THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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The US Economy in 2022 – 2024: A Return to Normalcy or Stagnation?

- Economic projections
- Consumer spending
- Implications for wages
- Inflation outlook
- Supply chain
- Profit margins
- Federal Reserve
- Business investments
- Energy prices

We enter 2022 with a disquieting mix of relief and a tint of foreboding.

The relief comes from medical experts who now say the Omicron variant, while highly contagious, may not be as virulent as first feared. Even people who are infected are far less likely to need hospitalization so long as they have been fully vaccinated. So let's at least take some solace in that.

But even that hopeful sign can't offset the growling agita that stems from uncertainty about where this economy is headed next.

Among the many moving parts that will compete to shape its path this new year are (1) the possible emergence of new Covid strains, (2) the struggle to undo supply chain knots, (3) more battles over the $1.75 trillion Build Back Better plan, (4) status of the Child Care Tax Credit, (5) on-going labor shortages, (6) stubbornly high inflation, (7) the transition to tighter monetary policy and (8) the potential fallout from a politically ferocious midterm election.

Oh, and if that's not enough to ruminate over, I could have also tossed into this gallimaufry rising trade tensions with China, the "red line" threats over Taiwan and the South China Sea, Russia's eagerness to devour Ukraine, and the menacing prospect of Iran becoming the newest nuclear military power.

But then why spoil the festive air of a brand New Year by adding all these foreign perils.

Rarely in economic history --- no, let's not fudge it this time --- never before in modern economic history have we faced such a dense fog of uncertainty about how the economy will perform the next 12 to 24 months. Indeed, given this miasmic backdrop, you have to wonder how it is even possible that *any* mathematically-driven economic model can possibly have a better chance at divining the future than a playful 8-ball with its freely floating revelations.

The most pointless truism heard last year was that "if you change the course of the Covid-19 virus, you change the course of the economy." Can't argue with that. The problem, of course, is we still have no clue how to shut down this dangerous microorganism. There's no silver bullet out there, and if you listen to the experts there is none on the visible horizon. (What's that again about man having dominion over the animal kingdom?)

What is known is that the Covid virus keeps changing the game every few months as it hunts for unvaccinated hosts anywhere in the world in order to thrive another day. What this highlight is the absolute urgency to vastly increase global vaccinations. And this is not just a moral imperative. It's an economic imperative. The global economy cannot fully recover until we get past this grueling health crisis.

Fortunately, most Americans have by now received multiple vaccinations to beef up their protection against the Delta and Omicron variants. Given the CDC's latest tracking, it is reasonable to project by the end of March, nearly 90% of the US "consumer population" (i.e., 12 years and older) will have received at least one dose, with more than 75% fully vaccinated (plus a significant proportion of those also getting boosters).

The economic implications are clear: The more comfortable people feel this year about venturing out to travel, spend and eat, the sooner we can return to a more normal business cycle.

Economic projections:

Let's begin with the broad macroeconomic backdrop. Like it or not, Covid has forced the future to come early. It has pushed many businesses and employees to jettison old practices and experiment with new ones, fundamentally changing the economic landscape in the process. The relevance to economists should be obvious. We have to incorporate a much more flexible and holistic approach to forecasting and steer clear of the rigid thinking that often comes with conventional economic theories.

With that in mind, let's dive in. Spearheading the economy's forward momentum this year will be two primary forces: healthy consumer spending and a major increase in business capital investments.

• Consumer spending:

Americans went through a roller coaster of emotions last year. But they entered 2022 with some documented optimism. The latest batch of confidence surveys (Conference Board and the University of Michigan), show consumers are turning more optimistic. Jobs are plentiful and those surveyed also believe inflation will crest later this year.

The fact that jobs are so plentiful should be a brassy reminder of how experts have misread the dynamics in the labor market the past several years. The conventional thinking had been that robotics, automation and AI would be job killers. Yet the precise opposite is happening. One of societies toughest challenges is to address the historic chasm between the job openings (November's was 10.6 million) and the number of unemployed seeking work (6.9 million that same month). Rather than obliterate jobs, the new technologies have helped spawn more positions than companies can fill. Complicating matters is the persistent mismatch in skills these new posts require.

The consumer: No economic recovery is possible without them.

Household spending: Expect weak start to 2022, but will rebound from 2Q onward.

2021: Final Snapshot

--- Lingering concerns about the "twindemic" (Delta/Omicron variants and flu).

--- Inflation (CPI - Nov.) leaped to 6.8% from year-ago, highest in 39 yrs!

--- Real wages takes a hit. Average hourly earnings less inflation = -1.9% (YOY). Consumers now digging into savings. Personal savings rate has fallen to 6.9% in Nov 2021., lowest in four years! (It was 26.6% just eight months ago!)

2022: Brighter Outlook Ahead:

- Two major consumer confidence surveys rose in December. Why? Jobs are plentiful and belief inflation will crest in 2022.
- Inflation to peak in 1H 2022. Reasons: (1) Economic growth will moderate. (2) Supply chains knots should loosen. (3) More people enter the workforce. (4) Companies find it more difficult to pass on higher costs. (Fear of losing market share.)
- Covid-19 infections slows after winter. Omicron threat recedes.
  --- By March 2022, 88% (currently 84%) of "*consumer population*" seen having one dose --- and 75% (71%) fully vaccinated
- RECORD US job openings (10.6 million) outpaces unemployed (6.9 million). Companies are in a fierce battle to hire top talent
- Expect the Federal Reserve to *gently* flick up short term rates this year. Forecast is one or two (25 bp each) hikes in 2022.

Sources: BLS; BEA; Conference Board; Univ. of Michigan; CDC; The Economic Outlook Group (forecasts)

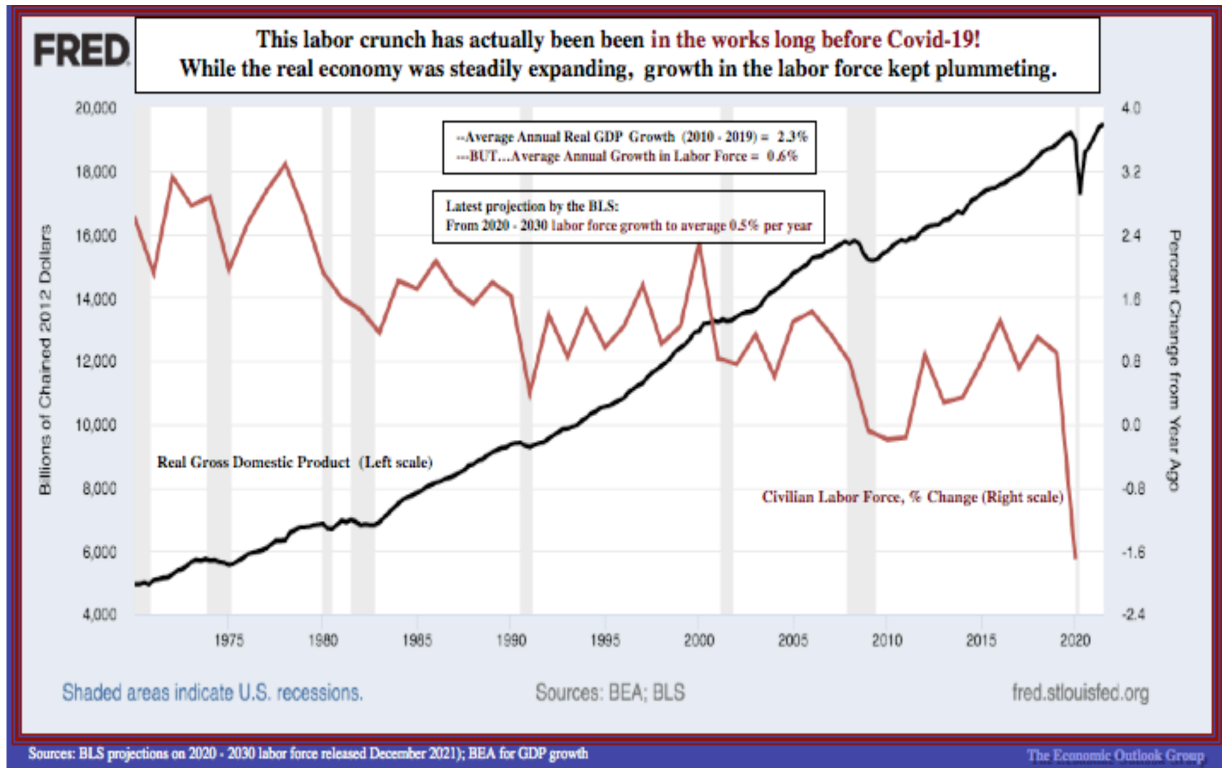
The Economic Outlook Group

Nor is this labor crunch anything really new. It has been in the works long before the onset of Covid. Case in point: In the last decade (2010 – 2019), real GDP has grown an average of 2.3% a year, while growth in the labor force managed to limp along at 0.6% per year. And that sleepy trend is set to be repeated if there is no change in policy. The BLS just projected that over the next 10 years the labor force will increase by an even skimpier 0.5% per annum. What's behind these weak long term trends? Severe restrictions on immigration into this country and decades of historic low birth rates are mostly to blame.

The pandemic has greatly aggravated this scarcity of workers. About 1.7 million more people chose to retire because of Covid, according to the Census Bureau. Caregivers with young unvaccinated children also found it difficult to return to work. Many pre-schools remain closed or have delayed openings. As many as one in three workers who lost jobs during the pandemic refused to even return to their old jobs, notes the

Federal Reserve Bank of Dallas. Some sought to take classes, either in person or via online courses, and learn new skills that would lead to more lucrative positions.

Others chose this opportunity to go out on their own and become entrepreneurs. According to Census data, new business formations surged nearly 60% in 2020 over the average of the previous 15 years, and 2021 was on track to do the same. For corporate HR departments, the top priority right now is to at least stop the internal bleeding of payrolls among their own colleagues.



• What are the implications for wage growth in 2022?

First, we expect the current gap between job openings and the number of unemployed to narrow over the year. How so? As the threat of Omicron recedes and with more people being fully vaccinated, those who have been on the sidelines and out of work should feel more at ease returning to an office. Second, fiscal policy will turn more restrictive this year. There are no plans for another round of emergency pandemic checks to households. Third, inflation has taken a punishing toll on each paycheck. The subsequent loss of purchasing power has forced consumers to shovel into savings to finance their shopping. As a result the personal savings rate fell in November to 6.9%, the lowest in four years! It was 26.6% just eight months ago.

As more individuals head back into job market, it will lift the labor force participation rate closer toward its February 2020 level of 63.3%, steps that should help mitigate wage pressures. Certainly no one should expect to see a precipitous fall in pay this year or next. We expect wages will be exceptionally sticky on the downside and that could spell trouble for corporate profit margins, since inflation (i.e., pricing power) is likely to drop faster than labor costs this year and next. (More on the inflation outlook below.)

Given the fiscal drag and inflation's corrosive effect on consumer purchasing power, real personal consumer expenditures is set to climb 3.4% in 2022, 2.5% in 2023 and 2.8% in 2024. The unemployment rate is projected to fall to 3.8% by the fourth quarter (2022), and 3.5% by the end of 2023.

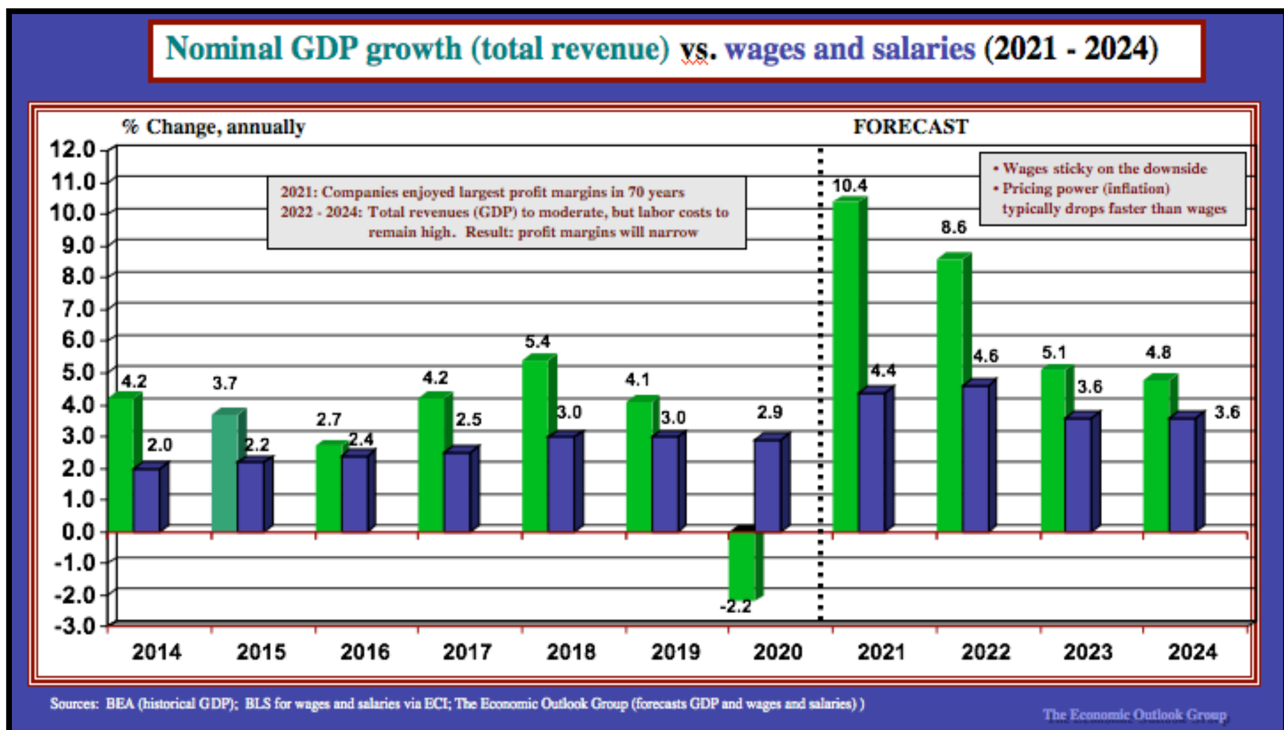
• Inflation to peak in 1Q 2022.

Inflation has clearly been on the minds of shoppers in 2021 and these concerns will flow into the early months of 2022. But we see consumer price inflation topping out at 7% in the first half, and then slide down to less than half that by the end of 2022. A 2% handle on the CPI is not expected until 2023.

Several factors should help to lasso in prices in the coming months:

(1) Progress in untangling the supply chain.

There are some glimmers of hope here. The nation's major ports are now processing nearly 20% more container volume than they did in 2019. Manufacturers are also reporting faster delivery times. In the latest (December) survey by ISM, supplier delivery times for manufacturers continue to improve and this has allowed the pricing index for goods to fall to its lowest level in more than a year. Foreign goods are now entering the US in record amounts. Imports jumped to $252 billion in November, fueled by sharp increases in industrial supplies, autos, consumer goods and food. Many of these items are finding their way to retailers more quickly. The latest read on retail inventories underscored this trend with a 2% increase in November.



But here's the rub for sellers. Many of these products were ordered last summer and early fall in preparation of the 2021 holiday shopping season. The subsequent delays in arrivals mean these products are being delivered just as consumers are winding down spending. Thus stock rooms in the first half of 2022 could fill up at a pace faster than sales. Both retailers and wholesalers now shudder at the prospect of unloading excess inventory through price discounts. Buying high and selling low was not part of the plan. But at least it's deflationary for consumers.

(2) Profit margins to compress in 2022

Profits margins reached record levels last year as the craving for goods violently collided with scarce supplies. Venders who were in a position to satisfy orders took full advantage to follow though on their newfound pricing power.

But as supply chain logistics improve and more goods flow through the economy, pricing dynamics will change. Factories have already moved to ramp up production. Manufacturing output in November climbed to its highest level since early 2019. Production at auto plants (remember, many had to be shut down last year due to shortages of semiconductor chips and other electronics) has now been scaled up. As stockrooms and backlots fill up with goods this year, market forces should take over and spur competitive pricing.

The result: Inflation's vertical take off last year cannot be sustained in 2022. Consumers and corporate purchasing managers will enjoy more options to seek out less expensive alternatives --- and that will further dampen inflation pressures. Any fanciful notion by sellers that they can keep passing those expenses on to clients in 2022 could face a brutal loss in market share.

We expect companies will make the hard choice to accept thinner margins this year in order to protect their customer base. They know well that once you lose market share, it is hellishly difficult and costly to win those buyers back.

• Federal Reserve's response to higher inflation:

We also begin the New Year with the hottest inflation rate in nearly 40 years and a Federal Reserve now prepared to cool some of that heat. It's a given they will terminate quantitative easing by March. But what happens after that?

Numerous respected money managers and economists implored the Fed last year to immediately begin raising rates. They feared policymakers were falling far behind inflation curve. Since the Fed didn't act in 2021, inflation hawks are now yowling for more aggressive action this year and next, with some insisting on no less than four hikes each year.

That is not our position. If history is any guide, such a steep escalation in the cost of borrowing often comes with a familiar epilogue ---recession.

While we expect the Fed will end its zero-bound fed funds policy this year, just how they proceed is critical. If inflation is trending down this year, which is our forecast,

then the Fed has several options. One approach is to first monitor the shape of yield curve now that QE is to end in March. With the Fed's absence as a major buyer in

the bond market, the price on the 10 yr note may drop and cause yields to edge higher. Given this note's crucial role as a benchmark to the cost of capital, rising yields could itself dampen economic activity enough to obviate the need for multiple rate hikes in 2022.

In the event the 10 yr yield barely budges even after QE is terminated, the Fed has another option, which is announce it would begin to slowly run off its $8.7 trillion balance sheet. A reduction in the balance sheet that focuses on unloading longer dated issues should steepen the yield curve and act as a gentle brake on excess spending and borrowing. The goal here is not to lock fed funds near zero, but to provide Fed policymakers with more options on how to proceed when raising short-term rates.

The real danger for the economy is if the Fed rapidly jacks up rates multiple times this year when market forces are already at work to bring down inflation. Such a situation could easily result in a sharply inverted yield curve and that is typically the death knell of a business cycle.

Given Fed chairman Powell's cautious approach to monetary policy and his preference for optionality, we expect to see no more than two 25 basis point increases this year and a maximum of three hikes in 2023 as the post-pandemic economy stabilizes and the Fed achieves its dual objectives of maximum employment and price stability.

• Business investments:

If there is one sector of the economy that has been largely absent in contributing to growth and productivity, it is capital spending---especially in amounts that exceed depreciation. The category of core business capital investments, specifically new orders ---ex defense and transportation – has been flat lining for years. One major reason for that is that large companies have chosen to funnel corporate profits to finance stock buybacks and boost dividends, rather than plow those funds back into their operations.

Now let me be clear. There's nothing wrong with rewarding shareholders for the risks they take. The problem is many of these firms failed to properly address the future needs of modernizing, upgrading, and streamlining their production so they can remain price competitive over the long term. The assumption prior to the pandemic was that if a firm needed to increase output, all they had to do was hire more people. There was an abundance of cheap labor after the 2008 – 2009 recession, while investing in capital was more costly.

The pandemic has reversed those costs. New orders for core capital goods (i.e., outside of defense and aircraft) have taken off the last 10 months, and we see this trend continuing through at least 2023.

Here are some of the reasons for this ramp up in new capital outlays:

- **Labor is getting expensive, while cost of capital remains relatively cheap**

• A desire to raise total factor productivity, since that allows businesses to both pay higher wages and enjoy healthy profits.

• Carry out plans that would allow for greater reliability, flexibility and control of supply chains.

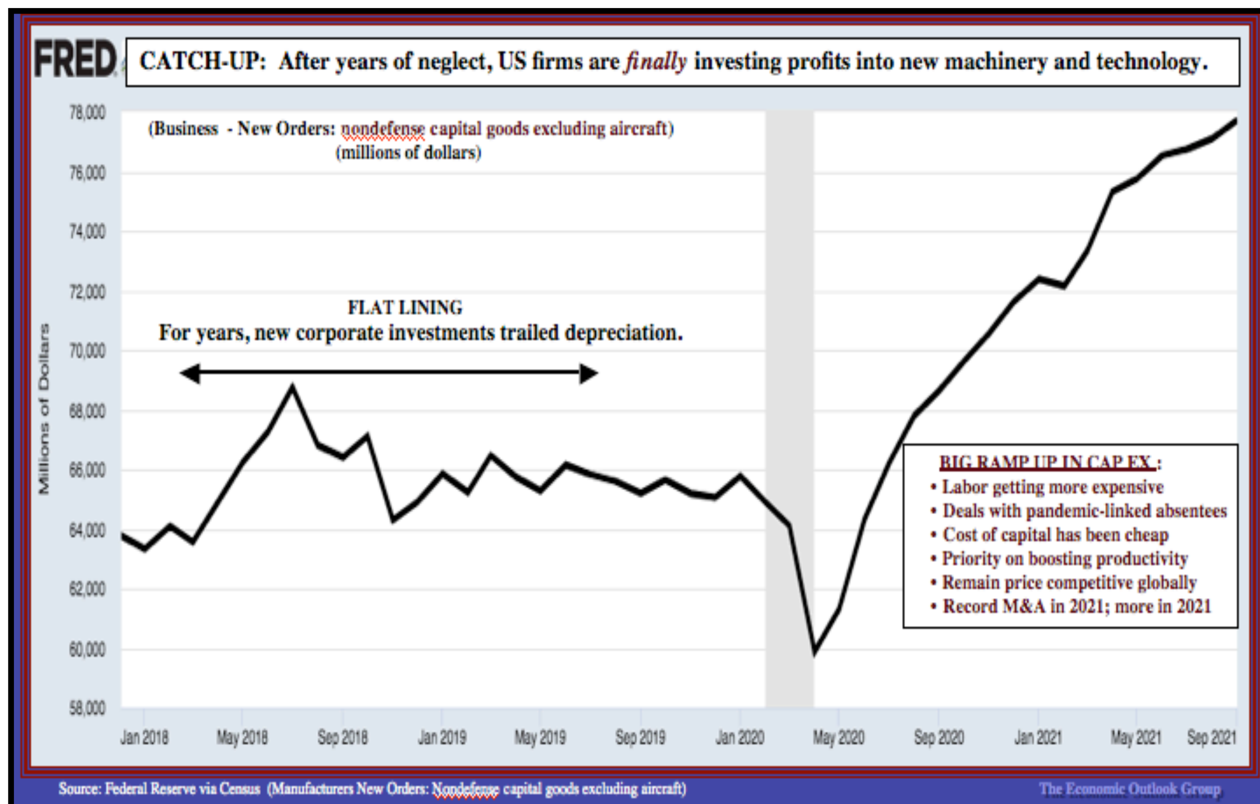
• Relocate foreign plants and factories to North America. The ongoing global supply chain seizure has made a mockery of just in time inventory, especially for US importers who are excessively dependent on shipments from Asia.

• Increase vertical integration by acquiring outside producers that supply essential material and goods needed to keep production lines going.

Our forecast calls for real non-residential fixed investments to increase 7.5% in 2022, 6.0% in 2023 and 4.8% in 2024.

Residential investments, however, will remain problematic because of the high cost and availability of construction supplies and labor. The situation has deteriorated so much that the current backlog of single-family homes authorized for construction but not yet started is the highest since 2006.

Thus spending on residential construction this year will inch up 1.6% this year, 0.6% in 2023 and 3.8% in 2024.



- **Energy prices. How realistic are predictions of oil prices reaching triple-digits?**

Here we will take the liberty of slightly adding to Peter Drucker's famous observation:

Forecasting oil prices is not a respectable human activity. (We inserted "oil prices" to Drucker's original quote.)

Drucker's theme is appropriate here because the price of crude is being buffeted by cyclonic forces that include rising geopolitical tensions, OPEC Plus polices, further reliance on renewables, fresh interest in shale oil, and the frequency of extreme weather patterns. In short, pegging the price of energy 6 or 12 months from now is tantamount to throwing darts at a numbers board.

Nevertheless, as risible as predictions of oil prices can be, $100 a bbl. still has a feel of improbability.

First of all, while there has been little price elasticity of demand for gasoline in the past, this may no longer be the case. Americans have options now. If forced to pay $5 or $6 or more for a gallon, it would be one more incentive these days to stop commuting to the office by car and instead work remotely as they have since 2020. Secondly, sales of electric vehicles and hybrids have surged in recent years. Plug in vehicles alone hit a record 5.6% share of the automotive markets last September, according to Atlas EV Hub. And that figure will increase exponentially if oil and gasoline prices keep climbing. Third, with crude firmly in the $70 and $80 range, it sits at a price point that is at least $30 bbl. above break even for producers in the Permian and Eagle Ford Basins, and data shows they are not planning to pass up such margins. The Baker Hughes rig count jumped to 586 in the US at the end 2021, a 67% increase over the past 12 months.

Moreover, OPEC Plus will continue with its plan to boost output by 400,000 barrels per day each month. There have been credible reports the 23-member group led by Saudi Arabia and Russia are seeking to keep the target price at $75 bbl. in 2022, but are prepared to accept a range of $65 to $80 during the year. Of course, by keeping prices so elevated, they are also hastening new investments into shale and renewables.

Our forecast is for oil prices to trend lower with WTI spot to average $62 this year and $54 in 2023.

Natural gas will also come down from its highs of 2021, with the spot price at Henry Hub averaging this year at $3.75 per million British thermal units (MMBtu) in the US. Of course the natural gas situation in Europe remains far more dire. But there is a flotilla of US LNG tankers on the way to help alleviate the Continent's acute energy shortage. Additional sales from the US and the likelihood the Nord Stream 2 pipeline will get regulatory approval from Germany by next winter should bring prices down from a recent peak of $60 MMBtu to between $10 - $20 MMBtu this year.

• **GDP Forecast:**

Wrapping it all up, our GDP forecast calls for the economy to grow 3.3% in real terms this year, 2.4% in 2023 and 2.5% in 2024. The risk of recession the next three years is less than 25%. After more two years since this pandemic made headlines and derailed our lives, we expect to see consumers and business leaders show new resolve to return to normalcy in 2022.

Conclusion:

Looking ahead, the primary risk to these forecasts remains the pandemic. The global medical emergency is far from over. Indeed, there is a growing belief Covid-19 is on the cusp of metamorphosing into an endemic. It will return in some form one or two times every year and complicate our lives again --- that is, until a universal coronavirus vaccine is developed that will protect against multiple mutations. Meanwhile we expect consumers, business leaders, and government policymakers to forge ahead with new ideas and strategies as they adjust to this lingering exogenous shock. One profound by product of these changes is that the US and international community could, in the process, be re-writing an entirely new set of economic rules. That is what will make economic forecasting from this point on so challenging, hazardous and exciting.

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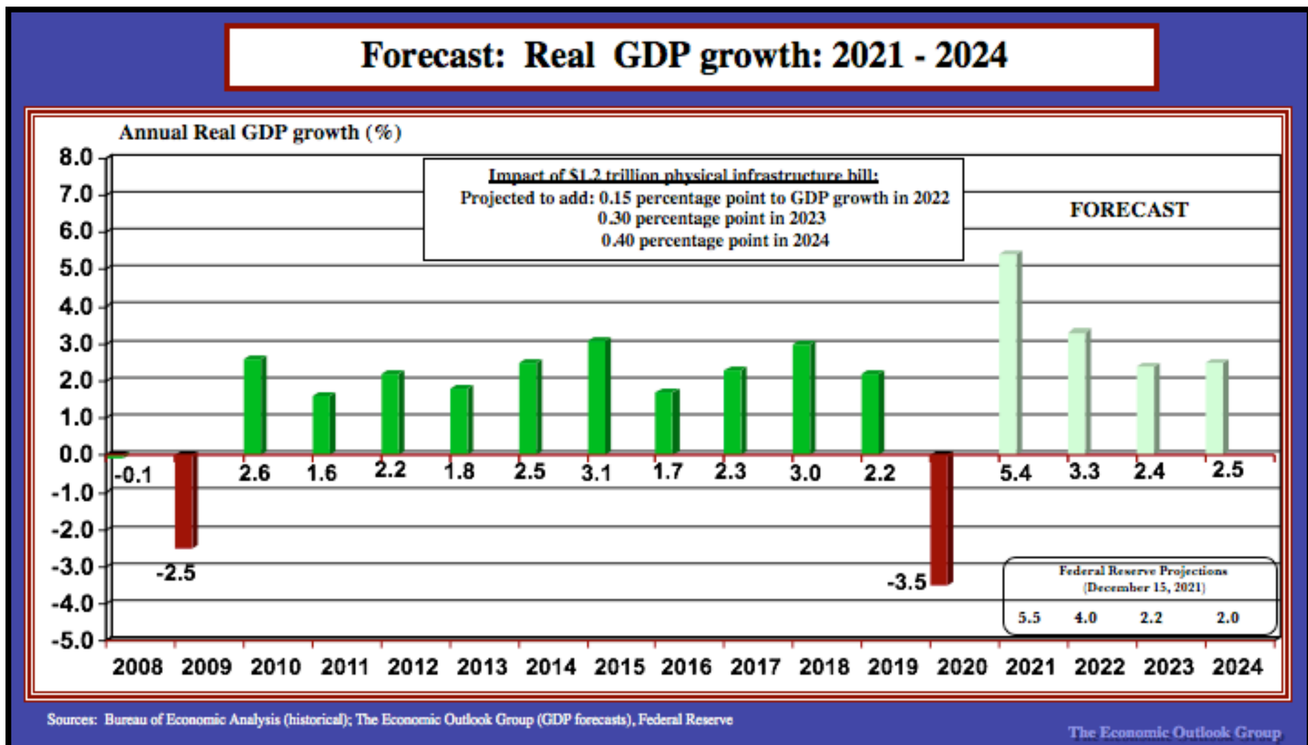

United States

	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023	I 2024	II 2024	III 2024	IV 2024
Real Gross Domestic Product (GDP):																
%	6.3	6.7	2.3	6.2	2.2	3.6	4.1	3.3	1.8	2.7	2.5	2.6	2.2	2.7	3.0	2.2
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	6.8	2.4	4.2	3.7	2.9	1.5	2.9	2.8	2.7	2.0	2.7	2.5	2.8
Inflation, end of period, year-over-year:																
CPI %	2.6	5.3	5.4	6.9	6.8	6.1	5.5	3.8	3.3	2.8	2.6	2.3	2.2	2.3	2.3	2.4
Unemployment Rate (end of period):																
%	6.0	5.9	4.8	4.1	4.1	4.2	3.9	3.8	3.9	3.7	3.6	3.5	3.7	3.6	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	465	455	625	665	640	385	510	495	410	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	1.60	1.65	1.75	2.05	2.10	2.10	2.26	2.35	2.35	2.45	2.53	2.45
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63	1.63	1.63	1.88	1.88

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.4	3.3	2.4	2.5
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.7	4.9	3.9	2.4	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	5.7	4.6	2.5	2.0
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.5	2.0	2.8	2.2	1.4
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.3	5.0	4.2	2.7	2.2
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-7.5	7.8	7.0	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	6.6	5.9	5.6	5.1
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.4	4.4	2.3	3.3	2.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.4	5.9	2.9	2.7	2.4
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.3	3.1	2.6	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-2.9	4.1	2.9	2.4	2.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	–3.4	5.4	4.8	3.6	3.2

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019	End 2020	End 2021	End 2022	End 2023	End 2024
USD/Yen	91	93	81	77	87	105	119	120	117	113	110	109	104	115	116	110	108
Euro/USD	1.40	1.43	1.34	1.29	1.32	1.37	1.21	1.09	1.05	1.20	1.14	1.12	1.23	1.17	1.11	1.19	1.22

Oil (Brent spot) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013	End 2014	End 2015	End 2016	End 2017	End 2018	End 2019	End 2020	End 2021	End 2022	End 2023	End 2024
Crude oil per barrel	46	78	95	107	111	111	58	38	49	67	54	67	52	78	69	66	65
Gasoline	1.61	2.57	3.00	3.27	3.30	3.32	2.26	2.00	2.31	2.47	2.26	2.58	2.25	2.29	2.24	2.20	2.20

Key Economic & Geopolitical Projections for 2021 & 2022

- Latest revision: December 27, 2021

PROBABILITY	U.S.
HIGH	Odds of recession from 2022 thru 2024 are about 20%, absent any major geopolitical shocks.
Moderate	Federal Reserve begins to raise short term rates in 2Q 2022. Expect two 25 basis point increases for the year.
HIGH	CPI inflation drops to 3% range late 2022 as supply chains improve, wages stabilize and WTI oil slips to mid $60s bbl.
Moderate	Treasury 10-yr. yields to hover between 1.60% to 2.10% in 2022, and peaks at 2.55% in 2024.
HIGH	Covid-19 becomes an endemic. Low vaccination rates in Africa & parts of Asia remain breeding grounds for new variants.
Moderate	Congress to pass a more modest ($1.5 trillion) "Build, Back Better" plan by 1Q 2022, with modest changes in tax rates.
	FOREIGN
HIGH	China's economy to sharply decelerate due to shakeout in property market, broad deleveraging & fresh Covid outbreaks.
HIGH	Beijing fortifies naval presence in SCS and ramps up threats against Taiwan.
HIGH	Biden orders greater US naval presence in SCS to defend International Law of the Sea and support regional allies.
Moderate	US - Russian tensions approach cold war levels as Moscow destabilizes Ukraine and other eastern European nations.
HIGH	A cyber World War is underway; likely to result in periodic disruptions to global financial networks and power grids.
HIGH	Iran secretly moves ahead to produce enough fissile material for a nuclear weapon. Israel readies pre-emptive action.
Moderate	Economies of US & Europe to steadily improve in 2022, but recoveries in Africa & Latin America to lag behind 1 - 2 years.

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