ECONOMIC OUTLOOK

REGIONS

March 2022

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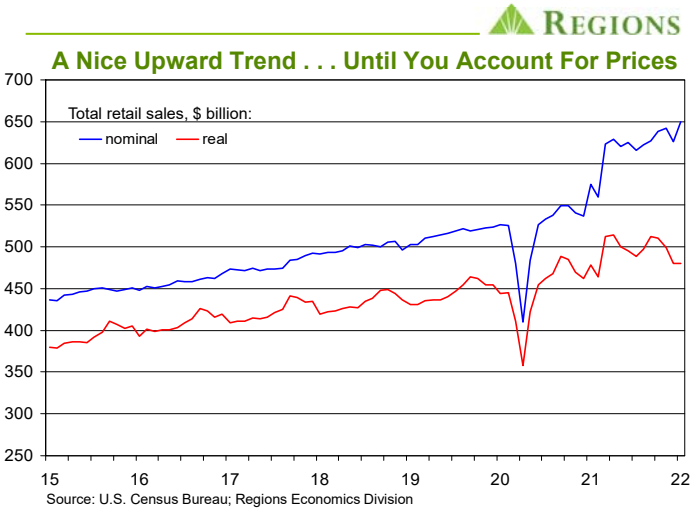
About That "Nice Upward Trend" In Retail Sales

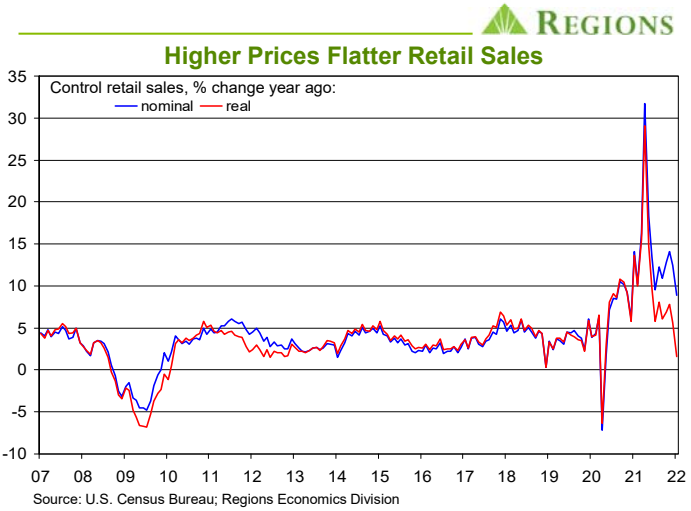
Even in the best of times, the monthly retail sales reports can put one's faith in data to the test, as the data on retail sales can be highly volatile from one month to the next and the initial estimate of sales in any given month is prone to sizable revision. The reports on retail sales in December 2021 and January 2022, however, have taken our, umm, regard, for the retail sales data to a new level, and not in a good way. Indeed, our reaction to each of the past two monthly retail sales reports was to dismiss them out of hand. Disruptions in typical seasonal patterns of consumer spending led to led to significant distortions in the seasonally adjusted retail sales data. As a result, the seasonally adjusted December data look much worse and the seasonally adjusted January data look much better than was actually the case in either instance.

We discussed this issue in our usual write-ups of the monthly retail sales reports and won't go back over that ground here. But, after seeing our take on the January data, one of our counterparts at another shop thought we were being unduly harsh on the retail sales data. Others noted the same high degree of noise that we did, but instead focused on the trend in sales hiding beneath the month-to-month volatility. And, sure, in all fairness, there is, as one analyst put it, a nice upward trend in seasonally adjusted retail sales, as seen in the following chart Kind of.



The blue line in the chart above shows the level of total retail sales. The dip in sales in December and the subsequent rebound in January are easily visible and, sure, allowing for these wide swings, there is indeed a nice upward trend in retail sales. The relevant question, however, is what that nice upward trend is really telling us – is it a testament to the staying power of U.S. consumers, or is there a less benevolent explanation? Recall that retail sales are reported in nominal terms, i.e., they are not adjusted for price changes. We could, then, rephrase our relevant question in the following highly technical manner: are U.S. consumers buying more stuff, are they just paying more to buy the same amount of stuff, or is it some of both?

The red line in the above chart shows retail sales in real terms, i.e., adjusted for price changes, and helps answer that question (the index of goods prices from Consumer Price Index (CPI) is used to deflate the series on nominal retail sales). As seen in the chart, when adjusted for price changes, there is no upward trend, nice or otherwise, in retail sales. Indeed, real retail sales peaked in April 2021 and have declined in each of the past four months. On a nominal basis, total retail sales were up 13.0 percent year-on-year in January, and while that sounds impressive, the CPI measure of goods prices was up by 12.4 percent over that same period, which leaves real retail sales up a paltry 0.5 percent year-on-year.



We can make that same comparison with control retail sales, or, retail sales excluding motor vehicle, gasoline, building materials, and restaurant sales. Control retail sales are of interest as this series feeds directly into the GDP data on consumer spending on goods. The level of real control sales peaked in March 2021 and has been bouncing up and down within a fairly narrow range over the past several months. On a year-on-year basis, nominal control sales were up 8.9 percent in January, but after adjusting for higher goods prices, real control sales were up just 1.6 percent year-on-year. Note that we use the CPI series on core goods prices excluding motor vehicles to deflate nominal control retail sales, with this measure up 7.2 percent year-on-year in January. So, whether one looks at it in terms of total or control retail sales, higher prices account for the overwhelming portion of the increase in nominal sales over the past year. Or, in terms of how we

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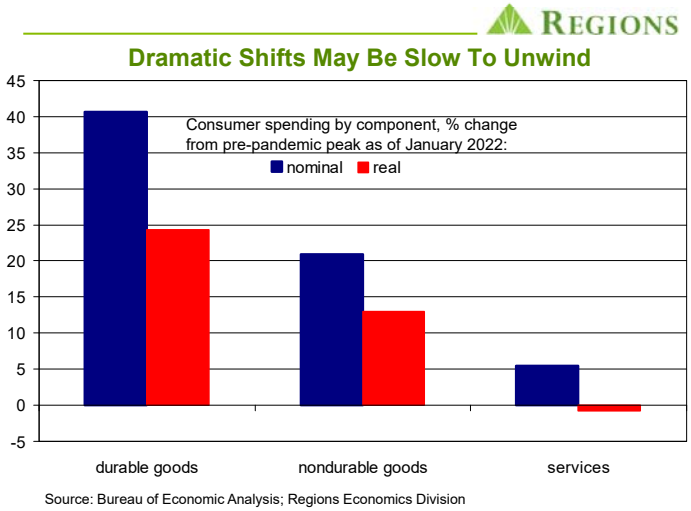
phrased the question above, consumers are buying a little more stuff but are paying a lot more to do so.

The dramatic increase in prices of consumer goods reflect the stark shifts in patterns of consumer spending since the onset of the pandemic. Relative to pre-pandemic norms, spending on goods has captured a higher share of total consumer spending and spending on services a smaller share. These shifts reflect demand side factors, supply side factors, and policy responses to the pandemic. Our view, shared by many analysts, is that these shifts will start to reverse over the course of 2022, i.e., the share of spending accounted for by goods will decline back toward the pre-pandemic level while the share of spending accounted for by services will rise back toward the pre-pandemic level. While we see this as the most likely outcome, it is far from certain due to a host of factors.

First, a sustained shift toward services spending is very much contingent upon there not being repeated spikes in COVID-19 cases that can alter consumer behavior and trigger policy responses. Thus far, spending on services, such as travel, tourism, dining out, recreation, and entertainment, has proved to be very responsive to ups and downs in COVID-19 case counts, including most recently with the rapid and wide spread of the Omicron variant and its subsequent reversal. Given the progress against the virus made to date, it could be argued that each successive spike in case counts has been less disruptive and that this should remain the case going forward. Anyone taking that as a given, however, clearly hasn't been paying attention over the past two years.

Another factor that will help determine the extent of any shift in consumer spending patterns is how much pent-up demand for consumer goods, particularly consumer durable goods, there is left to satisfy. Clearly, generous financial transfers and the shuttering of the services sector contributed to a wave of spending on goods such as motor vehicles, furniture, appliances, and recreational equipment. By their nature, purchases of consumer goods are much more one-off rather than repeated purchases, but at the same time supply constraints have frustrated many consumers looking to make such purchases. Our sense is that while there is still some pent-up consumer demand, there is not enough to delay the shift back toward services spending, though with new threats to global supply chains, it may take longer to know the answer to this question than otherwise would have been the case.

Finally, to bring us back to where we started this discussion, prices will play a role in determining whether, or to what extent, there will be shifts in consumer spending patterns over coming months. Our premise coming into 2022 was that global supply chain and logistics bottlenecks would ease over the course of the year which, combined with less emphasis on spending on goods and more on spending on services, would result in a marked deceleration in the rate of goods price inflation if not outright goods price deflation. While that is still likely, the timing is far more uncertain in the wake of Russia's invasion of Ukraine. Energy prices have spiked and are likely to push even higher, and food prices will follow suit. At the same time, to the extent there will be disruptions in production and/or exports of industrial commodities from Russia and Ukraine, that poses additional hurdles for global supply chains, which could mean that upward pressure on consumer goods is more persistent than we anticipated would be the case at the start of the year. To the extent consumers will have to pay even more for necessities such as food, energy, and shelter, that will leave them less income for discretionary purchases, such as the services we identified above. Additionally, to the extent consumer confidence is dented by geopolitical tensions and/or sharply higher prices for food and energy, they may simply be less willing to engage in discretionary spending than would otherwise have been the case.



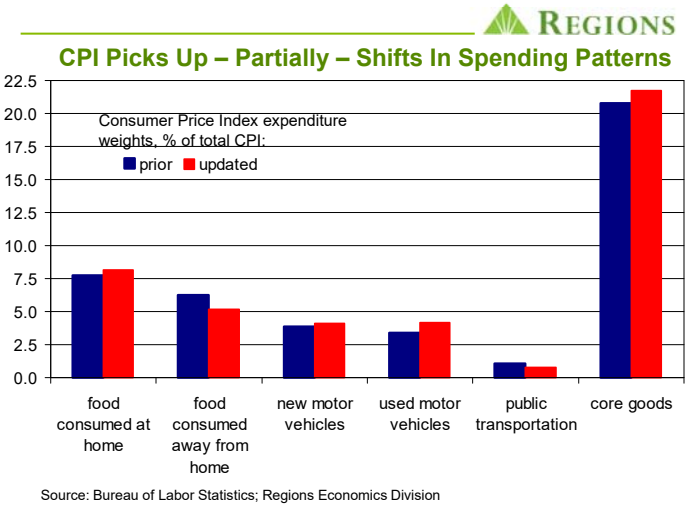
Source: Bureau of Economic Analysis; Regions Economics Division

The above chart neatly summarizes the shifts in consumer spending patterns since the onset of the pandemic and the role that higher prices have played. While the monthly data on retail sales do not capture consumer spending on services, the BEA's monthly measure of total consumer spending does. As of January, the latest available data, consumer spending on durable goods was 40.6 above the pre-pandemic peak while spending on services was 5.5 percent above its pre-pandemic peak, both before accounting for price changes. On an inflation-adjusted basis, consumer spending on goods is 24.3 percent above the pre-pandemic peak while spending on services is 0.8 percent below its pre-pandemic peak. With goods price inflation potentially being more intense and more sustained than we had expected coming into this year, that could delay any normalization in services spending. Even after accounting for changes in prices, the shifts in consumer spending patterns since the onset of the pandemic have been dramatic and may take considerable time to unwind.

Shifts In Spending Patterns Reflected In CPI

The shifts in consumer spending patterns since the onset of the pandemic have made their way into the Consumer Price Index (CPI) and, as such, will impact inflation as measured by the CPI. Recall that the CPI measures changes over time in prices paid by consumers for a fixed basket of goods and services. The basket includes necessities, such as food, shelter, clothing, energy, and transportation, and discretionary expenditures such as recreation, travel, and entertainment. Both the items that are included in the basket of goods and services and the weights attached to them are based on consumer expenditures surveys, and the Bureau of Labor Statistics (BLS) uses survey results to periodically update consumption baskets and assign new weights. The release of the

CPI data for January 2022 incorporated the latest update, based on consumer expenditure patterns over the 2019-2020 period. That is noteworthy in that the updated CPI basket and price weights now incorporate, at least partially, the shifts in consumer spending patterns in evidence since the onset of the pandemic.



Source: Bureau of Labor Statistics; Regions Economics Division

The above chart illustrates the changes in the weights attached to a few of the expenditure categories included in the CPI. Note the shift in weightings for food – since the onset of the pandemic many, if not most, households have prepared and eaten more meals at home and have eaten less outside of the home, which is reflected in the new weights. We also know that reliance on public transportation has diminished considerably since the onset of the pandemic with a greater reliance on private vehicles, as reflected in the new weights. While the new weights reflect the shifts in expenditure patterns seen since the onset of the pandemic, the updated weights are really a blend of pre-pandemic (2019) and pandemic-era (2020) spending patterns. Once the results of the expenditures surveys reflect 2020 and 2021 spending patterns, the shifts in weights will be more pronounced.

With the updated weights, core consumer goods, or, consumer goods excluding food and energy, account for 21.699 percent of the total CPI, compared to 20.768 percent in the prior set of weightings. The changes in weights shown here may not seem that consequential, going to our point about only partially capturing shifts in expenditures since the onset of the pandemic. Still, given the rate at which goods prices have been/are rising, these seemingly small changes in weights can make a difference in inflation as measured by the CPI. In other words, the items for which prices are rising the most rapidly now carry a higher weight in the CPI, which could bias measured goods price inflation and, in turn, total inflation, higher.

The flip side, however, will be evident once we do see meaningful relief from the supply chain and logistics bottlenecks that have helped push inflation so high. Whether we see either significantly slower goods price inflation or outright goods price deflation, that core goods prices carry a higher weight in the CPI will mean a faster deceleration in overall inflation than would have otherwise been the case. In short, while the shifts in consumer spending patterns seen since the onset of the pandemic will at some point begin to unwind, the effects of these shifts will persist in the data on the Consumer Price Index for some time to come.

Upside Risks To Inflation, Downside Risks To Growth

Coming into this year, our outlook called for inflation to slow from the elevated rate seen at year-end 2021 but nonetheless remain above the FOMC's 2.0 percent target rate into 2023. With global supply chain and logistics bottlenecks expected to ease over the course of 2022, global flows of goods would begin to normalize at a time when demand would be easing, at least here in the U.S. As a result, our expectation was that over 2H 2022 we would see meaningful deceleration in goods price inflation, if not outright goods price deflation. At the same time, however, we anticipated faster rates of increases in services prices as consumer demand rotated away from goods and toward services. As such, even with goods prices rising at a significantly slower pace, if not declining, faster services price inflation would sustain overall inflation above the FOMC's 2.0 percent target rate. Our expectation was that rents and medical care costs would be key drivers of faster services price inflation this year. Continued robust growth in labor costs was also expected to be a support for inflation in 2022.

Russia's invasion of Ukraine casts considerable uncertainty over the path of inflation, with inflation likely rising further and being more persistent than had been expected coming into 2022. Russia is a key exporter of crude oil, and in the wake of the invasion crude oil prices have pushed over $120 per barrel. There has already been pass-through to retail gasoline prices, and more is on the way, which will push inflation higher. Both Russia and Ukraine are key global suppliers of grains, and in the wake of the invasion prices for food commodities have risen significantly, which will be reflected in higher retail food prices. Both Russia and Ukraine are key producers of industrial commodities, including materials used to manufacture semiconductor chips and materials used to manufacture catalytic converters. Moreover, global shipping networks have been further disrupted in the wake of the invasion and global shipping costs have risen significantly.

In short, the economic fallout from Russia's invasion of Ukraine is that global supply chain and logistics bottlenecks, which had shown signs of easing prior to the invasion, may become more intractable. To the extent this is the case, already lean inventories of consumer durable goods and certain industrial goods will become even more so, which will add to upward pressure on prices. As such, goods price inflation will likely be higher and more persistent than had been anticipated at the start of 2022, meaning overall inflation will follow suit.

Already elevated inflation pushing higher poses downside risks to economic growth, in that it raises the risk of meaningful "demand destruction." Steadily rising prices erode the purchasing power of disposable household income, and higher prices for necessities such as food and energy leave less available for consumers to spend on discretionary purchases. Many point to the pool of "excess saving" (saving in excess of the level that would have prevailed had the pandemic not happened) on household balance sheets as factor that will cushion any impact to discretionary consumer spending. At this point, however, we'd argue that excess

savings are concentrated amongst higher-income households, leaving demand destruction as a credible threat. Consumer sentiment was already wavering ahead of recent events, and further deterioration would be another channel through which U.S. economic growth could be adversely impacted by geopolitical events. Additionally, in the days since Russia's invasion of Ukraine, we've seen sharp swings in equity prices and market interest rates, and this could remain the case until there is greater clarity around how the current situation will play out. Greater financial volatility and an uncertain outlook could make businesses more cautious, thus acting as a drag on business investment.

It had been almost universally expected that the FOMC would begin raising the Fed funds rate at their March 2022 meeting, though there was no firm consensus as to whether the initial rate hike would be 25 or 50 basis points or as to how many funds rate hikes there would be in 2022. With inflation elevated and the labor market at or close to full employment, it was no longer appropriate for the FOMC to provide the degree of monetary accommodation in place since the onset of the pandemic, and the FOMC's intent was to move the Fed funds rate closer to their estimate of neutral, or, around 2.5 percent. The FOMC's view was that supply chain and logistics bottlenecks were the primary sources of elevated inflation and, while these supply-side constraints would not be directly impacted by monetary policy, the Committee nonetheless felt it appropriate to begin paring down the high degree of monetary accommodation currently being provided.

While Russia's invasion of Ukraine will unambiguously add to inflation, that does not mean the FOMC will feel compelled to be more aggressive in raising the Fed funds rate. Instead, the Committee must also be mindful of the downside risks to economic growth and the heightened risks posed to financial stability. As such, while the FOMC will not be deterred from raising the funds rate, they are likely to move at a measured pace, i.e., raising the funds rate in 25-basis point increments, until there is more clarity as to the economic fallout from Russia's invasion of Ukraine.

February Employment Report

Total nonfarm employment rose by 678,000 jobs in February, with private sector payrolls up by 654,000 jobs and public sector payrolls up by 24,000 jobs. Additionally, prior estimates of job growth in December and January were revised up by a net 92,000 jobs for the two-month period. In addition to job growth coming in much stronger than expected, there are other elements of the February employment report that deserve mention.

Job growth was much more broad based in February than was the case in January. The one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups, rose to 76.6 percent in February from 61.1 percent in January, and February's reading is the second highest since the onset of the pandemic. While the rapid and wide spread of the Omicron variant clearly held down economic activity in January, rapidly subsiding case counts quickly translated into a pickup in activity in February, including increased labor force participation and hiring.

Unlike the prior several months, the February employment data are refreshingly free of distortions tied to seasonal adjustment. As we've noted in our regular write-ups of the monthly employment reports, our view is that the seasonally adjusted data overstate the strength of hiring over recent months, but those effects were absent from the February data. Indeed, hiring in industry groups such as leisure and hospitality services and construction was much stronger this February than is typically the case for the month. For instance, the not seasonally adjusted data show payrolls in leisure and hospitality services increased by 1.8 percent, which is roughly double the typical February increase and second only to last year's increase as the largest February increase on record. This goes to the point that economic activity rebounded sharply last month.

The labor force participation rate rose to 62.3 percent in February, the highest monthly rate since March 2020, with the participation rate amongst the 25-to-54 year-old age cohort, often referred to as the prime working age cohort, rising to 82.2 percent. While the increase in labor force participation over recent months is both encouraging and in line with expectations, it is worth pointing out that rising participation amongst the prime working age cohort has come entirely via increased participation amongst males. Amongst females in this cohort, the participation rate is below where it ended 2021 and over a full percentage point below where it was at the onset of the pandemic. We and many others expected that as COVID case counts fell and schools resumed normal operations, females would begin returning to the labor force in greater numbers. While this could, and likely will, still prove to be the case, there is simply no evidence of this change thus far.

Much – far too much, in our view – has been made of average hourly earnings being flat in February, having risen by only a cent from January. Many are taking this miniscule increase as a sign that the dynamics of the labor market have suddenly shifted, arguing that the lack of wage growth is a sign that, with more people coming into/back into the labor force, firms no longer have to raise wages in order to attract workers. This in a month in which the unemployment rate, you know, fell to 3.8 percent. We'll offer a detailed discussion of the flaws of the average hourly earnings (AHE) metric in our April *Outlook*, but for now will note two factors that held down measured AHE in February. First, AHE is sensitive to the mix of jobs added in a given month and, with lower-wage services industries accounting for the bulk of job growth, this mix effect was in play in February. Second, in months in which the BLS survey period ends prior to the middle of the month, measured AHE tends to be biased lower, which could reflect reporting issues around payroll dollars. This is particularly true in months in which an early survey period coincides with a sizable increase in hours worked, as was the case in February.

The U.S. economy has added over three million jobs over the past five months. While the level of employment is still short of the pre-pandemic peak, there are almost one million more people working full-time than was the case prior to the pandemic. The remaining gap in employment is more than accounted for by people working part-time, a number that has basically not budged over recent months. This is in stark contrast to the aftermath of the financial crisis, when notably weak labor demand meant that it took full-time employment almost eight years to return to its prior peak.

Clearly, the labor market remains a seller's market. Despite the stepped-up pace of job growth in recent months, there remain over ten million open jobs across the U.S. economy. Further increases in labor force participation should sustain rapid job growth in coming months, in part because robust wage growth will continue to draw people into/back into the labor market.

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Q3 '21 (a)	Q4 '21 (p)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)	Q1 '23 (f)	Q2 '23 (f)		2019 (a)	2020 (a)	2021 (p)	2022 (f)	2023 (f)
2.3	7.0	1.1	3.4	4.8	3.5	3.2	3.0	Real GDP[1]	2.3	-3.4	5.7	3.7	3.3
2.0	3.1	2.9	2.1	5.0	2.9	2.7	2.6	Real Personal Consumption[1]	2.2	-3.8	7.9	3.5	2.9
1.7	3.1	10.9	9.8	8.7	7.0	6.0	5.4	Real Business Fixed Investment[1]	4.3	-5.3	7.4	7.4	6.4
-2.3	2.4	10.0	8.6	8.3	6.4	6.1	5.8	Equipment[1]	3.3	-8.3	13.0	6.4	6.2
9.1	10.6	11.8	9.1	7.4	6.0	5.3	5.2	Intellectual Property and Software[1]	7.2	2.8	10.2	9.8	5.8
-4.1	-9.4	10.1	14.6	12.7	10.8	7.3	4.4	Structures[1]	2.0	-12.5	-8.1	4.7	7.7
-7.7	1.0	6.5	0.4	4.3	3.3	3.0	1.3	Real Residential Fixed Investment[1]	-0.9	6.8	9.1	0.8	2.4
0.9	-2.6	2.2	-0.2	0.8	2.3	2.4	2.2	Real Government Expenditures[1]	2.2	2.5	0.5	0.2	1.9
-1,316.6	-1,341.7	-1,419.8	-1,372.8	-1,380.3	-1,391.5	-1,395.7	-1,402.8	Real Net Exports[2]	-905.3	-942.7	-1,282.2	-1,391.1	-1,410.1
1,096	1,159	1,142	1,160	1,178	1,199	1,213	1,222	Single Family Housing Starts, ths. of units[3]	889	1,004	1,129	1,170	1,223
465	495	503	472	469	466	462	457	Multi-Family Housing Starts, ths. of units[3]	403	393	471	478	456
17.1	17.8	19.0	15.9	11.5	7.9	4.1	2.5	CoreLogic House Price Index[5]	3.9	6.0	15.0	13.4	3.0
13.3	12.9	14.2	14.5	15.3	15.7	16.0	16.2	Vehicle Sales, millions of units[3]	17.0	14.5	15.0	14.9	16.2
5.1	4.2	3.8	3.5	3.3	3.3	3.2	3.1	Unemployment Rate, %[4]	3.7	8.1	5.4	3.5	3.1
4.6	4.3	4.6	4.4	3.7	3.0	2.2	1.7	Non-Farm Employment[5]	1.3	-5.8	2.8	3.9	1.6
-4.1	-5.6	-3.3	0.9	3.3	3.4	5.3	3.8	Real Disposable Personal Income[1]	2.3	6.2	2.2	-3.8	3.9
4.6	5.9	6.4	6.3	5.7	4.7	3.7	2.8	GDP Price Deflator[5]	1.8	1.2	4.1	5.8	2.7
4.3	5.5	6.3	6.3	5.7	4.7	3.5	2.5	PCE Deflator[5]	1.5	1.2	3.9	5.7	2.6
5.3	6.7	7.9	7.6	6.6	5.2	3.6	2.4	Consumer Price Index[5]	1.8	1.2	4.7	6.8	2.5
3.6	4.6	5.4	5.0	4.5	3.9	3.0	2.6	Core PCE Deflator[5]	1.7	1.4	3.3	4.7	2.6
4.1	5.0	6.3	5.4	4.7	4.0	3.1	2.8	Core Consumer Price Index[5]	2.2	1.7	3.6	5.1	2.9
0.13	0.13	0.17	0.58	0.90	1.17	1.54	1.79	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	0.71	1.77
1.32	1.54	1.83	1.85	2.03	2.13	2.25	2.34	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.44	1.96	2.38
2.87	3.08	3.67	3.75	3.93	4.06	4.20	4.26	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.96	3.85	4.29
-3.7	-3.3	-3.4	-3.3	-3.4	-3.4	-3.5	-3.5	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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