

## The Seeds of Stagflation

Last week, the government reported real GDP in the US grew at a 6.5% annual rate in the second quarter and was up 6.4% at an annual rate in the first half of 2021. Real GDP is now 0.8% larger than it was at its peak just prior to COVID.

The problem is that getting back to where we were just prior to COVID is a low hurdle to clear. Real GDP would have grown much faster if COVID hadn't happened. In other words, the economy is smaller today than it would have been in the absence of COVID, which is to say the economy is healing but still has a long way to go before it's *fully* healed.

What's more interesting is that when we measure the economy in terms of the volume of dollars being spent – nominal GDP, which reflects both real GDP *and* inflation – we are already very close to where we'd be if COVID hadn't happened. Nominal GDP is not only at a record high but up at a 3.1% annualized pace since late 2019.

So, how is it possible that the total amount of spending is close to “normal” but “real” GDP is still below par? It doesn't take a Ph.D. in economics to figure out that inflation is the difference. Since late 2019, GDP prices are up at a 2.7% annual rate. And, yes, that includes the steep drop in prices early in 2020, during the onset of COVID. GDP prices grew at a 6.0% annual rate in the second quarter, the fastest pace for any quarter since 1981.

The rise in inflation is what you get when the government implements an unprecedented level of stimulus to support incomes while implementing policies like shutdowns and overly generous unemployment insurance that stifle production. It's

what you get when demand outstrips supply and this is exacerbated when the central bank prints excess amounts of new money. Inflation has arrived and it's not just transient.

In the near future we expect continued solid economic growth. Inventories plummeted in Q2 as businesses had to dip deeply into their shelves and storerooms to satisfy consumer demand. Customers with newly printed money are showing up to buy goods and services, but businesses are struggling to find workers to produce more. In turn, depleted inventories mean plenty of room for more production in the year or so ahead. As extra unemployment benefits wane, employment will rise and spending will come from production, not artificial stimulus.

The government poured massive fiscal stimulus into the economy during the past year, or so. Yes, Congress is likely to pass an extra spending bill or two later this year, but this additional government spending will be spread out over years, unlike the massive checks sent out earlier in 2021. What this means is that the impact from stimulus will wane.

Meanwhile, damage from shutdowns will linger. It's true that many supply-chain issues will be resolved, and some price pressures will ease, but the thought that real GDP will grow faster than nominal GDP is fanciful. With the money supply having risen so rapidly, and the ability of the economy to keep up with that growth diminished by a more burdensome government, stagflationary pressures (slower growth, higher prices) have been building. We don't expect those pressures to disappear. So, while there will be volatility of data in the quarters ahead, the GDP data is exhibiting the seeds of that stagflation.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-2 / 9:00 am	ISM Index – Jul	60.9	<b>61.0</b>	<b>59.5</b>	60.6
9:00 am	Construction Spending – Jun	+0.5%	<b>+0.2%</b>	<b>+0.1%</b>	-0.3%
8-3 / 9:00 am	Factory Orders – Jun	+1.0%	<b>+0.7%</b>		+1.7%
afternoon	Total Car/Truck Sales – Jul	15.3 Mil	<b>14.9 Mil</b>		15.4 Mil
afternoon	Domestic Car/Truck Sales – Jul	11.8 Mil	<b>11.3 Mil</b>		11.5 Mil
8-4 / 9:00 am	ISM Non Mfg Index – Jul	60.5	<b>60.6</b>		60.1
8-5 / 7:30 am	Initial Claims – Jul 31	382K	<b>385K</b>		400K
7:30 am	Int'l Trade Balance – Jun	-\$74.0 Bil	<b>-\$74.3 Bil</b>		-\$71.2 Bil
8-6 / 7:30 am	Non-Farm Payrolls – Jul	900K	<b>900K</b>		850K
7:30 am	Private Payrolls – Jul	750K	<b>800K</b>		662K
7:30 am	Manufacturing Payrolls – Jul	28K	<b>32K</b>		15K
7:30 am	Unemployment Rate – Jul	5.7%	<b>5.7%</b>		5.9%
7:30 am	Average Hourly Earnings – Jul	+0.3%	<b>+0.3%</b>		+0.3%
7:30 am	Average Weekly Hours – Jul	34.7	<b>34.7</b>		34.7
2:00 pm	Consumer Credit– May	\$22.5 Bil	<b>\$23.5 Bil</b>		\$35.3 Bil