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What will happen as the drivers of the U.S. economy evolve?

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- U.S. GDP has returned to pre-Covid-19 pandemic levels after only one year, driven by strong growth in demand for goods consumption and home sales. That said, goods consumption has begun to decline from mid-2021, lagging slightly behind home sales, which peaked earlier. We expect a slowdown in goods consumption to ease the global supply-demand imbalance in the manufacturing sector and apply friction to stem price increases in the goods market.
- The growth rate of the U.S. economy is slowing moderately as the driver of growth shifts from goods consumption to services consumption. GDP growth is expected to slow in 2022 as consumption of some services is unlikely to return to its pre-COVID-19 trend as quickly. In addition to moderating rise in prices of goods, the slowdown in GDP growth will be another factor restraining inflationary pressure. In this article, we explore some of the key implications of this for investors and the economy as a whole.

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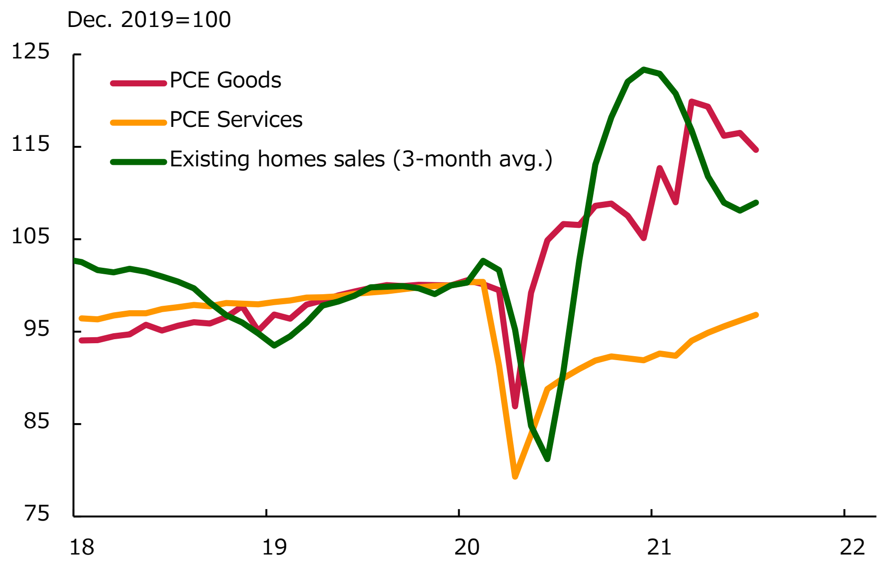
In the United States, post-pandemic economic normalisation has progressed at a rapid pace since April-June 2020, with real GDP growing by 12% in just one year as the economic blockade immediately after the outbreak of COVID-19 ended. Although the pandemic initially had the greatest negative impact on the economy in the post-war period, the pace of economic recovery has been rapid, with economic activity already having returned to pre-pandemic levels of October-December 2019.

"GDP growth of 12% driven by goods consumption and house sales"

This swift recovery has been driven by unusually rapid growth in household consumption of goods and home sales, as the U.S. government implemented massive cash subsidies and additional unemployment benefits to stem the economic effects of the pandemic, boosting household incomes on a much larger scale than in previous recessions. COVID-19 curbed consumption of services involving personal contact, meaning that much of this unprecedented scale of support provided was spent disproportionately on goods as opposed to services. As a result, goods consumption and sales of existing homes temporarily expanded by about 20% compared with pre-pandemic levels. These two factors were the driving force behind the growth of the U.S. economy after the pandemic (Figure 1).

Figure 1 : PCE* on Goods and Services/ Existing Home Sales



Period : From Jan. 2018 to Jul. 2021 (Monthly)
Source : Bloomberg

From the second half of 2020, supply and demand tightened in the markets for raw materials, such as timber for housing, and semiconductors for a wide range of products, leading to a rise in the prices of various materials. Furthermore, in 2021, the semiconductor market in particular experienced a severe supply-demand crunch, as production could not keep up with growing demand. This then led to a chain of events whereby the subsequent expansion of manufacturing production led to an increase in trade volumes, which in turn led to a backlog of container ships at ports and a sharp rise in the price of shipping, something that had hardly been seen since the 1990s.

As the battle for supremacy between the United States and China has intensified since 2018, the weaknesses of cross-border supply chain interdependency have become apparent in the production of high value-added products such as automobiles. Another factor may have been the inability of many companies to respond to an unexpected growth in demand, after having curbed their capital expenditure in the face of slower global economic growth since 2010.

We believe that the root cause of tighter supply and demand and higher prices across a wide range of goods markets is the unprecedented growth in goods consumption and home sales in the U.S., the world's largest consumer market. For many manufacturers, a 20% increase in demand from the U.S. in such a short period of time is an unexpected change in demand, especially for manufactures of upstream materials and semiconductors.

*PCE=Personal Consumption Expenditure

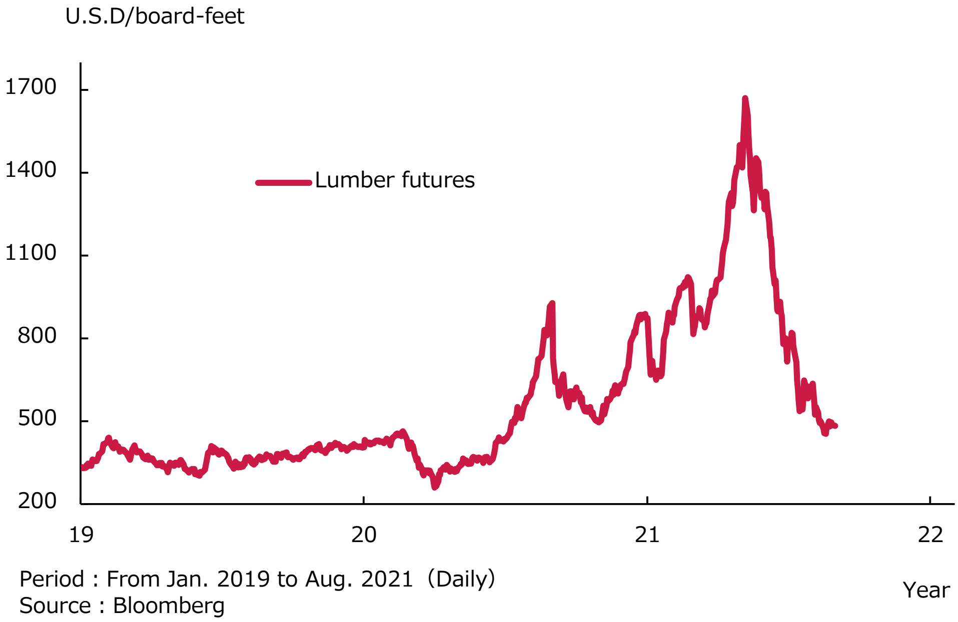
However, the sharp rise in U.S. lumber futures prices began to decline in early May, a few months after existing home sales in the U.S. had fallen earlier in the year (Figure 2)

The relationship between home sales and the lumber market is a classic example of how fluctuations in U.S. demand affect the raw materials market. As Figure 1 shows, the expansion in goods consumption slowed in mid-2021, somewhat behind housing sales. In the second half of 2021, therefore, the rise in raw materials and semiconductor prices that has been driven by the expansion in U.S. goods consumption is expected to come to a halt.

The rise in raw materials and transport costs has increased costs for companies in many countries in the first half of 2021 and has contributed to lower margins. However, a slowdown in U.S. consumer spending is expected to halt this decline in margins towards the end of the year.

"Timber prices fall as housing sales stop growing"

Figure 2 : Lumber Futures



Period : From Jan. 2019 to Aug. 2021（Daily）
Source : Bloomberg

As the spread of COVID-19 infections has subsided, the main driver of the U.S. recovery has already shifted to services consumption, which involves human contact, from the April -June quarter in 2021. We anticipate that, in the second half of 2021, the normalisation of services consumption will be the main driver of the economic recovery.

"Drive shifts to service consumption"

Compared to February 2020, the month before the COVID-19 pandemic, the level of services consumption was still around 3% lower than that in July 2021 (Figure 3). Services consumption will continue to grow at a similar rate to the April-June period until the end of 2021, closing this gap to some extent.

Figure 3 : U.S. PCE Services by Consumption Purpose

Period : From Feb. 2020 to Jul. 2021（Monthly）
Source : Bloomberg

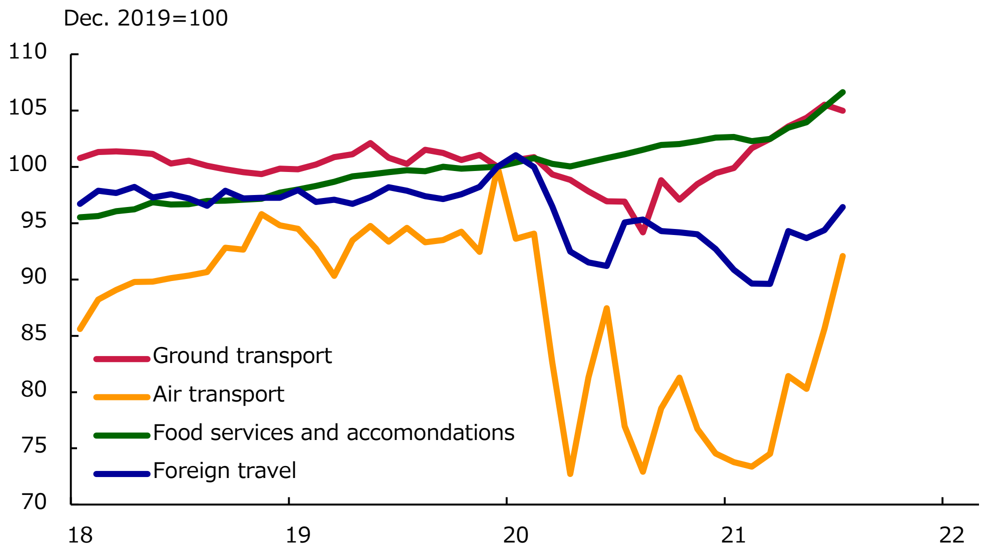
As mentioned above, goods consumption has surged beyond its pre-COVID-19 pace of growth, but will services consumption do the same? If consumption of services increases above pre-pandemic levels at a similar pace to that achieved so far in consumption of goods, the U.S. economy will continue to grow at a very high rate throughout 2022 and beyond.

However, while we expect consumption of services to increase steadily until the end of 2021, it is likely to slow down as it approaches pre-COVID-19 levels. One reason is that, unlike goods, which can be held in stock, service consumption is inherently less likely to display a rapid increase in a short period of time.

The second reason is that even if the normalisation of services consumption in the U.S. due to human contact continues in the near term, e.g. due to the progress in vaccination, it is unlikely for all of the service industries to return to their pre-COVID-19 levels quickly. Demand for services consumption will be restrained as some service industries will face a "demand ceiling", hence not returning to the same level of consumption demand and sales levels as at the end of 2019.

In the post-pandemic economy, some consumption is shifting to service sectors, however the pace of this will only be gradual, meaning that overall growth in service consumption with interpersonal contact will remain moderate. Overall consumer spending, which is a key driver of U.S. GDP growth, is expected to slow compared to the first half of 2021, when it was driven by goods consumption.

Figure 4 : PCE of Services Severely damaged by COVID-19



Period : From Jan. 2018 to Jul. 2021（Monthly）
Source : Bloomberg

"Inflation to be restrained by a combination of factors going forward"

Inflation in the goods market is likely to ease as the aforementioned tightening of supply and demand in the goods market slackens. In addition, a slowdown in the pace of economic growth to potential, against a backdrop of moderate growth in services consumption in 2022, will also act as a restraint on inflation. We expect the core inflation rate (core PCE (Personal Consumption Expenditure) deflator) to decline to around 2% from mid-2022. Looking at the price indices of the services industries, which have been severely impacted by the pandemic, the service industries with the greatest potential to normalise to pre-pandemic price levels are limited to some parts of the tourism sector, such as airlines and international travel (Figure 4).

The Federal Reserve has made it clear that it will begin tapering before the end of the year. In 2022, the central bank is likely to look for the right moment to end tapering and start raising interest rates. However, we expect that the cautionary stance to inflation currently held by hawkish members within the Federal Reserve will soften in the future as more and more factors restrain inflation, and their voices will gradually diminish. Consequently, we would expect that the Fed may not start raising interest rates until mid-2023 or later.

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