

# Transitory or Persistent Inflation?

A QUARTERLY MACROECONOMIC UPDATE  
BY IBISWORLD | MAY 2021

Against the backdrop of a recovering economy and ongoing government support, real gross domestic product (GDP) increased at an annual rate of 6.4% in the first quarter of 2021. This growth represents an acceleration in the pace of the recovery compared to previous quarter when GDP grew 4.3%. As the vaccination campaign has ramped up and more adults become fully vaccinated, state governments continue to lift restrictions on business activity. Service-based industries stand to benefit most by the reopening story, as those business models have been most impaired by social distancing. While an exact timeline for reaching herd immunity and fully reopening the economy remains unclear, some time in the third quarter appears to be a good bet.

*“ Some drags on the labor market are likely to remain through much of the summer ”*

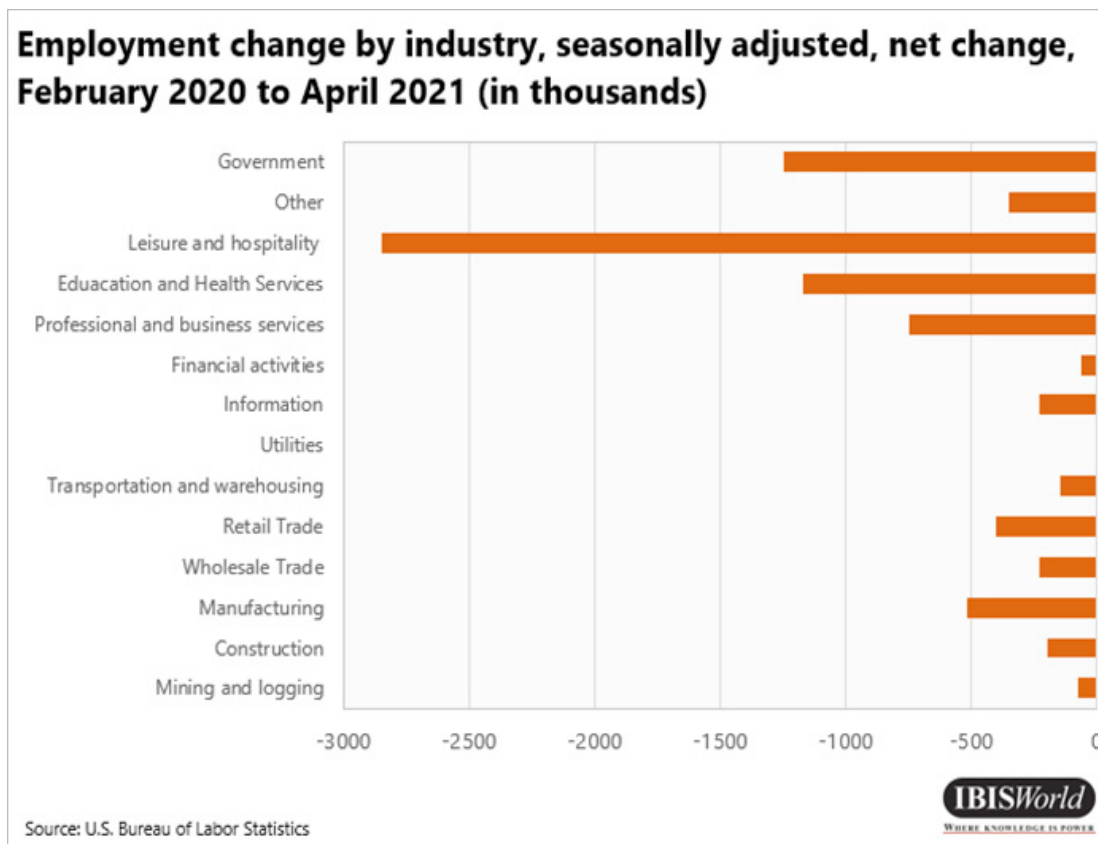
However, headwinds have materialized in the wake of the rapid recovery. The surge in demand, both domestically and globally, has strained supply chains, placing significant upward pressure on prices for a wide range of commodities and goods. With inventories tight and any material expansion in production capacity unlikely to occur in 2021, longer-term inflationary pressures are building. Additionally, unemployment benefit enhancements, lingering pandemic-related health concerns and difficulties relating to childcare are weighing on the labor market recovery. The confluence of factors has forced employers to raise wages to entice workers who are disincentivized from working, adding to the inflationary pressure in the economy. These factors are expected to be short-term in nature, however, as unemployment benefit enhancements are set to expire in early September, coinciding with the likely return to fully in-person schooling across the nation alleviating childcare difficulties for many families. Thus, while the worst of the economic upheaval has passed, some drags on the labor market are likely to remain through much of the summer.

## SNAPSHOT: RISKIEST INDUSTRIES 2021 OVERALL RISK SCORE

	VoIP in the US	6.92
	Telecommunication Networking Equipment Manufacturing in the US	6.75
	Credit Repair Services in the US	6.60
	Bare Printed Circuit Board Manufacturing in the US	6.57
	High Frequency Trading in the US	6.54
	Swimming Pool Equipment Stores in the US	6.46
	Online Photo Printing in the US	6.46
	Casting Agencies in the US	6.41
	E-Book Publishing in the US	6.39
	Telephone Wholesaling in the US	6.38

## LABOR MARKET LETDOWN

- 1.6 million nonfarm jobs were gained in the first quarter of 2021, including 266,000 added in April alone. Growth was well below consensus expectations, demonstrating slowing momentum, particularly as employers are facing hiring challenges as they pertain to skill gaps, continued virus concerns, childcare obligations and expanded unemployment benefits.
- As vaccines are rolled out and as restrictions ease, in April, 18.3% of employed Americans worked remotely, marking a decline from 21.0% in the previous month.
- Contrary to projections, the unemployment increased 0.1 percentage points to 6.1% in April. Despite this increase, the unemployment rate is still considerably lower than the peak of 14.8% in April 2020 and a slight decline from 6.3% at the start of the quarter.
- Sectors with the largest gains in employment in April include leisure and hospitality, other services and government (local government education). Meanwhile, transportation and warehousing and professional and business services exhibited notable declines in employment. These declines were primarily in temporary help services, as well as couriers and messengers.



## CONSUMPTION SURGE

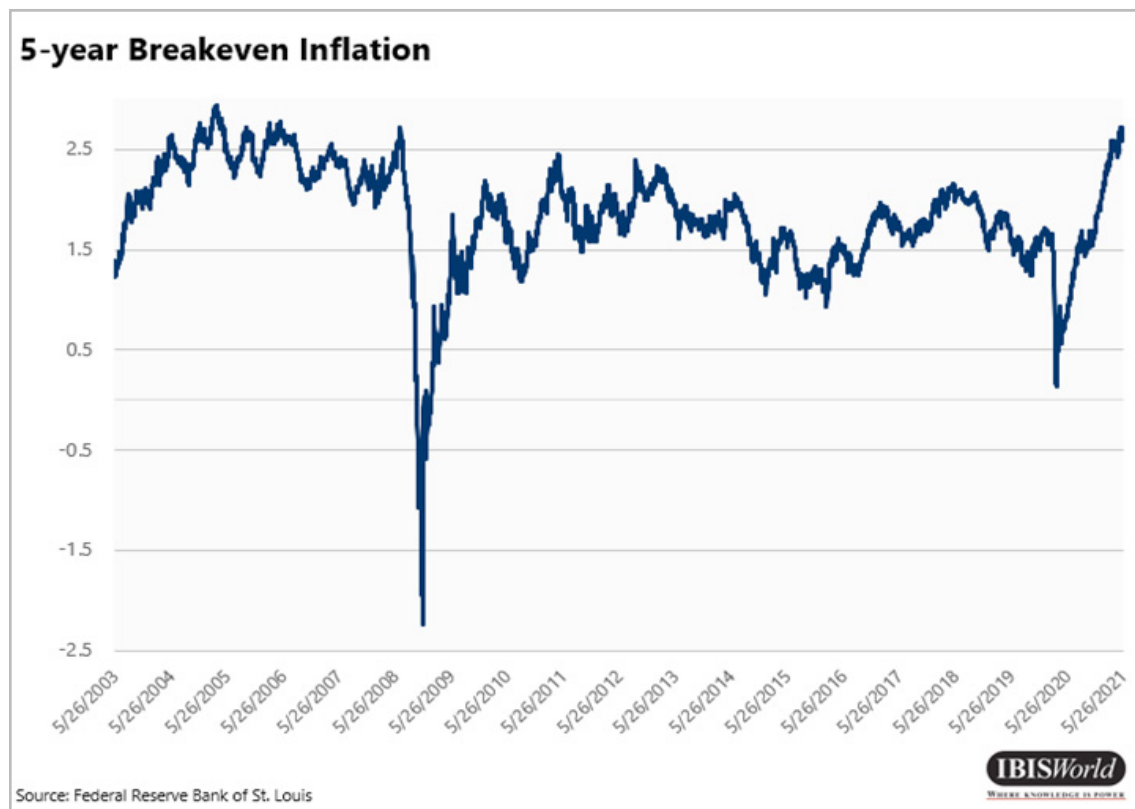
- Personal consumption expenditures (PCE) grew 2.6% over Q1 2021.
- For the first time since consumer spending cratered in April 2020, PCE expenditures are up 1.6% on a year over year basis since Q1 2020, higher than pre-pandemic spending levels.
- Spending has continued to be strong for durable goods, which contributed significantly to spending gains. Areas of strength include motor vehicles and parts, furniture, recreational and other durable goods.

## CONTINUED CONSUMPTION SURGE

- However, spending on services and clothing, which pretty steadily declined throughout the pandemic, saw growth in Q1 as well. This included spending on clothing and apparel, food services and accommodations, recreation services and transportation services.
- Surge in consumer spending most primarily aided by continuing vaccination campaigns, which have allowed people to begin undertaking activities they had been abstaining from. People are going back to work, restaurants and are eager to travel.

## TRANSITORY OR PERSISTENT INFLATION? AN INFLATION CONUNDRUM

- Personal Consumption Expenditures price index (excluding food and energy), rose 0.6% in Q1. Prices in March alone rose 0.4%, which amounts to the largest one-month price surge since 2009.
- YoY inflation stands at 1.8%, likely to surpass (at least for short time) inflation target of 2.0%.
- Federal Reserve Chair, Jerome Powell, has indicated that he will not raise interest rates in response to a surge in inflation believed to be transitory.
- The Fed's new long-run monetary framework has re-framed inflation targeting from a target of 2.0% to an average inflation target (AIT) of 2.0% in the long-run. Therefore, inflation may be allowed to run above 2.0% for a period of time after a period of it running consistently below 2.0% such as the prior decade.

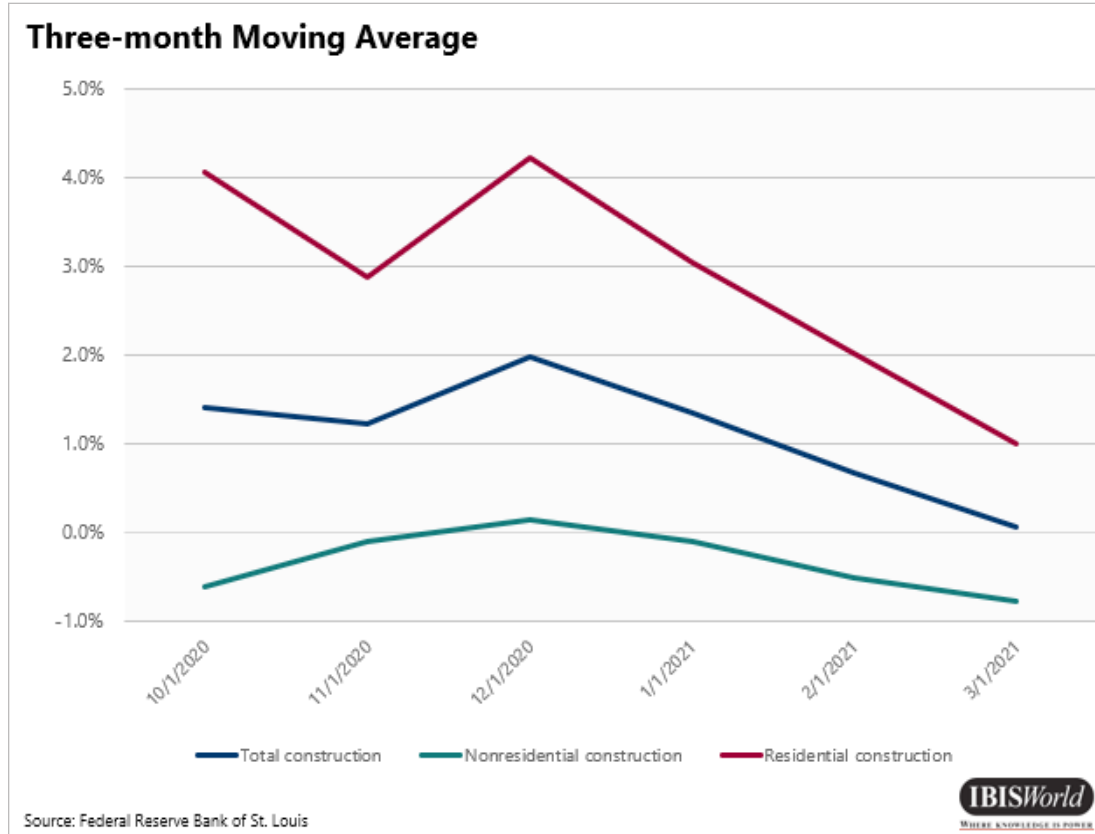


- Current price surges are being driven by supply bottlenecks caused by production issues and tight inventories, as well as a surge in demand following the pandemic. However, if inflation expectations become un-anchored, a longer period of inflation is possible.
- Some signs of this beginning to occur are evident in the US treasury yield curve, as 5-year breakeven inflation has surged to its highest levels in well over a decade, eroding real yields.

### CONSTRUCTION ACTIVITY DIVERGENCE

- Total construction spending increased just 0.2% in Q1 2021.
- There was a significant divergence within total construction, as residential spending increased 3.0% while nonresidential spending declined 2.3%.

- Overall construction activity is being boosted by increased demand on the residential side, while nonresidential construction remains subdued.
- With a relatively low housing stock and low mortgage rates, investment in residential construction has continued to expand. Despite the extremely strong growth in residential construction (up 23.3% YoY), total inflation-adjusted spending on housing remains below mid-2000s levels when the market was in a bubble.
- Nonresidential construction activity growth is expected to lag residential construction until the economy is fully reopened, as a surplus of existing real estate places and increasing vacancies place downward pressure on demand for new projects.
- Remote working will likely structurally alter demand for office space, so it remains to be seen how capital will be reallocated in the nonresidential space moving forward.



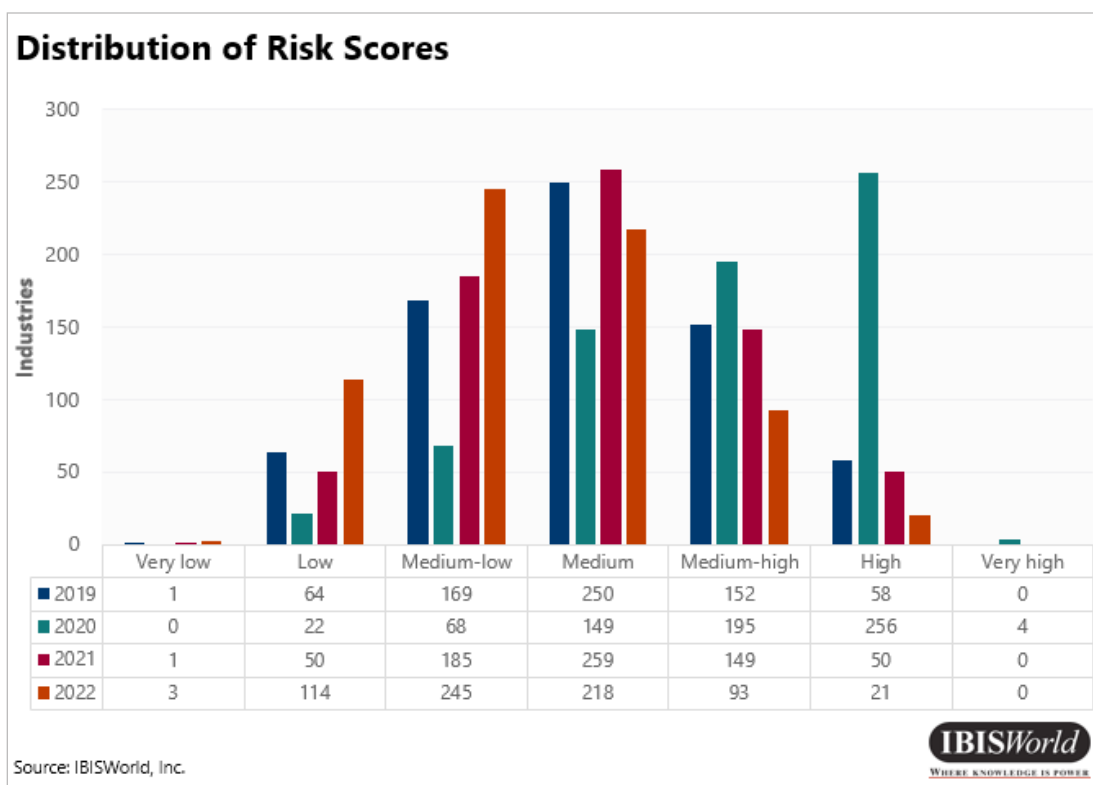
## FINANCIAL MARKETS

- S&P 500 produced a YTD price return of 10.73% in 2021, yet a 39.96% return between May 20, 2020 and May 20, 2021. Dow Jones U.S. Banks Index fared even better, producing a YTD price return of 32.83% and an 82.77% return during the same one-year period.
- The Federal Reserve has not changed its course regarding asset purchases, nor interest rate policy. The market-implied probability of interest rate hikes has increased over the year, but a hike before 2022 remains a tail-risk event.
- M&A activity for US targets totaled \$670.5 billion during the first quarter of 2021, an increase of 161% compared to the first quarter of 2020 and the strongest first quarter period for US deal making on record. Cash-rich companies are taking advantage of low borrowing costs to expand, especially as the economy is recovering.

- US banks are expected to fare well over 2021 as provisions for loan losses are likely to decline and net interest margins are likely to rise.

## DISTRIBUTION OF RISK RATINGS

- 2019 risk ratings were close to normally distributed.
  - 30.3% of industries rated as medium-high or greater risk.
- Risk in 2020 was concentrated at the higher end of the scale.
  - 65.6% of industries rated as medium-high or greater risk.
- While risk for 2021 in totality has moderated, conditions are expected to be more favorable during the second half of the year.
  - 28.7% of industries rated as medium-high or greater risk.
- The risk outlook is expected to improve significantly by 2022, once the economy is fully reopened.
  - 16.4% of industries rated as medium-high or greater risk.

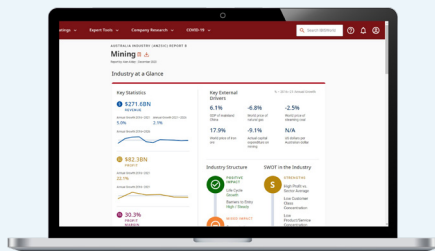


## SECTOR HIGHLIGHTS

- Accommodation and Food Services – Sector employment remains 2.8 million below pre-pandemic levels, as businesses remain challenged by the pandemic environment. As the economy continues on a path to being fully reopened, industries such as Hotels & Motels, Bars & Nightclubs and Single Location Full-Service Restaurants stand to benefit most from the surge in demand for tourism and discretionary activity. However, labor market frictions will likely continue to serve as a drag, as childcare difficulties stemming from restrictions on in-person learning and enhanced unemployment benefits disproportionately incentivize lower-income workers to stay home. These inhibiting factors are likely to last through the beginning of September.

*“ Unprecedented government support and economic recovery have contributed to a surge in demand that has placed significant upward pressure on home prices ”*

- Finance and Insurance – The federal funds rate is expected to remain at near-zero into 2023, though the Federal Reserve is expected to announce a change in its asset purchasing program. Market consensus is that the Fed will discuss tapering purchases of government debt and mortgage-backed securities in the summer and that actual tapering will begin by year-end. With the yield curve having steepened and interest rates on an upward trend, financial services industries such as Commercial Banking, Industrial Banks and Auto Leasing, Loans & Sales Financing should benefit from widening net interest spreads between their assets and liabilities.
- Construction – The housing market has remained extremely hot, as a low housing stock and historically low mortgage rates have buoyed the market. In addition to low borrowing costs, unprecedented government support and economic recovery have contributed to a surge in demand that has placed significant upward pressure on home prices. Industries such as Home Builders, Wood Framing, Plumbers and Roofing Contractors all stand to continue to benefit from the housing boom.
- Transportation and Warehousing – As the United States begins to distance itself from the worst of the pandemic, activities such as travel, freight and tourism will likely support the sector. While tourism has remained strained for much of the first half of 2021, it is expected to improve as the year progresses and travel picks up during the second half of the year. Domestic Airlines are positioned to benefit from the inevitable rebound in travel, while an overall surge in the commerce of goods should help lift industries such as Local Freight Trucking and Long-Distance Freight Trucking.



## Make Faster & Better Business Decisions with Insights & Analysis on Thousands of Global Industries

Founded in 1971, IBISWorld provides trusted industry research collected by in-house analysts that leverage economic, demographic and market data, then add analytical and forward-looking insights.

**Contact us today** to learn more about what IBISWorld can do for you