Economics

Special Commentary — February 26, 2021

The Economic Outlook: What Could Possibly Go Wrong?

Part XI: Conclusions

Summary

In this final installment of our series on economics risks, we summarize what we have learned in the previous nine reports. In our view, the potential for higher-than-anticipated inflation is the most notable risk that the economy faces in the next year or two. Low base effects and strong consumer demand should cause CPI inflation to be more than twice as high this year than the 1.2% rate that was registered in 2020. But to be clear, we do not forecast that inflation will subsequently get out of hand. Inflation expectations, although higher than a few months ago, generally remain contained, and a rise in the labor force participation rate once the pandemic has subsided should help keep a lid on outsized wage gains. But, higher-than-expected inflation in 2022, should it materialize, could lead the Federal Reserve to remove monetary accommodation faster than currently expected. The economy could weaken suddenly if the Fed were to apply excessive pressure on the monetary brakes.

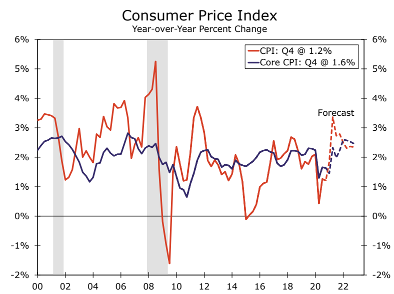
In our view, most of the other risks that we addressed in this series appear to be largely manageable at this time. The U.S. government is incurring gaping budget deficits, and the ratio of federal government debt-to-GDP has climbed to its highest level since the end of the Second World War. However, borrowing costs generally remain extraordinarily low, and investors probably will not become reticent about purchasing U.S. Treasury securities anytime soon. A sharp slowdown in global growth stemming from excessive fiscal consolidation, such as what occurred in 2010-2012, does not seem likely in the foreseeable future due to the relaxed attitude surrounding fiscal deficits among policymakers in most major economies.

China has an excessive amount of debt in its non-financial corporate sector, and a debt crisis in China, should one occur in the next year or so, would impart a sharp slowing effect on the global economy. But, a potential debt crisis in China likely would not lead to another global financial crisis on the scale of 2008, because the vast majority of Chinese debt is held onshore in China. The pandemic has had effects on the residential and commercial real estate markets in the United States, but potential fallout from these markets on the household sector and banking system should be limited because of the general healthy nature of their balance sheets at present.

Assuming that the pandemic does not come roaring back and close down the economy again, we look for strong rates of U.S. economic growth later this year and into 2022. But, we will be watching inflation and measures of inflation expectations closely in coming months to determine whether we need to make any changes to our economic forecasts.

Economist(s)

Jay Bryson
Chief Economist | Wells Fargo Securities, LLC
jay.bryson@wellsfargo.com | 704-410-3274



Source: U.S. Department of Labor and Wells Fargo Securities

After Nine Reports, What Do We Think Could Possibly Go Wrong?

Other than COVID, what other risks does the economy face?

The U.S. economy fell into a deep hole early last year when the COVID pandemic struck. But, the economy bounced back significantly in the second half of 2020, and as we outlined in a recent report, we look for it to accelerate considerably later this year as the country moves steadily toward herd immunity. Many American households have accumulated excess savings over the past year due, at least in part, to the income-boosting measures of the fiscal relief packages. These savings should finance strong growth in long-delayed spending on many services. If our forecasts of 6% real GDP growth this year and 5% in 2022 are realized, then these next two years would be the strongest two-year period of growth since the early 1980s.

There clearly are risks to this forecast, the most notable of which, at least in the near term, is COVID. If restrictions, which are slowly being relaxed in many localities at present, need to be re-imposed due to a spike in new cases, then the economy would not be able to achieve the strong growth rates we currently forecast. But, the path of the pandemic in coming weeks and months is largely unknowable. Rather, the objective of this series was to identify non-COVID risks that could lead to significantly slower economic growth over the next two years than we currently forecast. We have written about nine potential risks over the past month or so. In this final installment of the series, we outline what we believe to be the most notable risks that the economy faces in the foreseeable future.

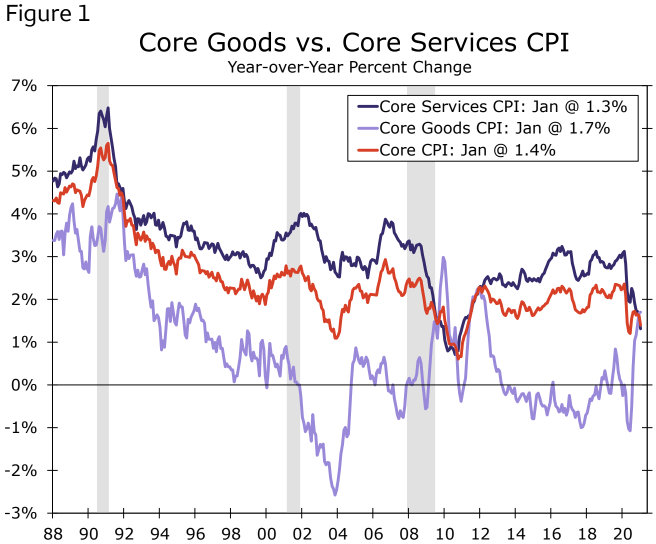
Inflation Is Probably the Biggest Risk

A rise in the prices of many services later this year should push the overall inflation rate higher.

In our view, the potential for higher-than-anticipated inflation is the most notable risk that the economy faces in the next year or two. We do indeed forecast that rates of consumer price inflation will be higher in 2021 than in 2020. Specifically, we look for CPI inflation to more than double in 2021 from the 1.2% rate that was registered last year. Base effects are part of the explanation for higher inflation this year. That is, prices of many goods and services initially fell when the economy went into lockdown mode last spring. The inflation rate will arithmetically rise as these price declines drop out of the year-over-year calculations.

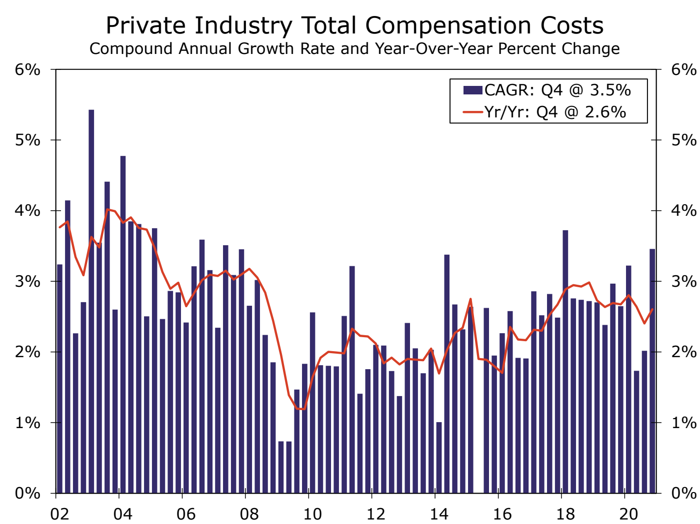
But as we noted in Part II of this series, there are also demand-side factors that should contribute to higher inflation this year. The sharp acceleration in consumer spending on goods since the pandemic struck has lifted "core" goods inflation to its highest rate in nearly nine years (Figure 1). Although the "core" rate of service price inflation has dropped considerably since last spring, these dis-inflationary effects should come to an end later this year as the economy fully reopens. Specifically, we look for the strong spending on services that we noted previously to lead to higher prices for many services as well.

Figure 1



Source: U.S. Department of Labor and Wells Fargo Securities

Figure 2



Source: U.S. Department of Labor and Wells Fargo Securities

Not only will these demand-side factors push inflation higher, but there are also supply-side factors to consider as well, which we discussed in Part III. Although the number of workers on non-farm payrolls remains nearly 10 million (more than 6%) below its February 2020 peak, there appears to be some tightness in the labor market. In that regard, total compensation costs for private sector workers rose at an annualized rate of 3.5% in Q4-2020 (Figure 2), the strongest sequential rate of increase since early 2018, when the unemployment rate was roughly 4.0%. The combination of rising input prices and compensation costs could lead many businesses to raise prices.

If inflation does indeed turn out to be higher than anticipated in the next year or so, then the Federal Reserve could potentially begin to dial back monetary accommodation. Rate hikes and/or shrinkage in the Fed's balance sheet, if done too quickly, could lead to significant economic deceleration, if not outright contraction. Furthermore, higher input and compensation costs could lead to margin squeeze. As we discussed in Part IV, the combination of falling profits and slower economic growth could lead many businesses to rein in investment spending and payrolls.

But as we also noted in our earlier reports, inflation is a process. A one-off increase in prices does not necessarily imply that the price level will accelerate on an ongoing basis. For starters, inflation expectations would need to ratchet up significantly for an upward spiral in inflation to take root. Although some measures of inflation expectations have been creeping higher recently, they generally remain within ranges that prevailed over the previous cycle, when rates of consumer price inflation remained benign. In addition, the eventual opening of new businesses that we expect and the rebound in the labor force participation rate that we forecast should help to restrain wages and prices in the next year or so.

Inflation is a process, and a one-off increase in prices does not necessarily imply that the price level will accelerate on a continuing basis.

In sum, we look for inflation to be higher in 2021 than it was in 2020. But to be clear, we do not suspect that inflation will get out of hand in the following year. That said, we readily acknowledge the **risk** that inflation could turn out to be higher than we expect, not only this year but in the following years. If so, then the Federal Reserve could potentially tighten monetary policy sooner and more rapidly than most market participants currently expect. Although removal of monetary accommodation may not necessarily bring the economy to its knees directly, higher rates could have negative implications for some other areas of the economy, to which we now turn, that potentially could be at risk.

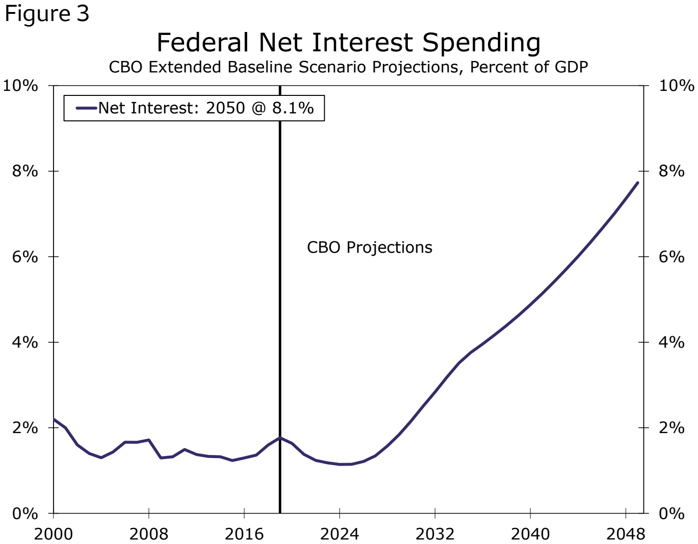
Higher Rates Would Push Up Government Borrowing Costs

The federal government could find itself in a vicious cycle of higher borrowing costs, higher debt, higher borrowing costs, etc.

We addressed the gaping budget deficits that the federal government has incurred in recent years and the accompanying rise in the level of government debt in Part VI. In short, the debt-to-GDP ratio of the federal government has risen to roughly 100%, the highest ratio since the end of the Second World War. But, the generalized decline in interest rates since the global financial crisis has caused the interest expense of servicing debt to fall to only 1.5% of GDP, about one-half the ratio that existed 25 years ago.

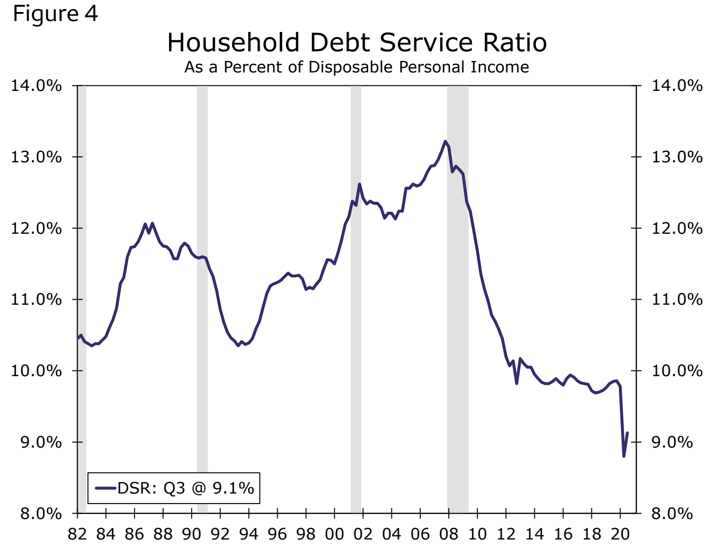
The Congressional Budget Office (CBO) projects that net interest expenses will start to trend higher later this decade when the Federal Reserve begins to raise rates (Figure 3). But, higher inflation could compel the Fed to raise rates sooner and more rapidly than expected. If so, net interest expenses could ratchet higher more quickly, and the federal government could find itself in a vicious cycle of higher borrowing costs, higher debt, higher borrowing costs, etc. Although investors likely would continue to buy the debt obligations of the U.S. government due to the depth and liquidity of the market for U.S. Treasury securities, rising interest expenses could squeeze other important areas of federal spending.

Figure 3



Source: Congressional Budget Office and Wells Fargo Securities

Figure 4



Source: Federal Reserve System and Wells Fargo Securities

Household Finances Could Deteriorate If Rates Moved Significantly Higher

Some households could be squeezed by higher interest rates.

Higher interest rates could have negative implications for household finances as well. As we discussed in (Part V), household debt has risen in recent years due largely to outsized increases in auto and student loans. That said, the debt-to-disposable income ratio for the household sector has receded by roughly 30 percentage points since 2008 and currently stands at its lowest level in nearly 20 years. In addition, the amortization and interest payments that households need to make on their total debt obligations (as a percentage of disposable income) have dropped to their lowest levels in at least 40 years. In general, we judge the financial position of the overall household sector to be generally solid at present (Figure 4).

Should the Federal Reserve start to tighten monetary policy due to a larger-than-expected rise in inflation, then borrowing costs for households would rise. Mortgages account for two-thirds of household debt outstanding, and interest rates on most mortgages are fixed. Because the overall financial health of the household sector seems to be in generally good shape at present, higher rates likely would not have devastating consequences for the aggregated balance sheet of the household sector. However, some highly indebted households, especially those with floating-rate debt obligations, could become financially stressed if rates were to move significantly higher in the next few years.

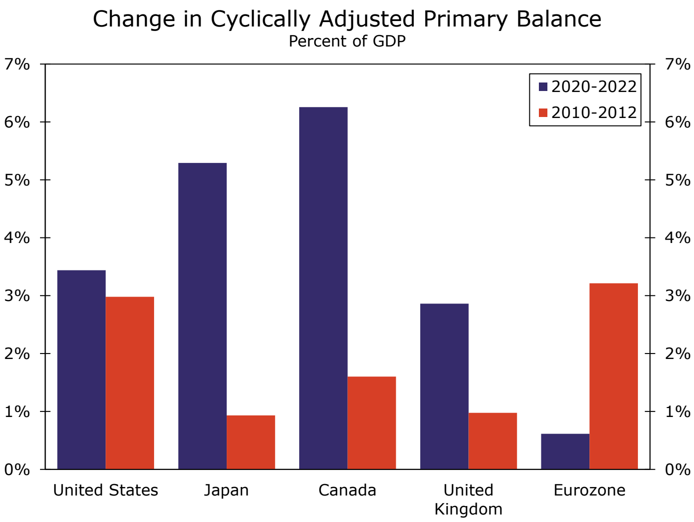
Fiscal Consolidation: 2010-2012 Déjà Vu?

Policymakers today do not seem to be as fixated on fiscal consolidation as they were a decade ago.

The takeaway so far is that aggressive monetary tightening in the next few years, should it occur, would exert headwinds on economic growth. But, premature fiscal consolidation could also exert a meaningful restraint on global economic growth. As we discussed in Part VII, the United States is not the only major economy that has experienced a sharp rise in government debt since the pandemic struck, and some governments could feel compelled to undertake fiscal consolidation as they did in the immediate aftermath of the global financial crisis a decade ago. Between 2010 and 2012, the cyclically adjusted primary balance narrowed considerably in many major economies and the OECD projects a similar degree (or more) of fiscal consolidation in the next two years (Figure 5).

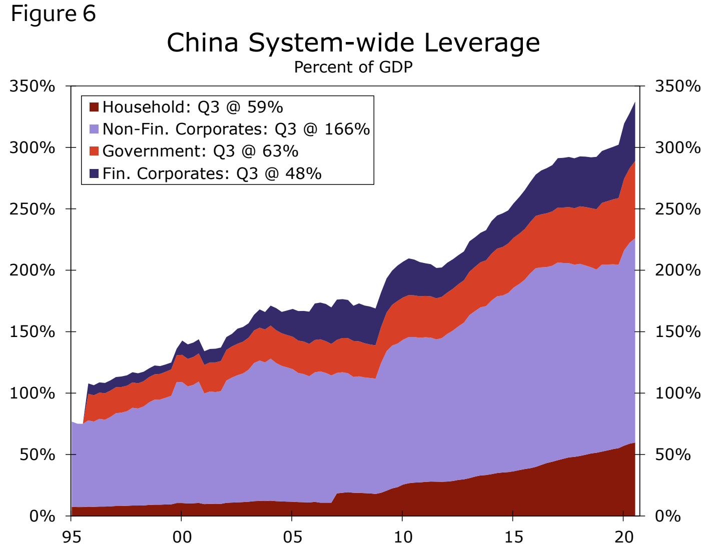
That said, we believe that the risk of significantly slower global growth due to fiscal consolidation *à* la 2010-2012 is rather low. For starters, the OECD projections may not actually be realized. Low borrowing costs at present have made most governments rather relaxed about gaping fiscal deficits and large stockpiles of debt. As we discussed in a recent report, the United States likely will enact another large fiscal relief package in the next month or so. Furthermore, household savings rates have risen markedly in many major economies. The combination of excess savings and pent-up demand for services should lead to acceleration in consumer spending that likely will offset any fiscal drag that may occur in the near term.

Figure 5



Source: OECD and Wells Fargo Securities

Figure 6



Source: IIF and Wells Fargo Securities

Chinese Debt Crisis Could Exert Significant Slowing Effect on Global Economy

The vast majority of Chinese debt today is held within China.

The advanced economies of the world are not alone in experiencing marked increases in debt. The overall debt-to-GDP ratio of the Chinese economy has risen considerably over the past decade. As we discussed in Part VIII, the rise in the ratio has been particularly troubling in the Chinese non-financial corporate sector (Figure 6). We are not in a position to reasonably estimate the probability of a debt crisis in China, because the Chinese economy and financial system are simply too opaque to do so with any accuracy.

A Chinese debt crisis, should one occur, would be a significant economic event for the global economy. China imports roughly $2.5 trillion worth of goods and services, and a debt crisis would lead to sharp economic deceleration, if not outright contraction, in the world's second-largest economy. The economic shock waves would be felt in many economies, especially those Asian countries with extensive trade ties with China.

Although we readily acknowledge that a debt crisis in China would be a significant economic event for the rest of the world, it likely would not have the same devastating effect on the global financial system as did the bursting of the U.S. housing bubble more than a decade ago. American debt securities were, and still are, widely held around the world, and financial institutions in other countries experienced significant losses when American mortgage-backed securities registered sharp declines in value. In contrast, the vast majority of Chinese debt today is held within China. Therefore, foreign financial institutions likely would experience few direct losses from a debt crisis in China.

Fundamentals of Residential Real Estate Generally Are Solid at Present

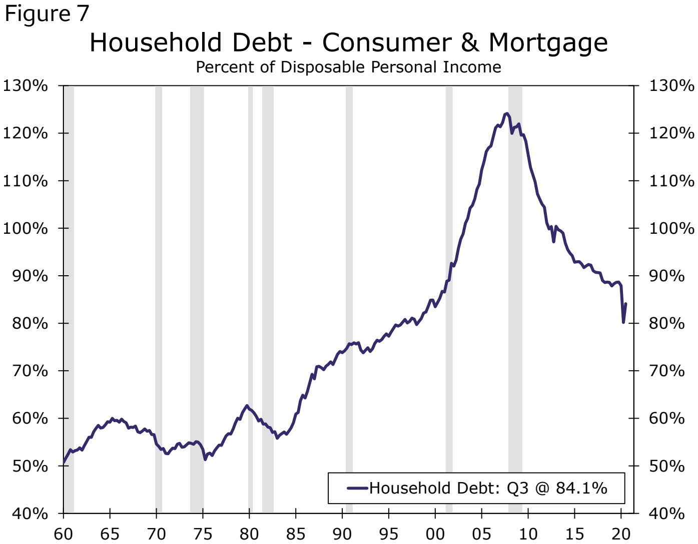
The household sector is less leveraged today than in was a decade ago, and the banking system is well-capitalized.

Acceleration in the prices of goods and services is not the only inflation risk that exists at present. The median price of an existing single-family home rose more than 15% last year, the largest increase since 2005. This outsized increase sounds eerily reminiscent of the housing bubble years during the early years of the 21st century.

In our view though, fundamentals factors, rather than speculative behavior *à* la the bubble years, are largely responsible for the recent marked increase in house prices. The necessity for many individuals to work and educate at home due to the pandemic has stoked demand for more living space, and low mortgage rates have reduced the financing costs of buying a home. Increased demand for housing coupled with restrained supply have pushed up house prices. Furthermore, underwriting standards are significantly tighter today than they were during the bubble years, and low FICO mortgage originations account for a very small share of total originations.

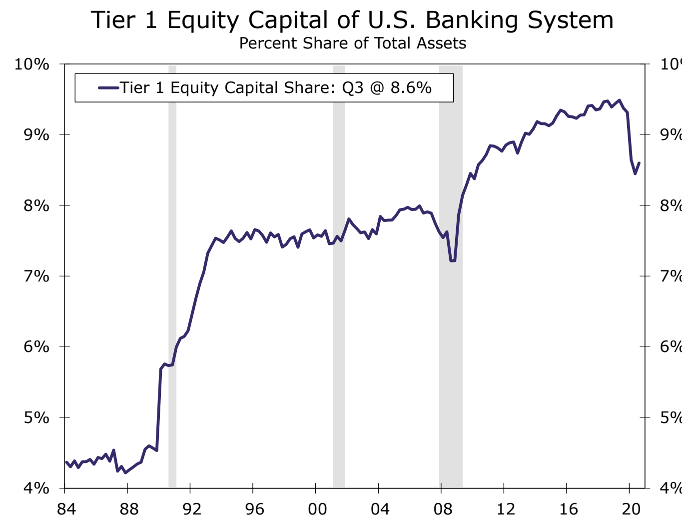
We acknowledge that house prices could retreat somewhat once the pandemic passes and life returns to some semblance of "normal." But any pullback in house prices, should one occur, likely would not have the same devastating effect on the economy that the implosion of the housing bubble did a decade ago. Households are significantly less leveraged than they were during the bubble years (Figure 7), and homeowners generally have more equity in their homes today than they did at the height of the bubble. The American banking system is very well-capitalized at present (Figure 8), giving it more resilience today than a decade ago.

Figure 7



Source: Federal Reserve System and Wells Fargo Securities

Figure 8



Source: FDIC and Wells Fargo Securities

Pandemic Has Affected the CRE Market, but Probably Not a Major Macro Risk

The American banking system should be able to absorb any CRE-related losses.

The pandemic has also had notable effects on the commercial real estate (CRE) market. The need to socially distance has necessitated work-from-home (WFH) for most office workers, which has led to weaker demand for office space. The retail and hotel sectors of the CRE market have also been dealt body blows from socially-distanced protocols.

We are of the belief that although WFH will alter the way that office workers do their jobs in coming years, there likely will still be demand for office space, given the key role it plays in fostering collaboration, innovation, culture and productivity. Likewise, retailers likely will continue to need “bricks and mortar” modes of distribution, although the mix could shift in favor of more outdoor space and less indoor shopping malls. Demand for personal travel and the associated need for hotel accommodations likely will recover after the pandemic passes, although business travel may be slower to recover. But, the American banking system likely would be able to absorb any CRE-related losses without undue stress to the overall financial system.

Conclusion

The economy was laid low by the onset of the COVID pandemic nearly a year ago, and the economic outlook continues to depend crucially on the path of the pandemic in the coming weeks and months. But, that path is largely unknowable. The objective of this series of reports was to consider a number of knowable factors that could also present risks to the economic outlook in the next year or two.

To paraphrase Tom Clancy, we believe that inflation represents the clearest and most present danger to the U.S. economic outlook at present. Low base effects and strong consumer demand should cause CPI inflation to be more than twice as high this year than the 1.2% rate that was registered in 2020. But to be clear, we do not forecast that inflation will subsequently get out of hand. Inflation expectations, although higher than a few months ago, generally remain contained, and a rise in the labor force participation rate once the pandemic has subsided should help keep a lid on outsized wage gains. But higher-than-expected inflation in 2022, should it materialize, could lead the Federal Reserve to remove monetary accommodation faster than currently expected. The economy could weaken suddenly if the Fed were to apply excessive pressure on the monetary brakes.

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	International Economist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	International Economist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economist	(704) 410-1681	shannon.seery@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Nicole Cervi	Economic Analyst	(704) 410-3059	nicole.cervi@wellsfargo.com
Sara Cotsakis	Economic Analyst	(704) 410-1437	sara.cotsakis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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