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The Delta Divide

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"Change the course of COVID; change the course of the economy - full stop."

I tweeted that on July 14, 2020 as we were entering our second wave of infections. Research comparing consumer behavior across counties during the three waves of infection last year revealed that fear, not lockdowns, drove the shifts in consumer behavior. Areas where a surge in fatalities occurred saw a pullback in in-person activities, regardless of restrictions or not.

During the second quarter of 2021, the overall economy easily sailed past the previous peak hit in the fourth quarter of 2019, before the pandemic. A combination of more vaccinations, fewer restrictions, less fear of contagion and three rounds of fiscal stimulus contributed to those gains. Consumer spending surged at a double-digit pace, leading to a rush of consumers eager to see and be seen after a long hibernation.

Employment gains in June and July approached the one million mark and concerns about a more persistent, sustained inflation surfaced. Consumers spent and businesses scrambled to ramp up faster than workers were able or comfortable returning to frontline jobs. This has given low-wage workers a moment in the sun after decades suffering in the shadows of the economy.

Then, vaccine hesitancy and the Delta variant collided. A fourth wave of infections has erupted, which has already exceeded the pace of last summer. Vaccinations are increasing but vary widely by state and age. Teens and young adults aged 18-24 are among the least vaccinated.

The Food and Drug Administration (FDA) has moved up its timeline for full vaccine approval. The goal is now September including approval of vaccines for children under 12 and boosters. That should prompt even more people to get vaccinated, according to surveys.

We expect to avoid lockdowns, but that will not stop consumers from curbing indoor interactions where contagion is highest. New York has opted to mandate proof of vaccination to stay open.

Major companies have delayed fully reopening offices. Workers who returned to offices with mask mandates are back to working-from-home. Some schools have been forced to close due to outbreaks; that undermines the ability of workers (mostly women) to return to work.

The experience of other countries suggests that the current wave will crest more rapidly than previous waves but additional waves cannot be ruled out. India is starting to see a resurgence of cases triggered by the Delta variant, while Dr. Anthony Fauci warned that Delta could mutate and evade vaccines "if we don't get good control over the community spread."

This edition of ***Economic Currents*** takes a closer look at what the Delta variant means for the outlook. The variant is expected to dampen, but not derail, the recovery in the U.S. Each wave of the virus has proven the U.S economy more resilient as more infections and casualties take a smaller toll on economic activity. Everything from technology to unprecedented stimulus has enabled us to spend our way through disruptions.

This time will be different because fiscal stimulus is waning; additional stimulus is unlikely. The Delta variant has reached many developing economies that escaped earlier waves; that is further disrupting supply.

Disruptions to the supply chain could be greater than those to demand, which would trigger a more persistent rise in inflation. Efforts to hedge against future supply chain disruptions could then make the economy vulnerable to a traditional boom/bust cycle when the Federal Reserve is forced to extinguish inflation. We have not seen anything like that for decades.

A More Moderate Recovery

Chart 1 compares the trajectory of growth last month with our forecast now that we have entered the Delta wave of the pandemic. The slowdown triggered by variants and a shortfall in the spending of funds allocated for fiscal stimulus are expected to suppress growth relative to what we had a month ago but keep the overall economy above the pre-pandemic trend through 2023.

We are assuming an acceleration in the pace of vaccinations after FDA approval. That shift and a build of antibodies from earlier infections are expected to stem, but not eliminate, a winter wave of infections.

Consumer Spending Moderates

The higher spending and inflation in the second quarter are likely to slow, but not fall off a cliff. Current expansions and supplements to millions of unemployed workers are slated to come to an abrupt end on September 6. Solid employment gains, expansions to the child tax credit and an overhang of savings generated by the crisis should keep spending going.

The saving rate is expected to return to pre-pandemic levels in 2022. The Delta variant could push out that timeline and prompt some to save more for fear of future disruptions. The problem is that those who are most likely to save are the least able to do so. The boost to savings triggered by stimulus checks and expansions to unemployment insurance is already waning.

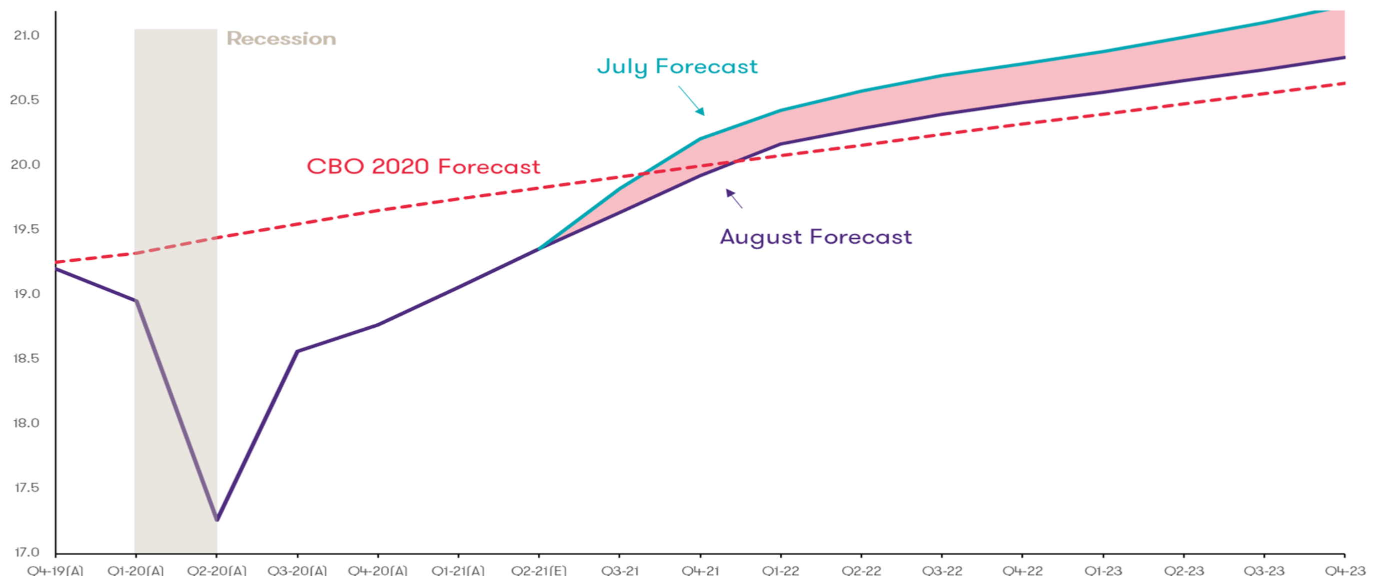
Housing: Victim of Its Own Success

Housing is expected to continue to moderate. Low inventories and material and labor shortages have collided with a surge in demand, forcing home prices to skyrocket. Increased purchases by institutional investors with deep pockets have exacerbated the spike in prices. First-time buyers are being crowded out.

Chart 1

Delta and Bottlenecks Dampen Rebound

GDP, 2012 $, Trillions



Source: Bureau of Economic Analysis, Grant Thornton LLP

Home buying and building went from driving overall growth at the start of the year to becoming a drag on growth in the second quarter; we expect it to remain this way in the months to come.

In June, home buying sentiment plummeted to the lowest level since the 1980s. Mortgage applications dropped to the lowest level since May 2020.

Multifamily construction is expected to fare better than single-family construction, especially in new technology hubs and suburbs. Remodeling should remain strong given the equity that homeowners have accumulated.

Businesses Scramble to Adopt New Technology

The pandemic triggered the fastest acceleration in business investment in new and existing technologies since the late 1990s. Leapfrog investments are being made in everything from computers to AI and robotics. The goals include faster production lines, contactless transactions and online order fulfillment.

Computer chip shortages remain the biggest hurdle. Producer backlogs increased in July after easing during the past two months in Taiwan, the world's largest chip producer. A fifty-year drought collided with the variant to idle production and reverse progress on backlogs.

Inventories are Replenished

Inventories are expected to be rebuilt after being drained dramatically during the pandemic and again in the first half of 2021. Supply chain disruptions are expected to slow the pace of rebuilding, relative to what is needed. Vehicle dealers would like to keep their inventories much lower than in the past, given the pivot to online sales and the cost of carrying large inventories.

That said, we can't rule out the bullwhip effect, a term known in logistics. That occurs when demand appears stronger than it actually is as buyers scramble to get products from multiple sources.

A good example is the housing market. Home builders struggling with backlogs on appliances are opting to buy retail instead of wholesale to more quickly complete homes. Orders for one house show up as two in order backlogs; builders are reluctant to cancel backlogged orders they might need to complete future projects.

Those shifts would exacerbate the rise in inventories triggered by the pivot from just-in-time to just-in-case systems designed to hedge against future supply shocks.

Government Spending Slows

Governments are not very efficient at spending the funds they have allocated. Spending at the state and local levels actually fell in the second quarter when they failed to spend transfers allocated in the last round of federal stimulus. We should see some of those losses recouped during the second half of 2021 and into 2022 but most of the boost from emergency aid and stimulus is behind us.

Indeed, the federal deficit, or the annual shortfall in spending relative to revenues, is poised to improve fairly significantly in fiscal 2022. Spending will slow as three rounds of stimulus play out. At the same time, tax revenues are expected to rise with payrolls.

A bipartisan infrastructure package would not do much to alleviate the drag on growth related to the end of fiscal stimulus in the near term. The Congressional Budget Office scoring of the bill adds $256 billion to deficits over the next decade, which is small relative to what we have seen recently. Our forecast does not include a larger spend on social programs using the budget process; that would also represent a slowdown from the pace of spending we have seen but allow deficits to widen more rapidly again after a brief reprieve in FY22.

Trade Deficit Narrows

Exports are expected to pick up faster than imports as consumers shift their demand from goods to services. A replenishment of inventories will limit that improvement, as it will put a floor on the pace at which imports are still coming into the country. Shortages of shipping containers and backlogs at U.S. ports are expected to take until 2022 to work through.

Inflation Abates, Doesn't Disappear

Inflation is widely expected to abate from the current pace; it most likely peaked in June. Much of the surge in prices was triggered by distortions created by the pandemic, rather than a more persistent gap between supply and demand. Inflation is expected to slow over the summer and into 2022 but remain higher than we have become accustomed to for some time.

A downdraft in prices at the onset of the pandemic has boosted year-over-year measures of inflation. Those base effects, as they are called, will play out over the next few months. They will start to work in the other direction and artificially suppress annual measures of inflation in 2022.

Much of the surge in prices now is triggered by pandemic-related bottlenecks and the resumption of economic activity, especially in the service sector. Affected items include air fares, hotel room rates, rental car fees and vehicles. Used vehicle prices have already peaked at the wholesale level, which should help to shift the momentum on goods and rental car inflation as we move into 2022.

Shelter costs are trickier. Rents, which dropped in some major cities during the crisis, have bottomed as young adults return to attend college and work in offices.

The housing component of shelter costs decelerated over the last year when a surge in refinancing reduced monthly mortgage payments. The rise in home values will show up with a lag in the amount homeowners believe they could rent their homes for when asked. That will show up in inflation measures in 2022.

Ultimately, the persistence of inflation depends on the mismatch between supply and demand; that includes the price of labor. The question is whether workers can maintain an upper hand over employers when more workers return to the labor market. It also depends on the extent that technology boosts productivity growth and accelerates the substitution of capital for workers.

It is no coincidence that the current surge in pay is being driven by large firms, which can better leverage technology to blunt the impact that rising wages have on profit margins. A consolidation of employment at those firms could reduce dynamism in the economy and ultimately undermine the bargaining power of workers. In the interim, risks remain to the upside on inflation.

Fed Removes Accommodation

The Federal Reserve is expected to start to taper its purchases of $120 billion a month in Treasury bonds and mortgage-backed securities by year-end. An announcement could come as soon as September. Any setback in growth related to the Delta variant could slow the pace of tapering.

We now expect the Fed to begin liftoff by the end of 2022 instead of in 2023, as disruptions to supply outweigh the blow to demand triggered by the Delta variant. Hawks, or those who expect to raise rates in 2022, will gain influence in the voting ranks of the Federal Open Market Committee (FOMC) next year. That will make it easier for them to push for an earlier rate hike.

Fed Chairman Jay Powell has stressed that inflation will be transitory one way or another. Either it will abate on its own as backlogs and bottlenecks clear or the Fed will extinguish it. The latter sounds easier in theory than reality and would be much more painful. (Understatement.)

Bottom Line

The Delta variant is driving a wedge between the vaccinated and the unvaccinated both within and across country borders. Developing economies have proven particularly prone to Delta disruptions, which have upped the risk of a more sustained inflation and a misstep by the Federal Reserve. The result could be an abrupt end to the current boom.

The only way to narrow that gap and reduce the risk of a premature end to the recovery is to increase the pace of vaccinations everywhere. That would break the vicious cycle of variants and ease supply chain disruptions. We have the vaccines; it is past time that we utilize them.

Economic forecast — August 2021

	2020	2021	2022	2020:4 (A)	2021:1 (A)	2021:2	2021:3	2021:4	2022:1	2022:2	2022:3	2022:4
National Outlook												
Chain-Weight GDP[1]	-3.4	6.0	4.3	4.5	6.3	6.5	5.9	5.9	5.1	2.4	2.2	1.7
Personal Consumption	-3.8	7.9	3.2	3.4	11.4	11.8	1.7	4.2	2.9	2.2	1.9	1.8
Business Fixed Investment	-5.3	8.2	6.5	12.5	12.9	8.0	6.7	8.6	7.3	4.8	4.9	4.0
Residential Investment	6.8	10.1	-3.8	34.4	13.3	-9.8	-1.1	-4.4	-1.6	-4.6	-4.8	-5.3
Inventory Investment	-42	-32	171	89	-88	-166	40	85	178	181	172	152
Net Exports (bil $ '12)	-935	-1246	-1216	-1125	-1218	-1251	-1273	-1243	-1240	-1228	-1209	-1188
Exports	-13.6	4.7	7.7	22.5	-2.9	6.0	5.0	7.5	8.4	8.4	8.6	8.3
Imports	-8.9	13.2	4.2	31.3	9.3	7.8	5.8	1.4	5.1	4.1	3.5	3.2
Government Expenditures	2.5	0.9	1.3	-0.5	4.2	-1.5	0.9	3.2	1.4	0.7	1.4	1.0
Federal	5.0	1.4	-0.9	-3.1	11.3	-5.1	-1.9	0.2	0.6	-1.8	-0.4	-1.6
State and Local	0.9	0.7	2.7	1.2	-0.1	0.8	2.7	5.1	2.0	2.4	2.4	2.6
Final Sales	-2.9	5.7	3.3	3.4	9.1	7.7	1.8	5.0	3.3	2.3	2.4	2.1
Inflation												
GDP Deflator	1.3	3.7	2.6	2.0	4.4	6.0	4.6	2.9	1.9	1.9	1.6	1.9
CPI	1.2	4.2	2.4	2.5	3.7	8.5	5.9	1.5	1.6	1.3	1.3	1.6
Core CPI	1.7	3.5	3.1	1.8	1.2	8.2	5.9	2.3	2.4	2.3	2.3	2.3
Special Indicators												
Corporate Profits[2]	0.9	5.9	-0.5	0.9	17.6	30.6	5.6	5.9	3.3	2.8	0.8	-0.5
Disposable Personal Income	6.2	2.0	-2.7	-8.3	57.6	-30.6	-7.5	-3.1	0.5	3.3	3.1	1.7
Housing Starts (mil.)	1.40	1.57	1.45	1.58	1.60	1.57	1.56	1.56	1.51	1.47	1.42	1.39
Civilian Unemployment Rate	8.1	5.6	3.7	6.7	6.2	5.9	5.5	4.8	4.1	3.7	3.5	3.4
Total Nonfarm Payrolls (thous.)[3]	-7317	5633	863	1873	821	1542	1896	1374	1494	885	670	401
Vehicle Sales												
Automobile Sales (mil.)	3.5	3.8	3.8	3.9	3.9	3.9	3.7	3.8	3.8	3.8	3.8	3.7
Domestic	2.5	2.5	2.5	2.8	2.6	2.6	2.4	2.4	2.5	2.5	2.4	2.4
Imports	1.0	1.3	1.3	1.1	1.3	1.3	1.3	1.4	1.3	1.3	1.4	1.3
Lt. Trucks (mil.)	10.5	12.6	12.6	12.3	13.1	13.0	11.8	12.3	12.5	12.5	12.7	12.7
Domestic	8.6	9.7	9.8	9.6	10.3	9.9	9.0	9.5	9.8	9.7	9.9	9.9
Imports	2.4	2.9	2.8	2.7	2.8	3.1	2.8	2.8	2.7	2.8	2.8	2.8
Combined Auto/Lt.Truck	14.0	16.4	16.4	16.2	17.0	16.9	15.5	16.1	16.3	16.3	16.5	16.4
Heavy Truck Sales	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4	0.5
Total Vehicles (mil.)	14.4	16.8	16.8	16.7	17.5	17.4	16.0	16.6	16.8	16.7	16.9	16.9
Interest Rate/Yields												
Federal Funds	0.4	0.1	0.1	0.09	0.08	0.07	0.10	0.10	0.10	0.11	0.11	0.14
10-Year Treasury Note	0.9	1.4	1.8	0.86	1.32	1.59	1.35	1.45	1.60	1.72	1.84	1.93
Corporate Bond BAA	3.7	3.5	3.9	3.36	3.54	3.61	3.34	3.41	3.60	3.78	3.97	4.05
Exchange Rates												
Dollar/Euro	1.13	1.21	1.23	1.19	1.20	1.20	1.23	1.23	1.23	1.23	1.24	1.24
Yen/Dollar	106.8	108.9	109.6	104.5	106.2	109.4	110.0	110.0	110.0	110.0	109.7	108.5

1. in 2020, GDP was $18.4 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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