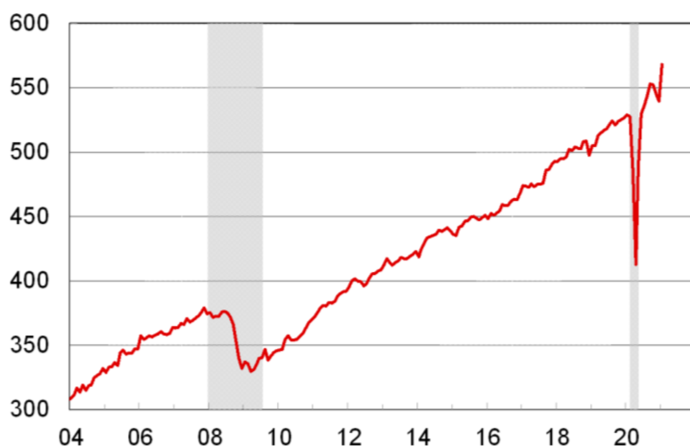
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. February 19, 2021

US ECONOMY STRONGER THAN EXPECTED IN JANUARY

The U.S. economy stumbled out of the gate in 2021 but regained its footing very quickly. Initial claims for unemployment insurance rose to a five-month high in the week ending January 9 but fell sharply over the next two weeks. The improvement in the labor market didn't occur soon enough to have much impact on the monthly employment report, which is based on surveys conducted the week that includes the 12th day of the month. Nonfarm payroll employment rose by just 49,000 in January. The unemployment rate, based on a survey of households, fell from 6.7% to 6.3%, but that was due more to a 406,000 decline in the labor force than to the 201,000 increase in civilian employment.



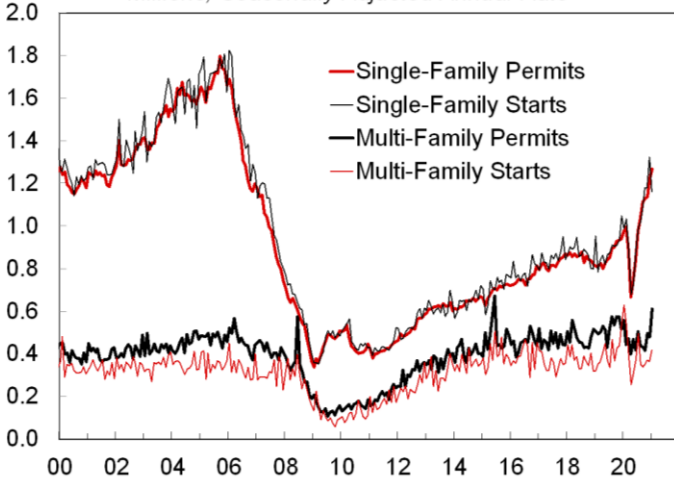
Subsequent economic reports have been much stronger than expected and suggest the economy improved significantly after the employment survey week. The big story was retail sales, which rose 5.3% in January, more than four times expectations. The broad-based increase was led by double-digit increases at "nonstore" (primarily online) retailers, department stores, electronics and appliance stores, and furniture and home furnishings stores. The so-called "control group" used to calculate the consumer spending components of Gross Domestic Product rose 6.0%. The strength in retail sales, particularly in the control group, means that most forecasters, myself included, need to raise our forecasts for GDP growth in the first quarter. The Federal Reserve Bank of Atlanta's GDPNow "nowcast", an estimate of quarterly growth based on available monthly and weekly data, is now pointing to 9.5% annualized GDP growth in the first quarter, up from 4.5% before the release of retail sales data. I doubt growth with be that strong, but because first-quarter growth has an outsized impact on annual growth, an upward revision to my first quarter forecast means my forecast for full-year GDP growth will rise from a close-to-consensus 4.6% to something closer to 6%.

The downturn in COVID-19 cases in mid-January might account for some of the surge in retail sales, but most of the strength is attributable to the $900 billion relief package that was passed in late December. That relief package, which included $600 checks for most Americans and enhanced and extended Unemployment Insurance benefits, boosted spending, mostly by cash-constrained households at lower income levels. Data from Affinity Solutions, analyzed by Opportunity Insights, shows that spending by households making less than $60,000/year was up 20% year-over-year in the week ending January 10. Spending by households making more than $100,000 was little changed.

Industrial production also outperformed expectations in January. Industrial production in U.S. manufacturing rose 1.0%, and growth over the previous five months was revised up. Industrial production in mining rose 2.3%, its third straight monthly increase. Headline (total) industrial production rose "just" 0.9% because of a weather-related decline in output of electric and natural gas utilities. January's strong

increase in industrial production is unlikely to be repeated in February. Motor vehicle production is being constrained by a shortage of semiconductors, and oil and gas production and refining have been shut down by extreme cold in Texas. But oil production has bottomed and will rebound with warmer weather.

Building permits for single-family homes rose to another cyclical high in January. Still, construction is being constrained by tight supplies of land, labor, and lumber. That will keep housing starts from rising much above the pace of late 2020. Longer-term, the outlook for housing has weakened. With immigration way down in recent years and deaths up because of COVID-19, projections of the U.S. population over the next decade have been revised down, and it is ultimately population that drives the demand for housing.



Stronger-than-expected growth in January has been accompanied by higher prices and higher long-term interest rates. The headline Producer Price Index for final demand, including some services, rose 1.3% in January. That was the largest increase since the series began in December 2009. Price increases were widespread. Even when prices of food, energy and trade services are excluded, the PPI was up 1.2%. The PPI for finished goods, which I prefer because of its longer history, rose 1.1%, the biggest increase since last May. However, increases in the PPI over the last nine months followed three months of sharp declines. The PPI for finished goods was up just 1.1% year-over-year in January.

The jump in producer prices in part reflects increases in commodity prices, including oil, natural gas, and copper, and in shipping costs. So far, these increases have not been passed through to consumers to any great extent. The Consumer Price Index, excluding food and energy, was essentially unchanged in January and was up just 1.4% year-over-year. The pass-through of higher costs and a broad acceleration in prices require tighter markets. Profit-maximizing firms don't raise prices because labor or material costs go up or because the money supply grows too fast or because interest rates or the unemployment rate are too low. They raise prices because demand exceeds supply at the current price.

Long-term interest rates have also risen. The yield on 10-year Treasury notes rose from 0.93% on January 4, the first trading day of the year, to 1.30% on February 16. So far, the increase in bond yields should be viewed as a reflection of stronger nominal growth – real growth plus inflation – rather than as a threat to future growth. A too-rapid increase in bond yields might affect stock prices, but short-term interest rates have a much bigger impact on real growth than do bond yields. Growth is likely to remain above-trend and, aside from a brief decline in the second half due to weak prior-year comparisons, inflation is likely to accelerate until well after the Federal Reserve begins to raise its federal funds rate target.

The last economic expansion was very slow – it took nine years for GDP to reach its estimated "potential" – but it lasted a long time. This expansion, thanks to more aggressive fiscal and monetary policy, is off to a much stronger start. That means we will get back to full employment more quickly – a good thing – but it also means that if the Fed and the fiscal authorities don't remove the stimulus quickly enough, inflationary pressures will build. This and the subsequent tightening could shorten the expansion.

Relief checks accounted for most of the strength in retail sales in January, but future increases in economic activity will be mostly due to the decline in COVID-19 cases that will result from the combination of vaccinations, immunity acquired through prior infections, warmer weather, and learning how to engage in economic activities safely. New variants of the virus that make vaccines less effective could interfere with the economic recovery, but for now, it looks like growth will be very strong in 2021.

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