Current Economic Conditions

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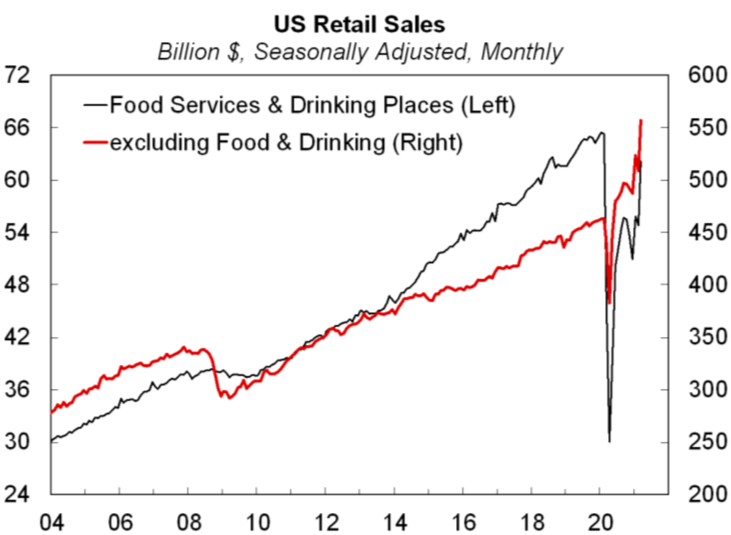
SUPPLY NOT KEEPING UP WITH DEMAND IN A "FIELD OF DREAMS" ECONOMY

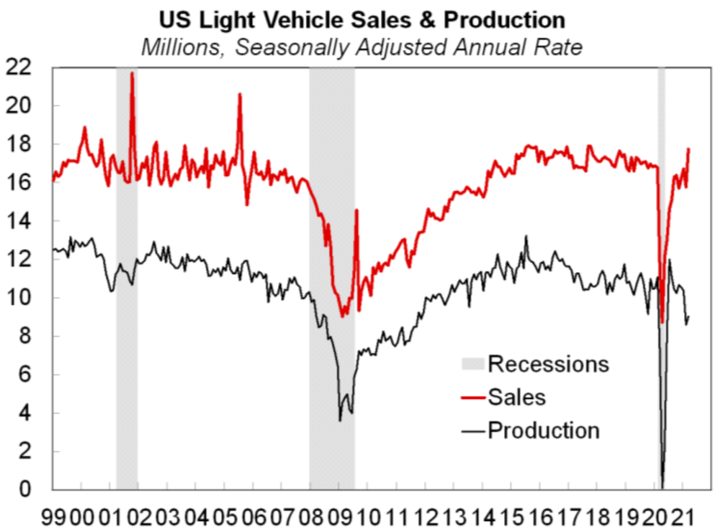
Most measures of economic activity in the United States were exceedingly strong in March. Payroll employment rose 916,000, and February job gains were revised up. Housing starts rose to a 15-year high. But the strongest report for the month was a 9.8% month-to-month increase in retail sales. It was the second largest increase ever, surpassed only by the 18.3% increase when the economy reopened in May 2020. Retail sales at food services and drinking places, which have been hit hard by the pandemic, rose 13.4%. Because of the savings that many Americans have accumulated – the result of relief checks from the federal government and money not spent on activities that were curtailed by the pandemic – the rollout of vaccines and decline in COVID-19 cases by themselves would have unleashed a surge of spending. But the surge in spending was further boosted by the $1400 "recovery rebate" checks sent to most Americans in March. The combination of falling COVID risks and government checks left retail sales in March 17.1% above where they were in January 2020, **before the pandemic.**



In contrast, industrial production in U.S. manufacturing disappointed in March. While a 2.7% increase would normally be regarded as a blowout report, it came on the heels of February's 3.7% decline and left production 1.1% below January's post-recession high. Most industries rebounded strongly from February's weather-related declines, but production of motor vehicles and parts and production of chemicals (excluding pharmaceuticals) recovered little. Motor vehicle production is being held down by a shortage of semiconductors that has shut down some plants and eliminated shifts at others. Taiwan Semiconductor, a leading manufacturer of semiconductors, has suggested that the shortage will last into 2022, so it might be a while until motor vehicle production fully recovers. That will hold down growth in industrial production (and employment) in 2021 but will bolster it in 2022. Damage caused by extreme cold in Texas in February is still restraining chemical production; repairs (e.g., to valves) are being slowed by a shortage of supplies. Problems in both the chemical industry, its source of raw materials, and the auto industry, its biggest market, are holding down production of plastic and rubber products.

Because retail sales mostly reflect demand for goods, and industrial production reflects the (domestic) supply of goods, March data suggest that supply is having trouble keeping up with demand. Three things happen when supply can't keep up with demand. First, inventories are drawn down. Real (inflation-adjusted) manufacturing and trade inventories declined from December 2019 through August 2020; they had recovered little through January 2021 and probably fell in February and March. If the excess of demand over supply is too large and too persistent to be satisfied by a drawdown of inventories, the result will be some combination of higher prices and increased imports. Before the opening of the Chinese economy in 1979 and passage of the North American Free Trade Agreement in 1994, excess demand mostly manifested itself in higher prices. Since then, inflation has stayed low and trade deficits have been very large. (Before NAFTA, the Federal Reserve's preferred measure of inflation had been at or above 2.5% for 27 years; since then, it has been above 2.5% in only one month.)

Supply-chain disruptions in the rest of the world and at U.S. ports have at least temporarily prevented imports from serving as an inflation relief valve. Consequently, prices rose strongly in March. The Producer Price Index for finished goods rose 1.3%. It has risen 4.8% (15.1% annualized rate) over the last four months, its biggest four-month increase since 1980! The Consumer Price Index rose 0.6% in March. The Fed argues that these are one-off increases in prices that will result in temporary/transitory increases in measured inflation. If the Fed starts tapering bond purchases in 2021 and starts raising interest rates in 2022, that might be true. If they wait until 2024 to raise interest rates, it probably won't be.



Nowhere is the disparity between supply and demand more glaring than in motor vehicles. While production has been held down by the semiconductor shortage, sales rose to a 41-month high in March. Apparently, consumers were afraid that if they didn't buy now, they wouldn't be able to buy later. Production shutdowns last year caused inventories on dealer lots to shrink. Strong sales and weak production this year have kept dealers from rebuilding inventories to desired levels.

The failure of supply to keep up with demand reflects both the boost to demand from relief checks and supply-chain disruptions caused by the pandemic, cold weather in Texas, and the blockage of the Suez Canal. At an April 8 Economic Outlook webinar for the American Chemical Society and Science History Institute, I asked the audience if their companies had been unable to satisfy demand for their products because of an inability to hire enough workers or because of insufficient supplies of materials. Almost 20% of the respondents reported an inability to hire enough workers. Over 39% reported insufficient supplies of materials. (Many reported both.) Only 43% reported no inability to satisfy demand.

You might think that with employment still 8.4 million below its pre-recession peak, businesses would have no trouble finding workers, but that's not what I'm hearing from my subscribers and audiences, and it's not what members of the National Federation of Independent Business are reporting. A record 42% of NFIB members reported that they had jobs they couldn't fill in March. The Job Openings and Labor Turnover Survey (JOLTS) reported nearly 7.4 million job openings at the end of February. That's only slightly below the record of 7.6 million reached in November 2018. A combination of excessive unemployment insurance benefits, closed schools, and skills mismatches is making it hard to hire.

With demand so strong and supply constrained, we're in a "Field of Dreams" economy; if you build it, they will come. Companies that best manage their supply chains, attract enough workers, boost the productivity of existing workers, and maintain adequate inventories are likely to gain market share at the expense of those that don't. And market share is "sticky;" if you lose market share, it will take time, money, and effort to get it back. In particular, this is not the time to over-manage your inventories. For goods that are not expensive to store and that don't go bad or obsolete, the main cost of holding inventories is the cost of the money tied up in those inventories, which depends on interest rates. It has always baffled me that managers exhort their employees to minimize inventories even when interest rates are near zero. But the cost of holding inventories is much easier to measure than the cost of sales lost because of stockouts, and "what gets measured gets done." In the current environment, the cost of sales lost because of insufficient inventories is almost certain to dwarf the cost of holding excessive inventories.