THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.economicoutlookgroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

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Peer Through the Hubble Telescope and You Might Catch A Fleeting Glance at Inflation.

The argument one increasingly hears these days goes something like this: Prepare for a major outbreak in inflation and for 10 yr. Treasury yields to shoot past 2% this year. The reason: Households and businesses are flush with cash, eager to spend much of it, and now --- thanks to the broad roll out of the vaccine ---will be able to do so. Now add to that the implementation of the massive $1.9 trillion Covid relief package and it quickly becomes apparent all the rocket fuel that is set to ignite the US economy.

The result, of course, is that all this stimulus would rapidly drive up demand, inflame inflation and ratchet up market rates to levels unseen in years. And making matters worse is the appearance of a Federal Reserve that is much too complacent about the coming inflation threat and thus already behind the curve in refusing to tighten monetary policy.

What I've described above is a view that has won many supporters in recent weeks. And the release of several current economic indicators will likely reinforce their expectations.

This morning the BLS reported weekly claims for unemployment insurance just dropped to 684,000, the fewest in a year. Moreover, US GDP was revised up to show a 4.3% growth rate in the fourth quarter, not 4.1%.

Taken all together, is it any wonder that forecasters are saying the US could see growth rates of 6% to 9% in the coming quarters, along with much higher than expected inflation. One analyst summed it up by saying the economy's rebound this year "will take your breath away!"

Frankly, what's taken my breath away is this widening group of economists warning that hyperinflation and painfully high market rates are just around the corner. So let me say that this is view I do not share at all. Fortunately Fed Chairman Jerome Powell and Treasury Secretary Janet Yellen also testified this week that such dangers are extremely remote.

In some sense this growing divergence of views about future GDP, inflation and interest rates is understandable. Historically, when an economy reaches a major inflection point the level of uncertainty and confusion tends to be greatest. So here is our assessment.

First, a new economic cycle has begun in the US, though we don't expect it to reach full throttle until 2022. The current year should be viewed essentially as one of transition. We can celebrate the latest drop in new applications for unemployment benefits, but let's not ignore that in the same report 19 million Americans still rely on some form of unemployment aid, versus 2 million a year ago. As for the upward revision in IVQ GDP, much of the bump up was due to stronger inventory restocking by businesses and better than expected home construction. But consumer spending (PCE), non-residential business investments, as well as inflation for both GDP and the PCE price index were all revised lower.

What do these data points tell us about economic trends in 2021? Actually, not much. Business spending will accelerate later this year, but the maximum benefit of the $1.9 trillion stimulus and its multiplier effects will mostly be felt in the final months of this year and 2022.

Is there any sign, any hint, any evidence the Federal Reserve is falling behind the inflation curve by keeping its benchmark short-term rate near zero? No! Should Powell begin to remove the punch bowl before the party gets too rowdy? Again, no!

The Fed has not relegated the inflation threat. They are simply differentiating between a short-lived burst of inflation triggered by temporary government stimulus, along with the unleashing of private pent-up demand --- from those factors that could produce a systemic upward spiral of inflation due to a structural imbalance in the real or financial economy.

In other words, no one should be terribly surprised to see a temporary jump in prices during the coming months. This is especially the case when viewed on an annual basis. When the pandemic drove the economy off a cliff last spring, it hammered inflation down to zero! So when the BLS measures year-over-year inflation rates, the numbers in the coming months are bound to be disturbingly high. But, again, we have to look beyond these brief spurts.

When does inflation warrant and justify tighter monetary policy? History provides a clear and unambiguous answer. If there is one solid predictor of stubbornly high inflation it is when wages significantly and consistently out pace productivity. Case in point: Back in the late 1970s, it wasn't so much the six-fold increase in oil prices that fired up consumer prices. It was the wage and price spiral that followed plus a

Federal Reserve that was under political pressure at the time to keep monetary policy highly accommodative.

In the absence of accelerating wages, inflation cannot thrive. This is especially the case today in an era of technology-driven productivity, eCommerce, globalization, changing demographics and a decline in union membership.

All you need to do is look at the two years prior to the outbreak of Covid-19. US unemployment rate stood in the 3.5% range, lowest in more than half a century. There was such an acute shortage of jobless Americans that companies fiercely competed for the few unemployed, even grabbing up those who never completed high school. And yet, even under those conditions of extremely tight labor markets, inflation remained mute because wage growth held steady.
And the threat of rampant inflation is even less today. Labor markets are far from tight. Covid-19 has still left 9.5 million Americans out of work and the number of job openings today is far smaller than that. Employers therefore have a much larger pool of workers to choose from, thereby diminishing the risk of wage inflation.

So let's be clear. For a short time aggregate demand is expected to exceed the economy's productive capacity. Our estimate is that this imbalance will last for perhaps for two to three quarters and we could well see inflation pressures pick up during that period. But after that, we expect to see a pull back in demand (once all that pent-up spending has been satisfied) ---- and, simultaneously, the nation's output of goods and services should revert back to its pre-pandemic level.

Lastly, the strength of the US dollar will also help suppress inflation pressures. It appreciated 3% so far this year and odds are the dollar will retain its clout in FX markets and dampen import inflation. Foreign investors will continue to flock to the US because they see America's economic prospects looking brighter than most other major countries. A second factor is that interest rate differentials favor the US in both nominal and inflation-adjusted terms. These trends will continue to attract more direct and indirect foreign investments to US shores.

Treasury yields:

A week ago, the benchmark 10-year Treasury yield reached 1.75%, a 14-month high. We argued that same week that this sell off will not continue and drive yields to 2%, but instead settle into a new equilibrium and hover between 1.4% and 1.7% in 2021.

Those who foresee much higher yields point to how the US dramatically increased debt issuance last year to finance its stimulus programs, and that another $4 trillion in new borrowings are on tap for in 2021. Normally, such massive numbers and a budget deficit approaching 16% of US GDP would frighten away domestic and foreign investors from fixed incomes and the dollar.

But these are clearly not normal times. The dollar has held up despite all the red ink. Consumers may have a boatload of savings stashed away, but they are still anxious about future job and income security. Companies possess the resources to speed up hiring and expand operations, yet they are not quite sure what to make of

this business cycle. The only certainty at this moment is this: the health of the economy in 2021 will hinge solely on how well the vaccinations at protecting Americans from Covid-19 and its multiple variants. On that score the US is so far done much better than most countries.

Looking ahead we see demand for US debt continue to keep pace with the increase in auction sizes. For example, the result of yesterday's 5-year Treasury debt issuance was well received, with a bid-to-cover ratio at 2.36, compared to 2.24 when this paper was previously sold. We expect to see similar interest in the sale of the 7 yr. note today.

Again, this has largely to do with advantage the US has in offering higher returns in fixed incomes relative to other industrial countries. There is also greater confidence the dollar will not suffer a major retreat since the US economy will outperform those of Europe, Japan and the UK this year and next.

But the key lesson here is not to be overly alarmed by the upcoming bounce in both aggregate demand and inflation. Our forecast holds that GDP will rise by 5.1% this year and 5.3% in 2022, before settling back to 3% in 2023. During this time, inflation (CPI) will fluctuate within the 2% to 2.8% range and 10-yr. Treasury yields gradually rising to 2.4% by 2023.

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United States

	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023
Real Gross Domestic Product (GDP):																
%	-5.0	--31.4	33.4	4.3	4.2	5.1	5.3	6.1	3.1	6.2	5.5	4.8	2.8	3.8	3.1	2.9
Personal Consumption Expenditures:																
PCE %	-6.9	-33.2	41.0	2.3	4.4	5.2	4.7	6.0	2.4	5.2	4.1	3.9	4.0	4.1	2.8	3.5
Inflation, end of period, year-over-year:																
CPI %	1.5	0.6	1.4	1.4	1.5	2.0	2.5	2.7	2.5	2.5	2.3	2.2	2.5	2.6	2.6	2.7
Unemployment Rate (end of period):																
%	4.4	11.1	7.8	6.7	6.2	6.0	5.9	5.8	5.8	5.8	5.6	5.4	5.4	4.9	4.4	4.1
Non-farm Payrolls, monthly avg. thousand:																
	-303	-4,427	1,322	283	322	385	370	380	270	285	265	240	185	225	235	250
Treasury 10-yr Note Yield % (end of period):																
	0.63	0.65	0.68	0.91	1.47	1.51	1.60	1.70	1.82	2.05	2.00	1.94	1.90	2.05	2.00	2.10
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.88	1.13

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.1	5.3	3.1
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.8	3.3	2.5	2.0
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.9	4.4	4.6	3.1
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	2.2	0.3	0.7	-4.8	2.4	2.8	2.2
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.1	5.4	3.4	2.9
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-8.2	9.1	6.4	5.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.9	5.7	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.1	2.9	2.7	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.3	3.3	2.8	2.7
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	2.5	3.0	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-3.1	2.4	3.3	2.0
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.9	-4.2	4.4	4.2	3.9

Economic & Geopolitical Probabilities for 2021 & 2022

- Projections made: March 22, 2021

PROBABILITY	U.S.
HIGH	Congress to pass smaller $1.5 trillion infrastructure plan late 2021; includes tax increases & resurrects earmarks.
Moderate	Covid-19 vaccinations will not reach 75% of US population before 4th quarter 2021.
HIGH	The fiscal stimulus, vaccinations and consumer spending to produce a "temporary pop" in inflation in 2021.
HIGH	Treasury 10-yr. yields to hover between 1.3% to 1.7% in 2021; inflation returns to 1.5% to 2.0% range by 2022.
HIGH	The Fed will gradually scale back asset purchases in IVQ 2021 as new economic cycle takes hold.
Moderate	Bottlenecks in US supply chains should begin to clear in second half of 2021.
	FOREIGN
HIGH	China tests Pres. Biden's mettle: Beijing will ratchet up tensions over SCS, Hong Kong and Taiwan.
HIGH	Pres. Biden orders larger US naval presence in SCS to support allies and defend International Law of the Sea.
HIGH	Pres. Biden beefs up sanctions against Russia for its cyberattacks, extrajudicial killings and Nord Stream 2.
Moderate	A cyber World War escalates and may disrupt global financial networks and power grids.
HIGH	Iran acquires enough fissile material for nuclear weapon. Tensions surge as Israel readies a preemptive strike.
Moderate	Europe's economic recovery delayed as more virulent Covid strains spread and confidence in vaccinations erodes.
HIGH	Biden to reset trade relations with Europe, but is in no rush to reverse tariffs placed on Chinese imports.

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