

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

Yelena Maleyev, Economist

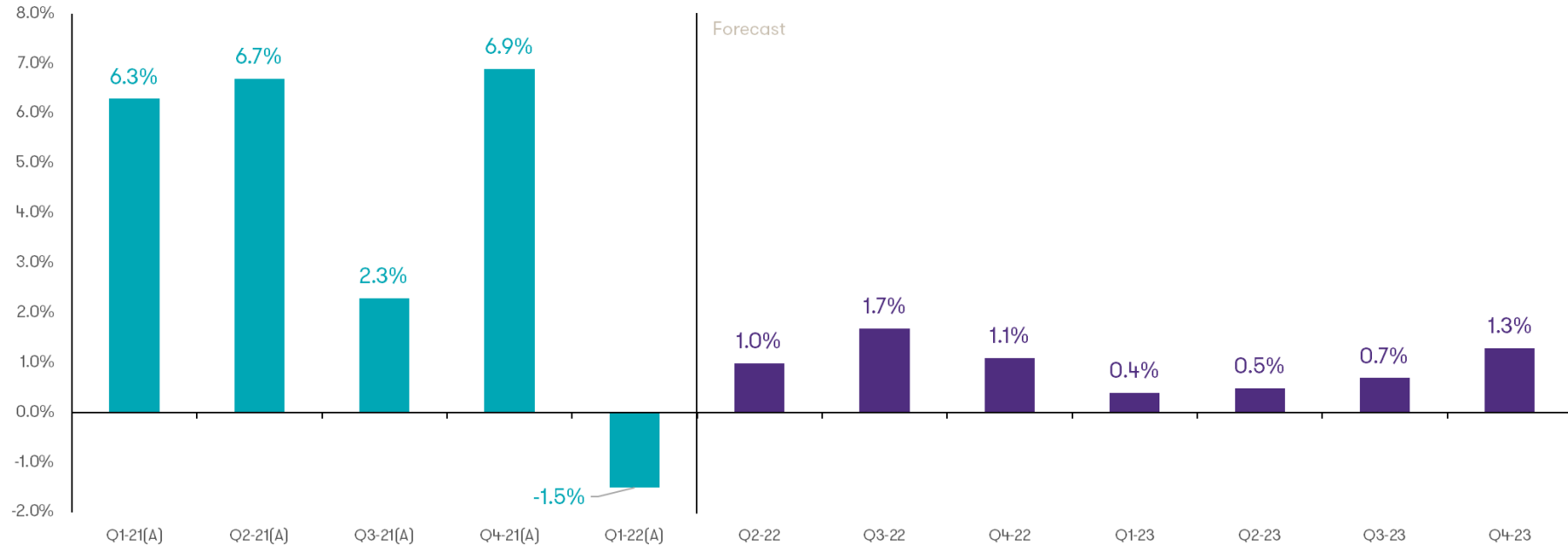
SIFM New York

June 23, 2022

Snapshot of U.S. Economy

Slow Growth Ahead

GDP Annualized Percent



Source: Grant Thornton LLP

Contributions to Growth

GDP Growth Components

Percent

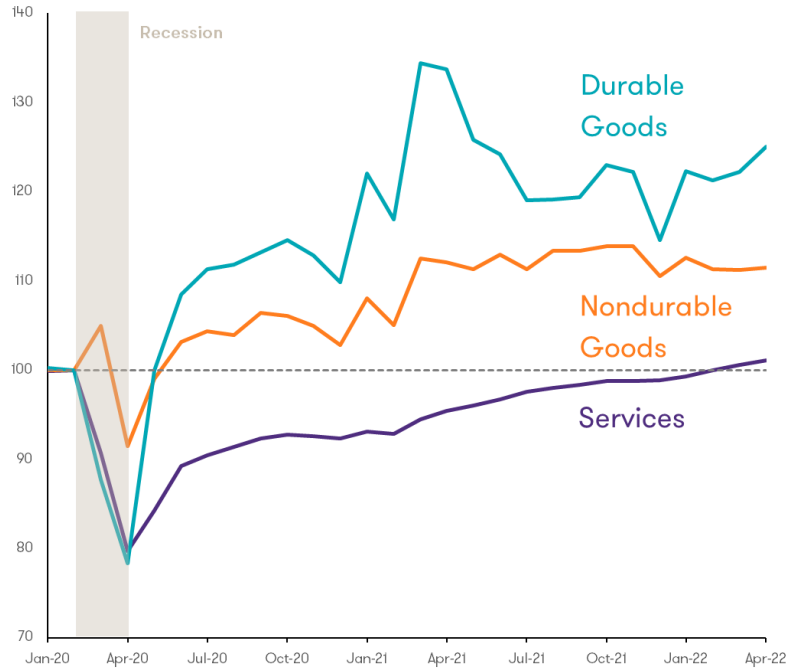


Source: Bureau of Economic Analysis, Grant Thornton LLP

Consumption

Services Spending at Prepandemic Levels

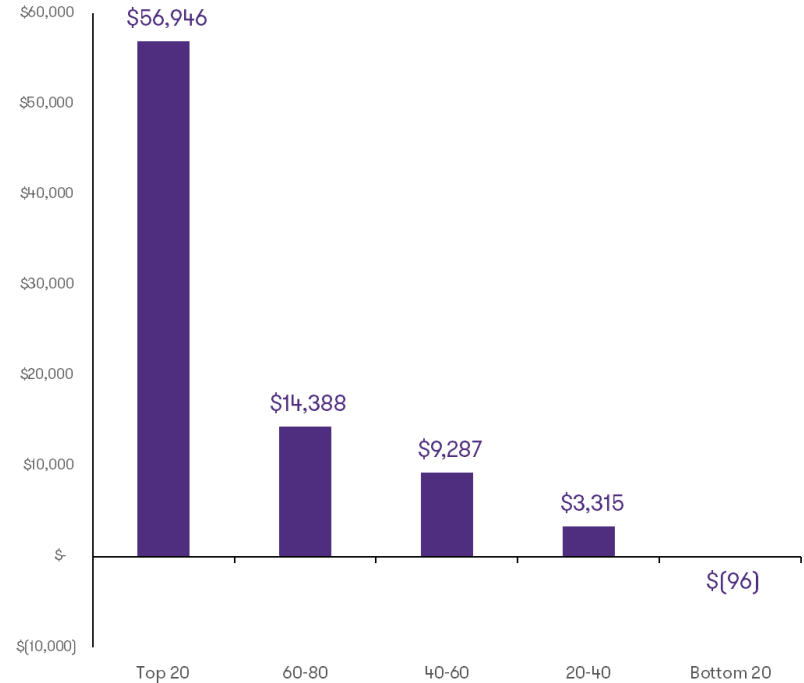
Index, February 2020 = 100



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

Cushion on Saving Eroding

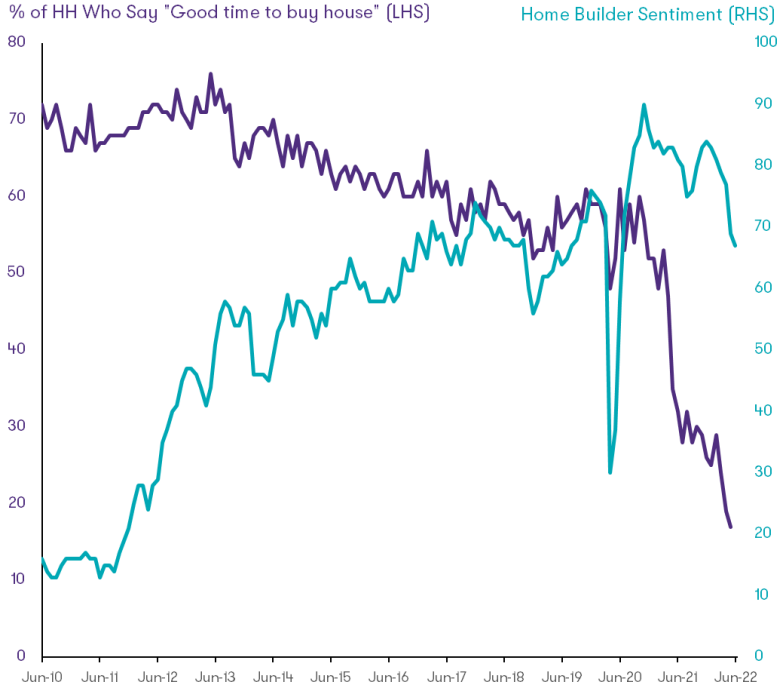
Excess Cash per HH Relative to 4Q19 by Income Quintile as of Dec. '21



Source: Replication of Morgan Stanley Research using Federal Reserve Data

Investment: Residential and Business

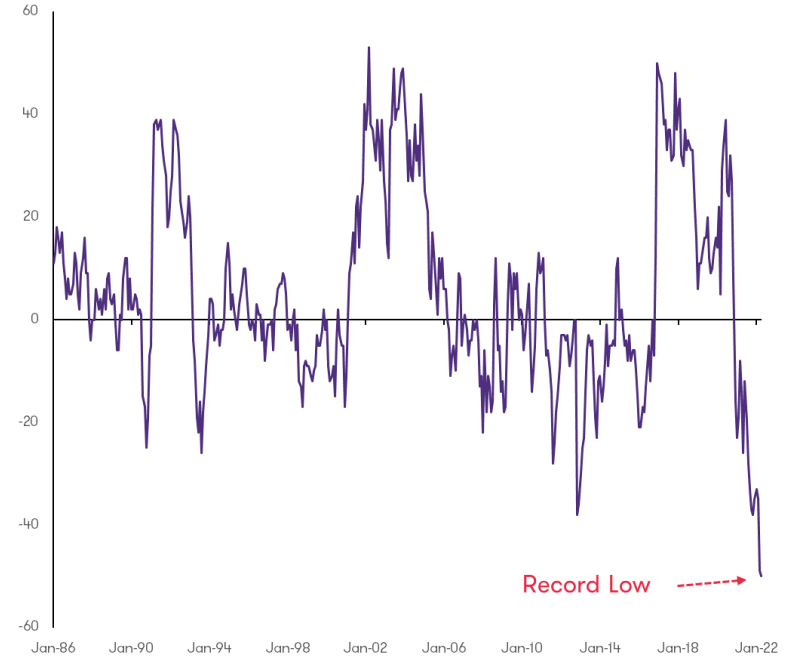
Housing Market Sentiment Drops



Source: Fannie Mae, National Association of Home Builders

Small Business Optimism Plummet

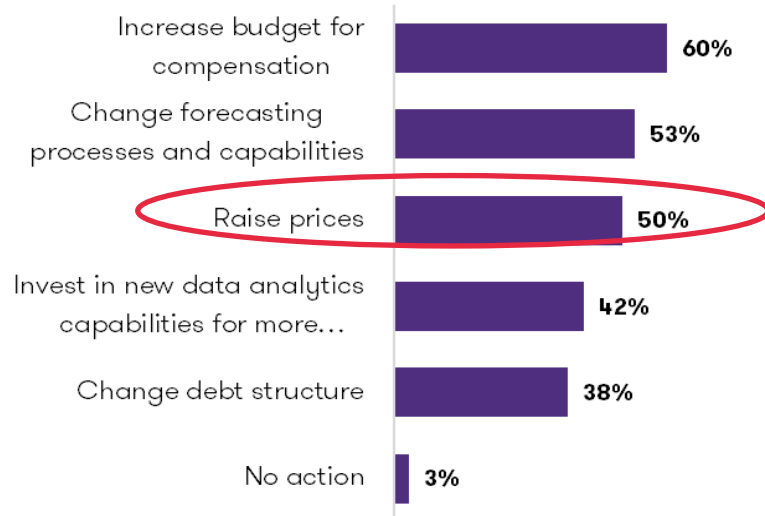
Percent of Firms Expecting Economy to Improve, SA



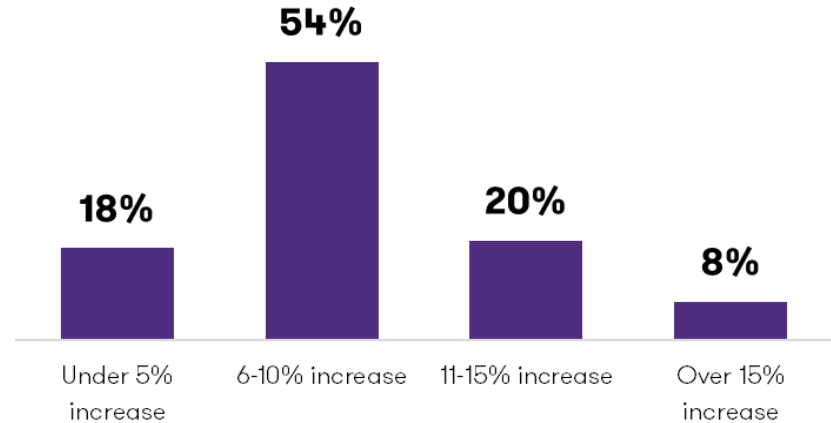
Source: National Federation of Independent Business

CFOs Uncertain and Raising Prices

Which of the following actions do you plan to take to manage inflation?



By how much do you expect to raise your pricing over the coming months as a result of inflation?



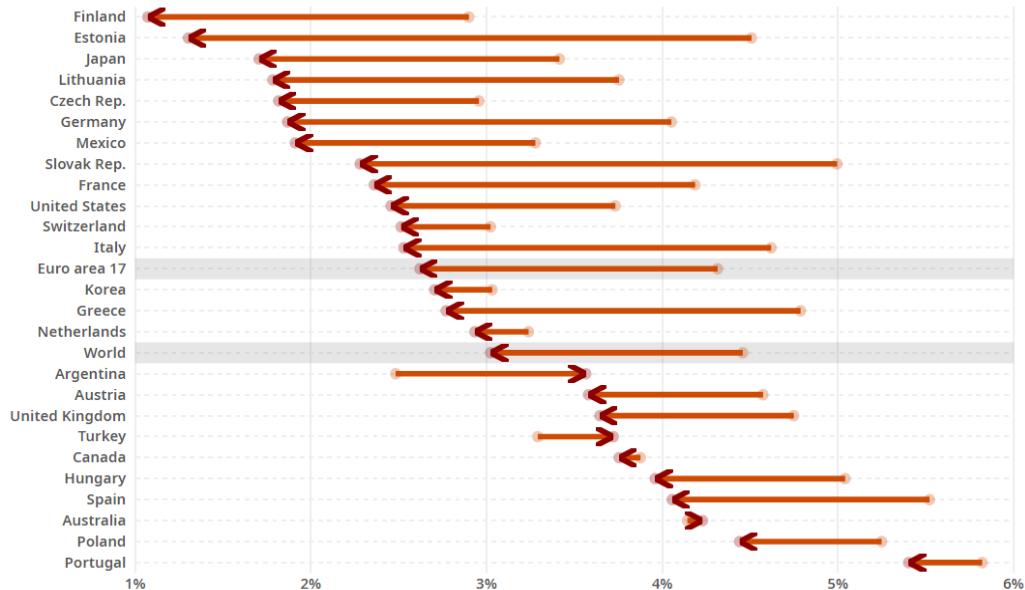
Source: Grant Thornton Q1 2022 CFO Survey

Rest of World Worse Off

Annual GDP growth projections for 2022

Year on year, %

● December 2021 projection ● June 2022 projection



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.

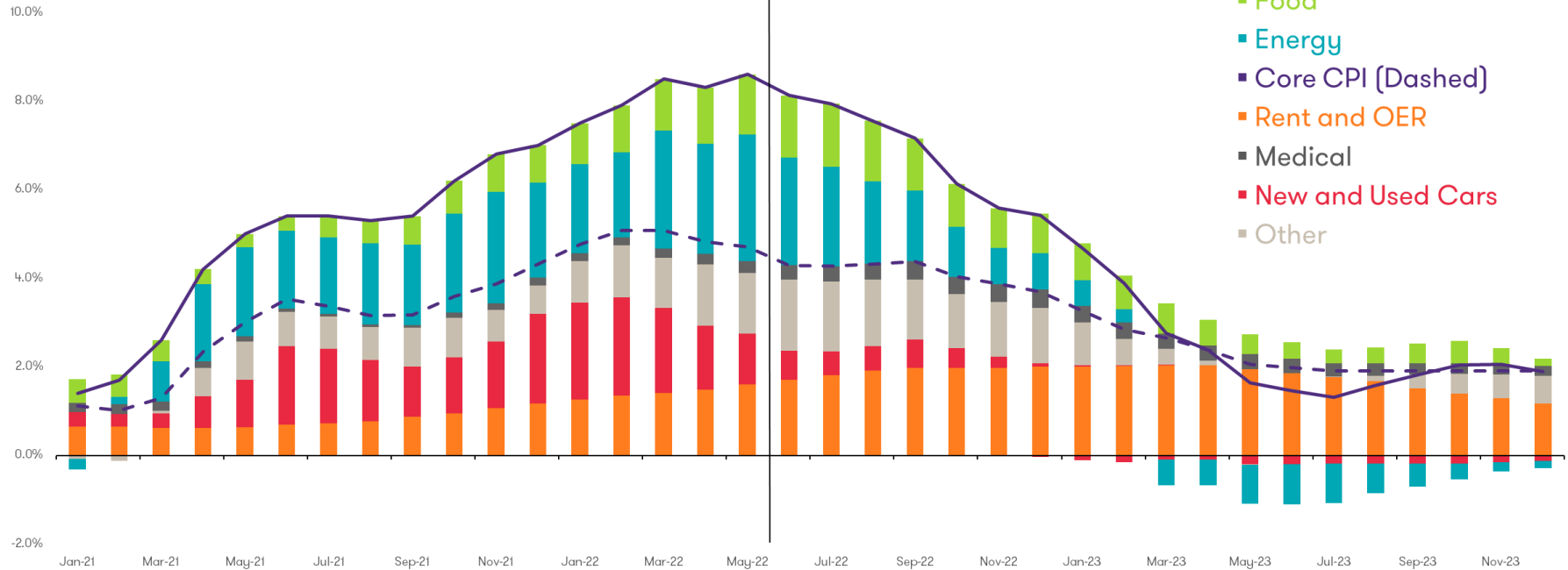
Inflation: A Perfect Storm

- **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

Surge in Shelter and Medical Costs Consequential

Yr/Yr CPI % Change

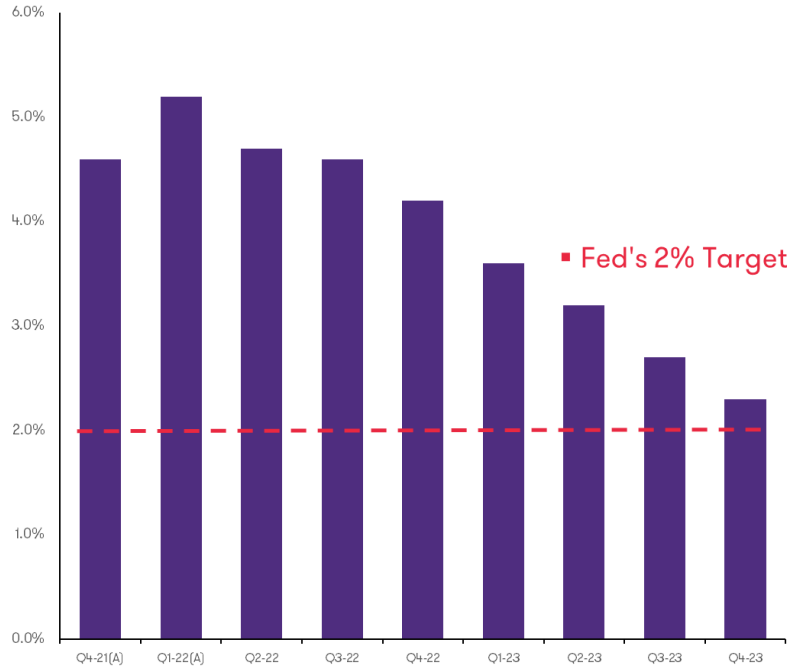


Source: BLS, Grant Thornton LLP

Federal Reserve Behind the Curve

Inflation Stubbornly High

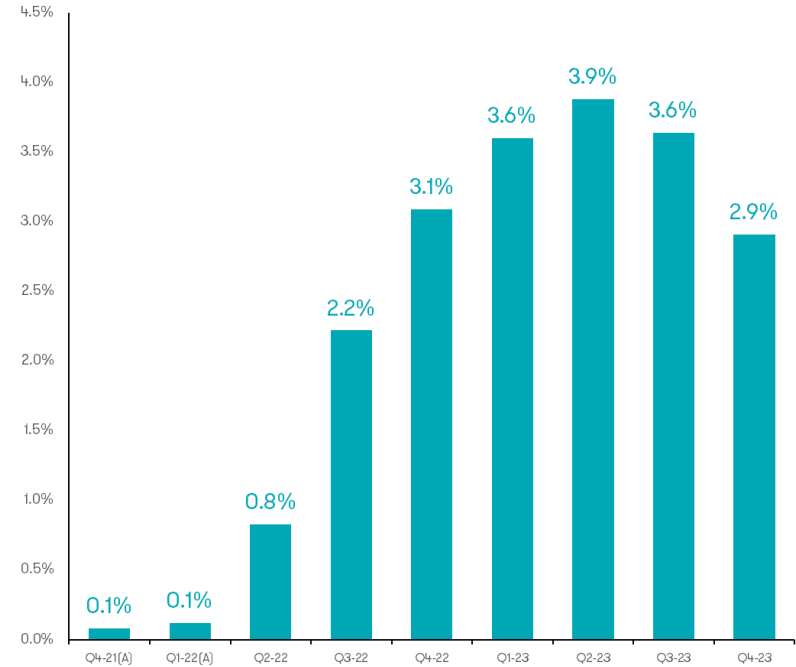
Core PCE Percent Change, 4Q/4Q



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

Gap Between One and Five Year at Record High

Inflation Expectations, Percent

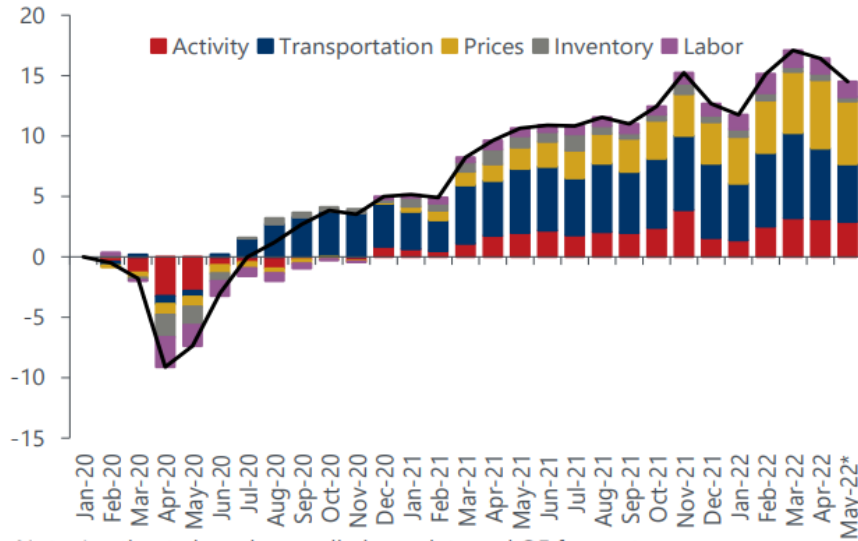


Source: University of Michigan

Supply Chain Disruptions Linger

US: Supply chain stress tracker

Index; > 0 = rising stress



Note: * estimate based on preliminary data and OE forecasts

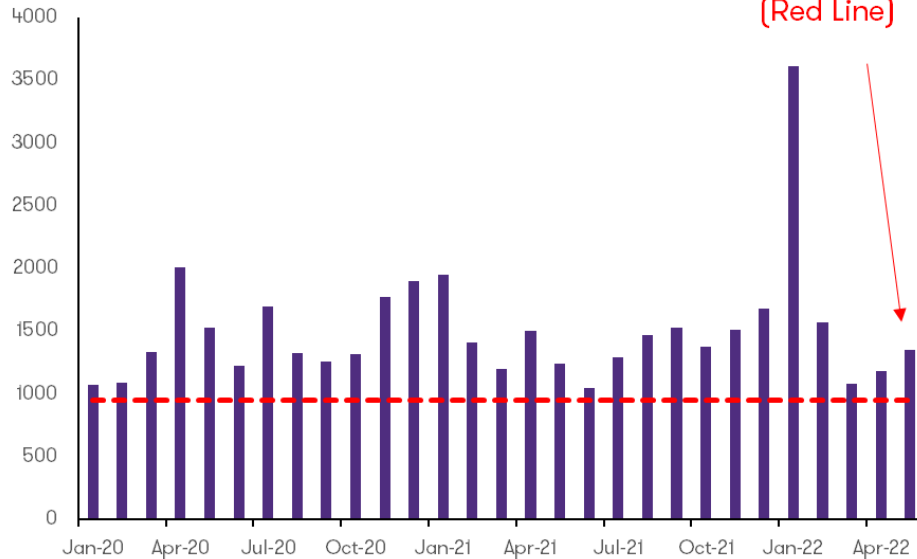
Source: Oxford Economics

- 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

More Sick, More Often

Number Employed but Not At Work due to Illness,
Thousands



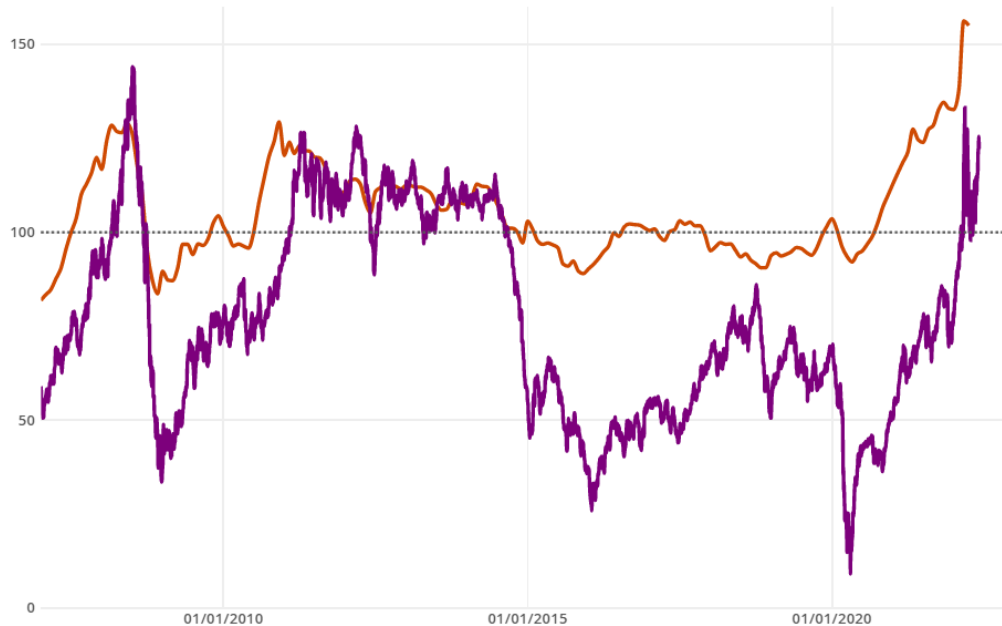
Source: BLS

- 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

Food and energy prices have risen sharply

■ Food price index (2014-2016=100) ■ Brent crude oil (USD/barrel)

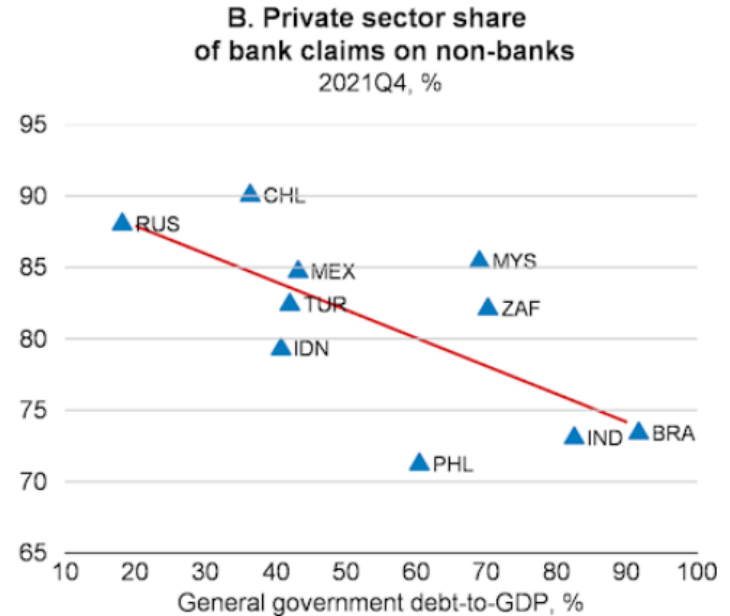
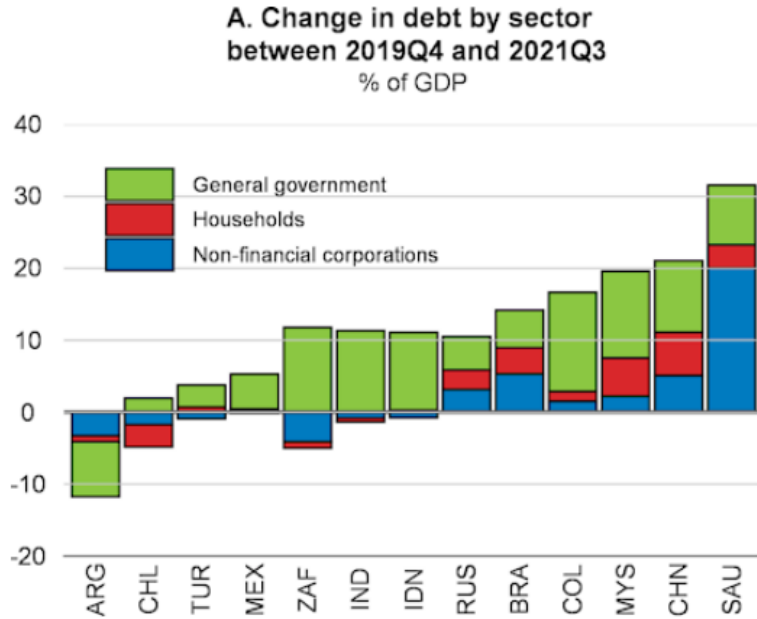


Source: [OECD Economic Outlook \(Edition 2022/1\)](#).

- "...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

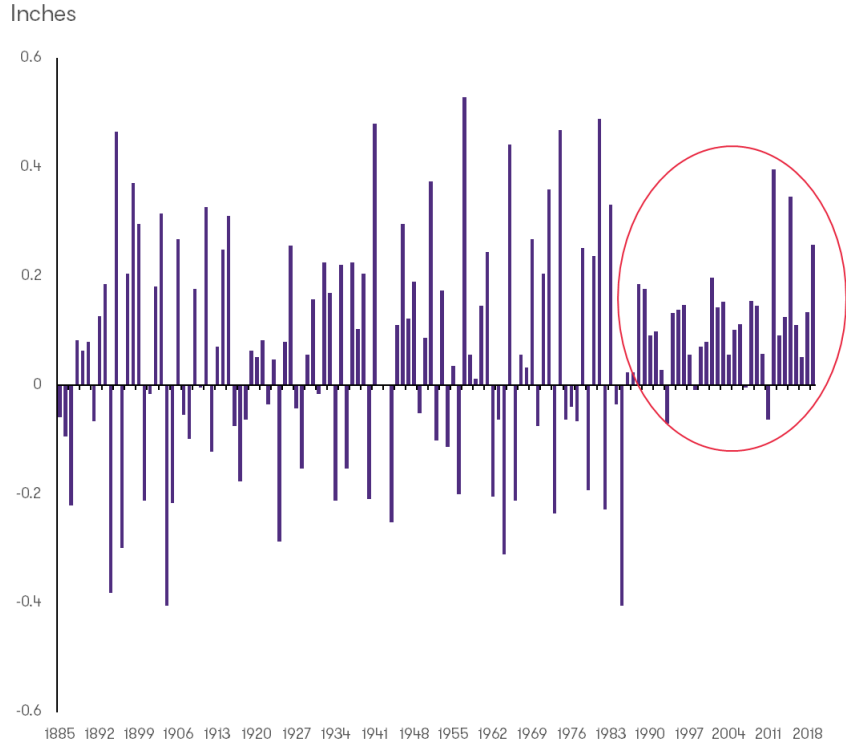
Figure 1.39. **High public debt in emerging-market economies restrains lending to the private sector**



Source: OECD [June 2022 Report](#)

Climate Change

Change in Global Avg. Absolute Sea Levels



Source: US EPA using NOAA and CSIRO data

- 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.
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Thank You

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