ECONOMIC OUTLOOK

REGIONS
October 2021

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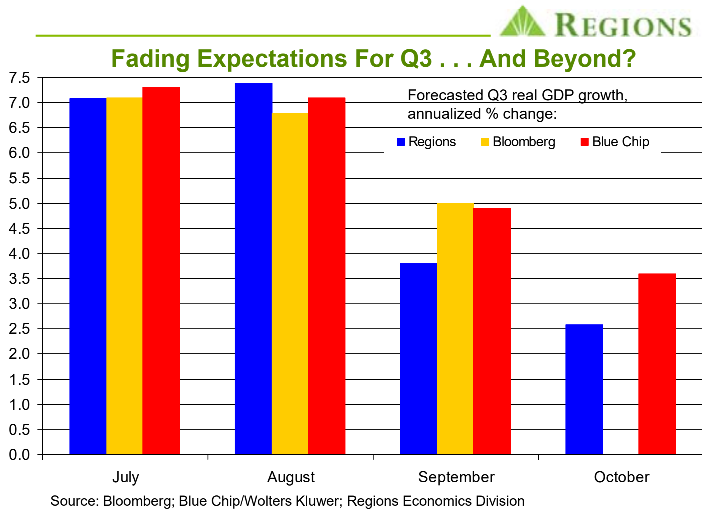
Q3 Real GDP Growth: Suddenly Not So Great Expectations . . .

Whether high expectations are a gift or a curse is a question for greater minds than ours. Either way, however, it is clear that Q3 real GDP growth will fall far short of the lofty expectations we and many others had for it as the quarter kicked off in July. At that point, the most recent surge in COVID-19 cases had not yet begun, while further normalization of consumer spending on services such as travel, tourism, entertainment, dining out, and recreation was expected to provide a boost to growth even as consumer spending on goods began to slow. And, while global supply chain and logistics bottlenecks and labor supply constraints had already left their mark on the economy, there was at least some hope that they would begin to abate and become less of a drag on economic growth. These factors, in conjunction with ongoing support from business and residential fixed investment, made annualized real GDP growth of seven percent or more seem well within reach for Q3, and that remained the case at the time we produced our August baseline forecast.



As seen in the above chart, we were not alone in having somewhat lofty expectations for real GDP growth. Our July forecast called for annualized Q3 real GDP growth of 7.1 percent, matching the consensus in the monthly survey conducted by *Bloomberg* and a bit short of the consensus forecast of 7.3 percent in the monthly *Blue Chip* survey (we participate in both surveys). For a sense of how high expectations were, the average annualized Q3 growth rate anticipated in the ten lowest forecasts in the July *Blue Chip* survey was 5.2 percent. The flow of economic data during the month of July did nothing to dent expectations of Q3 growth, as evidenced in the August forecasts. As a frame of reference, we, and most of our counterparts, update our forecasts upon the release of the monthly employment report, which typically occurs on the first Friday of any given month. When we produced our August baseline forecast on August 6, fresh on the heels of the report showing nonfarm employment had risen by 943,000 jobs in July while the unemployment rate had fallen from 5.9 percent in June to 5.4 percent in July, we continued to expect big things from Q3, as did participants in the *Bloomberg* and *Blue Chip* surveys – the average annualized Q3 growth rate anticipated in the ten lowest forecasts in the August *Blue Chip* survey was 5.1 percent.

Those August forecasts, however, had been rendered moot by time the ink on them was dry, to borrow a phrase from pre-historic times. COVID case counts spiked rapidly in August, both here and abroad, which clearly weighed on economic activity. In the U.S., various trackers of consumer spending picked up on rapid declines in spending on services as we moved through August. At the same time manufacturing and shipping hubs across Asia were shutting down due to rising COVID cases, thus exacerbating supply chain and shipping bottlenecks. With supply-side constraints intensifying rather than abating, any hopes for meaningful improvement on the inventory front in Q3 quickly faded.

As such, by time we struck our September baseline forecast on the heels of a notably weak August employment report, expectations for Q3 real GDP growth had been scaled back considerably, as was the case with the median forecasts in the *Bloomberg* and *Blue Chip* surveys. To a large extent, that our September forecast of Q3 real GDP growth was so far below the median forecasts in the *Bloomberg* and *Blue Chip* surveys reflected the degree to which we downgraded our expectations for consumer spending. Our September forecast pegged annualized growth in real consumer spending at just 0.6 percent for Q3, compared to 2.3 percent and 2.1 percent in the *Blue Chip* and *Bloomberg* surveys, respectively.

Our 0.6 percent call, however, came to seem too ambitious once the BEA released their report on August consumer spending. While real consumer spending (combined spending on goods and services) rose by 0.4 percent in August, revised data showed a 0.5 percent decline in July, steeper than the original estimate of a 0.1 percent decline. Even allowing for a rebound in September, mainly due to higher spending on services, our October baseline forecast anticipates real consumer spending will grow at an annualized rate of just 0.2 percent for Q3. Between marking down our forecasts of consumer spending, net exports, residential construction, and the contribution made by inventories, our October baseline forecast anticipates annualized Q3 real GDP growth of just 2.6 percent, compared to the median forecast of 3.6 percent in the *Blue Chip* survey (the October *Bloomberg* survey had not been published as of this writing). To be sure, forecasts can, and do, change frequently, but we can recall few instances in which expectations for a given quarter changed as markedly and as

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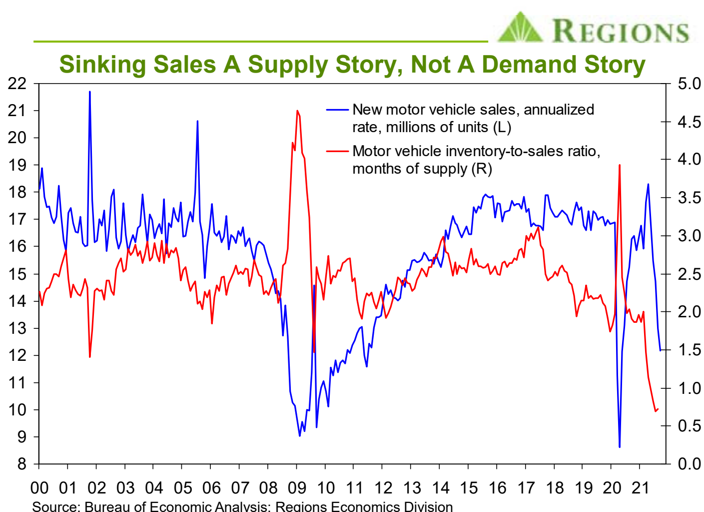
quickly as did those for Q3 real GDP growth. And, under the heading of you just can't win for losing, even a seemingly positive revision to our Q3 forecast – a lower unemployment rate than we anticipated going into the quarter – has largely come about for the wrong reason, i.e., labor force participation failing to improve.

Aside from consumer spending on services growing slower than we had anticipated, the main factor behind our fading expectations for Q3 growth in real consumer spending is a much larger decline in real spending on consumer durable goods than we anticipated going into the quarter. Our October forecast incorporates a 29.2 percent annualized decline in real, or, inflation adjusted, spending on consumer durable goods, a category which includes things such as motor vehicles (only new vehicles are included in the GDP data), household furnishings and appliance, and consumer electronics. The severe contraction in spending on consumer durable goods in part reflects the extent to which supply constraints are limiting the quantities of consumer durable goods available for purchase, while at the same time surveys of consumers indicate that elevated prices have pushed some consumers out of the market.



Nowhere are the effects of supply constraints more apparent than with new motor vehicle sales. Recall that sales fell from 14.7 million units in July to 13.0 million units in August (annualized sales rates) which, aside from the early months of the pandemic, was the lowest monthly sales rate in a decade. What really stood out about that decline, however, is that it wasn't until the latter half of August that sales began to tumble as inventory shortages became more binding. Sales fell even further in September, to an annualized rate of just 12.2 million units, and while this still leaves the average Q3 sales rate at 13.3 million units, it sets a low base for Q4 sales, which in turn sets the stage for another decline in real spending on consumer durable goods in the Q4 GDP data.

While not the only instance in which the combination of dwindling supplies and still-solid demand is pushing up prices, motor vehicles are perhaps the most obvious and most widely discussed instance. Production of new motor vehicles has been significantly curtailed by the global shortage of semiconductor chips, which thus far has shown no signs of abating. The inventory-to-sales ratio has fallen to the lowest on record, and lack of inventories are clearly holding down unit motor vehicle sales. Though perhaps not as visible, the same effects are being seen with other consumer durable goods which, as noted above, is contributing to the significant contraction in inflation adjusted spending. One difference between now and earlier in 2021 is that earlier in the year, inventories acted as a buffer between production and sales. But, with inventories having been drawn down to the extent seen over recent months, that buffer is much thinner, thus contributing to declines in unit sales.

Another channel through which supply constraints are weighing on top-line real GDP growth is new residential construction. Inability to procure construction materials and finishing touches such as cabinetry, appliances, windows, and doors has resulted in a slower pace of single family completions and sales, and commentary from builders suggests these issues won't resolve any time soon. As such, residential construction will make a smaller contribution to top-line real GDP growth than we had previously anticipated, which is reflected in our baseline forecast.

While Q3 has come to a close, we're still processing incoming data for the month of September, including data on new residential construction, new home sales, business investment, net exports, nonfarm business inventories, and consumer spending. As such, there is still ample room for our view of Q3 real GDP growth to change between now and October 28, when the BEA releases the initial estimate of the Q3 GDP data. Still, even if the incoming data put it in a more favorable light, when all is said and done Q3 growth will fall far short of the lofty expectations we and others had for it as the quarter began. The bigger question, however, is what the disappointing Q3 growth might mean going forward.

A Not So Welcome Blast From The Past?

The combination of a marked deceleration in the pace of real GDP growth and elevated inflation is leading some to fear a return of the 1970s. Not so much the return of polyester leisure suits, platform heels, and glittering disco balls, though those are indeed legitimate grounds for fear, but instead the return of "stagflation," or, the combination of stagnant GDP, elevated unemployment, and rapid inflation. That combination prevailed over much of the 1970s and early-1980s, and the term "stagflation" has come up with an increased frequency over the past several weeks which, in the context of the above discussion of fading Q3 real GDP growth and what for the past several months have been elevated rates of inflation, is understandable. Whether or not the U.S. economy is actually heading into a period of stagflation is a different matter, and while the past eighteen months have hammered home the lesson of never saying never, a return to the stagflation of the 1970s/early-1980s seems unlikely.

One parallel between now and the 1970s those worrying about a return to stagflation draw is considerable disruption on the supply side of the economy. A near-tripling of crude oil prices and leveling off of oil imports in 1973 sent the industrial sector of the U.S. economy, which accounted for a much larger share of employment than at present, reeling, fueled soaring inflation, and triggered a severe and prolonged recession. Another significant disruption in the market for crude oil occurred in 1979 in the wake of the Iranian Revolution, when a decline in oil imports and sharply higher prices led to a sharp contraction in the industrial sector, pushed inflation higher, and triggered a period of recession starting in Q1 1980.

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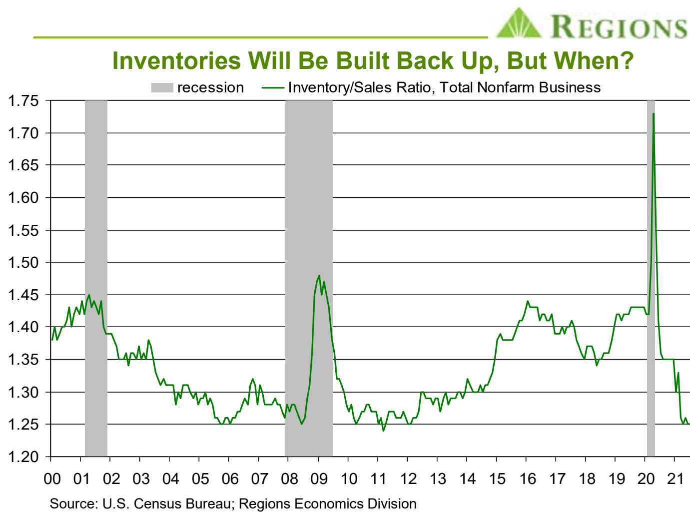
Clearly, the supply side of the economy is in disarray at present, which has contributed to the sharp acceleration in inflation seen over the past several months and which contributed to the rapid deceleration in real GDP growth in Q3. This disarray has its origins in the pandemic, which led to much of the global economy being effectively shut down for over a month in the spring of 2020. That initial disruption in global production has since been exacerbated by repeated COVID outbreaks, parts shortages, weather events, labor shortages, and, more recently, energy shortages, particularly in China, all magnified by inadequate global shipping capacity.

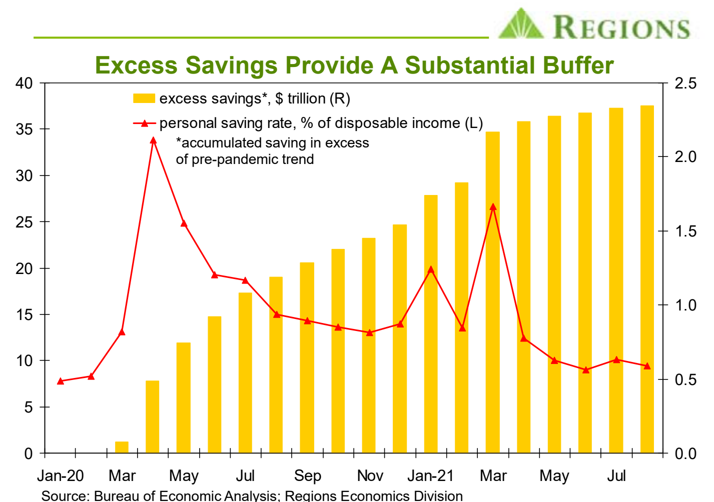
Still, while supply chain and logistics bottlenecks have clearly fed inflation pressures, they are not the only factors behind elevated inflation. Fueled by the aggressive U.S. policy response to the pandemic, the demand side of the economy has rebounded strongly, which has contributed to higher inflation. Put simply, the supply side of the economy has been unable to keep pace with the demand side, which has led to the marked acceleration in inflation. And, while higher prices may be taking some of the steam out of demand, whether for consumer durable goods or home purchases, the demand side of the economy nonetheless remains quite robust, which is one key difference between current conditions and those that prevailed during the periods of stagflation in the 1970s.



The challenge for producers has not been how to contend with a lack of demand but instead how to keep pace. Manufacturers of goods are sitting on increasingly large backlogs of unfilled orders, as is also the case with homebuilders. At the same time, the rapid drawdown in business inventories over the past several months means that firms will, at some point, have to replenish stocks. The combination of filling outstanding orders and rebuilding inventories will act as a meaningful tailwind for economic growth. What is less certain, however, is when that will be the case, which will depend on when global supply chains and shipping channels begin to normalize. Right now, that is looking like more of a 2H 2022 story, but even that timeline is starting to feel somewhat ambitious. In terms of how this impacts growth forecasts, ours and others, the outlook for growth over the next few quarters becomes a bit dimmer while the outlook for growth in late-2022/early-2023 becomes a bit brighter. But, even if that proves to be the case, that does not necessarily mean that that the next few quarters will look, or feel, like the stagflation of the 1970s/early-1980s.

To be sure, there is always the risk that the anticipated tailwind for growth, in the form of unfilled orders being filled, depleted inventories being built back up, and fulfilling pent-up demand for consumer durable goods, does not materialize. After all, unfilled orders can be cancelled, and a meaningful drop-off in demand would quickly push inventory-to-sales ratios higher, lessening the extent to which stocks would need to be built back up. With inflation already elevated and looking to be more persistent than many had anticipated would be the case, rapidly rising energy prices could be the thing that tips household budgets, particularly those of lower-income households, resulting in a pullback in discretionary consumer spending.

Such a scenario, however, seems unlikely given current financial conditions in the household and corporate sectors. For instance, after plummeting by $6.26 trillion in Q2 2020, household net worth has since risen by $31.09 trillion, reflecting higher house prices and higher equity prices. Obviously not all households have benefitted from rising asset prices, but the increase in household saving over recent quarters has been more widely dispersed. Our estimate puts the level of excess savings in the household sector (the difference between actual saving and the level that would have prevailed in the absence of the pandemic) at just over $2.3 trillion as of August, the latest available data. At the same time, accelerating growth in labor earnings is filling the void left as pandemic-related transfer payments run their course. A sharp decline in household debt service burdens has also freed up cash, which is another support for consumer spending.



As such, while growth in consumer spending could be slower than we anticipate over coming quarters, a significant and sustained decline seems most unlikely. It is worth noting that the bulk of the consumer spending fueled by pandemic-related transfer payments was directed toward spending on goods, while consumer spending on services remained below pre-pandemic levels. As the economy reopened, there was a marked pick-up in services spending, which was interrupted by the spike in COVID cases in August. As this spike subsides, it is reasonable to think that we will see another upturn in services spending while spending on goods slows further. Such a shift would ease some of the upward pressure on goods prices and would reinforce our point that a significant and sustained decline in consumer spending is unlikely.

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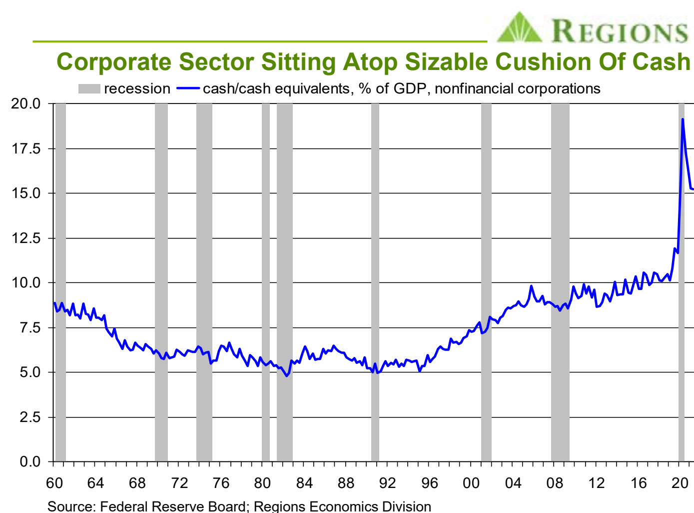
It is a similar story in the corporate sector. As we discussed in our September *Outlook*, corporate profit margins have widened significantly after having compressed sharply in Q2 2020, to the point that as of Q2 2021, after-tax margins were wider than at any point since Q1 2012. To be sure, persistent cost pressures figure to push profit margins down, which we expect to see in the upcoming Q3 data, but given the starting point of significantly elevated margins, they will still be wide compared to historical norms. And, just as households are sitting on top of a significant pool of excess savings, nonfinancial corporations are sitting on top of a significant pool of cash. Healthy corporate balance sheets have been a support for what has been a run of strong growth in business fixed investment over recent quarters. As with consumer spending, it could be that clogged up supply chains and shipping channels lead to a slower pace of growth in business fixed investment over coming quarters, but a significant and sustained decline seems unlikely.



Global supply chain and logistics bottlenecks will remain a drag on economic growth over the next few quarters, perhaps longer, while inflation is likely to remain elevated over that same span. That does not, however, mean we are in for a return to the stagflation of the 1970s. Given the ample liquidity in the household and corporate sectors, we have few worries about the demand side of the economy. Indeed, it could be that, rather than a return to stagflation, the bigger risk to the economy is that even as supply side constraints begin to ease, the supply side of the economy will still not catch up with the demand side. Such a scenario poses its own risks, such as faster sustained inflation, but that would still leave us a long way from stagflation.

September Employment Report: A Clear As Mud Guide . . .

Ahead of its release, many saw the September employment report in terms of "it either is or it isn't," as in, it is either strong enough to warrant the FOMC deciding to taper the pace of the Fed's monthly asset purchases or it isn't. We never agreed with such a simplistic characterization. For one thing, the FOMC is assessing the cumulative improvement in the labor market seen since last December, not the number of jobs added in any single month. Moreover, it is more than a bit naïve to expect any single data release to offer the high degree of clarity many were ascribing to the September employment report prior to its release, particularly given how volatile the economic data have been and how badly typical seasonal patterns in economic activity have been distorted since the onset of the pandemic.

Forget about providing meaningful guidance for a significant policy decision, the September employment report offered few useful clues to the state of the labor market, and you had to look really hard to find those. Total nonfarm employment rose by 194,000 jobs, well short of expectations of around 500,000 jobs. While private sector payrolls rose by 317,000 jobs in September, public sector payrolls fell by 123,000 jobs. Well, at least in the seasonally adjusted data. The not seasonally adjusted data show that hiring related to education on the state and local government levels rose by 1.033 million jobs but, as this was a smaller increase than is typical for the month of September, the seasonally adjusted data show a decline of 160,800 jobs. This is but one illustration of our point about seasonal patterns being distorted by the pandemic. Prior estimates of job growth in July and August were revised higher, with a net upward revision of 169,000 jobs for the two-month period, the third straight month in which the net upward revision for the prior two-month period topped 100,000 jobs.

One thing in the September data that caught our eye was that payrolls amongst hospitals and nursing homes/residential care facilities fell by 45,700 jobs, and this is not seasonal adjustment noise as the not seasonally adjusted data show a similar decline. It is too soon to know whether this reflects fallout from vaccination mandates, but it at least raises the question of what type of fallout there may be from wider applications of such mandates.

While the unemployment rate fell to 4.8 in September from 5.2 percent in August, a decline in labor force participation contributed to the lower jobless rate, and what is both puzzling and troubling is that declining participation amongst the 25-to-54 year-old age cohort, or, the "prime working age population," more than accounted for the entire decline in the labor force. At the same time, labor force participation amongst females, which has been hit much harder by the pandemic than has participation amongst males, fell further in September, contrary to the increase we and many others had anticipated with the start of the new school year.

With demand for workers continuing to far outdistance the number of job seekers, average weekly hours increased in September and average hourly earnings rose by 0.6 percent. That said, growth in hourly earnings continues to fall short of inflation, and September is the sixth consecutive month in which real, or, inflation adjusted, average hourly earnings fell on a year-on-year basis, and that streak is likely to remain intact over the next several months.

Anyone anticipating clarity from the September employment came away sorely disappointed. Coming months' reports are likely to remain riddled with noise, particularly with typical seasonal hiring patterns likely to be distorted. The challenge will be to look through that noise. The trends in the data show the labor market remains on the road to recovery, though that road is far from a smooth one. It is those trends, not any one month's numbers, that the FOMC is taking into account as they deliberate policy moves, which is why we anticipate they will announce their plans for tapering the Fed's asset purchases at their November 2-3 meeting.

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Q1 '21 (a)	Q2 '21 (a)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)		2019 (a)	2020 (a)	2021 (f)	2022 (f)	2023 (f)
6.3	6.7	2.6	4.4	6.1	4.8	3.6	3.4	Real GDP[1]	2.3	-3.4	5.5	4.6	2.9
11.4	12.0	0.2	3.5	5.4	4.0	3.7	2.9	Real Personal Consumption[1]	2.2	-3.8	7.7	4.1	2.8
12.9	9.2	5.5	5.7	7.1	8.7	7.1	6.1	Real Business Fixed Investment[1]	4.3	-5.3	8.1	7.0	6.1
14.1	12.1	5.6	4.0	6.4	10.9	7.7	6.7	Equipment[1]	3.3	-8.3	14.3	7.2	7.0
15.6	12.5	9.5	8.3	7.7	5.7	5.4	5.2	Intellectual Property and Software[1]	7.2	2.8	10.1	7.5	5.2
5.4	-3.0	-4.4	3.8	7.0	9.6	9.0	6.1	Structures[1]	2.0	-12.5	-7.3	4.9	5.4
13.3	-11.7	2.1	4.3	7.0	6.0	2.8	1.8	Real Residential Fixed Investment[1]	-0.9	6.8	10.7	3.6	1.5
4.2	-2.0	0.6	0.0	2.5	1.9	1.5	1.8	Real Government Expenditures[1]	2.2	2.5	0.6	1.2	1.4
-1,226.1	-1,244.5	-1,289.3	-1,287.9	-1,292.1	-1,296.6	-1,320.7	-1,325.4	Real Net Exports[2]	-905.3	-942.7	-1,262.0	-1,308.7	-1,384.7
1,156	1,107	1,108	1,154	1,181	1,189	1,188	1,193	Single Family Housing Starts, ths. of units[3]	889	1,004	1,131	1,188	1,204
443	482	466	464	462	462	461	456	Multi-Family Housing Starts, ths. of units[3]	403	393	464	460	450
10.1	14.8	17.7	16.3	13.3	8.8	5.0	4.0	CoreLogic House Price Index[5]	3.9	5.8	14.8	7.6	4.2
16.8	16.9	13.3	11.8	13.0	13.6	14.3	14.8	Vehicle Sales, millions of units[3]	17.0	14.5	14.7	13.9	15.5
6.2	5.9	5.1	4.5	4.1	3.9	3.8	3.7	Unemployment Rate, %[4]	3.7	8.1	5.4	3.9	3.5
-5.6	8.5	4.6	4.2	4.6	4.0	2.9	2.3	Non-Farm Employment[5]	1.3	-5.7	2.7	3.4	1.5
54.7	-30.2	-4.9	-5.5	1.1	3.8	3.6	3.5	Real Disposable Personal Income[1]	2.3	6.2	1.8	-2.4	4.2
2.0	4.0	4.5	5.2	5.0	4.1	3.4	2.7	GDP Price Deflator[5]	1.8	1.2	3.9	3.8	2.0
1.8	3.9	4.3	5.2	5.1	4.2	3.4	2.8	PCE Deflator[5]	1.5	1.2	3.8	3.9	2.1
1.9	4.8	5.3	5.9	5.9	4.5	3.5	2.8	Consumer Price Index[5]	1.8	1.2	4.5	4.2	2.2
1.7	3.4	3.7	4.3	4.5	3.7	3.1	2.8	Core PCE Deflator[5]	1.7	1.4	3.3	3.5	2.3
1.4	3.7	4.1	4.4	5.0	3.8	3.2	3.1	Core Consumer Price Index[5]	2.2	1.7	3.4	3.7	2.6
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.17	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	0.14	0.66
1.32	1.59	1.32	1.70	1.84	1.89	1.98	2.03	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.48	1.94	2.14
2.88	3.00	2.87	3.15	3.33	3.48	3.62	3.69	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.98	3.53	3.79
-3.4	-3.3	-3.1	-3.3	-3.4	-3.3	-3.4	-3.4	Current Account, % of GDP	-2.2	-2.9	-3.3	-3.4	-3.5

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2021 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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