ECONOMIC OUTLOOK

REGIONS
March 2021

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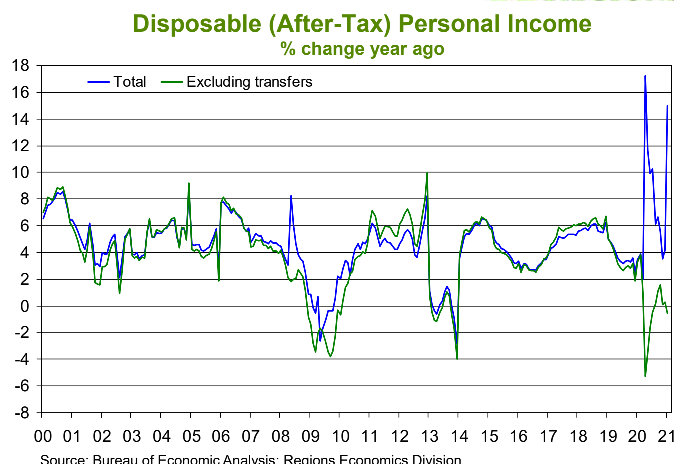
Consumer Spending Set To Surge. Or Not . . .

The Bureau of Economic Analysis (BEA) recently released the January data on personal income, spending, and saving. While total consumer spending rose by 2.4 percent in January (thanks in no small measure to generous seasonal adjustment), that increase was no match for the 10.0 percent increase in total personal income or the 11.4 percent increase in disposable (or, after-tax) personal income. As a result, the personal saving rate leapt to 20.5 percent in January from 13.4 percent in December. The spike in personal income in January largely reflects the distribution of the second round of Economic Impact Payments (EIP) of up to $600 per eligible adult and each eligible dependent provided for in the *Coronavirus Response and Relief Supplemental Appropriations Act* which was signed into law in December 2020.

That bill was in many ways an extension of the CARES Act, passed in the early days of the pandemic, which provided the initial round of EIP of up to $1,200 per eligible adult and each eligible dependent as well as supplemental unemployment insurance (UI) benefits, extended UI benefits for those exhausting regular state benefits, and special programs to pay UI benefits to those, such as gig workers, typically not eligible. The late-2020 bill provided for continuation of these various UI benefit programs. There is more to come along these lines, and perhaps quickly, as the Biden Administration's *American Rescue Plan* will be signed into law this month. The bill will include a third round of EIP, providing payments of up to $1,400 for each eligible adult and each eligible dependent, which we expect to be distributed this month, and will extend the various UI benefit programs being funded by the federal government.

The magnitude of support provided to households can be most readily seen in the data on disposable personal income excluding transfer payments. Note that transfer payments include a wide range of programs, such as Social Security, in addition to the various programs that have arisen in response to the pandemic, while private sector wage and salary earnings are the single largest block of personal income. As such, the path of disposable personal income excluding transfer payments has been closely aligned with the ups and downs in COVID-19 case counts and the imposition/relaxation of restrictions on economic activity. This helps account for ex-transfers disposable income falling by 0.1 percent in January, leaving it down 0.5 percent year-on-year. Unlike total disposable personal income, which as of January stood 14.2 percent above the pre-pandemic peak, disposable personal income excluding transfer payments was 1.3 percent below the pre-pandemic peak. And, for some added perspective on the impact of the various pandemic-related transfer payments, prior to spiking during the pandemic, the personal saving rate (saving as a percentage of disposable personal income) averaged 7.5 percent from 2017 through 2019.



The above chart illustrates our point, with the two notable spikes in total disposable personal income growth coinciding with the two rounds of EIP distributions. While we envision another spike in the March data when we expect the bulk of the third round of EIP will be distributed, that could fall into April, which would alter the timing but not the effect. When the third round of EIP does hit the books, there will be a corresponding spike in the personal saving rate which should push it above January's rate of 20.5 percent.

This extraordinarily high level of personal saving is one reason that many analysts expect a significant jump in consumer spending later in 2021 once a much higher share of the population has been vaccinated against the COVID-19 virus and the economy is more fully reopened. To be sure, while many analysts expect to see a jump in consumer spending, expectations as to the magnitude and the timing of any such jump vary widely, and the reality is that these things hinge upon the progress made on the vaccination front. Keep in mind that any such jump in consumer spending won't solely be fueled by the pool of personal saving, as the economy more fully reopening will be accompanied by a much faster pace of improvement in labor market conditions, which should also support income growth and consumer spending.

To help assess the potential contribution from personal saving, we've used the monthly data on personal income, spending, and saving to make a rough estimate of how much "excess" saving has accumulated in the household sector of the U.S. economy. We use the term "excess" in the sense that the magnitude of the transfer payments funneled to the household sector since last April has helped households build up saving considerably in excess of the level that would have otherwise prevailed. Clearly, there is no way

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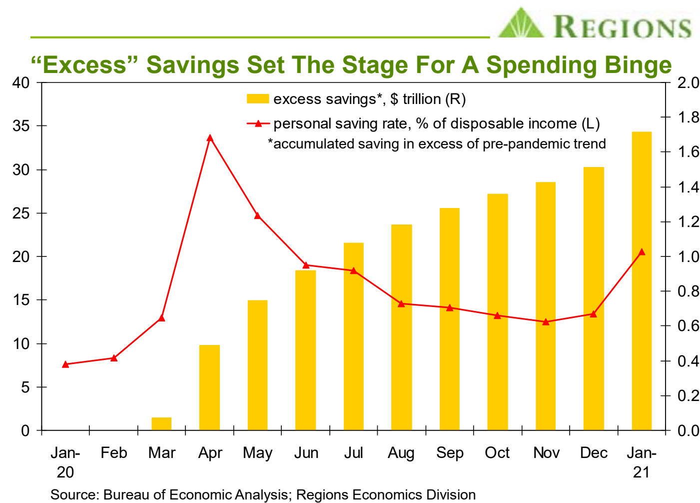
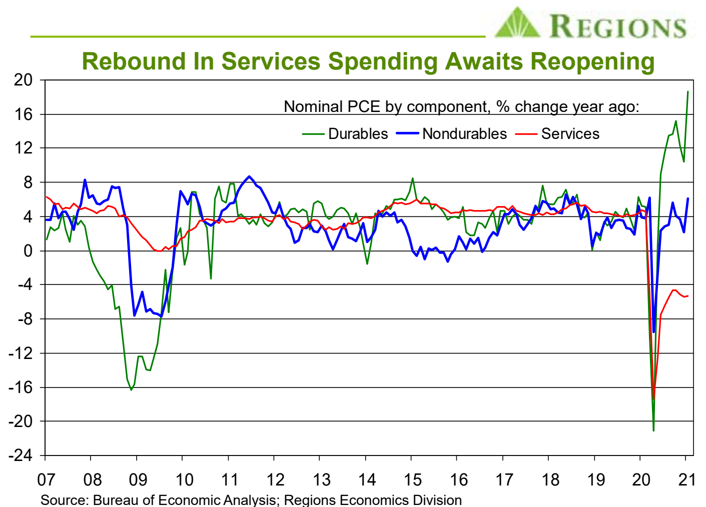
to precisely estimate the magnitude of "excess" saving; our estimate will differ from estimates made by others depending on assumptions about starting points and the "equilibrium" saving rate accounting for much of the differences. So, while no one really knows the "true" number, the estimates we've seen do not differ dramatically, and directionally are all moving in the same way, i.e., the pool of "excess" saving has gotten larger. With a third round of EIP on the way, there will be even more saving at the disposal of households at some point in the weeks ahead.



We estimate that as of January there was roughly $1.72 trillion of excess saving in the household sector relative to what the level of saving would have been had the pre-pandemic saving rate held over the past year. Again, whether our estimate is too high or too low doesn't alter the underlying point, which is the potential for accumulated saving to fuel a significant increase in consumer spending at some point in 2021. It helps to note that, as reflected in the data for March 2020 in the above chart, transfer payments are not the only factor behind the elevated degree of personal saving. While the first round of EIP was not distributed until April, the personal saving rate nonetheless jumped to 12.9 percent in March 2020. This reflects the pullback in consumer spending as the economy began to shut down in March, such that even though disposable personal income declined, the decline in spending was much more pronounced, thus pushing the saving rate higher.

With much of the services sector still either partially or fully shut down, much of what consumers would have otherwise spent on services such as travel, tourism, dining out, recreation, gaming, sporting events, and live arts performances has instead been saved, which has contributed to the pool of "excess" savings illustrated in the chart above. Keep in mind that, prior to the pandemic, spending on services accounted for over two-thirds of all consumer spending, so foregone spending on services has made a meaningful contribution to the build-up of personal saving, even if this effect is more concentrated amongst upper-income households. That is worth noting because, while consumers have indeed spent some portion of the first two rounds of Economic Impact Payments, much of that spending has fallen on consumer goods, particularly consumer durable goods such as motor vehicles and recreational vehicles, home furnishings and appliances, electronics. As of January, the latest month for which complete data on consumer spending are available, spending on consumer durable goods was 19.8 percent above the pre-pandemic level, spending on nondurable consumer goods was 6.4 percent above, and spending on services was 5.5 percent below. Given the relative weightings, this leaves total personal consumption expenditures 0.4 percent below the pre-pandemic level.



Our relaying those figures is more than a mere bookkeeping exercise, as they help shape our expectations of what any jump in consumer spending later in 2021 may look like. As we've noted before, the surge in spending on consumer durable goods seen in 2020 after the initial round of Economic Impact Payments hit is not likely to be repeated as, by their nature, purchases of durable goods tend to be one-off. This isn't to argue that there is no pent-up demand for consumer durables, but rather that any such effect is likely to be much smaller with the third round of EIP.

That leaves services as the area in which we are likely to see the biggest jump in consumer spending later in 2021. There are some who argue either that there is no pent-up demand for spending on services or whatever pent-up demand there may be is minimal, on the basis that people won't go back and make up for spending on services that was foregone while much of the services sector was fully or partially shutdown. In other words, if you took a trip each month prior to the pandemic, once the economy is more fully reopened will you take one trip to celebrate a return to, or close to, normal, or will you take twelve trips to make up for the ones you didn't take over the past year?

Okay, sure, we have a colleague who insists he will go to his favorite coffee shop and all at once make up for the pricey latte he missed out on each day he worked from home (we don't doubt him, but at the same time wish to be nowhere near him as he works through that backlog). For more normal people, however, it is a relevant point, but even if people don't make up for spending foregone over the past year, that isn't the same as saying they won't go out and spend on services once the economy is more fully reopened. Perhaps a more relevant question is the degree to which people will feel confident enough to return to activities they considered normal prior to the pandemic. It could be that, even with widespread vaccination, there will be some segment of the population that simply won't be comfortable returning to the old

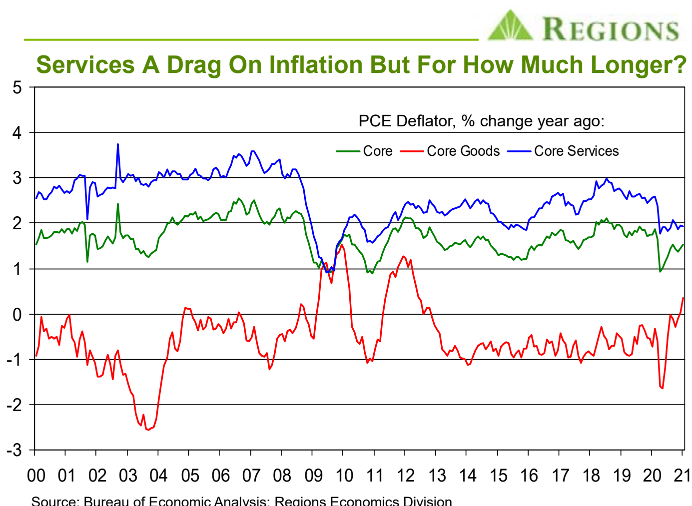
normal and will instead settle into a new normal in which they simply spend less or shift more of their spending to goods such that they make bigger ticket, but less frequent, purchases. Another possibility is that the experience of the pandemic, particularly the sudden loss of jobs and incomes, motivates more people to save more, such that there is a new, higher "equilibrium" personal saving rate, or to pay down debt, if not both. It is worth noting that the Census Bureau's *Household Pulse Survey*, designed to measure the financial and health effects of the pandemic, shows that roughly 75 percent of respondents report they used the January round of EIP primarily for saving or paying down debt. We think it highly unlikely that efforts to shore up savings and pare down debt will be abandoned once the economy is more fully reopened. Still, with the magnitude of savings as high as it will be after the third round of EIP, there is likely to be ample room in many household budgets for both a one-off burst of spending and maintaining a higher long-term level of saving.

The reality is that at this point in time none of us know the answers to any, let alone all, of these questions. Obviously, one cannot make a forecast without explicitly or implicitly making assumptions about these and related points, but for right now that's all they are, and only time will tell how valid any forecaster's set of assumptions proves to be. Our own forecast puts us about in the middle of a very wide range and, in all honesty, nothing we see in the data in the months ahead will surprise us given the number of open questions that remain on the public health front and on the economic front. This is one reason we can't claim a high degree of conviction around whatever our forecast is in any given month. Either way, it's hard to look at the sizable sum of excess saving, which we know is about to become even larger, and not expect some response in consumer spending once the economy is more fully reopened.

Faster Inflation Is Coming, But Is It Staying?

If the stage is indeed set for a spike in consumer spending at some point in the months ahead, it is reasonable to ask whether any such spike in consumer spending will be accompanied by a spike in prices. Indeed, inflation expectations have moved higher over recent weeks, which has contributed to higher market interest rates and raised questions about the FOMC's commitment to not changing the Fed funds rate target until the labor market is much closer to being fully healed than is at present the case.

In the January *Outlook*, we laid out the case for why we expected inflation to accelerate over the course of 2021. Once we get into the data for March and April, base effects will push measured inflation significantly higher. Recall that these are the months last year in which prices tumbled as the economy shut down, meaning that over-the-year comparisons this March and April will be much easier. For instance, if the February data show a 0.4 percent increase in the CPI, in line with the consensus forecast, all it would take would be monthly increases of just 0.1 percent in March and April to push headline CPI inflation over 3.0 percent. Sure, the actual increases will be larger and measured inflation will be even faster, but the point is these are simply base effects that will say more about what was happening a year ago than about what is happening now, and which will subside in subsequent months. As such, the FOMC, and presumably most market participants, will look past any such base effects.



The dramatic deceleration in inflation as the economy shut down last spring is visible in the above chart (the PCE Deflator is the FOMC's preferred gauge of inflation). While prices for both goods and services fell as the economy shut down note how rapidly core goods (consumer goods excluding food and energy) price inflation has bounced back, while core services (services excluding energy) inflation has remained fairly listless. This is in part a reflection of the patterns in consumer spending we discussed in the prior section, i.e., consumer spending on goods is well above the pre-pandemic level while consumer spending on services remains well below the pre-pandemic level. In addition to stronger demand, core goods prices have also been supported by supply constraints and a weaker U.S. dollar (which makes imported goods more expensive for U.S. consumers). It is also worth noting that in the overall index of core inflation, services prices carry a much heavier weighting than do goods prices, which simply reflects the relative shares of overall consumer expenditures.

If, as we and most others expect, there is a burst of consumer spending on services once the economy is more fully reopened later this year, it is reasonable to expect a normalization of services prices, as providers adjust to suddenly higher demand. If that does prove to be the case, that would push overall inflation higher, but the more relevant question would be for how long. In other words, would we see a transitory period, say, a few months, in which services prices adjust and then begin to level off, or would we see a more sustained period of steadily rising services prices that in turn would have a more lasting effect on inflation. We tend to think the former, not the latter, would be the case, particularly as any burst of spending associated with the economy reopening will ultimately fade away, so it would follow that upward pressure on services prices would ease. More significantly, this is how the FOMC would view such an occurrence, based on public comments made to date by Fed Chairman Powell and other FOMC members.

While base effects and normalization of services prices would act to push inflation higher, any such effects would be transitory, meaning inflation would ultimately ease. As such, the FOMC would not be overly concerned, particularly given as they are much more focused on what remains a high degree of labor market slack,

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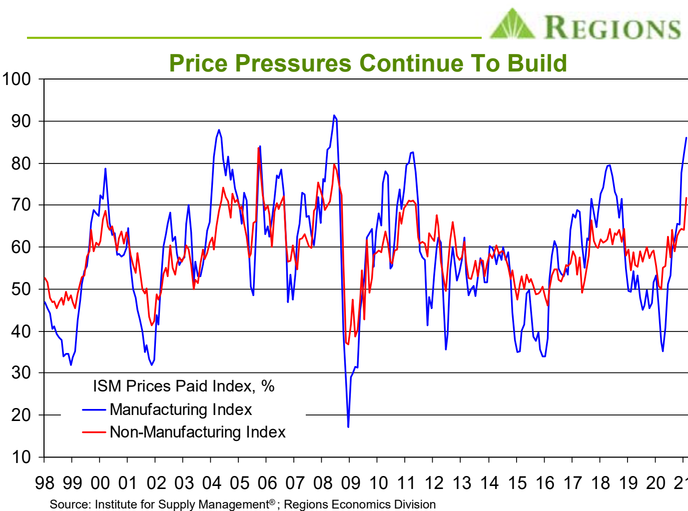
which in their (collective) view will act as a check on inflation pressures. It is, at least to us, reasonable to ask whether there are other forces in play that could lead to inflation accelerating more and having more staying power than many now anticipate.

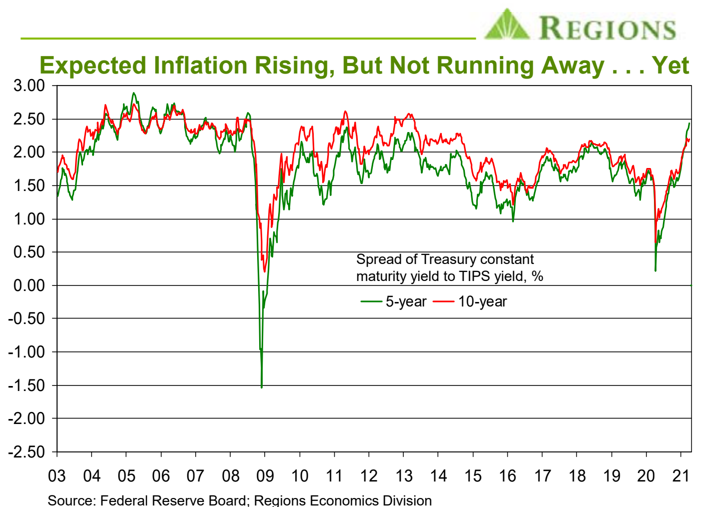
For instance, the effects of February's unusually harsh winter weather led to jumps in food and energy prices, which we expect will be reflected in the February and March inflation data. While any such increases would be expected to be transitory, it could be that energy prices continue to push higher in the months ahead as the global economy recovers. To some degree, this depends on the extent to which OPEC holds to its commitment to hold the line on production, though the track record here isn't exactly stellar. But, it could also be the case that higher oil prices do not elicit as strong a response from U.S. producers as we have seen in the past given the greater degree of financial discipline many have been operating under over the past several months.



The ISM's monthly surveys of the manufacturing and services sectors are sending signals on prices that we think merit attention. Survey respondents are asked each month whether prices for raw materials and other inputs have risen, fallen, or stayed the same and, as seen in the above chart, input prices have risen sharply over the past several months. Indeed, of the 18 industry groups surveyed in the manufacturing sector, all 18 have reported paying higher prices in each of the past three months, and price pressures are also broad based in the services sector. To some extent, upward pressure on input costs reflects shortages and supply chain/logistics issues. It would be reasonable to expect that over time these issues will be resolved and upward pressure on input prices will abate, but how long that will take remains to be seen, particularly amid a global economic recovery.

Moreover, our sense is that goods producers and service providers will have more latitude to pass along higher input costs in the form of higher prices for intermediate and final goods/services than has been the case over the past several years, meaning more of an effect on measured inflation. Granted, in most instances, labor costs remain the largest individual component of overall costs for producers of goods and providers of services, but that doesn't mean that higher input costs and higher shipping/transportation costs won't have an impact on measured inflation.

Another factor to watch is the exchange value of the U.S. dollar, which has an impact on core goods prices – a stronger (weaker) U.S. dollar puts downward (upward) pressure on core goods prices. One factor behind stronger core goods prices over the past several months has been the pronounced decline in the exchange value of the U.S. dollar. In our January *Outlook* we discussed how we thought the decline in the dollar was starting to look overdone and that we expected the dollar to stabilize and then begin to firm up at some point in 2021. The dollar has indeed reversed course of late, and it is too soon to know whether this is just a pause amid a longer-running downturn. The answer to this question, however, will impact core goods prices and, in turn, core inflation.



Clearly, there will be more factors driving inflation in 2021 than simple base effects and a normalization of services prices. While the FOMC is not overly concerned, many market participants aren't quite as sanguine, as seen in inflation expectations as measured in Treasury Inflation-Protected Security (TIPS) yields. Both five-year and ten-year breakeven inflation rates have risen sharply over recent weeks. It is interesting to note that the five-year rate has been above the ten-year rate, which could signal that while market participants expect higher inflation over the coming few years, they do not expect that to persist, at least not to the same degree, over a longer-term horizon. It should also be noted that TIPS yields are not a perfect gauge of inflation expectations. As the Bank for International Settlements (BIS) recently noted, the Federal Reserve has been buying TIPS along with regular U.S. Treasury securities as part of their monthly asset purchases, and with the volume of TIPS much smaller than the volume of regular Treasury securities, that means a smaller pool of TIPS has been available to investors. This could be exaggerating the upward movement in TIPS yields such that TIPS yields could be overstating the extent to which investors are expecting inflation to accelerate.

In short, perhaps the relevant question is not whether inflation will accelerate in the months ahead, as it almost surely will. Instead, the relevant questions are the extent to which inflation will accelerate and how persistent that acceleration will prove to be. Those are questions that will only be answered over time, but much is riding on the FOMC's seemingly high degree of confidence in their ability to rein inflation in should it pose a more serious threat to the U.S. economy.

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Q3 '20 (a)	Q4 '20 (p)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)		2018 (a)	2019 (a)	2020 (p)	2021 (f)	2022 (f)
33.4	4.1	4.9	6.8	6.3	4.9	3.9	2.7	Real GDP[1]	3.0	2.2	-3.5	5.6	4.1
41.0	2.4	4.5	8.9	7.2	6.1	4.2	2.8	Real Personal Consumption[1]	2.7	2.4	-3.9	6.3	4.6
22.9	14.0	9.0	8.5	5.7	5.4	5.7	5.1	Real Business Fixed Investment[1]	6.9	2.9	-4.0	8.0	5.5
68.2	25.7	16.5	12.2	5.1	3.0	3.1	3.2	Equipment[1]	8.0	2.1	-5.0	15.7	3.8
8.4	8.4	4.3	6.7	7.3	8.2	7.0	5.5	Intellectual Property and Software[1]	7.8	6.4	1.6	5.6	6.6
-17.4	1.1	-1.1	1.6	3.8	6.2	10.5	9.9	Structures[1]	3.7	-0.6	-10.6	-4.0	7.8
63.0	35.8	19.7	9.3	4.5	3.5	-0.1	-2.1	Real Residential Fixed Investment[1]	-0.6	-1.7	6.0	17.1	1.3
-4.8	-1.1	1.8	-3.3	2.0	1.9	3.0	3.0	Real Government Expenditures[1]	1.8	2.3	1.1	-0.5	2.2
-1,019.0	-1,123.0	-1,168.2	-1,193.0	-1,211.4	-1,234.7	-1,235.4	-1,246.6	Real Net Exports[2]	-877.7	-917.6	-926.3	-1,201.8	-1,248.0
1,037	1,228	1,161	1,240	1,254	1,243	1,232	1,229	Single Family Housing Starts, ths. of units[3]	872	893	1,000	1,224	1,232
395	360	399	380	365	372	374	375	Multi-Family Housing Starts, ths. of units[3]	376	403	396	379	377
15.3	16.1	16.2	16.4	16.3	16.4	16.4	16.4	Vehicle Sales, millions of units[3]	17.2	17.0	14.4	16.3	16.5
8.8	6.8	6.2	5.8	5.5	5.2	4.8	4.7	Unemployment Rate, %[4]	3.9	3.7	8.1	5.7	4.6
-6.8	-6.0	-5.7	8.7	4.3	3.9	4.2	3.3	Non-Farm Employment[5]	1.6	1.3	-5.7	2.6	3.1
-17.4	-10.0	57.1	-32.5	-0.7	-1.7	5.2	3.9	Real Disposable Personal Income[1]	3.6	2.2	5.8	1.9	-0.4
1.2	1.3	1.8	2.8	2.5	2.5	2.1	2.0	GDP Price Deflator[5]	2.4	1.8	1.2	2.4	1.9
1.2	1.2	1.8	2.7	2.4	2.6	2.1	2.1	PCE Deflator[5]	2.1	1.5	1.2	2.4	2.0
1.3	1.2	1.9	3.4	2.8	2.6	2.1	1.8	Consumer Price Index[5]	2.4	1.8	1.2	2.7	1.8
1.4	1.4	1.7	2.3	2.0	2.2	2.0	2.1	Core PCE Deflator[5]	2.0	1.7	1.4	2.1	2.0
1.7	1.6	1.4	2.3	1.9	2.1	2.4	2.4	Core Consumer Price Index[5]	2.1	2.2	1.7	1.9	2.3
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
0.65	0.86	1.28	1.58	1.63	1.70	1.76	1.79	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.89	1.55	1.82
2.95	2.76	2.85	3.16	3.24	3.34	3.43	3.51	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.12	3.15	3.53
-3.4	-3.2	-3.3	-3.4	-3.5	-3.4	-3.4	-3.3	Current Account, % of GDP	-2.2	-2.2	-2.9	-3.4	-3.3

a = actual; f = forecast; p = preliminary

Notes:
- 1 - annualized percentage change
- 2 - chained 2012 $ billions
- 3 - annualized rate
- 4 - quarterly average
- 5 - year-over-year percentage change

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