Bridgewater®
Daily Observations
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The Wall of US Nominal Demand Is Here and Likely to Be Sustained

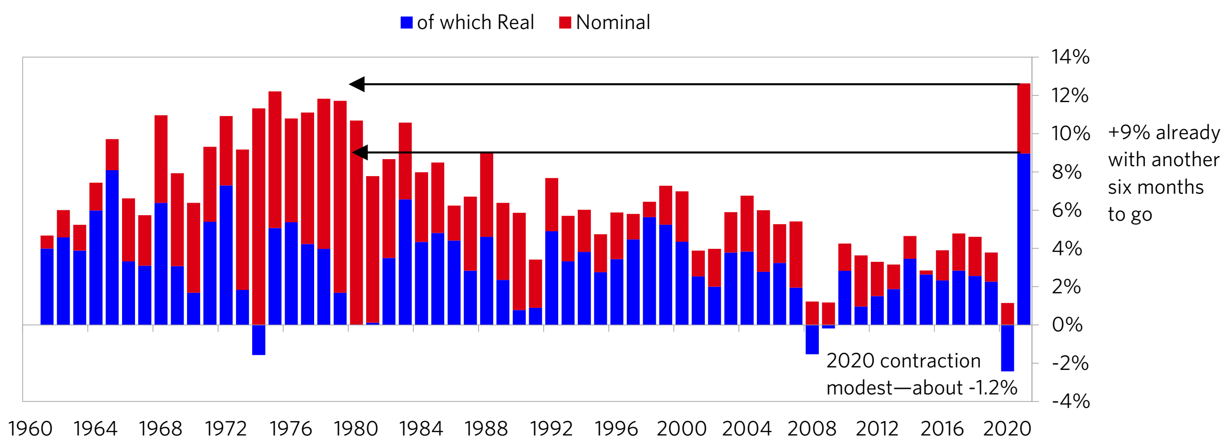
Markets are looking through the ongoing inflationary boom,
but we expect it to take more tightening than priced in to contain it.

Coming into this year, our view was that the US economy would experience a sustained surge in nominal demand that would be stronger than consensus and much more significant than discounted. In terms of economic outcomes, this is what has actually transpired, with significant real growth but even more of a surge in prices. What has not occurred so far has been a change in market discounting. This market action would be consistent with the expectation that the surge in nominal demand will be short-lived or will not require much of a tightening to slow it. As we discuss below, we think the strength of demand is sustainable even if many of the specific dynamics happening today, such as shortages of chips and cars, are temporary. And that surging nominal growth will make it much more challenging for the Fed to remain as easy as is currently discounted. Below, we highlight:

- How massive the surge in nominal household spending has been in 2021, despite ending 2020 down only modestly for the year. It will slow over the next six months, but it will still be strong off very high levels.
- Surging demand into the tightest labor market in decades is increasingly inflationary. Rising prices will be needed to create rationing because supply chains are strained and labor is in short supply.
- Nominal demand growth is likely to remain strong. Income and financial conditions for most households are extremely supportive relative to the last few decades. High savings rates reflect lingering pandemic effects that are more likely to ebb than to revert (we will cover in more detail how we are tracking developments around the Delta variant in future *Observations*).
- Surging home prices and rising rents also reflect this dynamic—and are inflationary pressures that are also likely to be sustained (a theme we will cover in more detail in future *Observations*).
- A recovery in exports as the rest of the world catches up is still ahead.
- Domestic businesses are just beginning to respond to this strength in demand by doing more capex and raising prices (we will also cover this in more detail in future *Observations*).

The chart below puts the surge in nominal spending in perspective.

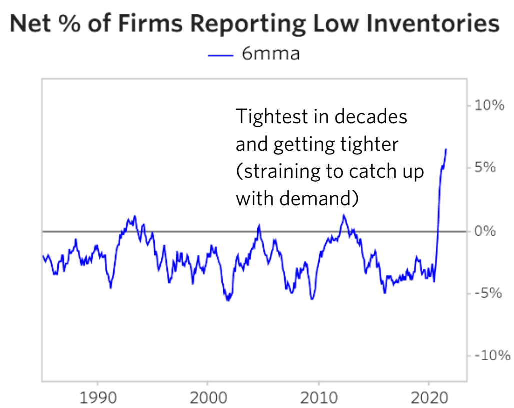
USA Nominal Household Demand Growth (Y/Y)

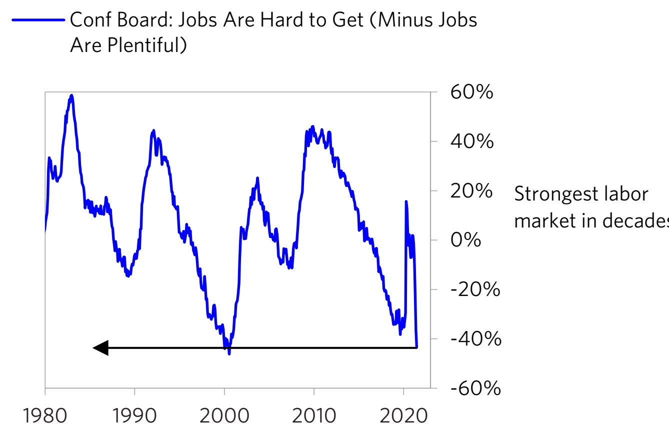


Note: 2021 extended with consensus expectations

The huge surge in demand shown above is running into the tightest labor market in decades. This balance of strong demand and tight capacity is going to be increasingly inflationary. Beyond the labor market, capacity is tight across the board.

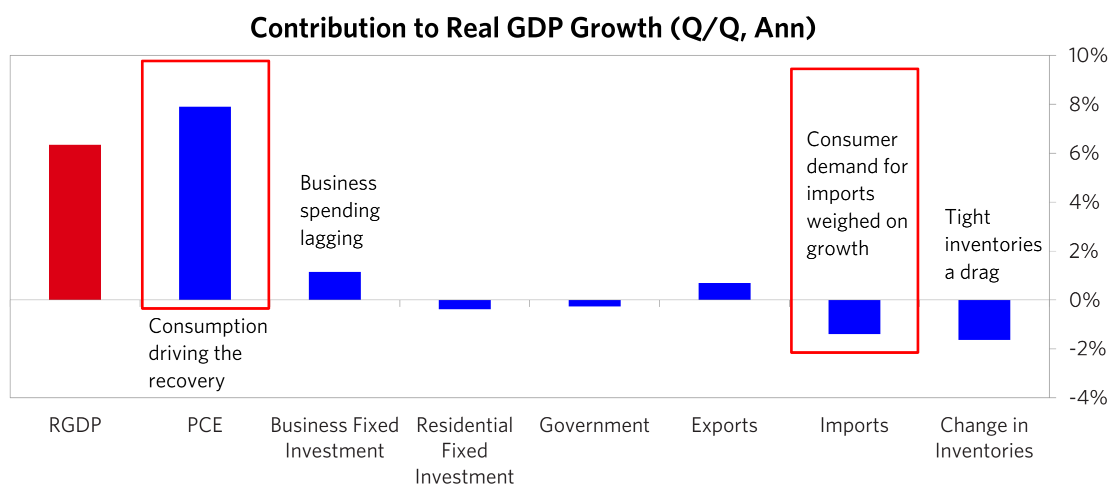
Tight inventory and straining global supply chains are in part symptoms of this strength in demand (i.e., not purely idiosyncratic).





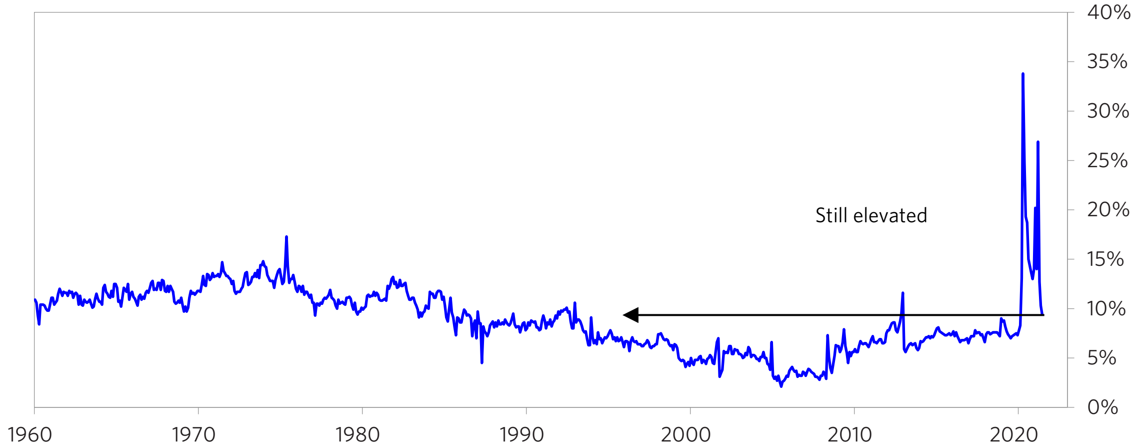
Thursday's GDP Report Showed Above-Consensus Demand and Growing Difficulties Meeting It

Thursday's GDP report for the second quarter showed strong nominal demand growth (13% quarter-over-quarter, annualized), with real growth of over 5%, which was constrained by supply. Consumer demand was above expectations and continues to drive growth. The real number was below expectations largely because inventories continue to shrink rapidly and much of the demand is being met by imports (which, in an accounting sense, count as a drag on growth). Residential fixed investment also fell despite strong demand because of supply constraints. And business investment has lagged far behind consumer demand. All of these "misses" point to more strength in spending in the future.

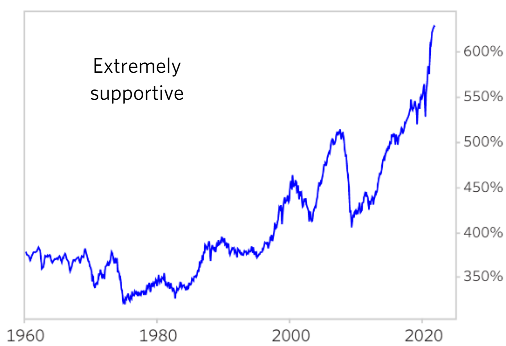


Looking ahead, we expect nominal household demand growth to slow from its historically high pace but still remain very strong. The pandemic has transformed household balance sheets, and they are the strongest they have been in decades. The savings rate remains elevated, with record wealth levels and low rates increasing the incentive for households to spend. At the same time, we see room for further recovery in spending that has been most impacted by the pandemic.

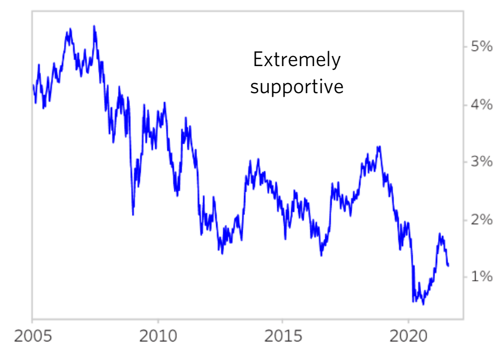
Household Savings Rate (% Disp Income)



Household Net Wealth (%GDP)

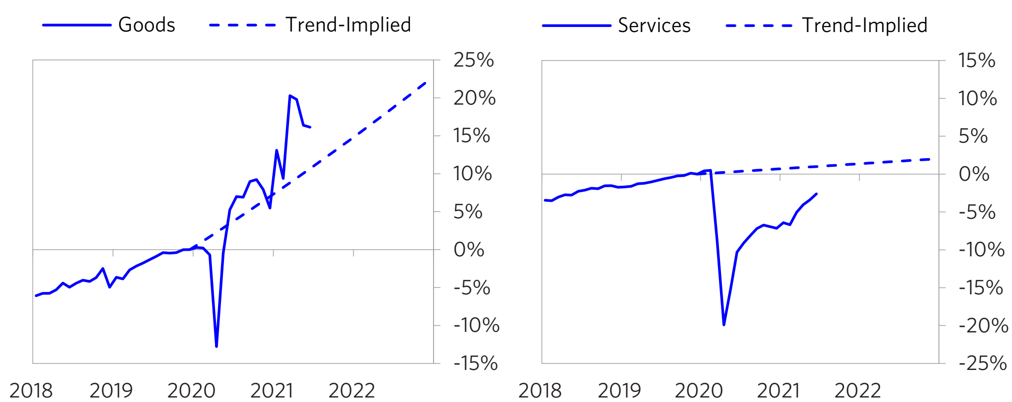


10yr Nominal Yields

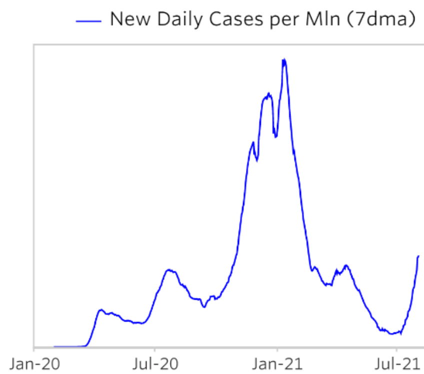


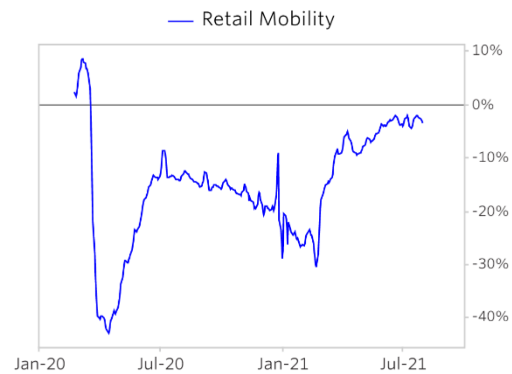
The composition of household spending is still consistent with virus drags weighing on services. As we show below, goods spending is well above 2019 levels and the levels implied by trend, while services are still depressed. How much of the bounce back in services is additional spending versus consumers changing their behavior as more virus-exposed activity becomes safer will be an important driver of activity going forward.

Real Household Spending on Goods and Services (Indexed to EoY 2019)

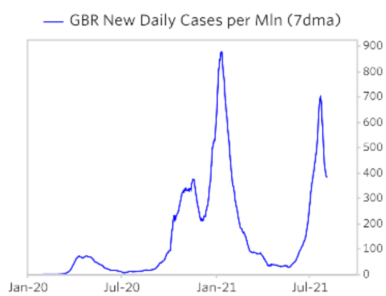


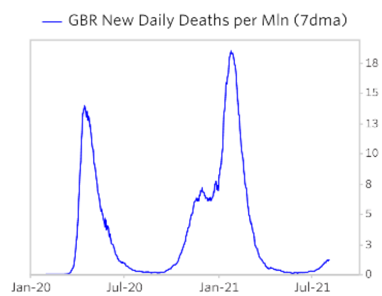
As we have described in prior *Observations*, we are tracking the outbreak of the Delta variant closely for signs that the virus is starting to weigh more heavily on activity. The main signs we are watching for are restrictions that curtail economic activity or consumers pulling back out of fear. For economies where the vaccine is more widespread, we believe the economic impacts of the variant are likely to be less extreme than in prior outbreaks. To date, though cases have been rising, the vaccine has lowered the pass-through of these cases to severe infections and death, lowering the likelihood that hospitals will get overwhelmed and more restrictions will be needed. Mobility has remained near post-pandemic highs in the last several weeks. As is always the case, we will process the available information and adjust our views accordingly. There is always the possibility of future mutations becoming significant enough to change our synthesis.

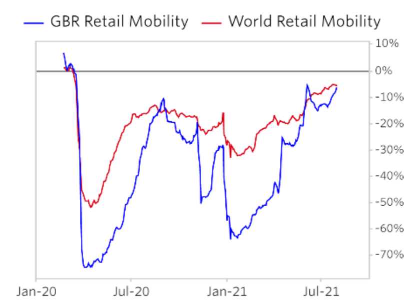




The UK provides a useful case of an economy where, like the US, vaccination rates are high but where the Delta variant began spreading earlier. As we show below, though cases rose extremely rapidly, the pass-through from higher cases to rising deaths has been significantly less severe than what we saw in prior outbreaks. The economy also reopened from lockdowns despite these cases, and mobility is near highs.

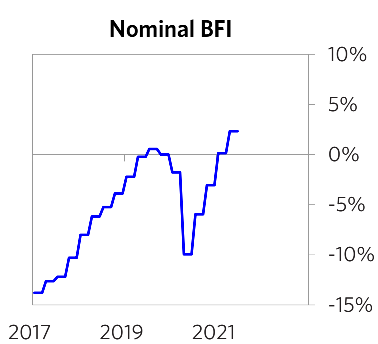


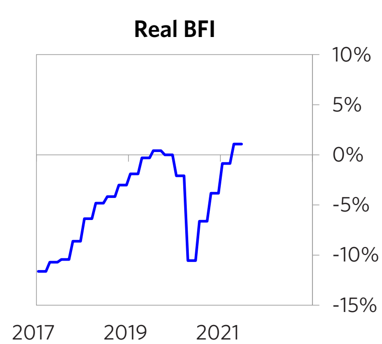


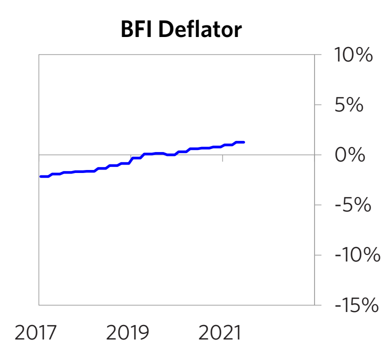


Business Catch-Up Still Ahead: More Capex to Come and Firms Are Planning to Raise Prices

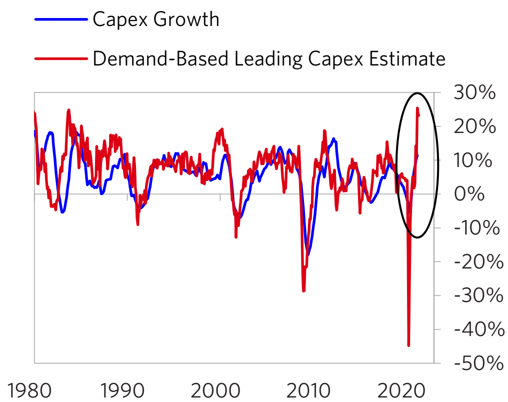
While consumer spending has been the main engine of the recovery to date, we expect that businesses are well positioned to reinforce the surge in nominal spending going forward. As we show below, business investment has been somewhat weaker and is only slightly above pre-pandemic levels. This is something to be expected, as businesses typically respond to rising demand with a bit of a lag around cyclical turning points.



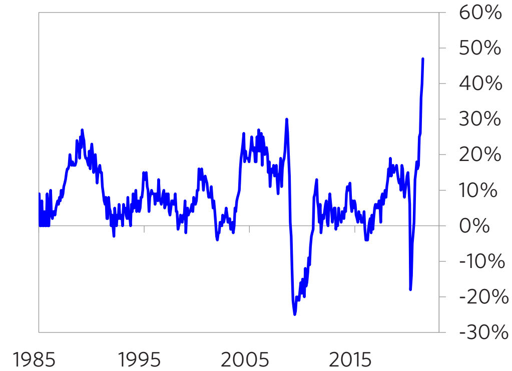




As strong demand is sustained, it is more likely that businesses pick up their spending, reinforcing the pickup in growth. At the same time, we're seeing increasing evidence that businesses are likely to begin raising prices from here, which is likely to be inflationary. We will discuss this dynamic in more detail in future *Observations*.



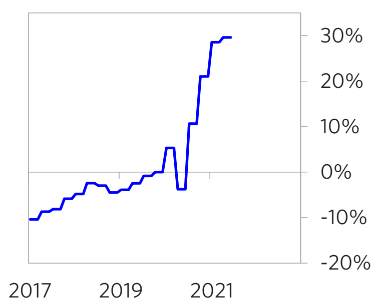
Net % Firms Raising Prices



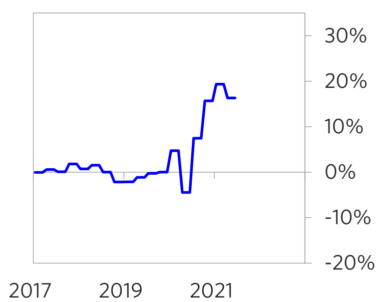
The Housing Sector Is a Clear Microcosm of Demand Hitting Material Supply Constraints

As we show below, since the pandemic began, housing activity has surged massively, with construction activity picking up along with home prices skyrocketing. Through Q2, nominal housing activity continued to pick up, but real activity fell—reflecting the impact of supply constraints.

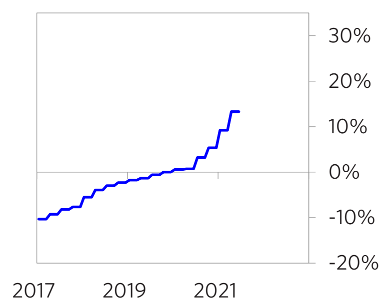
Nominal RFI



Real RFI



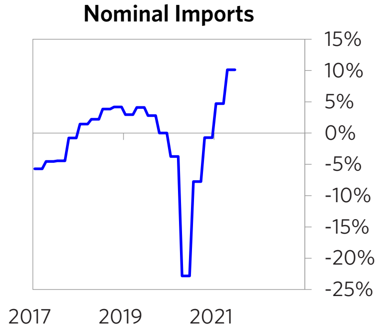
RFI Deflator



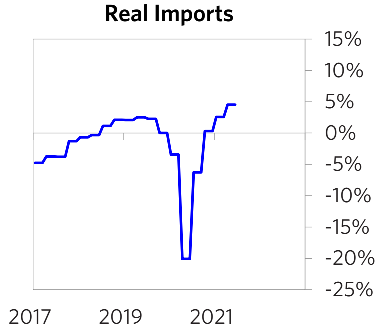
Demand Has Been Met Through Imports, Even as Global Supply Chains Experience Strain

Imports are mechanically a drag on growth, and this drag tends to be larger in periods when consumer demand for goods is stronger, as many goods bought in the US are imported from abroad. Given the huge surge in consumer demand, and the fact that so much of that demand has been for goods, which tend to be imported at a higher rate than services, strong imports have weighed on growth. As you can see below, the nominal spending on imports has outpaced real activity.

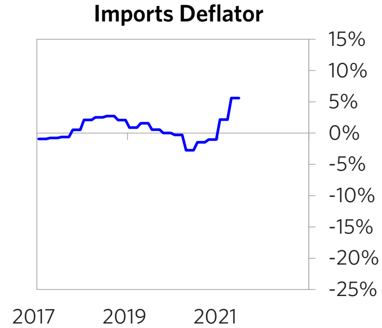
Nominal Imports



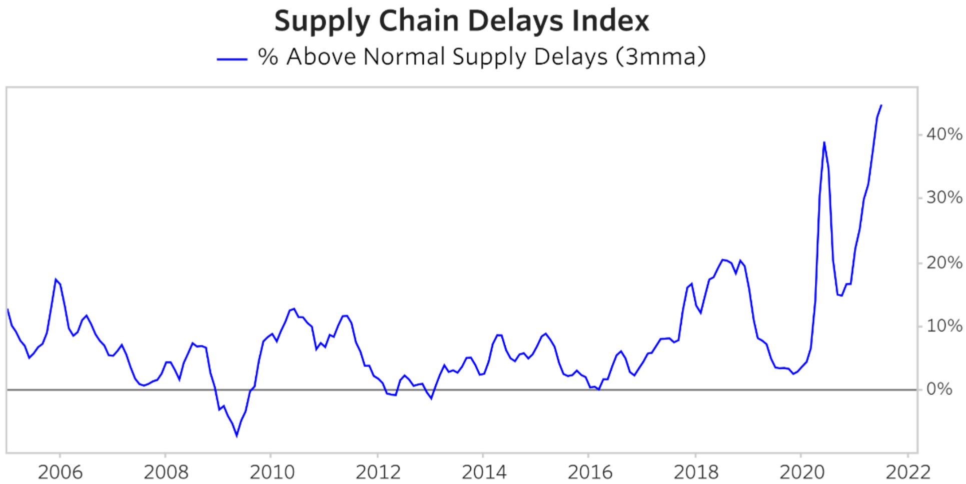
Real Imports



Imports Deflator

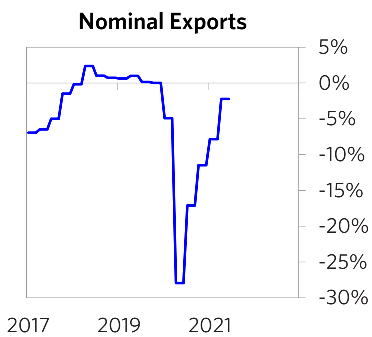


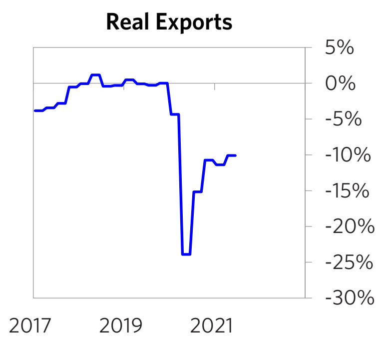
Due to the material increase in demand for goods, global supply chains have experienced strains that look to be continuing to mount. Below, we show an index of supply chain delays, which is at highs.

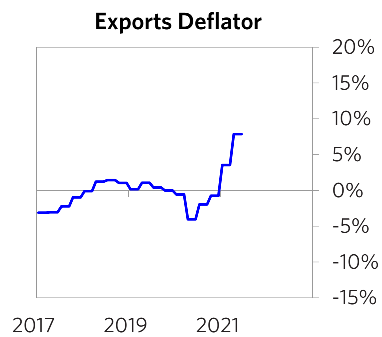


Export Surge Is Still Ahead as Rest of World Recovers

US exports have been somewhat weaker, in part reflecting that the recovery in much of the rest of the world is still ahead of us.



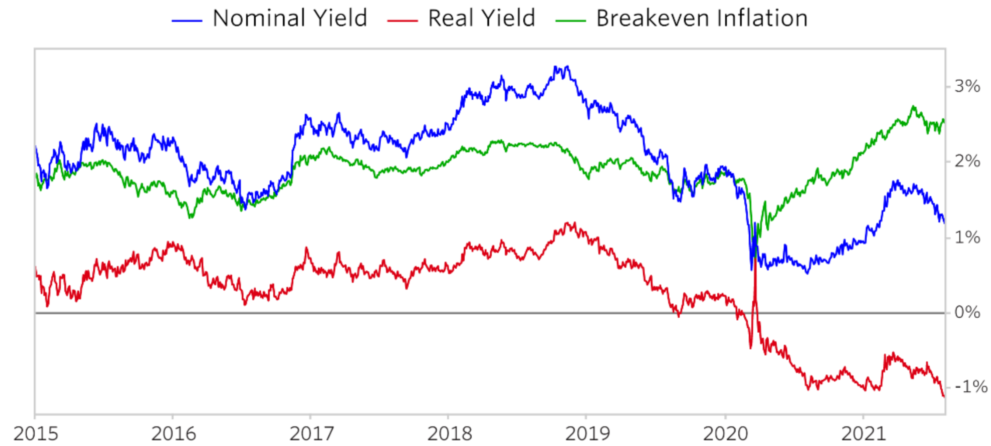




Though Drivers Are Aligning for This Surge in Nominal Growth to Be Sustained, Markets Are Pricing That It Will Be Transitory

Despite the strength in activity, and the drivers that are aligned for it to be sustained, market discounting has not yet changed to reflect this reality. Current market action and pricing are more consistent with the expectation that the surge in nominal demand will be short-lived and will fade without requiring much tightening at all. Below, we show US 10-year nominal yields along with their real yield and breakeven inflation components. Real yields are at secular lows, with inflation priced to be only slightly above policy-maker targets. Short rates remain pinned near zero, with no tightening (beyond the unwinding of QE next year) discounted until 2023.

10yr Yields



Nominal Short Rate with Discounted Path