Slow Growth and High Inflation: Cooling Demand in a Supply-Constrained Economy

Yelena Maleyev, Economist

SIFM New York

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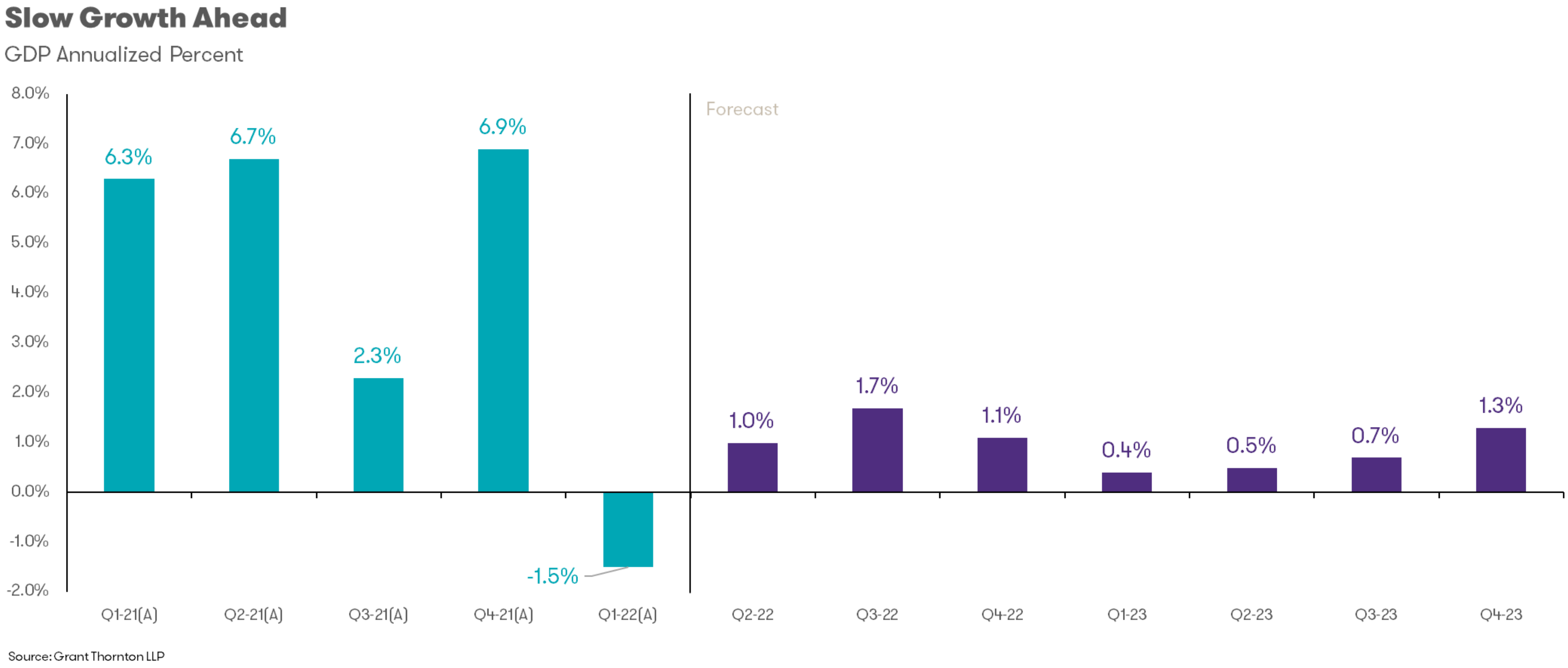
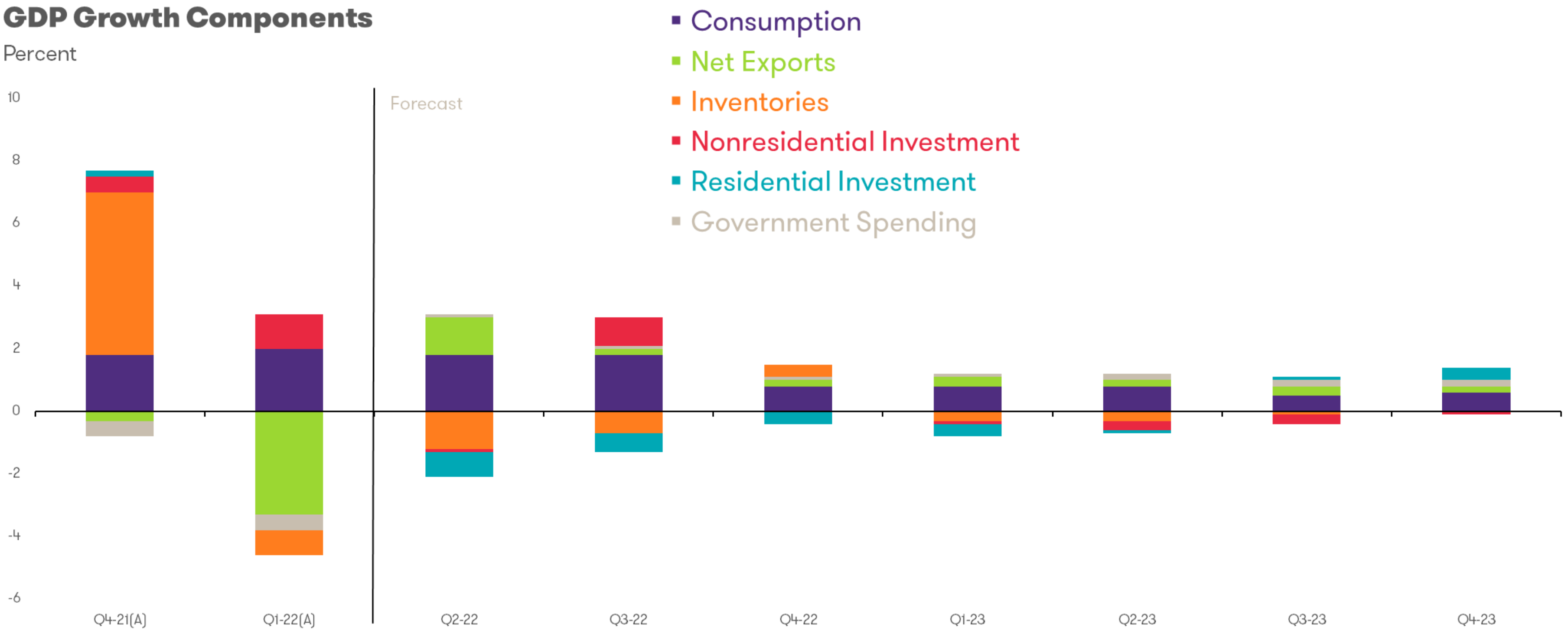
Snapshot of U.S. Economy



Contributions to Growth

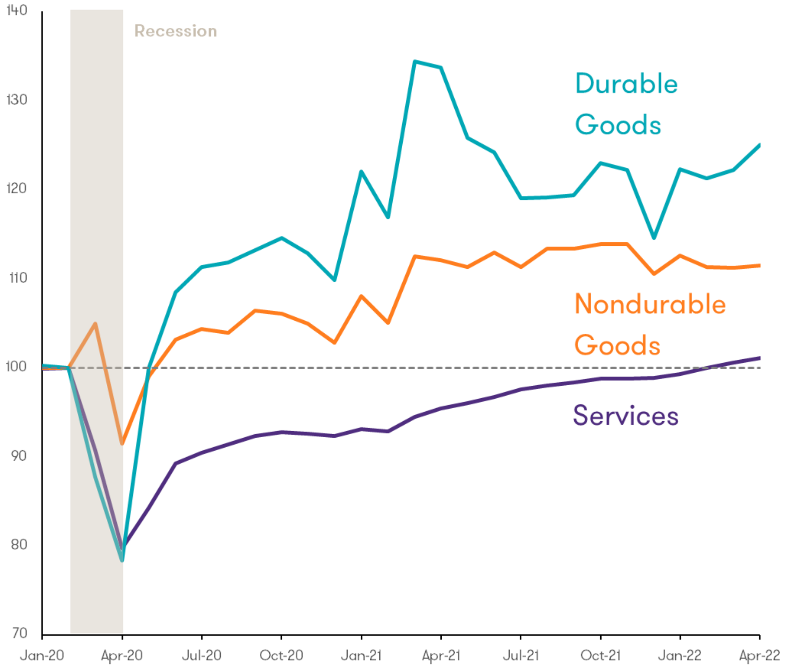


Source: Bureau of Economic Analysis, Grant Thornton LLP

Consumption

Services Spending at Prepandemic Levels

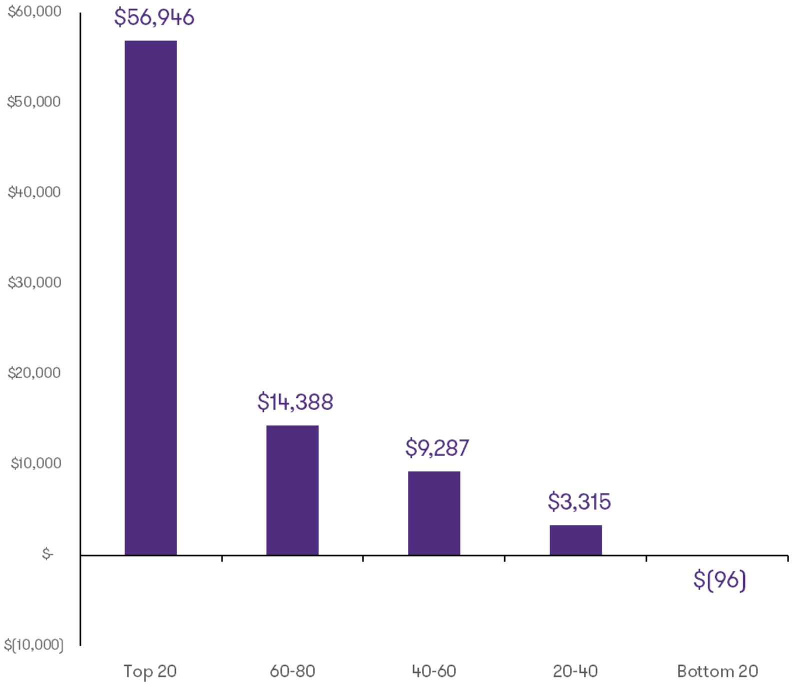
Index, February 2020 = 100



Source: Bureau of Economic Analysis/Haver Analytics, Author Calculations

Cushion on Saving Eroding

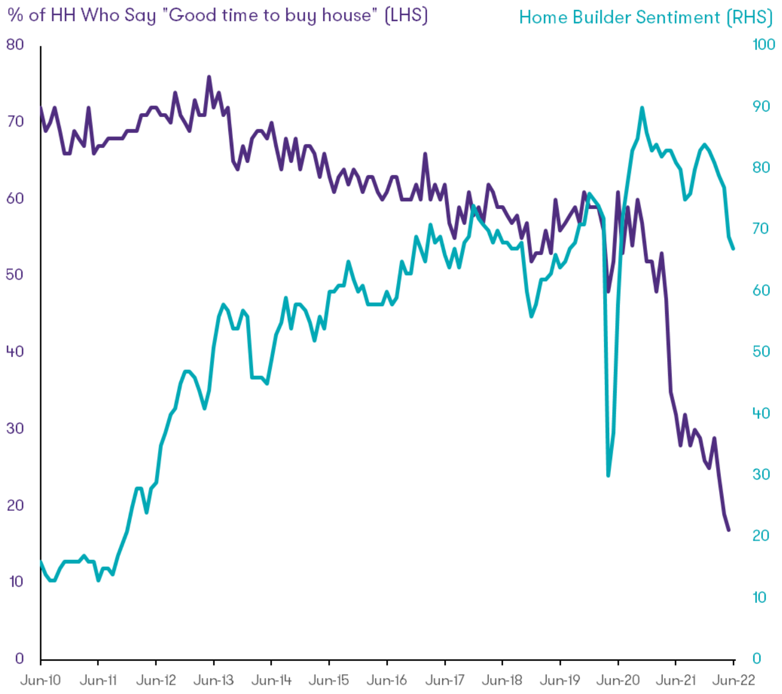
Excess Cash per HH Relative to 4Q19 by Income Quintile as of Dec. '21



Source: Replication of Morgan Stanley Research using Federal Reserve Data

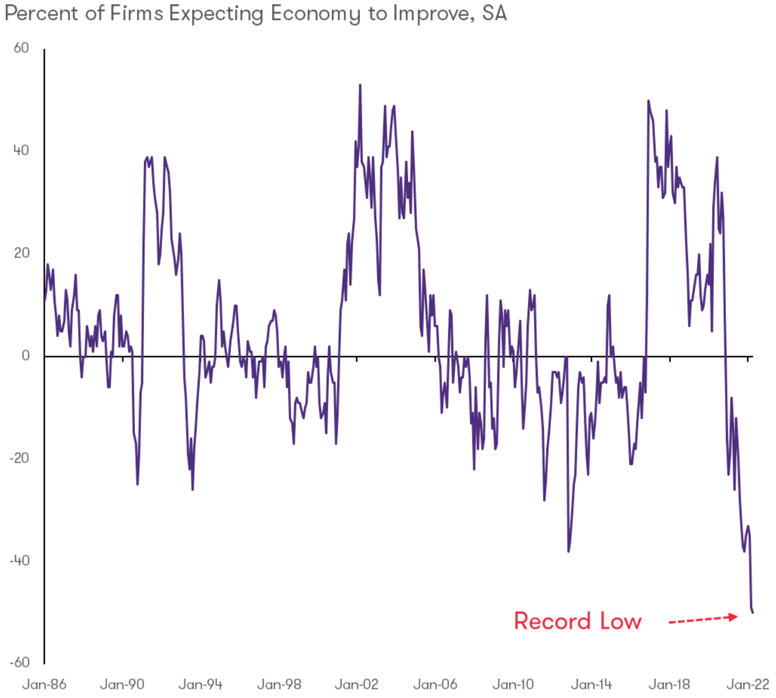
Investment: Residential and Business

Housing Market Sentiment Drops



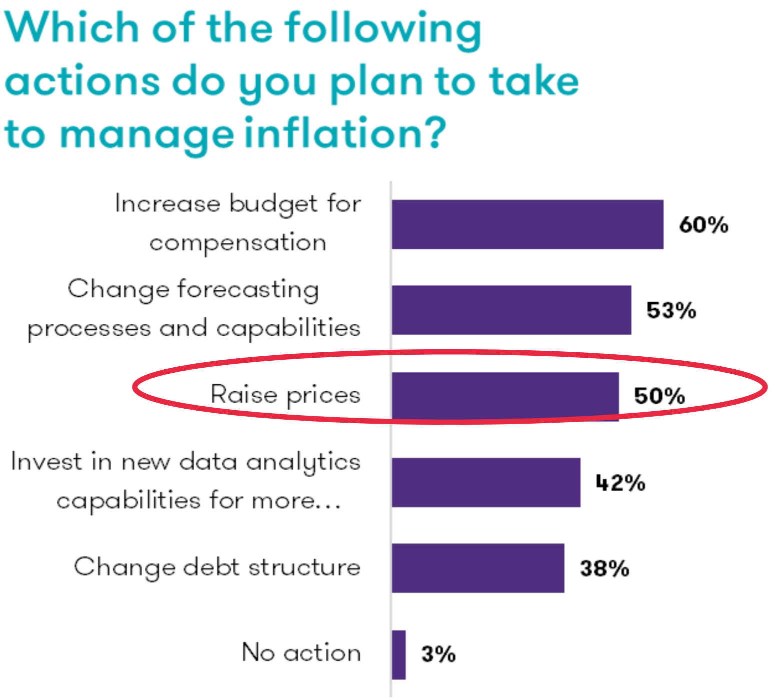
Source: Fannie Mae, National Association of Home Builders

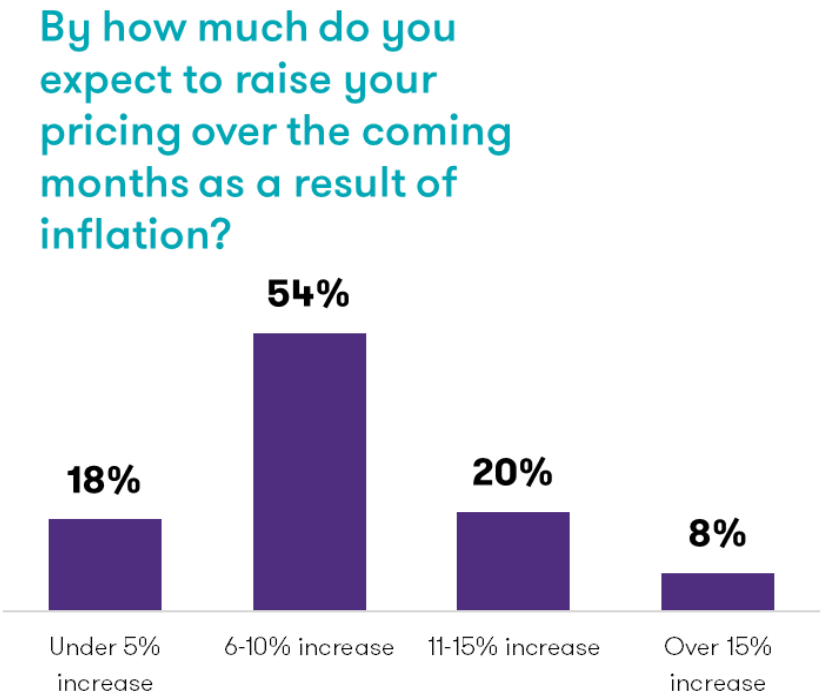
Small Business Optimism Plummets



Source: National Federation of Independent Business

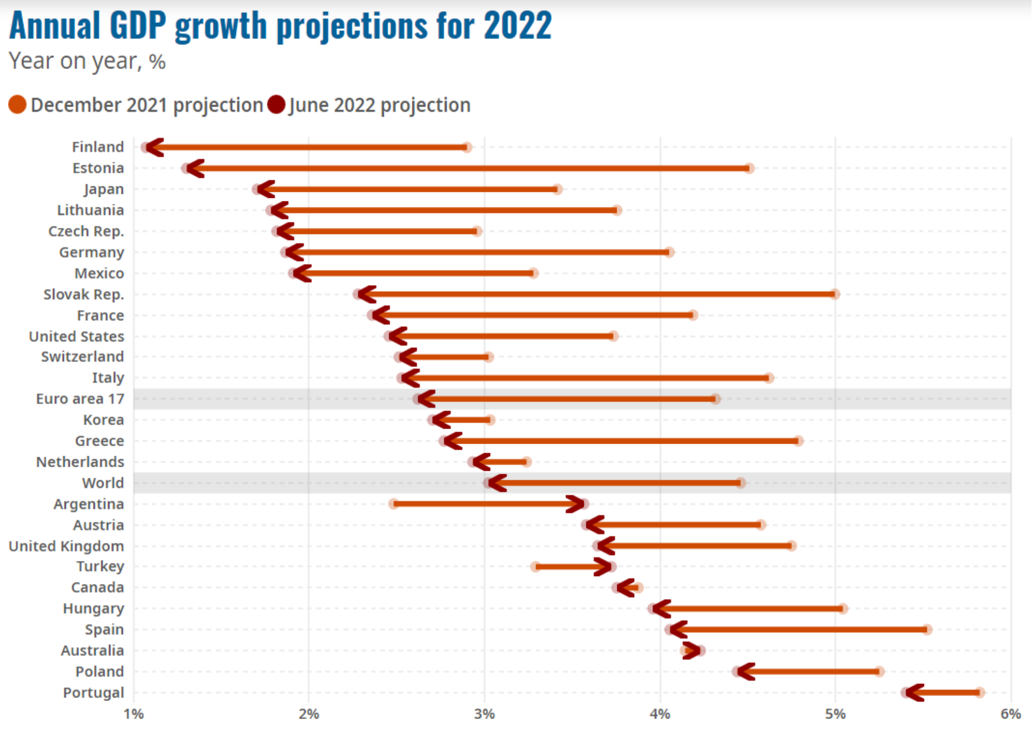
CFOs Uncertain and Raising Prices





Source: Grant Thornton Q1 2022 CFO Survey

Rest of World Worse Off



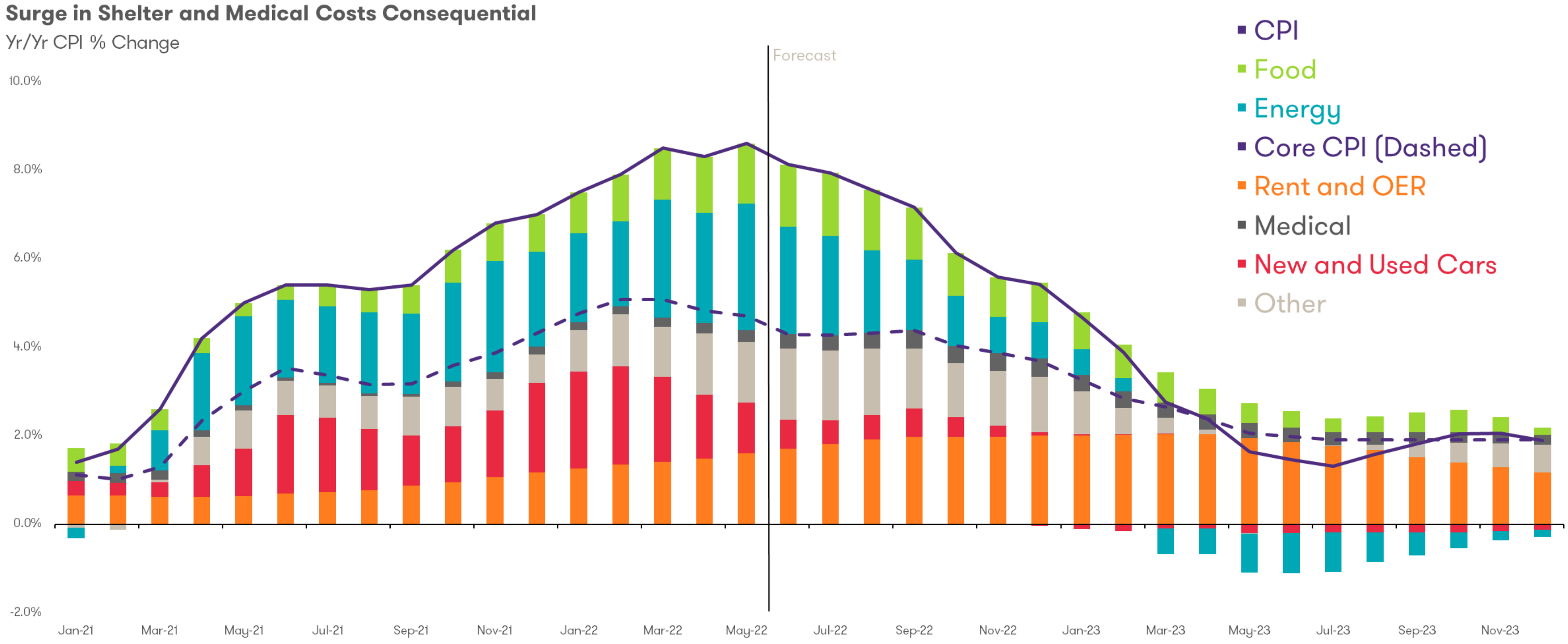
Source: OECD Economic Outlook (Edition 2022/1).

- Higher commodity prices bigger hit to economies outside of the U.S.
- Governments who push policies that ease inflation concerns (reducing taxes, banning exports) exacerbate inflation problems.
- Central banks must counter with tighter policy.
- People in developing economies lack access to credit markets; tighter monetary policy will be felt through blow to employment. Recessions are more likely.
- China now a laggard; no longer boosting global growth the way it did in the Global Financial Crisis.

Inflation: A Perfect Storm

- **Demand:** Stimulus, excess savings, pandemic distortions (spike in demand for cars and other durables), housing boom, delayed medical appointments.
- **Supply**: COVID waves, China's zero COVID policy, war, labor shortages.
- **Market Concentration:** Amplified labor market tightness and inflation; undermined investment and boosted prices/profits.
- **Inflation is Inertial:** Expectations are nonlinear and close to a tipping point.
- **Offsets**: Pivot from goods to services (bullwhip effect), strong dollar.
- **Inflation-Prone Future:** Climate change, geopolitical tensions, nationalism, regionalization, just-in-case inventories, aging and long-term labor shortages and increased churn due to hybrid work.

Services Prices Put Floor on Inflation

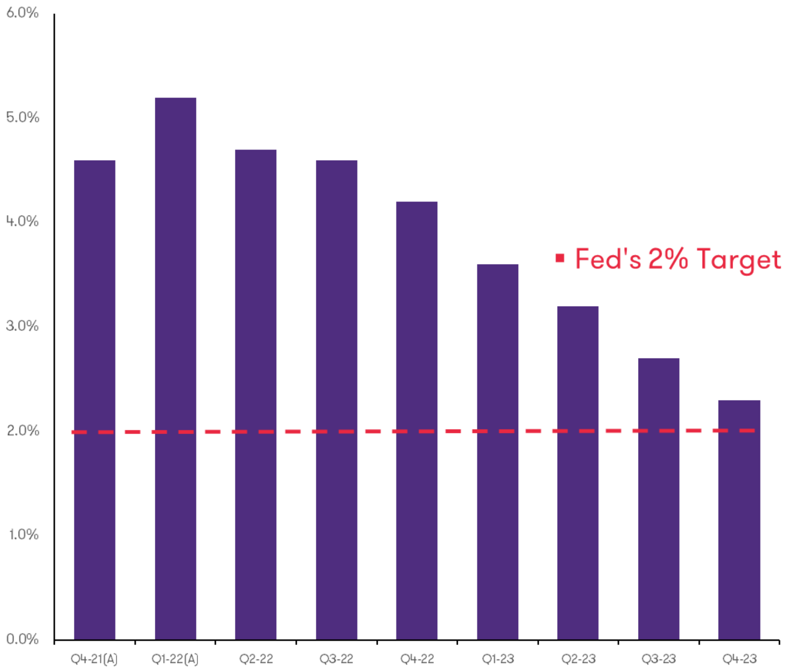


Source: BLS, Grant Thornton LLP

Federal Reserve Behind the Curve

Inflation Stubbornly High

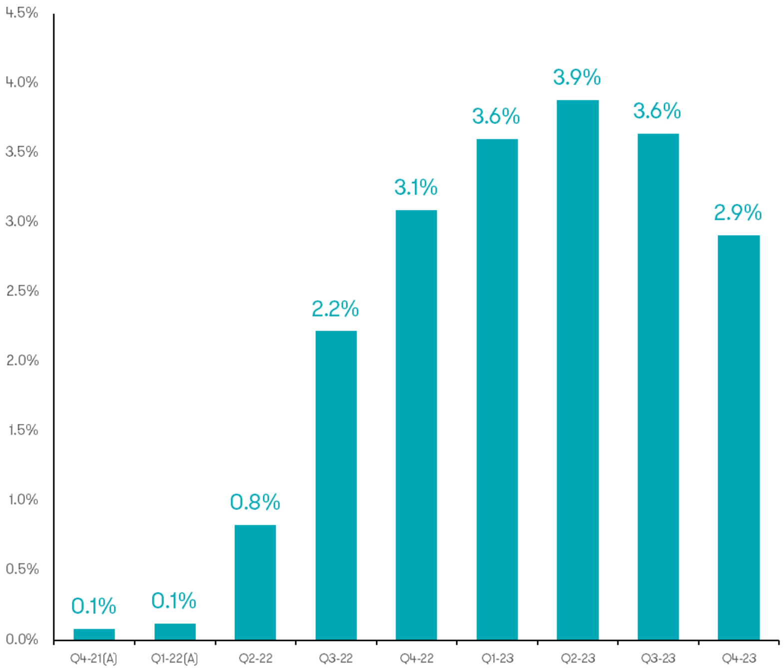
Core PCE Percent Change, 4Q/4Q



Source: Bureau of Economic Analysis, Grant Thornton LLP

Fed Tightening Aggressively

Short Term Rate, Level Percent

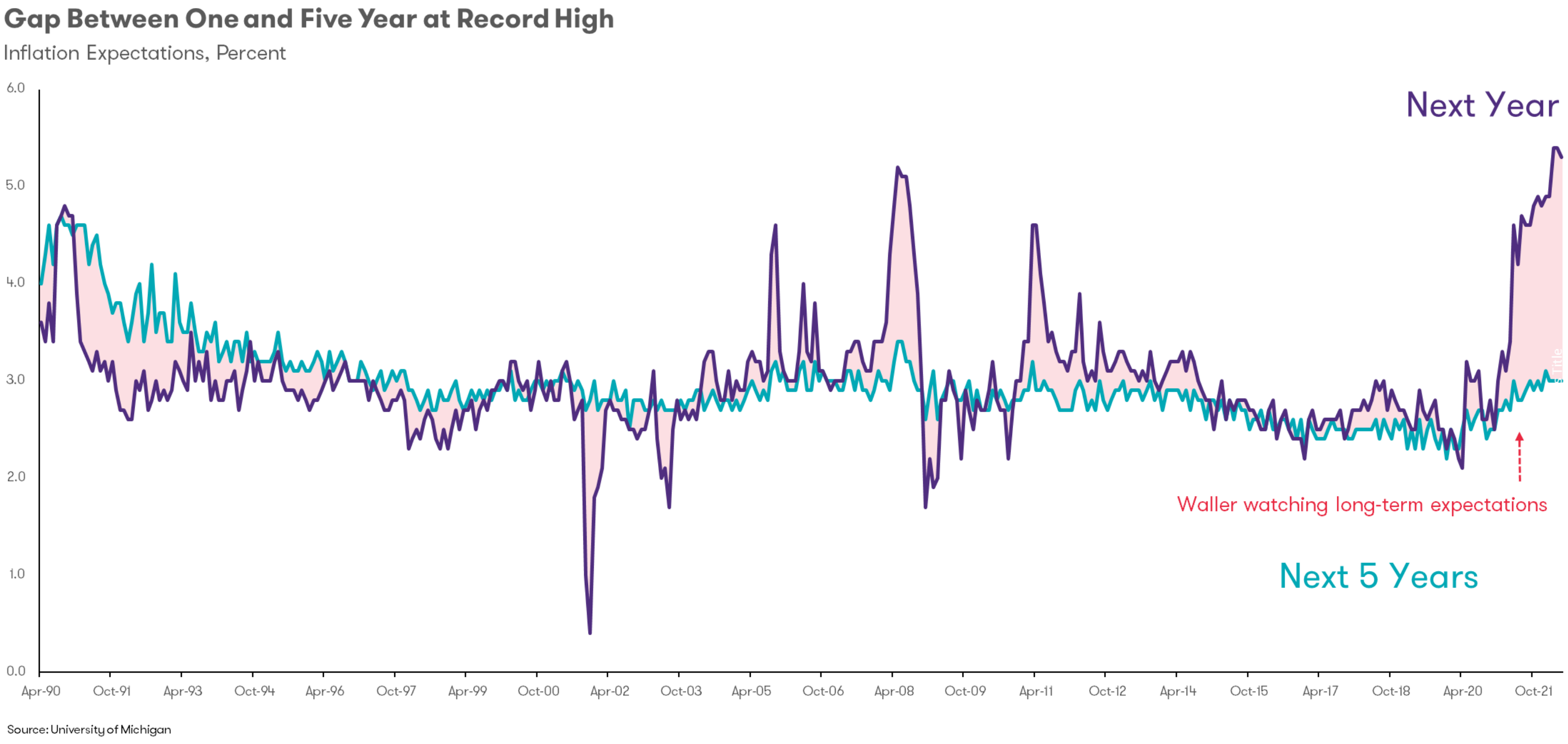


Source: Grant Thornton LLP

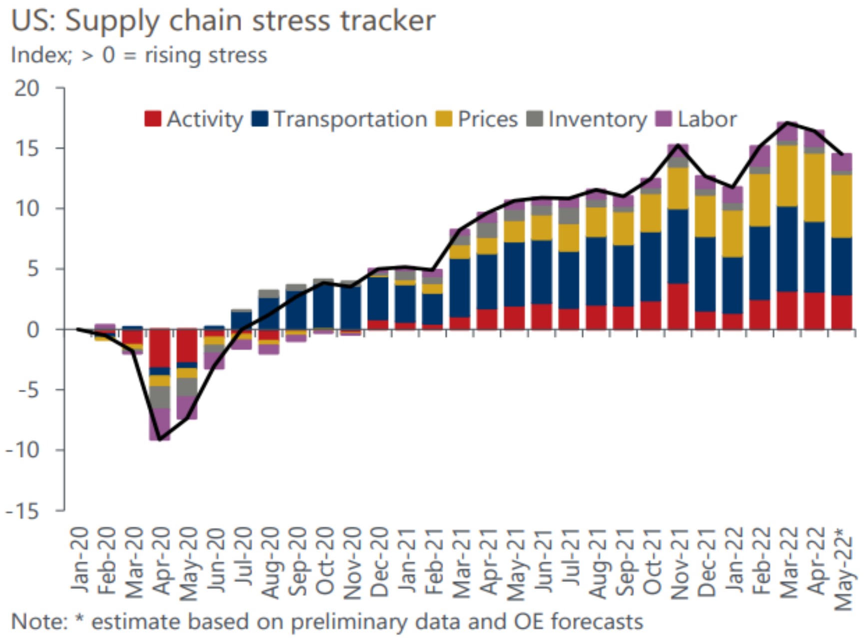
Risks to Growth and Inflation

- Inflation Inertial – Expectations Can Become Unmoored
- Supply Chain Pressures
- Labor Market Tightness
- Geopolitical Uncertainty
- Sovereign Debt Concerns
- Climate Change

Un-anchoring of Expectations Possible



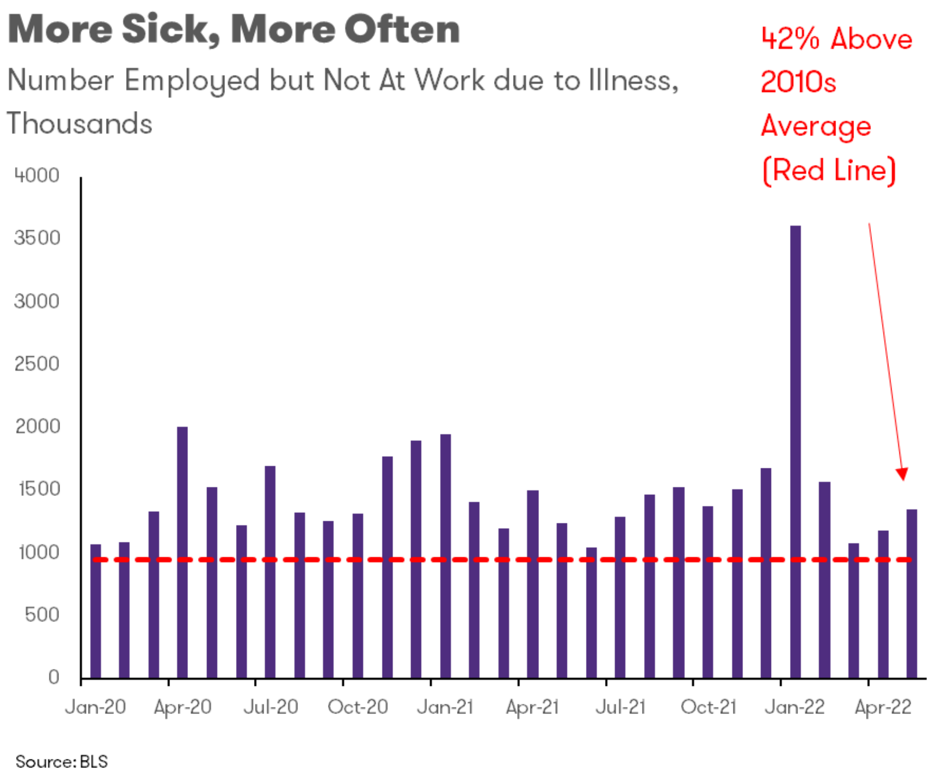
Supply Chain Disruptions Linger



Source: Oxford Economics

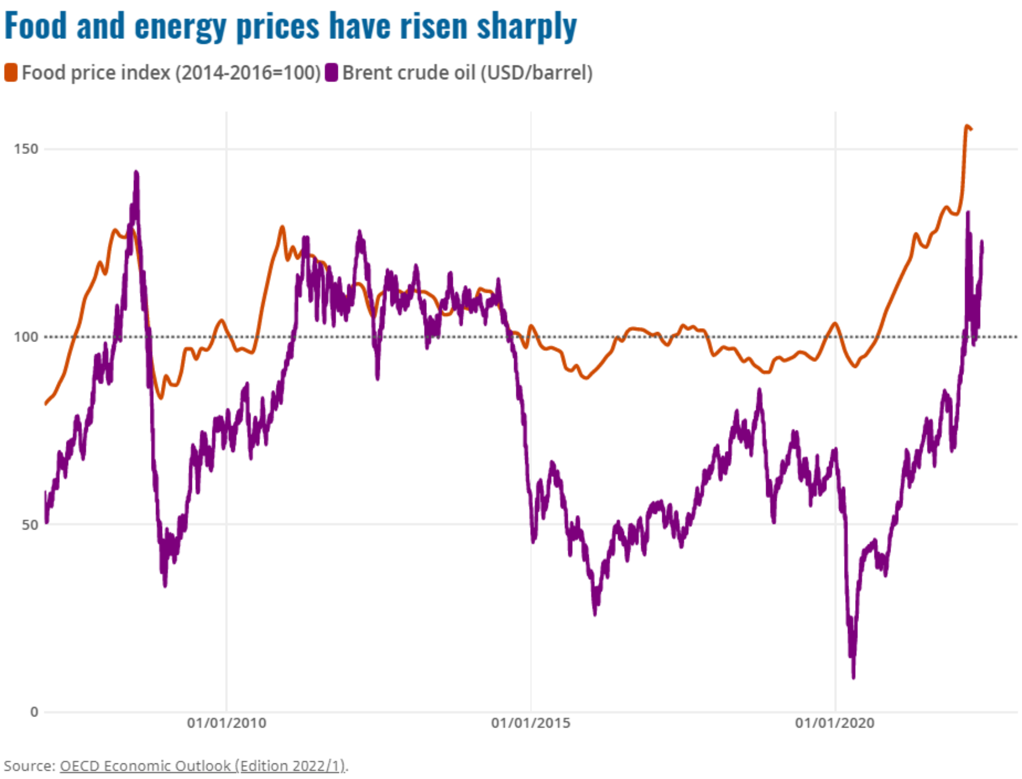
- War in Ukraine adds stress to shipping routes; high geopolitical uncertainty and rising commodity prices add to costs.
- Zero tolerance for COVID in China add to supply chain pressures.
- The number of container ships waiting to unload at the ports of LA and Long Beach declined 10% in May, but the pause is due to China's lockdowns.
- Manufacturing prices moderating according to Fed surveys but remain stubbornly high and are sticky.

Labor Supply and Demand Mismatch



- Job postings to number of workers in May at **1.9 openings per worker**. Ratio of 1:1 sustainable.
- Larger, tech-savvy employers offer attractive wages/benefits while automating and gaining productivity. Small and midsize companies cannot compete (margin squeeze.)
- Early retirements (up to 3 million more retirees in 2020), lack of childcare and long COVID sidelined workers.
- Immigration screeched to a halt; missing 2 million workers.

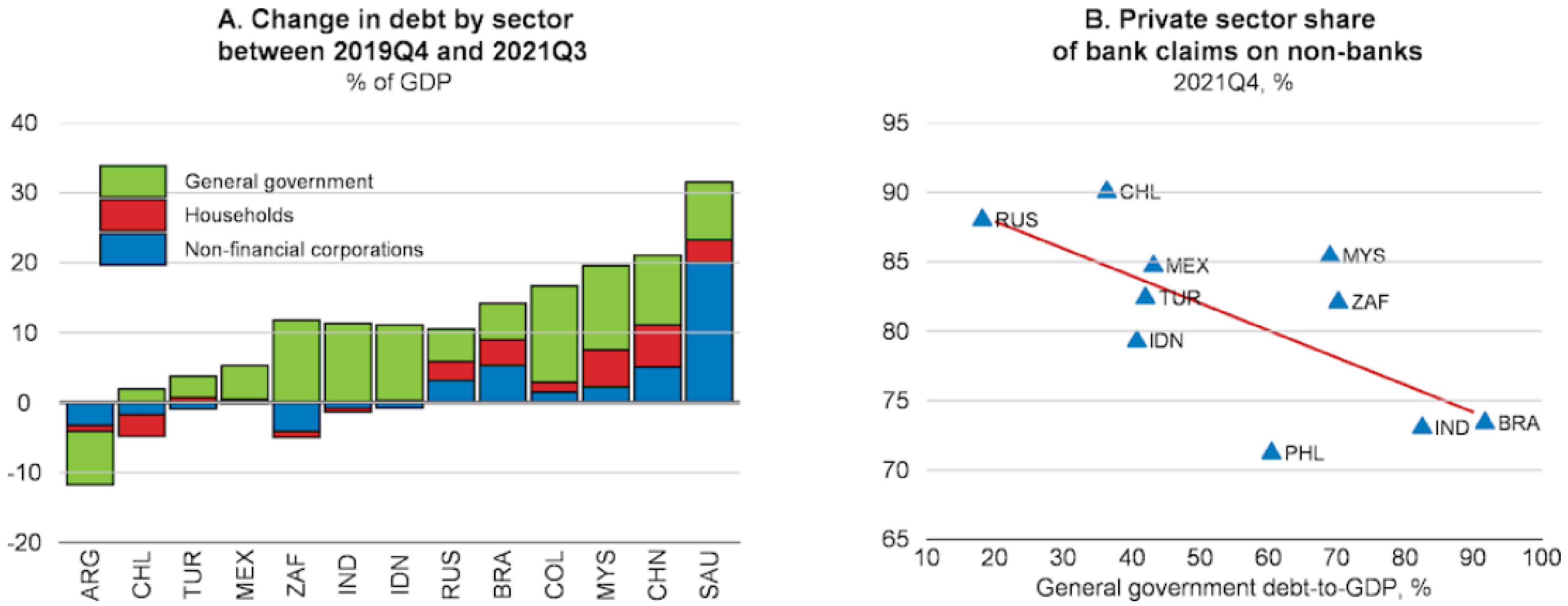
War and Rising Commodity Prices



- *"…there is [a] high risk of a food crisis. Supply disruptions are rising, particularly threatening low-income countries that are highly dependent on Russia and Ukraine for basic food staples."* – OECD, June 2022
- Countries most vulnerable are also least capable of providing for their citizens. Pandemic already stretched budgets thin and increased debt levels.

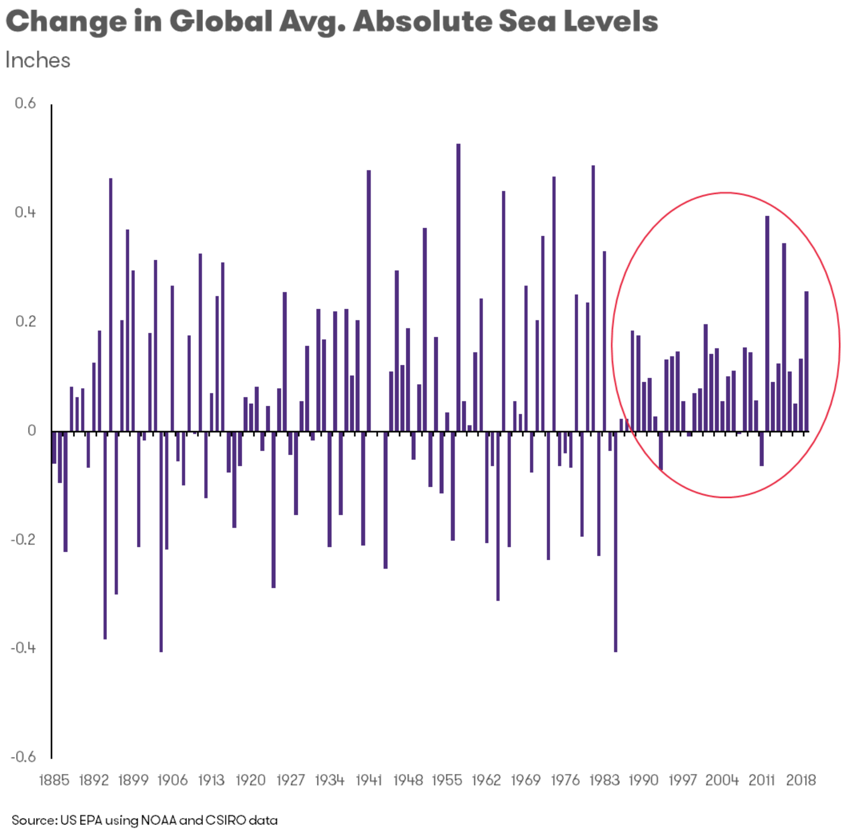
High Debt in Emerging Markets

Figure 1.39. **High public debt in emerging-market economies restrains lending to the private sector**



Source: OECD June 2022 Report

Climate Change



- Disruptions to infrastructure and livelihoods due to extreme weather events becoming more frequent.
- Higher costs due to living in higher risk areas. Some no longer insurable.
- Next asset bubble will be in renewable energies – will take time to see it form. In medium term, green investments (estimated $130 trillion by Mark Carney) will be where money flows.
- Jury out on electric vehicles – higher costs and higher crash risk. Need charging infrastructure.
- Developing nations becoming greater polluters – will need support from developed world.

Conclusions

- Economic growth at a slower pace of **2% in 2022;** stagflation (inflation with a stagnating economy) a large risk.
- Inflation will cool to Fed's target of **2% at end of 2023**; rate cuts necessary after.
- Commodity prices expected to be volatile. War and defense spending are inflationary.
- Middle East unrest heating up (Iran able to build atomic bomb.)
- Higher cost environment post-pandemic means shorter business cycles and more activist central banks, including the Federal Reserve.
- **Silver linings:**
  - Disinflationary structural changes (e.g. aging population) create downward pressure on long-term rates.
  - Removing/reducing tariffs by current administration will alleviate price pressures.
  - Balance sheet operations by the Fed may have more impact on cooling demand (less rate hikes necessary).
  - Lower labor force participation and disruptions from the pandemic moved up the natural rate of unemployment (economy can handle a higher unemployment rate without falling into recession).
  - Faster shift away from fossil fuels could help reach Paris agreement goals.

Thank You

