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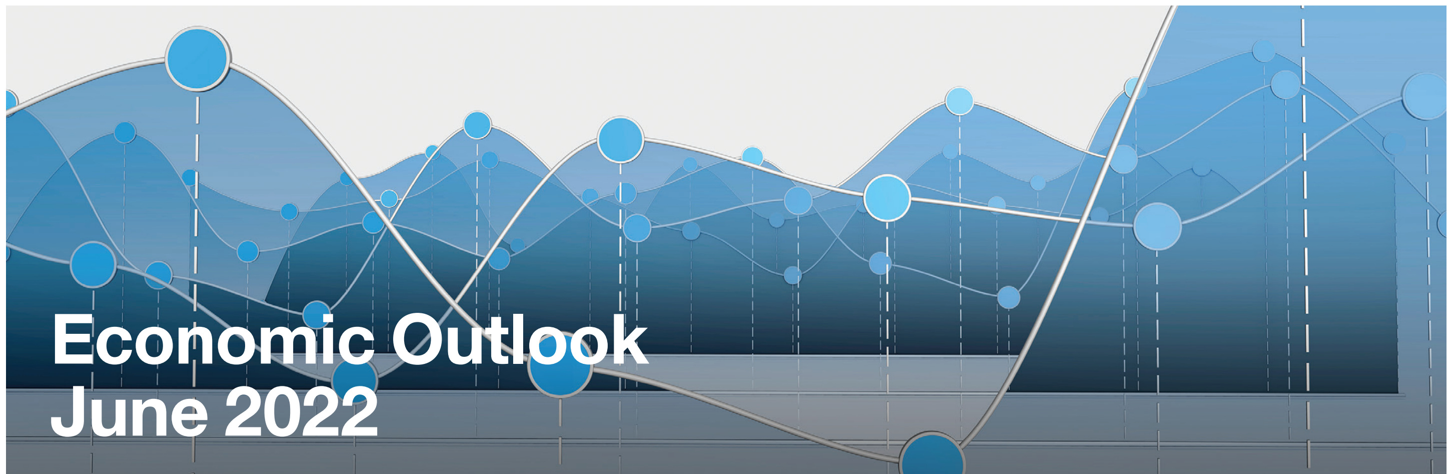

Economic Outlook June 2022

by Bruce McCain, PhD, CFA®

Overview

Inflation has become public enemy number one. The Consumer Price Index (CPI) has risen four to five times as fast as the Federal Reserve's target of 2% inflation, while the Fed's preferred index, the Personal Consumption Expenditures Index (CPE), has risen roughly three to four times faster than the target. Both measures have increased more than at any time since the early 1980s, the last time inflation spiraled out of control. With income gains for most households and businesses lagging behind, inflation has become a major political issue. The Federal Reserve seems prepared to do whatever it takes to tame inflation — even risking a recession. Hence, the 1.5% estimated decline in GDP in Q1 may be just a foretaste of broader weakness in coming months.

Yet despite the decline in overall GDP, consumer spending contributed a solid 2.1% to Q1 economic growth. Although spending on goods, particularly autos, was strong as the quarter began, the much larger services sector contributed more to GDP growth over the quarter. Consumers dipped into savings to supplement income growth, which means the current level of spending may not be fully sustainable. Still, at least in aggregate, consumer finances seem strong, with a significant cash reserve. That spending reserve, along with the reduced likelihood of layoffs in an extremely tight labor market, could make consumption less responsive to tightening Fed policy than has historically been the case. That could force the Fed to tighten harder for longer.

Nonresidential fixed investment spending also contributed a strong 1.2% to GDP growth in Q1. A major part of that came from computer equipment, industrial equipment,

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and software, areas that are vital to making a severely constrained labor force more productive. Energy production could have been stronger, given energy's role in current inflation pressures, but drilling activity has at least accelerated. Rising rates and a slowing economy pose clear threats to business investment and production, but while managers are worried, they have not as of yet significantly cut investment or hiring.

Businesses did reduce inventories in Q1, however. In Q4 of 2021, an extremely large inventory build added significantly to GDP growth (+5.3%). That made sense given both supply chain disruptions and the potential for continuing economic growth. Yet, in Q1, rising rates and the likelihood of a slowing economy may have encouraged the inventory drawdown that subtracted 1.1% from GDP. Since inventories do not seem overly bloated relative to sales, further liquidations should depend heavily on how sales hold up.

Trade also weighed on Q1 GDP growth, with exports net of imports reducing overall growth by 3.2%, as dollar strength encouraged imports and discouraged exports. Since imports tend to correlate with consumer spending, reduced imports should also help buffer GDP in any downturn. Additionally, as more countries tighten monetary policy to fight inflation, pressure should come off the dollar. Hence, trade seems unlikely to remain as negative for growth as it was in Q1.

In Q1, government spending actually reduced GDP modestly (0.5%). We often hear that government spending is responsible for inflation. It is true that the massive Federal appropriations over the last two years funded a large share of consumer cash reserves. Nonetheless, much of the money appropriated for infrastructure and other spending projects has yet to be spent. Until appropriations are actually spent, their impact should be more psychological than economic.

So, can the Federal Reserve reduce inflation without precipitating a recession? The odds seem tilted against it. The Fed has fallen well behind the curve on calming the strongest inflation in forty years. That means they must rush to catch up by implementing larger rate hikes over a shorter period of time, and perhaps by raising rates higher than might otherwise be necessary. Given the lagged way the economy responds to rate hikes, that increases the chances monetary tightening will overshoot and cause a recession.

At the same time, while officials were overly optimistic supply chain improvements would quickly reduce inflation, it does seem inflation has resulted more from constrained supply than excessive demand. Offering hope that an end to COVID lockdowns in China and other source countries might also ease inflationary pressure. While supply chain improvements will not resolve the shortage of labor, due in large part to global demographics, or the shortage of energy, aggravated by efforts to sanction Russia, they would lighten the need for reducing demand through monetary policy.

Consumers

While many areas of the economy have recovered from the pandemic, consumer sentiment has not. Just prior to the pandemic, the University of Michigan Consumer Sentiment survey reading ranked close to the 90th percentile, relative to scores back to 1980. Recent scores ranked only in the 2nd percentile. Concerns about the pandemic have eased but have not been entirely resolved. Inflation, both in general and due to rising energy costs in particular, is pressuring household budgets. And while rising interest rates do not directly impact all consumers, financial market declines suggest the public currently fears economic slowing.

Yet while general consumer confidence remains extremely low, jobs are readily available and most households seem to be in comparatively good financial condition. Generally, too, as long as incomes rise enough to cover added spending, consumers may express low confidence but still increase spending. As we closed out 2021, in aggregate, nominal consumer spending, which grew at close to a 6% annualized rate (ar) off the prior top, rose substantially faster than spending's 3.9% ar rise over the last expansion. But because aggregate personal income also grew 5.9% ar off its top, income growth largely balanced spending growth and there was little need for consumers to draw down savings.

Consumption surged well ahead of income gains in Q1 2022.

*annualized rate

The same has not been true in 2022, as consumption surged well ahead of income gains. Aggregate nominal income grew 5.0% ar in the first quarter of 2022, while consumption surged 17.4% ar. January was exceptionally strong, especially for new vehicle sales. Retail sales also reflected the spending splurge. The advance number rose 25.6% ar in the 1st quarter, roughly six times the 4.2% ar it grew over the last expansion. January sales rose at an annualized clip of 37.8%, with February and March posting gains closer to 20% ar. In April, sales decelerated to an 11.4% annualized gain. Consumers should have enough money in reserve to sustain spending that outstrips income gains for a while, but consumption will eventually need to reflect income growth more closely.

Business activity

CEO Magazine notes that "Amid historic inflation, choked supply chains, rising interest rates, and an unending battle for talent, CEOs are increasingly worried about the year ahead." As headwinds have increased, the CEOs' outlook for future business conditions has fallen to its lowest level in almost 6 years. Yet while 46% of the CEOs expect conditions to deteriorate, the magazine notes that "the predictions of decline are hardly unanimous" among the CEOs polled. The survey reported that 70% of the CEOs expected revenues to increase and 58% expected profits to increase. Moreover, 53% of CEOs planned to increase capital expenditures and 60% expected to add to headcount over the next year. Thus, while CEOs are increasingly worried, they apparently do not expect severe economic slowing.

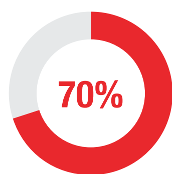
Smaller businesses report less optimism. The National Federation of Independent Business (NFIB) reported that a net 50% of businesses do not think business conditions will improve over the next six months, which is the lowest level recorded in the survey's 48-year history. NFIB Chief Economist Bill Dunkelberg reports, "The labor supply is not responding strongly to small businesses' high wage offers and the impact of inflation has significantly disrupted business operations." NFIB found that 47% of firms had positions they could not fill, and 93% of those trying to hire were disappointed with the quality of applicants. On balance, too, smaller businesses expect adverse sales and profitability trends, with a net 12% believing sales will not improve and a net 17% projecting disappointing profit trends.

Industrial production remained weaker than other parts of the economy, aggravating at least one major source of inflation. Off its pre-pandemic peak, nominal GDP has grown roughly 12.0%, a 6.0% annualized gain. That is just a little faster than the 5.3% ar economic growth since 1980. Nominal oil and gas extraction, however, remains about 5.6% below its pre-pandemic peak. And drilling stands 7.7% below the prior level, although a 54% increase over the last year has helped close the gap. According to the U.S. Energy Information Administration, production of U.S. crude oil on its own stood 20.9% below its prior peak. Energy inflation attests to the tightness of energy supplies relative to global demand, aggravated by efforts to limit Russian energy sales. Unfortunately, little in the U.S. production figures offer much hope of a quick resolution to the tight supplies.

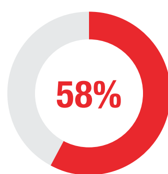
Strong investment spending is the best long-term hope for overcoming shortages of labor, energy, and other critical inputs. Yet off the peak in spending prior to the pandemic, nonresidential investment has not fully recovered. Since the end of 2019, real nonresidential investment spending rose 2.1% ar versus a 5.0% ar growth over the last economic expansion. Real spending on structures has been particularly disappointing, remaining roughly 22% below the level prior to the pandemic. Energy spending accounts for part of that decline, although investment in most other structures has also declined. Investment in equipment has done better, but the 4.1% ar real gain post-pandemic is still less than the 6.7% ar growth achieved over the last expansion. Only spending on intellectual property, up 7.4% ar, has beaten its growth of 5.8% ar off the prior peak.

Real investment spending surged in Q1, however, making up some lost ground and contributing 1.2% to GDP growth. Annualized, overall real nonresidential spending rose 9.2%, while equipment spending rose 13.2% and intellectual property spending increased 11.6%. Bucking the improvement, structures investment declined at a 3.6% ar clip. Investment spending can be volatile. Additionally, rising prices and the risk of higher rates may have encouraged businesses to accelerate investment projects. Certainly, however, higher rates and slowing economic growth are unlikely favorable for investment spending in the coming months.

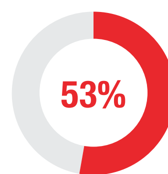
Despite CEOs being increasingly worried about the year ahead, the predictions of decline are hardly unanimous among those polled.



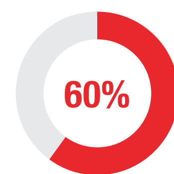
expected revenues to increase



expected profits to increase



plan to increase capital expenditures



expected to add to headcount over the next year

Exports and international economies

International trade subtracted 3.2% from GDP growth in the first quarter of 2022. Part of that came from the extremely strong growth of imports (-2.6% contribution), which often accompanies strong consumer spending growth. Exports (-0.6% contribution) were comparatively weak as well. Weakening overseas growth combined with a strong dollar reduced U.S. exports. While overseas economies may not strengthen anytime soon, some of the currency pressure may ease if overseas growth, inflation, and interest rate policies become more equivalent to U.S. conditions.

Economic activity in the Eurozone shows signs of modest slowing, and Ukraine poses a downside risk. Annualized growth of 1.1% for Q1 2022 fell below the 1.4% growth achieved over the last expansion. A Manufacturing PMI of 54.6 and a Services PMI of 56.3 suggest solid growth in the coming months, but trade uncertainty, particularly from the Ukrainian war, poses major risk. Europe's heavy reliance on Russian energy also presents a significant problem, as escalating energy costs would make European products less competitive. Worse still, countries in the region may have trouble getting all the energy they need.

The United Kingdom reported strong growth through Q1, but also faces a slowdown. GDP growth of 3.0% ar was well ahead both of European growth and the U.K.'s own growth over the last expansion (1.9% ar). The outlook for manufacturing has deteriorated only slightly, with a solid 54.6 on the Manufacturing PMI. As with Europe, however, a longer or an escalating Ukrainian conflict could severely impact U.K. trade. In the wake of the Brexit divorce, conflict over Northern Ireland trade has also intensified. Moreover, with energy and other living costs putting a major squeeze on household budgets, the outlook for the domestic sector has deteriorated significantly. The Services PMI plunged seven points, to a marginally positive reading of just 51.8.

Given Japan's long worry about deflation, it seems odd to have Bank of Japan (BOJ) Governor Kuroda voice worry about inflationary pressures damaging the economy. Core consumer inflation is running only 0.1% above the BOJ's 2.0% target, and Kuroda admits the concern may be premature, but wage gains are not keeping up with costs of living and the opposition party is trying to make inflation an issue. With GDP contracting at an annualized 1.0% in Q1 and neither the Manufacturing (53.3) or Services (53.3) PMI indicating a particularly strong outlook, Kuroda insists the BOJ will maintain its extremely accommodative monetary policy.

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China's economy also faces major problems. Some of the worst are of its own making. For years property ownership has been one of the few investments where Chinese citizens could accumulate financial wealth. That divorced property values from their economic utility, however, helping to create a speculative "bubble." The government's attempt to reduce that speculation now threatens collapse of an area that has accounted for a significant amount of both GDP and government receipts. China's "zero tolerance" for COVID cases has also created economic havoc, as the highly infectious, but less lethal, current strains encouraged most other countries to abandon widespread lockdowns. Both problems have restricted economic growth. China's economy grew 4.8% over the last 12 months, below the official 5.5% target, in a year critical to President Xi's political future. Recent PMI scores were also discouraging. A 48.1 Manufacturing PMI score suggests a lethargic manufacturing sector on the edge of decline, while an abysmal Services PMI score of 36.2 reflects the horrendous cost of broad lockdowns in major cities.

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About Bruce McCain

Bruce McCain serves as a consultant providing perspectives on the economy and the market to both investors and business operators. He has appeared regularly on CNBC and Bloomberg providing market perspectives and has been quoted in The Wall Street Journal, Investor's Business Daily, and MarketWatch as well as published articles on Forbes.com. He retired from KeyBank in 2019 after 32 years.

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