bulk of the rise in core prices came from services rather than goods during this period.

That changed last year, when core CPI goods inflation surged 11.7 percent, well above core CPI services inflation of 4.1 percent (see Chart 1). A more detailed examination of the data revealed that core goods inflation was widespread last year and not driven solely by new and used car prices as often suggested by media reports. There is little doubt that new and used car prices soared over the last year (12 percent and 40 percent, respectively). However, if new and used car prices are excluded from core goods prices, this narrower measure of prices still registered an advance of 7.2 percent from January 2021 to January 2022, after essentially no change on average for the prior ten years (-0.1 percent).



Source: Bureau of Labor Statistics.

As I have mentioned in the past, a primary concern of monetary policymakers is not just current inflation but also what rising inflation expectations might mean for future inflation. After all, if price hikes are expected, there is less resistance to businesses raising prices to preserve profit margins. By most measures, inflation expectations in the last year have edged up slightly to a level only marginally higher than the Federal Reserve's long-range inflation target. Expectations are not considered problematic at such a level, but that could change quickly, especially with the war-induced surge in energy prices, supply-chain disruptions likely to be even slower to correct, and a probable shortfall in labor productivity gains all putting added pressure on businesses to raise prices.

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, suppose the problem is that demand is so strong that it continues to outpace supply even after the obvious adjustments to the supply chain. In that case, inflation most certainly will not be temporary. In addition, given the further decline in the unemployment rate to 3.8 percent last month, labor costs will certainly rise, adding to inflation expectations.

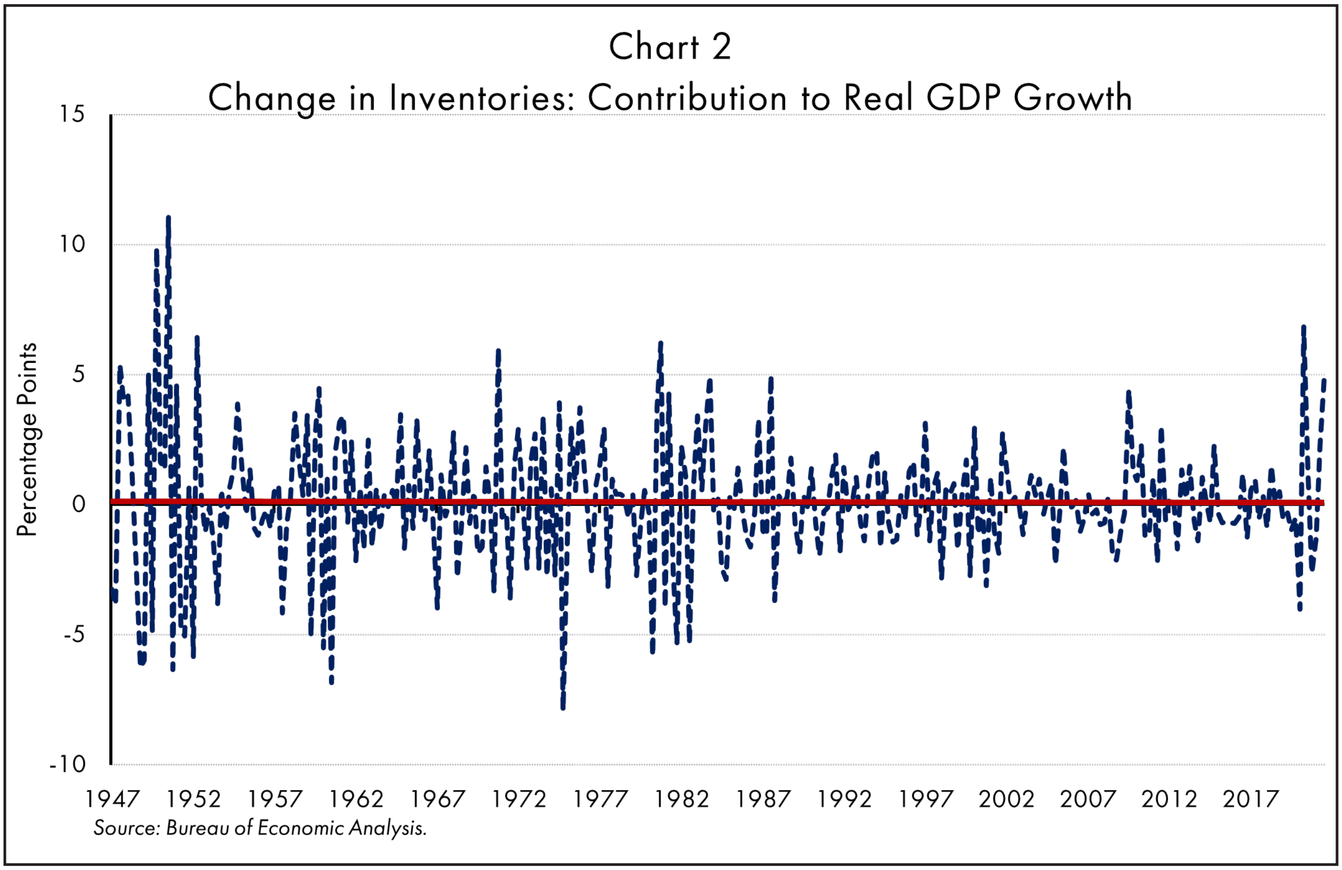
However, higher wages alone do not always lead to higher consumer prices, especially if higher wages are offset by higher labor productivity. Productivity and Cost data released by the Bureau of Labor Statistics best illustrates this point. Unit labor costs are the cost of labor per unit of output produced. Unit labor costs go up when labor compensation per hour increases faster than real output produced per hour worked and vice versa. On a moving average basis, the percent change in unit labor costs from a year ago followed a downward trend for decades, contributing markedly to an era of disinflation.[1] In recent years, this moving average has turned and now seems to be trending upward again, suggesting that the era of disinflation is probably over. This puts added macroeconomic pressure on financial assets and makes asset selection more important.

Business Inventories are Temporary

Although real gross domestic product (GDP) grew at an average annual rate of 4.5 percent for the second half of last year, real final sales grew at an average of only 1.0 percent. The difference between real GDP and real final sales is the change in private business inventories, suggesting that much of the growth in real GDP in the second half of last year (roughly 75 percent of it) was due to a surge in inventory accumulation by businesses rather than strong final demand. The point is that businesses hold inventories as an intermediate product to be used in the process of adding value to a final product, suggesting that they are temporary. In turn, their impact on real GDP growth tends to be temporary as well.

In that regard, the change in real inventories contributed 2.2 percentage points to real GDP growth in the third quarter and a whopping 4.9 percentage points to growth in the fourth quarter, or an average of 3.5 percentage points for the second half of last year. Based on past behavior, such a pace of inventory accumulation cannot be sustained. This is best illustrated in Chart 2, which plots the quarterly contribution to real GDP growth from the change in business inventories since 1947, as well as the trend line of those contributions over the same period with a trendline (dark red line). The most interesting aspect of this plot is that the trendline is almost on top of the zero axis, suggesting that the near-term impact of the change in inventories on real GDP growth is offset over time.

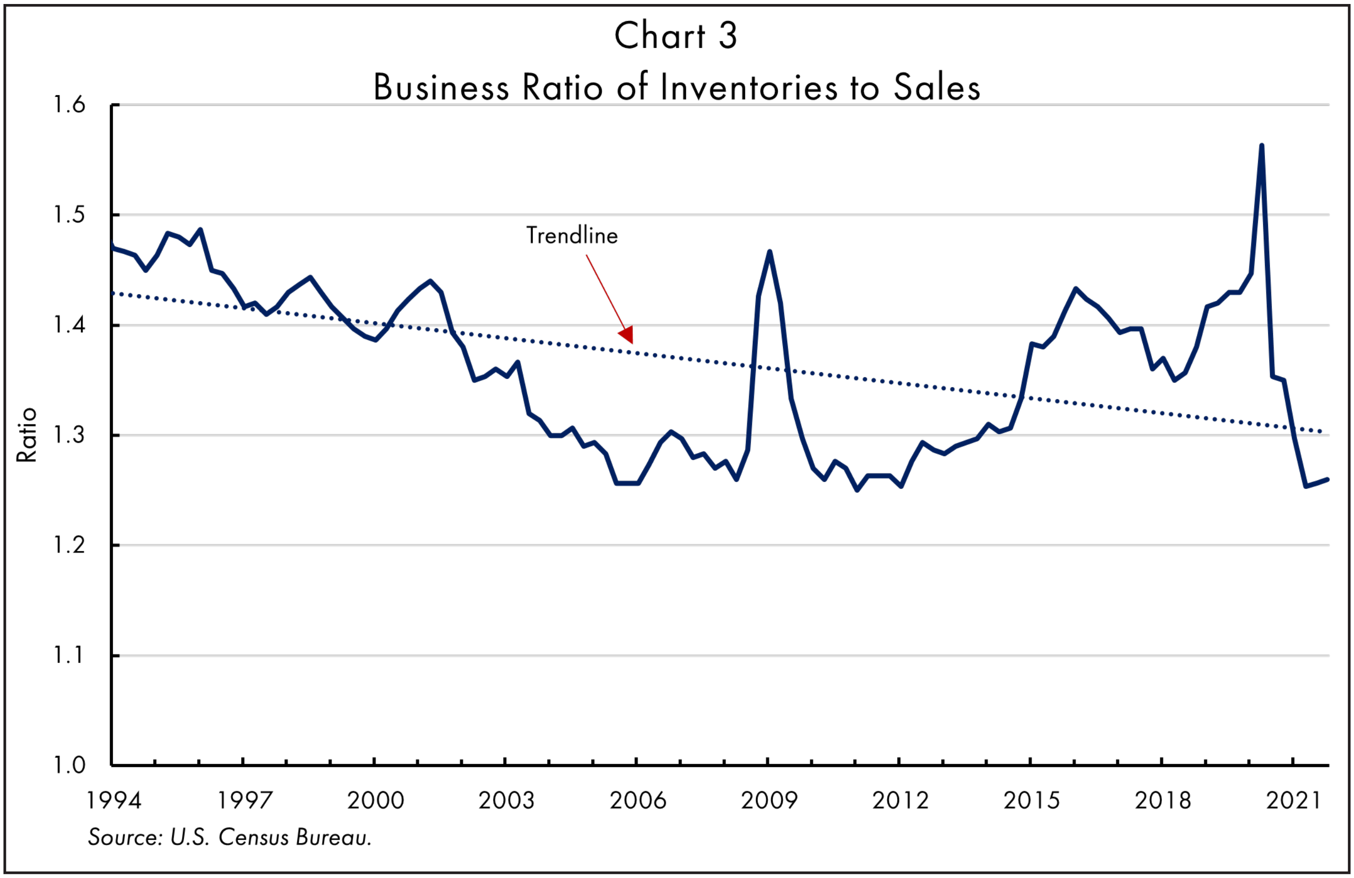
[1] The title of my first speech when I started working in the private sector in 1987 was "The Era of Disinflation." That same theme was used in many of my presentations for decades.



Since the change in inventories contributed 3.5 percentage points to real GDP growth in the second half of 2021, the trendline suggests that the change in inventories will detract an equal percentage from real GDP this year. At the moment, the consensus forecast seems to expect most of the drag from inventories to occur in the first quarter. The consensus seems to consider all of the inventory accumulation last year as unplanned and, needs to be liquidated. That may not be the case. At least some of the excessive inventory building late last year may have been planned due to ongoing concerns about supply-chain disruptions caused by the pandemic. These disruptions probably got even more problematic with the Russian invasion of Ukraine. The implication is that under these circumstances, businesses will want to operate with more inventories than they would normally to protect their operations somewhat from future supply disruptions.

What makes this interesting is that even with the uptick in inventories relative to sales late last year, the inventories-to-sales ratio at 1.26 was still very near its record low of 1.25, last recorded in the second quarter of 2021 (see Chart 3).

If businesses decide to maintain inventories in line with sales in the first quarter of 2022 so that the inventories-to-sales ratio remains at 1.26, then the change in business inventories should have little or no impact on first-quarter real GDP growth. However, if monthly data are considered, the inventories-to-sales ratio was 1.29 in December of last year, which suggests that the ratio falls in January to maintain a 1.26 average for the first quarter but probably not by much. As a result, the change in business inventories is expected to detract from real GDP growth in the first quarter but not nearly as much as expected by the consensus.



To be more precise, I expect the change in inventories to detract 1.1 percentage points from real GDP growth in the first quarter rather than the 3.5 percentage points suggested by most. Positive real GDP growth in the first quarter would be more easily achieved if inventories did not detract 3.5 percentage points. Although there are numerous moving parts to the forecast at the moment, the most recent addition being Russia's invasion of Ukraine, real final sales are expected to grow at a 3.3 percent annual rate in the first quarter, roughly in line with the consensus and up substantially from the 1.9 percent annual rate of growth in the fourth quarter of last year. If inventories detracted 3.5 percentage points from real GDP in the first quarter, real GDP would decline 0.2 percent. If inventories detract only 1.1 percentage points as I expect, first-quarter real GDP will expand 2.2 percent.

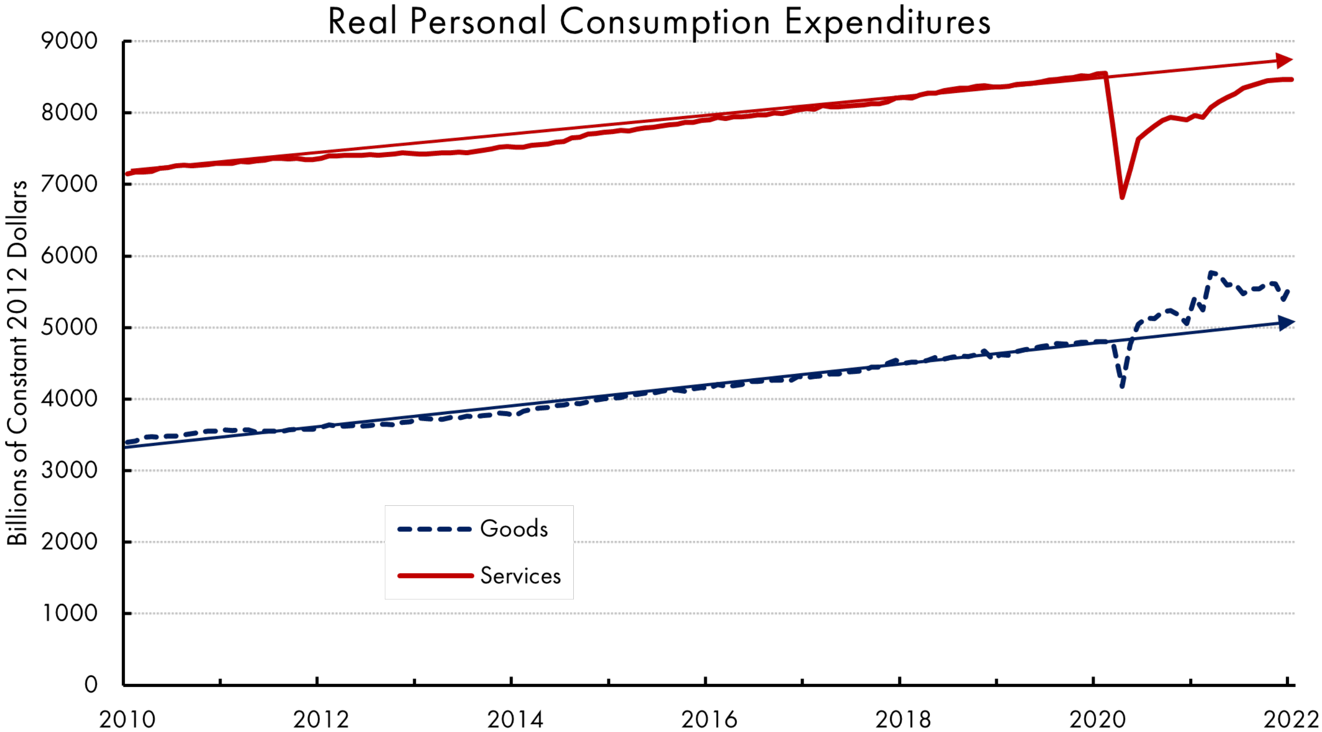
Beyond the first quarter, the factors that led businesses to accumulate inventories in excess of final sales late last year will still be in place. As such, the ratio of private inventories to final sales of domestic businesses may slowly climb back to its trendline shown in Chart 3. This suggests that the drag on real GDP growth will not only be smaller than the consensus now expects for the first quarter, it could also be less for all of 2022. The current forecast is that the change in inventories will detract 0.3 of a percentage point from real GDP growth over the four quarters of 2022.

Growth Expected to Slow

Without a doubt, the outlook for all of 2022 is even more uncertain than normal due to the rise in geopolitical risks associated with the crisis in Ukraine. On the one hand, some still argue that inflation is temporary and that any action by the Fed will only derail the expansion. On the other hand, some contend that the outcome will be the undesirable combination of sluggish growth and high inflation (so-called stagflation). The most likely outcome is somewhere between these two. Inflation was expected to slow some before the latest spike in crude oil prices but not enough to prevent the Fed from hiking rates. It now seems that rate hikes are more likely and even more frequent than before. Real GDP growth for the U.S. was expected to slow as well before the invasion but remain well above the U.S. economy’s potential growth rate, providing room for the Fed to attempt to engineer a soft landing for the economy. Successfully achieving a soft landing has proven to be very elusive. With the more recent spike in energy prices due to the invasion of Ukraine, the Fed successfully engineering a soft landing becomes even more elusive, while the economy becomes more volatile.

Real personal consumption expenditures on both goods and services are plotted in Chart 4, along with the trendline for each category based on data from January 2010 to January 2020. As shown, real consumer spending on goods trended upward steadily from January 2010 to January 2020 before plunging owing to the pandemic. However, goods spending recovered quickly, rising above the pre-pandemic ten-year trendline by June 2020 and has remained above trend ever since. The concern is that this level of spending on goods cannot be sustained and that a return to something more in line with the previous trendline seems in order. Such a return to trend would put considerable downward pressure on consumer spending. At the moment, the consensus seems to expect goods spending to return to its trend very quickly. I expect it will happen in fits and starts, causing goods spending to be less of a drag on real GDP for all of 2022 than many now suggest. That said, it certainly will be a source of growth volatility over the next several quarters.

Chart 4
Real Personal Consumption Expenditures



Source: Bureau of Economic Analysis.

Although the level of consumer spending on services plunged sharply in early 2020, its rebound has been far less dramatic. In fact, unlike spending on goods, services spending has not yet returned to its pre-pandemic ten-year trendline. The implication is that there is considerable pent-up demand for services. Once the pandemic is considered finished, this demand will resurface and drive services spending above trend for a while. There is anecdotal evidence that it may be already underway.

The point is that real final sales in the first quarter of 2022 are expected to register a gain of 3.3 percent at an annual rate, led by real consumer spending increasing at a 3.2 percent pace. Final sales likely will accelerate a bit more in the second quarter, also led by consumer spending growth, with a little help from an improving international trade deficit. In the second half of 2022, real final sales growth should slow somewhat, as consumer spending slows as well. Nevertheless, the pace will still be enough to apply further pressure on pricing by businesses to maintain profit margins.

Financial Market Implications

The equity market late last year was priced for "perfection" only to be reminded once again that the world is far from perfect. The problem is that now an increasing number of market analysts have swung in the other direction and are suggesting Armageddon. Although the outlook is not nearly as rosy as it was, the U.S. economy still has a future. I expect corporate profits will be very good in the near term as long as companies have the pricing power to maintain profit margins in a rising cost environment. Of course, this will not last, but investors are likely to be pleasantly surprised by profits before it ends. This is another way of saying that since I do not expect a recession this year, the stock market has at least one more run at a new record high before this expansion ends. Without a doubt, the stock market will be very volatile for the remainder of this expansion.

I am amazed why some people question the prospect of higher interest rates when it is so obviously justified. After all, there is no reason why the 10-year U.S. Treasury note yield should be 1.8 percent, given that the current-dollar measure of the U.S. economy grew in excess of 10 percent over the four quarters of last year. That said, it would be equally difficult to justify a 10 percent yield as well. Where will it settle? I am convinced that the 10-year Treasury yield on average will ratchet higher over the remainder of this year to a fourth-quarter average of roughly 2.3 percent, with more subdued increases in 2023.

Typically, as long as investors feel confident that the Fed needs to raise rates further to engineer the proverbial soft landing (low inflation and low unemployment) for the U.S. economy, yields on long-term Treasury obligations will rise along with short rates but not quite as much. Once investors are convinced that the Fed is close to doing enough, longer-term Treasury yields will respond even less to any further short-term rate hikes. More short-term rate hikes by the Fed at this point will cause investors to become increasingly concerned that the Fed has gone too far. As a result, the likelihood of a hard landing for the economy becomes the consensus view, causing the yield curve to invert. Given that the 10-year Treasury yield peaked recently at just over 2 percent, some market participants insist that the 10-year yield has already discounted the Fed's rate hikes and is now pricing in the late stage of the tightening cycle. The problem is that the Fed hasn't even started yet.