Current Economic Conditions

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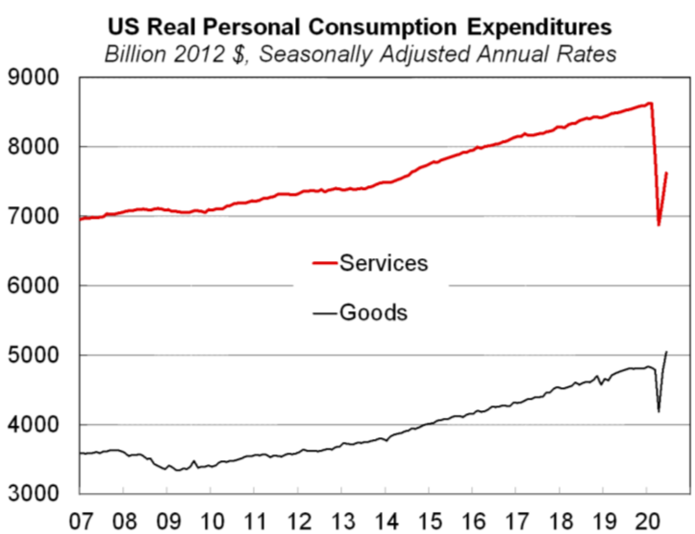
THINK MICRO, NOT MACRO: THE DEVIL IS IN THE DETAILS

There's an old saying that "in a crisis, all correlations go to one." That is most often applied to stock prices and points to the near impossibility of finding stocks that go up when a crisis is pulling the overall market down; there are few negative-beta stocks. But it also applies to economic activity. In a recession, virtually all sectors of the economy go down; there are few counter-cyclical industries. In truth, the correlation across sectors is strong throughout the business cycle. That's why there **is** a business cycle and a field called macroeconomics and why it usually makes sense to talk about broad economic aggregates like Gross Domestic Product and broad price indexes like the Consumer Price Index.

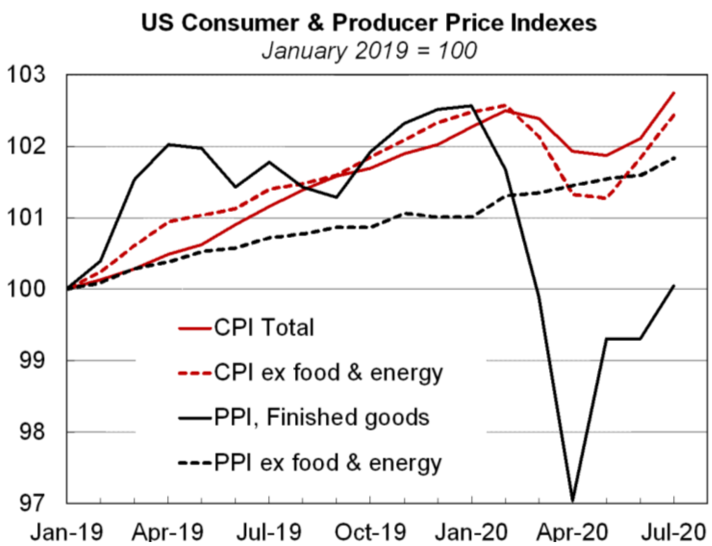
This has not been a normal crisis, and correlations have not gone to one this year. In most recessions, there are few if any winners, but despite the worst recession since the 1930s, there have been winners this year. That shows up in stock prices. Stocks of companies that benefit from working and shopping from home have soared, while those connected to travel and non-food brick-and-mortar retailing have cratered. But the big disparity is between publicly traded companies overall and privately held companies. The broad stock market is back to its February peak. The economic losses from the COVID-19 pandemic have largely been borne by small privately held companies and their employees.

The contrast between winners and losers also shows up in data on personal consumption expenditures (PCE), which account for 70% of GDP. Last month I pointed out that the goods sector of the economy had suffered a recession but had rebounded quickly while the services sector had suffered a depression and a paused recovery. June data on PCE make the disparity clear. Real spending on goods rose to record highs. Think about that; two months after the trough of a very deep recession, consumer spending on goods had more than fully recovered from the recession. Meanwhile, consumer spending on services was still 11.6% below its February peak. Retail sales are reported with a shorter publication lag than PCE. Excluding food services, retail sales rose in July to their second straight record high.



There are three possible explanations for the extreme strength in consumer spending on goods in June and July. First, consumers might have been satisfying pent-up demand; catching up on purchases that they would have made in late March and April but were unable to because of government-mandated lockdowns or a simple reluctance to shop. If this is the reason, spending will fall back in coming months once pent-up demand is satisfied. Second, spending could have been boosted by government stimulus checks and enhanced Unemployment Insurance benefits, which unprecedentedly pushed disposable income to new highs during a recession. If this is the reason, spending will fall back unless Congress and the President agree on another stimulus program, although the big jump in the savings rate in the second quarter could cushion the blow for a month or so. Third, the jump in spending on goods could reflect a shift in spending from services to goods. If this is the reason, spending on goods will stay strong and spending on services weak at least until a vaccine makes its safe for people to resume their normal activities. (In some cases, the shift will be more permanent. People who can work productively from home won't go back to the office . . . and the restaurants and dry cleaners nearby. People who bought Pelatons won't go back to the fitness club. People who bought RVs won't trade them in on plane tickets.)

Industrial production in U.S. manufacturing rose for a third straight month in July but was still down 8% from its February (pre-pandemic) level. The recovery has been led by production of motor vehicles and parts, which rose in July to within 0.4% of its February level as sales rebounded and auto dealers tried to rebuild inventories. Other manufacturing industries that are within 5% of February production levels include computer and electronic products, food and beverages, and pharmaceuticals. At the other extreme, production of primary metals in July was almost 25% below its February level. The rebound in motor vehicle production should be helping the metals industry, but so far it hasn't offset the weakness in aircraft production and oil and gas drilling. The printing industry also remains weak, with production still down 19% from February. Weakness in retailing has translated into weakness in print advertising. Building permits for single-family homes rose 17% in July, leaving them just 1.1% below the cyclical peak hit in February. The strong rebound in housing bodes well for production of building materials and appliances.



The stronger-than-expected rebound in consumer spending on goods combined with supply constraints (and mandated shutdowns) that have limited production have drawn down inventories and put upward pressure on prices. Both the Producer Price Index and the Consumer Price Index rose much more than expected in July. Most of the jump was just a rebound from temporary declines, particularly in energy prices, and both indexes remained below their pre-pandemic trends. But the broad price indexes, which macroeconomists concentrate on, conceal shifts in relative prices, which microeconomists focus on. In industries where demand is strong (and supply constrained), relative prices will rise. In industries where demand fails to recover, relative prices will fall. Because prices are sticky downwards, meaning that businesses are more reluctant to cut prices than to raise them, a shift in relative prices can cause the overall price level (and the rate of inflation) to rise. There is tremendous inertia in inflation – the best predictor of tomorrow's inflation rate is today's inflation rate – but the combination of massive monetary stimulus, supply constraints that get too little attention, and big shifts in relative prices will push inflation higher over the next few years. (The supply constraints are partly due to an inability to hire workers when people can make more from unemployment insurance benefits than from working. That problem might have been eliminated, at least temporarily, by the expiration of enhanced UI benefits in late July.)

If you're a producer of goods, especially goods that go into houses and cars and personal protective equipment (PPE) and not into airplanes and oil wells, or if you build or renovate single-family homes, you've probably been pleasantly surprised by the resilience of demand, and your biggest problems are probably supply constraints and insufficient inventories (stock outs). You might have more pricing power than you've had in recent years. If you own a restaurant or bar or airline or oil drilling company or you're a supplier to such a business, I wish I had better news. Business is likely to remain depressed, and you won't be able to make up for lost volume by raising prices. Unfortunately for the macroeconomy, services account for more of GDP and employment than do goods. GDP and employment will remain well below their pre-recession peaks for a long time even if spending on goods continues to set record highs.