Current Economic Conditions

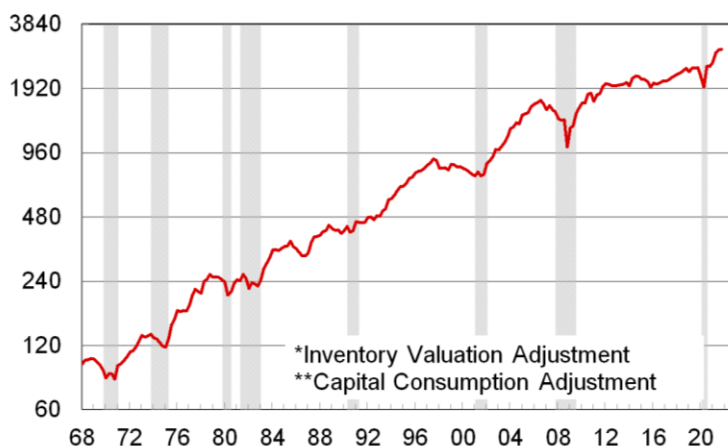
Robert C. Fry, Jr., Ph.D. April 19, 2022

YOU AREN'T DOING AS WELL AS YOU THINK YOU'RE DOING

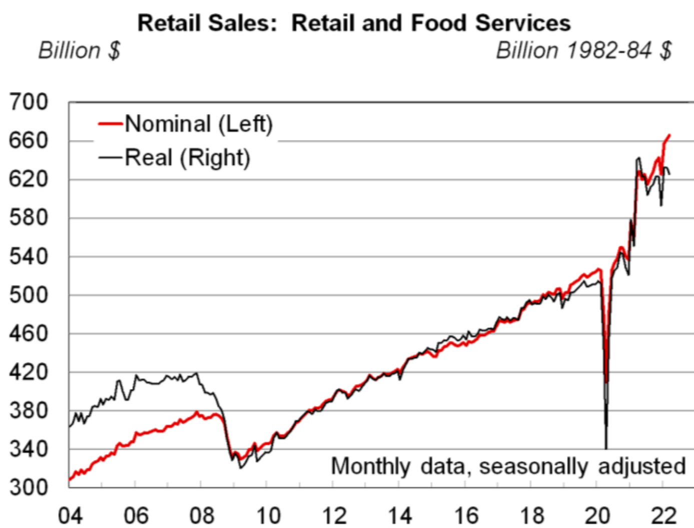
Economists tend to focus on **real** economic activity. Most of the measures they use reflect increases in volume but not in prices. These measures are either adjusted to remove the impact of inflation (e.g., Real Gross Domestic Product and its components) or they directly measure volumes (e.g., employment, light vehicle sales, housing starts, home sales). Industrial production indexes reflect a combination of both approaches. Managers and investors, on the other hand, tend to focus on **nominal** (dollar) measures. When companies report earnings and revenue, they don't adjust those numbers for inflation. Over the last three decades, when inflation was low, real and nominal measures tended to paint the same picture of the economy. When nominal corporate earnings were growing strongly, the real economy was also doing well. When nominal wages and salaries were rising, workers were really better off. Now, with inflation at its highest levels since 1982, the distinction between real and nominal matters. Companies aren't doing as well as they think they're doing, and workers are worse off, despite big raises.

The Consumer Price Index rose 1.2% in March, with most of the increase coming from higher energy prices. The year-over-year inflation rate rose to 8.5%. Investors briefly took solace in the fact that, excluding food and energy prices, the CPI rose just 0.3% in March. However, Producer Price Indexes, released the next day, showed big price increases even when food and energy prices were excluded. The headline PPI for final demand, which includes services, rose 1.4%. It was up 1.0% excluding food and energy prices. The PPI for finished goods, which was the headline measure until 2014, rose 1.9%, on top of a 2.6% increase in February. The PPI for finished goods excluding food and energy, my favorite measure of underlying inflation, rose 0.8% and was up 8.4% year-over-year. Producer (wholesale) prices don't always lead consumer prices, but big increases in producer prices, especially for intermediate materials, suggest there is plenty of inflation "in the pipeline" that hasn't reached consumers yet.

Nominal wages and salaries (average hourly earnings), which are reported with the monthly employment report, were **up** 5.6% year-over-year in March. Real average hourly earnings, which are calculated and reported with the release of the Consumer Price Index, were **down** 2.7% year-over-year. Wages and salaries have not been keeping up with inflation. In a tight labor market, with the unemployment rate at 3.6% and job openings far exceeding the number of unemployed, that makes no sense and is probably not sustainable. (It may explain why a Grant Thornton survey showed that 40% of people who changed jobs in the last year are actively looking for another job.) And the labor market is still tightening. Payroll employment rose 750,000 in February and 431,000 in March. New claims for unemployment insurance are near a record low. Going forward, wages and salaries are likely to rise faster than prices. That won't be good for corporate earnings, which tend to turn down **before** the economy falls into a recession.



So far, though, corporate earnings have remained strong. Corporate profits from the National Income and Products Accounts were 21% higher in the fourth quarter of 2021 than they were in the fourth quarter of 2020 (and 22.1% higher than in the fourth quarter of 2019, before the pandemic). I prefer the NIPA measure, which comes from the same source and data release as GDP, to S&P500 earnings per share, which are distorted by stock buybacks. (Reporting earnings per share when you're reducing your share count is cheating, but until analysts call them out, companies will keep doing it!) Over the entirety of 2021, NIPA profits grew much more rapidly than inflation, but in the fourth quarter, profits grew at just a 2.8% annual rate, much less than inflation. I expect nominal earnings growth to remain strong in 2022 – and data on corporate tax revenue indicate profits were strong in the first quarter – but much of the growth will come from higher prices, not from increased economic activity. In real terms, earnings growth will slow. Managers, who like to report double-digit earnings growth, might prefer 10% earnings growth and 8% inflation to 4% earnings growth and 2% inflation, but their shareholders, on a real after-tax basis, would be better off with the latter. So would the overall economy.



Unlike real GDP and many other data series, retail sales are reported in nominal terms. They were up 0.5% month-to-month and 6.9% year-over-year in March. A series calculated by the Federal Reserve Bank of St. Louis shows real retail sales declining for a second straight month in March and well below the unsustainably high levels in March and April 2021, after passage of the American Rescue Plan. However, this series is calculated using the Consumer Price Index, which might not be appropriate for the establishments covered by the retail sales data. A more appropriate price deflator might show that real retail sales are still trending up, but at a much slower rate than nominal retail sales.

While economists tend to prefer real measures of economic activity, we should be clear that it is much easier to measure nominal activity. Calculating nominal measures of activity basically involves adding up the dollars. It is arithmetic. Splitting nominal growth into its real growth and inflation components is much more difficult. It involves economics and statistics, and it requires decisions that are at least somewhat arbitrary. Nominal GDP data are probably quite accurate, but reasonable people can disagree over whether real growth is higher or lower than what is reported while inflation is lower or higher.

I expect above-trend growth this year, but strength will be concentrated in sectors that have not fully recovered from the pandemic, either because of shortages of labor and materials (e.g., motor vehicles) or because of the pandemic itself (e.g., travel and entertainment and the derived demand for planes and jet fuel). Other parts of the economy won't grow as rapidly. If your sales are no longer being constrained by either the pandemic or by shortages of labor and materials, and your customers' inventories are no longer too lean, you should expect growth to slow to its long-term trend. Pent-up demand will keep housing starts near March's 16-year high, despite the recent surge in mortgage rates, but we shouldn't expect further growth. Industrial production in U.S. manufacturing, the favorite measure of real activity for this former manufacturing-sector economist, rose 0.9% in March, after a 1.2% increase in February. The March increase was led by big increases in production of motor vehicles and aircraft. In most manufacturing industries, production has already risen above pre-pandemic levels. The major exceptions are motor vehicles, aerospace, and petroleum refining, which should benefit from pent-up demand for vehicles and travel this year. But pent-up demand and inventory rebuilding are, by their very nature, temporary. Growth will slow in each industry as they are exhausted. Once travel and entertainment are back to normal and pent-up demand for cars and houses is satisfied, likely in 2023, overall growth is likely to slow significantly.

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