ECONOMIC OUTLOOK
REGIONS
September 2021

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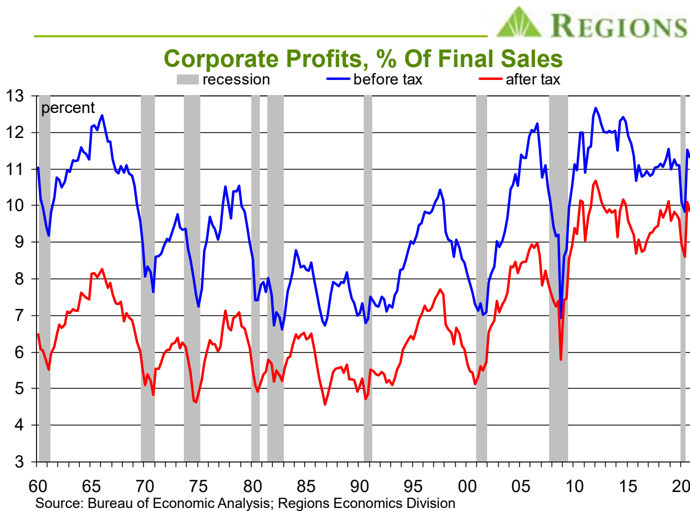
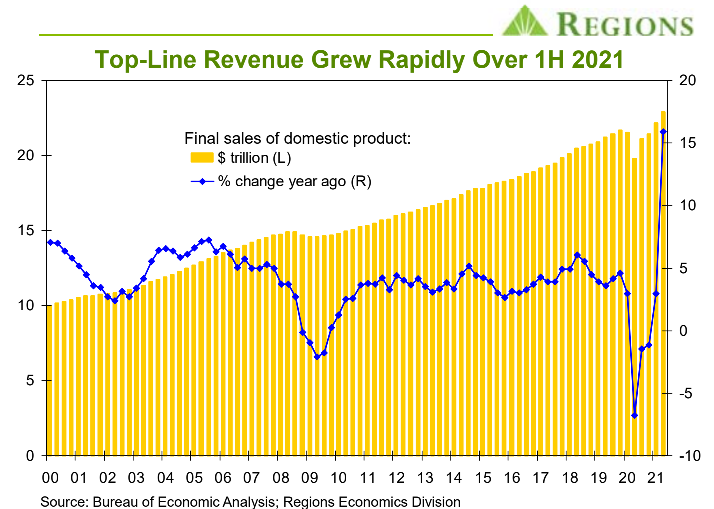
Businesses Exercise Pricing Power To Offset Higher Costs

The second estimate from the Bureau of Economic Analysis (BEA) put Q2 2021 real GDP growth at 6.6 percent, slightly faster than the initial estimate of 6.5 percent. In conjunction with the release of the revised GDP data, the BEA published their initial estimate of Q2 corporate profits. Prior to the release of the data, one would have been excused for thinking that sharply higher costs for inputs, shipping, and labor would have taken a steep toll on corporate profits. The data, however, show this to not have been the case, with pre-tax corporate profits rising by $234.5 billion in Q2, reflecting a 9.2 percent increase from Q1 2021 (note this is a straight quarter/quarter percentage change, not an annualized change). Robust growth in consumer and business demand coupled with higher prices drove top-line revenue considerably higher in Q2. That profits grew so strongly reflects the extent to which businesses were able to exercise pricing power to offset higher costs for inputs, shipping, and labor.



Perhaps the best way to put Q2 corporate profits into proper context is to look at corporate profit margins, or, profits as a share of revenue from sales, as shown in the above chart. At 12.16 percent, before-tax profit margins were wider in Q2 than in any quarter since Q4 2014, while after-tax profit margins, at 10.57 percent, were the widest since Q1 2012. At the extremes, firms facing higher costs of production can pass those higher costs along in the form of higher prices or they can absorb them and accept slimmer profit margins, with reality typically falling somewhere between the two extremes. Over the first half of 2021, however, firms were more aggressive with their pricing (profits rose by 5.10 percent in Q1), taking a cue from what has been robust growth in demand over recent quarters. That final demand has been so strong over recent quarters set the stage for firms, whether producing intermediate or final goods, to exercise greater pricing power. This is evident in measures of inflation on the wholesale and retail levels and in wider corporate profit margins. How long this will remain the case, however, remains to be seen.

Before proceeding with that discussion, a few bookkeeping notes are in order. Corporate profits as measured in the BEA's National Income and Product Accounts (NIPA) differ from profits as reported by the S&P 500 companies, the latter being more widely followed. The NIPA measure of profits is a much broader measure which includes profits of all corporations headquartered in the U.S., whether or not publicly traded, as opposed to only capturing the large corporations which comprise the S&P 500. There are also differences in accounting conventions, such as for payments of tax obligations, that can result in differences in measured profits. Still, while there can be sharp divergences between the two measures of profits in any given quarter, over time the broad trends in profits yielded by the two measures tend to be more closely aligned. Also, while many use nominal GDP as a proxy for top-line corporate revenue, we prefer final sales of domestic product, the difference being that GDP includes changes in inventories and final sales do not. As such, final sales – the sum of consumer spending, business investment spending, and total government consumption and investment expenditures – is a more fitting proxy for top-line corporate revenue than is nominal GDP.



As seen in the above chart, revenue from final sales has rebounded strongly after plummeting in Q2 2020. Final sales were up 15.9 percent year-on-year in Q2 2021, and while that comparison is flattered by the sharp decline in Q2 2020, as of Q2 2021 the level of final sales was 5.7 percent above the pre-pandemic peak. By

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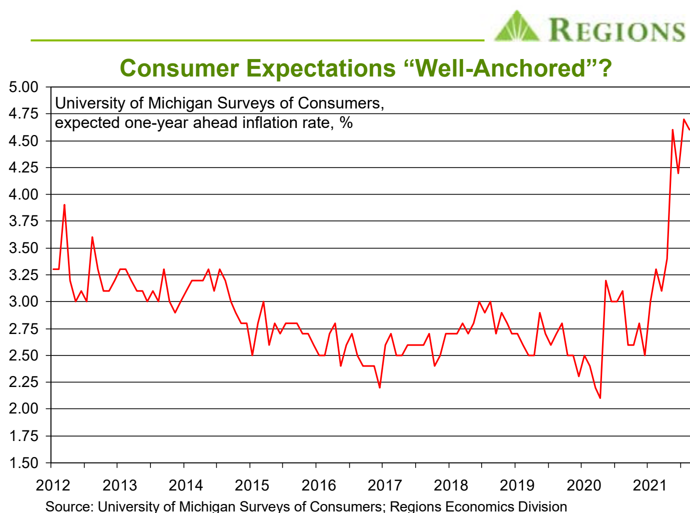
way of comparison, as of Q2 2021 real final sales (i.e., adjusted for price changes) were 1.5 percent above their pre-pandemic peak, which illustrates the extent to which higher prices have helped boost nominal final sales above their pre-pandemic peak.

As noted above, the strength of final demand has given firms greater latitude to raise prices. The fiscal and monetary policy response to the pandemic has, via generous fiscal transfers and lower interest rates, helped stoke demand. Indeed, we've wondered whether the boost to personal income in the form of generous fiscal transfers and the sizable pool of excess saving in the household sector have made consumers more accepting of higher prices than would have otherwise been the case. And, despite repeated assurances that inflation expectations remain "well-anchored," surveys of consumers, such as those conducted by the University of Michigan and the Federal Reserve Bank of New York, show consumers have come to expect significantly higher inflation than had been the case prior to the pandemic. For instance, in the University of Michigan's monthly survey of consumer sentiment, the one-year ahead expected rate of inflation in February 2020 was 2.4 percent, considerably lower than the 4.6 percent rate reported in the August 2021 survey. In a sense, that consumers are expecting higher prices gives firms some cover when they actually do raise prices.



A few months ago, we made the comment that, if firms can't raise prices in this environment, they'll never be able to raise prices. While at the time that may have been an exaggeration, it doesn't seem like much of one today. Price increases have in many cases been steep, and firms have raised prices with few concerns about losing customers. Again, though, the question is how much longer that can remain the case. There are already signs that firms may be reaching the limits of their pricing power. For instance, in the University of Michigan's August survey, a majority of consumers indicated they think this is a bad time to make major purchases such as appliances or motor vehicles, with many citing higher prices as the reason for their assessment. As recently as April, majorities indicated it was a good time to make such purchases.

While this doesn't indicate that a 1970s style inflation psychology is about to take hold, it does suggest that higher prices are impacting consumers' spending decisions. That is something firms will have to take into account when deciding whether, or to what extent, to push for further price increases. We think this is relevant given that there are growing signs that the supply chain and logistics bottlenecks that have hindered firms for the past several months will persist into 2022. This suggests further price increases for non-labor inputs to production and further increases in shipping costs, while at the same time labor costs will continue to push higher in the months ahead.

To the extent we are correct on this point, it isn't necessarily the case that firms will be able to simply raise prices to cover these higher costs. This is particularly true for firms who have already raised prices more than once over the past several months. This is where elevated profit margins may come into play. In other words, that margins were, as of Q2, well above the averages of the past several years means firms would be better able to absorb higher costs and still enjoy healthy, but slimmer, profit margins. While that may or may not go over well with equity investors, slimmer margins would mitigate the risk of prospective customers being put off by further price increases.

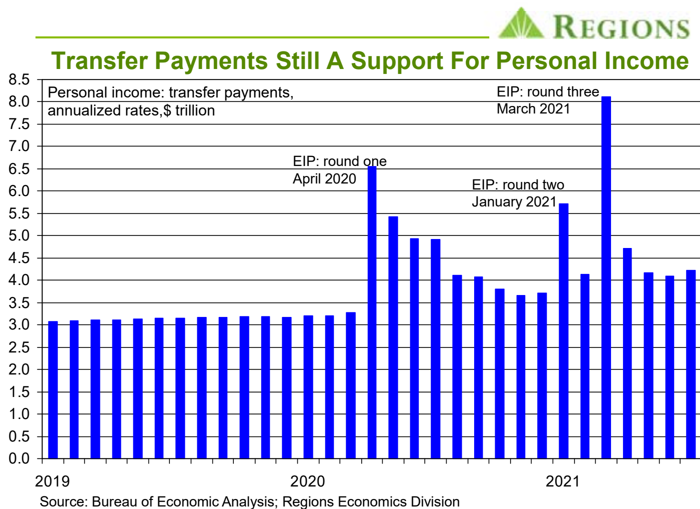
It is worth also noting that even aside from whether, or to what extent, firms are able to raise prices to offset higher costs, growth in revenue is likely to become increasingly constrained by supply chain and logistics disruptions. To some extent, even though production in Q2 was inhibited by these supply-side constraints, firms were able to accommodate robust growth in demand by drawing down inventories. The drawdown in nonfarm business inventories deducted 1.26 percentage points from top-line real GDP growth in Q2, but that is not something that can be sustained indefinitely. With inventory-to-sales ratios down sharply in the manufacturing and trade sectors over recent quarters and demand still strong, inventories will provide less of a buffer between supply and demand going forward than has been the case, as is evident in the sharp decline in motor vehicle sales in August. While that suggests continued upward pressure on prices, from a total revenue perspective, declining volumes will be the more powerful effect. The net result will be either slower growth or outright declines in total revenue that will in turn weigh on profits.

An additional threat to profit growth going forward is the likelihood that corporate taxes will almost surely be increased as part of funding for coming increases in government spending from the two "infrastructure" packages likely to be approved by Congress, perhaps as soon as this month. While spending from these bills won't begin immediately, revenue offsets will likely be in place beginning January 1, 2022. At this point there are no final details on either the spending or revenue sides, but it seems more a matter of "how much" as opposed to "whether" corporate taxes will be increased. As such, this will be another factor weighing on growth in corporate profits over coming quarters. This isn't to say earnings will decline, but instead that growth in corporate profits will likely be slower going forward than was the case over 1H 2021.

Less Support From Transfer Payments Going Forward

Substantial fiscal transfers were part of the aggressive fiscal policy response to the pandemic and, by boosting personal income, have helped support robust growth in consumer spending, as was noted

above. The most recent boost to personal income was apparent in the July data (the latest available data), with the expanded Child Care Tax Credit (CCTC) contributing to a healthy increase in total personal income. Going forward, however, transfer payments will provide less support for total personal income, and income growth will be much more closely aligned with growth in private sector wage and salary earnings. While in normal times this is generally the case, as private sector labor earnings are the largest single component of personal income, it has not been the case since the start of the pandemic, with transfer payments a more significant driver of the month-to-month swings in total personal income.



On a month-to-month basis, transfer payments tend to be fairly stable, as seen in the data from January 2019 through March 2020 shown in the chart above. That clearly changed as the fiscal policy response to the pandemic unfolded and pushed transfer payments sharply higher. On an annualized basis, the level of transfer payments was just over $1 trillion above the pre-pandemic run rate as of July. To further illustrate the impact of higher transfer payments, as of July the level of disposable (or, after-tax) personal income was 7.9 percent above the pre-pandemic peak, while the level of disposable personal income excluding transfer payments was 2.3 percent above the pre-pandemic peak. As noted above, transfer payments will continue to normalize in the months ahead.

The most impactful transfer payments were the three rounds of Economic Impact Payments (EIP), payments of up to $1,200 for each eligible adult in April 2020, up to $600 per eligible adult in January 2021, and up to $1,400 in March 2021, with each round including payments for eligible dependents (note these months are the months in which most of the EIP funds were distributed). Other boosts to transfer payments include enhancements to regular state-level unemployment insurance benefits, payments made to small businesses in the form of loans made under the Paycheck Protection Program (PPP) which were subsequently converted into grants, increased Medicare reimbursement rates, and, as of July, the expanded CCTC. The overall impact of the expansion to the CCTC is somewhat modest, amounting to roughly six-tenths of one percent of disposable personal income. What makes it more impactful is that the first half of the expansion is being paid in monthly installments – from July through December – as opposed to recipients getting a bulk credit during tax season, which is how the second half of the expansion will be delivered. The six monthly installments are, in the personal income data, booked as transfer payments, hence the boost to personal income growth in July. Note that there will be no such boost to growth from August through December as the level of monthly payouts will be fairly stable, and in the January 2022 data there will be a notable decline in transfer payments as the CCTC payments drop from the data.

REGIONS

Less Support From Transfer Payments Going Forward

Pandemic-related contributions to personal income, annualized rates, $ trillion:
Other
CCTC
PPP
Economic Impact Payments
UI enhancements

5.0 4.5 4.0 3.5 3.0 2.5 2.0 1.5 1.0 0.5 0.0

Apr-20 May Jun Jul Aug Sep Oct Nov Dec Jan-21 Feb Mar Apr May Jun Jul

Source: Bureau of Economic Analysis; Regions Economics Division

More immediately, with enhancements to regular state-level unemployment insurance benefits – supplemental unemployment insurance benefits, and payments provided under the Pandemic Emergency Unemployment Compensation (PEUC) and Pandemic Unemployment Assistance (PUA) programs – having expired on September 6, there will be a sizable decline in transfer payments in the September personal income data. With 26 states having already withdrawn from some or all of these programs (some states withdrew from the supplemental benefits program but remained in PEUC and PUA) and the ranks of the unemployed having fallen sharply over recent months, the contribution to personal income from enhancements to unemployment insurance benefits had already been declining. That decline, however, will be much more pronounced in the September data.

As transfer payments normalize further over the months ahead, we could see more of the monthly declines in total personal income that have been common over the past sixteen months – for instance, in each month following the Economic Impact Payments. And, on an over-the-year basis, we'll see declines in disposable personal income as far out as Q1 2022, as the boost from two rounds of EIP in Q1 2021 will make for a tough comparison in the Q1 2022 data. Any such declines should not, however, be cause for concern, and what will be more relevant will be the path of disposable personal income excluding transfer payments. As noted above, growth in ex-transfers income will be driven primarily by further growth in private sector wage and salary earnings, which have posted solid advances over the past five months and which, as of July, were six percent above the pre-pandemic peak.

In addition to further growth in private sector labor earnings, what is a sizable pool of saving in the household sector will also help cushion the impact of further declines in transfer payments. As of July, the personal saving rate stood at 9.6 percent, well above the

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pre-pandemic norm, and our estimate puts the level of "excess saving" in the household sector at roughly $2.3 trillion. Clearly there are distributional issues, i.e., lower-income households are likely to have less of a buffer in the form of saving, but, on the whole, there will be more support for consumer spending that will be implied by what could be considerable volatility in monthly personal income growth in the months ahead.

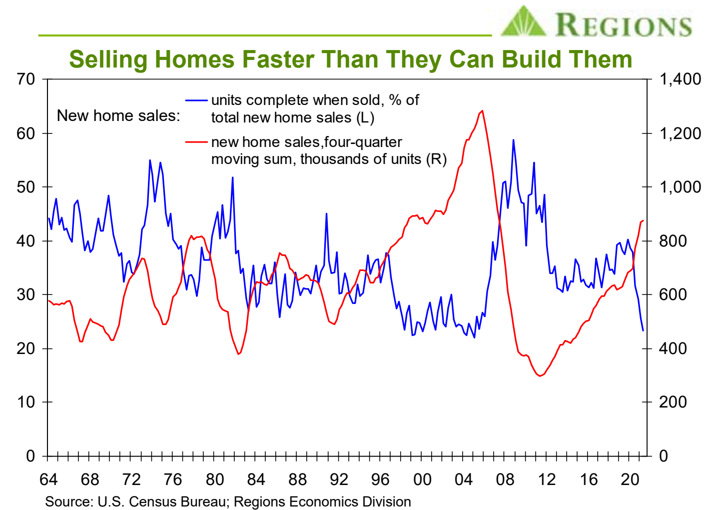
Spec Inventories On The Rise, But Not Much Risk To Builders

The overriding theme in the U.S. economy over the past several months has been a growing imbalance between demand and supply resulting in prices rising at a significantly faster pace. This is apparent in markets for non-labor inputs to production, markets for consumer goods, and the labor market (substitute "wages" for "prices"). The same theme is apparent in the housing market, i.e., a mismatch between robust demand and lean inventories leading to a faster pace of price appreciation. The difference, however, is that the imbalance in the housing market isn't new, with its origins going back well before the onset of the pandemic. To that point, we have for some time, measured in years, not weeks or months, been discussing how lean inventories have been acting as a meaningful drag on sales of new and existing homes and leading to house prices being higher than would otherwise be the case.

There are, however, signs of progress on the inventory front in the housing market. After hitting a bottom in February, inventories of existing homes for sale have since risen significantly. Yet, with demand still solid, the market for existing homes remains well out of balance; as of July (the latest available data), inventories were equivalent to 2.6 months of sales, far below the 6.0 months that is generally considered consistent with a balanced market. On that basis, however, the new homes market could be considered well-balanced, as inventories have risen in recent months while sales have slowed sharply. As such, as of July, inventories of new homes for sale were equivalent to 6.2 months of sales.

The nice, neat, and tidy narrative making the rounds after the last few monthly reports on new home sales showing falling sales and rising inventories is that higher prices had put off buyers to the point they stopped looking for homes and exited the market, leaving builders sitting on rising inventories of unsold homes. As is typically the case with nice, neat, and tidy narratives based on a cursory glance at headline numbers, this one misses the mark. The shifting dynamics of the market for new homes, at least as relayed by builders and industry analysts, are a bit more nuanced.

To be sure, though still solid, demand for home purchases has softened a bit over recent months, with some prospective buyers frustrated over losing out on bidding wars or new home lotteries with others having been forced out of the market by affordability constraints. Softer demand is apparent in the downward drift in applications for purchase mortgage loans over recent months. Still, as is the case with the broader economy, we think falling new home sales are more of a supply side story than a demand side story. Indeed, even with demand having softened, builders were falling further and further behind and, as a result, sitting on larger and larger backlogs of unfilled orders. For instance, the number of single family homes permitted but not yet started is hovering at a level last seen in 2006. All the while, short supplies of construction materials and uncertainty over materials prices and delivery times made it difficult for builders to properly price and commit to delivery dates for new homes.

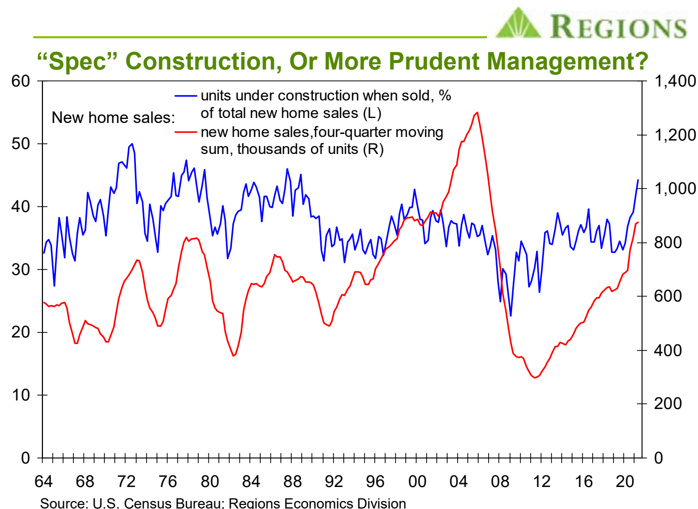


The chart above shows another way of looking at the extent to which builders were having trouble keeping pace with demand. Keep in mind that new home sales can take place at three different stages – before construction has started, while construction is underway, and after construction has been completed. Over the past several quarters, the share of new home sales accounted for by completed homes has fallen sharply; finished units accounted for 23.4 percent of all new homes sold in Q2 2021, the lowest share since Q1 2005. It makes sense that finished units account for higher shares of new home sales when the market is slowing; builders start fewer spec units and focus on completing units previously started, leaving finished units to account for a greater share of sales. When demand is as robust as has been the case over recent quarters, let alone as frenzied as it was at the peak of the prior cycle, pre-construction sales and sales of spec units under construction become more common, leaving finished units to account for a smaller share of sales.

Indeed, when new home sales kicked into a higher gear last summer, units on which construction had not yet started began to account for higher shares of new home sales. As noted above, however, this led to builders sitting on larger and larger backlogs of unfilled orders during a time when the availability of materials became more and more uncertain and materials prices, particularly lumber, were rising sharply. This simply became untenable for many builders, and during the summer months they responded accordingly.

One element of their response was that many builders began to either limit or completely suspend sales, focusing instead on working down backlogs of unfilled orders. Another element of their response was to begin construction of new homes but not price them or make them available for sale until construction was well underway. In so doing, builders were reducing uncertainty related to availability and delivery of materials while at the same time transferring price risk to buyers rather than bearing it themselves.

This response is readily available in the data on new home sales; new home sales have fallen over recent months, and units under construction have accounted for an increasing share of total new home sales. This goes to our point that the decline in sales over recent months is more of a supply side story than a demand side story, and also explains our interpretation of rising inventories of new homes for sale.



Spec inventories, which we often refer to as "physical" homes for sale consist of completed units for sale and under construction units for sale. After having fallen to a more than two-year low in March, spec inventories have since risen. Contrary to the narrative of builders sitting on rising inventories of unsold homes, however, the number of completed single family units for sale was, at the end of Q2, the lowest in the life of the inventory data, which go back to 1973. Instead, the increase in spec inventories has been driven by under construction units which, as shown in the chart above, have been accounting for a rising share of new home sales; as of Q2, this share was higher than at any point since Q4 1988.

As noted above, however, builders aren't exactly acting on hope. The increase in sales of under construction units reflects the decision of builders to move more and more to "spec" construction in response to uncertainty over materials pricing and delivery and being confident enough in demand to start units before actually placing them for sale. At the same time, the share of sales made up of units on which construction had not yet started has been falling, consistent with many builders having voluntarily capped pre-sales. Though reported spec inventories have been rising, pushing the months supply metric higher, that is somewhat misleading given how readily builders have been able to sell these under construction units. While there is always the risk that demand will evaporate, the degree of risk is somewhat low. Even with the increases seen over recent months, spec inventories are still well below historical norms, such that even were demand to fall significantly, the level of inventories of unsold units would be nowhere near the magnitude seen in the last cycle.

Indeed, demand is still strong enough that, with there having been some relief on materials pricing, builders have begun to relax the caps on sales they imposed this summer. Our view is that the rise in reported inventories and decline in sales seen over recent months has been mostly a supply side story, reflecting builders imposing some degree of order on what had become an unruly market instead of simply rushing to book as many sales as they possibly could have, which would have left them with intractable orders backlogs. Clearly, builders have been playing the longer game here, which has not always been the case.

August Employment Report: Not So Substantial Further Progress

Total nonfarm payrolls rose by 235,000 jobs in August, well below expectations, with private sector payrolls up by 243,000 jobs and public sector payrolls down by 8,000 jobs. Measured public sector job growth has been significantly distorted over recent months by seasonal adjustment issues around the education segment of state and local government and, as such, should be heavily, if not totally, discounted. That leaves the question of what to make of the significant downside miss on private sector job growth. It is worth noting that there is a long history of the initial estimate of August job growth significantly undershooting the final count; over the past five years, the initial estimate of August job growth has been revised up by an average of 75,000 jobs by the final estimate, and there is no reason to think this year will prove to be an outlier. That, however, is no more than meaningless noise. Of more relevance is that there are signs that rising COVID case counts had an adverse impact on August job growth. The not seasonally adjusted data show sizable declines in employment in retail trade and leisure and hospitality services, in line with various spending and mobility trackers that show consumers pulled back in August amid rising case counts. At the same time, with many firms pushing return to office dates further out – many had anticipated returning after Labor Day – hiring amongst providers of building services and amongst retail and restaurant establishments in close proximity to office clusters was likely also pushed back.

We do think it worth noting that prior estimates of job growth in June and July was revised up by a net 134,000 jobs, making this the second straight month in which the net upward revision for the prior two-month period was over 100,000 jobs. Given the dreaded "August effect" noted above, we'll go out on a limb here and say next month will make it three in a row. It is also, in light of the prior discussion on personal income, worth noting that aggregate private sector wage and salary earnings were up 1.0 percent in August after a like-sized increase in July and have grown strongly over the past several months. With private sector labor earnings set to resume their usual role as the main driver of changes in total personal income, this bodes well for income growth as pandemic-related increases in transfer payments run their course.

At the time of its release, we thought the July employment report was unambiguously strong, and revisions make it even stronger. We do not think the labor market deteriorated as much last month as the August employment report implies. Yet, since many will see the August employment report solely in the context of what it might mean for the FOMC as they deliberate tapering the Fed's monthly asset purchases, we'll say the August data reflect grudging further progress rather than the substantial further progress the FOMC is looking for, thus giving them the latitude to punt on a decision at their September meeting

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September 2021

Q1 '21 (a)	Q2 '21 (p)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)		2019 (a)	2020 (a)	2021 (f)	2022 (f)	2023 (f)
6.3	6.6	3.8	5.6	5.2	4.1	3.2	2.6	Real GDP[1]	2.3	-3.4	5.8	4.5	2.5
11.4	11.9	0.6	2.6	5.0	4.2	3.5	2.5	Real Personal Consumption[1]	2.2	-3.8	7.7	3.9	2.5
12.9	9.3	5.0	7.4	8.1	7.2	6.0	5.0	Real Business Fixed Investment[1]	4.3	-5.3	8.1	7.0	4.9
14.1	11.6	4.5	8.1	9.8	8.3	6.0	4.3	Equipment[1]	3.3	-8.3	14.3	7.8	4.2
15.6	14.6	9.3	8.0	7.5	6.0	5.5	5.4	Intellectual Property and Software[1]	7.2	2.8	10.4	7.5	5.3
5.4	-5.4	-4.4	3.7	4.0	6.5	6.7	5.8	Structures[1]	2.0	-12.5	-7.8	3.1	5.5
13.3	-11.5	3.4	7.2	8.1	2.8	1.4	0.4	Real Residential Fixed Investment[1]	-0.9	6.8	11.2	3.7	1.3
4.2	-1.9	0.8	1.2	2.6	2.3	1.7	1.7	Real Government Expenditures[1]	2.2	2.5	0.7	1.6	1.5
-1,226.1	-1,247.1	-1,232.4	-1,254.6	-1,280.6	-1,302.0	-1,321.8	-1,322.9	Real Net Exports[2]	-905.3	-942.7	-1,240.0	-1,306.8	-1,343.6
1,156	1,107	1,148	1,176	1,187	1,188	1,192	1,200	Single Family Housing Starts, ths. of units[3]	889	1,004	1,147	1,192	1,215
443	479	452	460	456	454	451	446	Multi-Family Housing Starts, ths. of units[3]	403	393	458	452	443
10.2	14.9	18.1	16.0	12.9	8.1	4.0	3.4	CoreLogic House Price Index[5]	3.9	5.8	14.8	6.9	3.7
16.8	16.9	13.4	13.6	14.3	14.8	15.4	15.7	Vehicle Sales, millions of units[3]	17.0	14.5	15.2	15.1	16.0
6.2	5.9	5.2	4.8	4.6	4.4	4.2	4.1	Unemployment Rate, %[4]	3.7	8.1	5.5	4.3	3.9
-5.6	8.5	4.5	4.1	4.4	3.8	2.7	2.3	Non-Farm Employment[5]	1.3	-5.7	2.7	3.3	1.6
54.7	-31.0	-5.0	-4.0	0.6	3.2	3.0	3.3	Real Disposable Personal Income[1]	2.3	6.2	1.7	-2.5	3.7
2.0	4.0	4.3	4.7	4.3	3.3	2.7	2.3	GDP Price Deflator[5]	1.8	1.2	3.8	3.1	2.1
1.8	3.9	4.3	5.0	4.6	3.6	2.9	2.4	PCE Deflator[5]	1.5	1.2	3.7	3.4	2.2
1.9	4.8	5.4	5.9	5.6	4.1	2.9	2.4	Consumer Price Index[5]	1.8	1.2	4.5	3.7	2.1
1.7	3.4	3.7	4.3	4.3	3.4	2.9	2.5	Core PCE Deflator[5]	1.7	1.4	3.3	3.3	2.3
1.4	3.7	4.2	4.6	5.1	3.7	3.0	2.8	Core Consumer Price Index[5]	2.2	1.7	3.5	3.6	2.6
0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	0.13	0.47
1.32	1.59	1.32	1.49	1.67	1.75	1.85	1.92	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.43	1.80	2.01
2.88	3.00	2.87	3.08	3.28	3.40	3.53	3.59	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.96	3.45	3.67
-3.6	-3.3	-3.1	-3.3	-3.4	-3.3	-3.4	-3.4	Current Account, % of GDP	-2.2	-2.9	-3.3	-3.4	-3.5

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2021 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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