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LATEST U.S. ECONOMIC OUTLOOK

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U.S. Economic Outlook Report: **Inflation's Influence on Economic Growth and Stability**

Prevedere Chief Economist, Andrew Duguay, provides a personal view on topical economic issues

Companies are dealing with massive economic disruption. From COVID to supply chain issues and labor shortages, business leaders find themselves in uncharted territory. The big question today is whether the economy has the strength to grow in an environment where inflation is here to stay?

Oil Prices Impact on Inflation

The most commonly quoted number about inflation is the consumer price index from the Bureau of Labor Statistics. In September, the consumer price index was 5.2% year-over-year growth compared to a low of almost 0% during the depth of the pandemic. The only time in recent history that a jump in inflation like this has occurred was a brief moment in 2008 leading up to the great recession. In the coming months, the consumer price index is likely to remain fairly elevated due to a variety of factors, including oil prices.

Oil is a large part of the economy and sudden changes in oil prices can make a big economic impact. For most of the year, oil prices have been steadily within $60-70 per barrel which is good, especially compared to some of the wild price swings in other areas such as lumber, corn, steel, and copper. However, in the last month, that equilibrium broke down and oil has jumped above $70 per barrel to the low eighties where it remained for most of October. This jump in oil prices is notable as oil can be one of the biggest contributing factors to overall inflation. Everything from plastics to construction materials and many household goods starts with oil and its byproducts.

Heading into 2022, the consumer price index is likely to remain high for the next few quarters, particularly as oil prices remain high. Some people may argue that the consumer price index is a skewed number and that this inflation is temporary, but oil prices are a counterargument that suggests otherwise. While supply chain issues may fade away, ongoing high oil prices will have a sustained impact on inflation.

Inflation is Here to Stay

In addition to the consumer price index, there are other ways to measure inflation that adjust for various factors. For example, a significant part of the consumer price index jump in 2021 is used car prices, which have been abnormally high. These other measures of inflation, such as the "Trimmed Mean Rate of Inflation" or the "Core Inflation (excluding food & energy) rate, can help normalize and account for these types of temporary price increases. However, these other "stabilizing" measures of inflation are almost all signaling a sustained rise in inflation as well, as the price gains are now much broader than just a few categories like used cars. If you were to exclude food, shelter, energy, and used cars from the consumer price index, the result is still at a 28-year high. Even if you take a 24-month inflation rate instead of a 12-month inflation rate, as many have suggested to remove the COVID effects, it's still at a 13-year high.

Ultimately, no matter how you look at it, inflation numbers are high across the board. All of this is to say that businesses should be prepared for a sustained inflationary period for the coming months. When planning for 2022, we are advising businesses that it is not unreasonable to create scenario plans for a consumer price index that stays above 5% throughout the year or oil prices up to $100 per barrel.

Inflation and Economic Growth

While inflation may be here to stay, it's important to recognize the potential for economic growth and to understand the dynamic between inflation and economic growth in the coming months. Now that inflation appears to be more long-term, economists have had to upgrade and raise their inflation expectations. Right now, economists are expecting core inflation, excluding food and energy, to be around 3% next year. However, while inflation expectations are growing, GDP forecasts have not been ratcheted down by the same amount, still staying close to 4% expected growth for the year.

There are some historic examples of the economy growing while there is a 5-6% inflation level, but not within the past 20 years. 2022 is shaping up to be one of these rare environments where we see economic growth at the same time as high levels of inflation.

On the other hand, if economic growth doesn't reach 4% next year, it won't be because of inflation alone. Labor availability and supply chain constraints will be bigger limiting factors on economic growth. Without those two factors falling into place, the economy can only grow so much.

Economic Growth Expectations

In previous economic updates, Prevedere has expected a strong holiday shopping season and despite rising oil prices and inflation, we are still expecting a strong holiday season due to consumer savings and desire to spend. Independent research from Deloitte is suggesting that holiday retail sales will increase to about 7-9% compared to 5.8% last year. Early signs from the National Retail Federation also suggest that they are expecting holiday spending conditions to be a very strong 8.5% to 10.5% ahead of 2020.

Overall, there are many pockets of the economy where people have saved up over the last two years and are eager to spend during the holiday season. Many people are worried right now about the availability of goods during the holidays and the supply chain will certainly make headlines, but in reality, there will be stock in stores, even if there is not as much variety as consumers typically expect. The supply chain crisis has not reached the level of completely bare shelves, and we think it is generally safe to dismiss the supply chain as a cause for retail spending to be negatively impacted. Remember March 2020 in the early days of the pandemic, retail sales hit new records while bare shelves made headlines as inventory of toilet paper, cleaning supplies and other household goods fell. Sometimes scarcity drives even more retail spending.

Conclusion

In summary, oil prices are rising and since oil is a key element of the supply chain, it's going to continue to impact prices and inflation in the months ahead. The sustained inflation may be above federal reserve targets, which may accelerate steps to more conservative monetary policies, such as raising interest rates, but this will likely be slow and gradual. Despite all of these negative factors, economic growth is still expected to be strong, at least in the remainder of 2021 and early 2022. There are some constraints on growth such as the supply chain and labor market, but overall this year is likely to finish strong. Ultimately, the consumer is still in a solid financial position with elevated levels of savings versus pre-pandemic trends and the tight labor market has helped sustain wages which should all bode well for the holiday shopping season.

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Almost all businesses have had forecasts and plans adversely impacted by pandemic sourced volatility. Some industries saw unprecedented gains while others saw severe losses.

A 'new norm' is needed for strategic planning and forecasting. Businesses now need to pay very close attention to relevant external influences and to economic and industry signals, especially those that are leading indicators for their current and future business.

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