Economic Indicator — July 22, 2021

Leading Index at Mid-year: Supply Constraints Holding Back Growth

Summary

The Leading Economic Index (LEI) came in at just 0.7% in June, a notch short of expectations. The softness is due, in part, to a sharp drop in building permits in June and the third straight monthly drag from the average workweek. Both of these components reflect supply chain problems that are holding back what would otherwise be robust growth.

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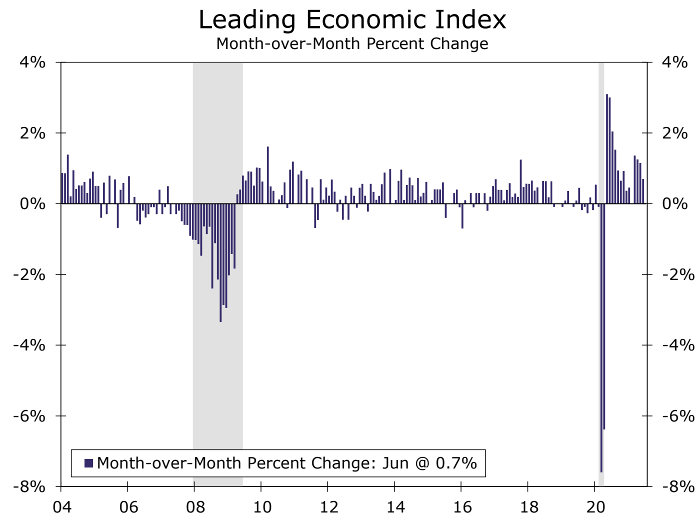
Leading Index Signals a Moderation in the Pace of Growth

The Leading Index increased 0.7% in June. While the index continues to indicate expansion, the pace of its growth has moderated, due to slower growth from the index's positive contributors and further widening between solid demand and struggling supply.

Initial jobless claims were once again the largest contributor on the month, adding 0.25 percentage points, as initial claims for unemployment continued to decline. With the labor market recovery slated to continue over the summer, we expect that over the course of the second half of the year, jobless claims will continue to boost the headline. That said, we may not see a boost in July, because the number of weekly initial claims averaged 391K so far in the month, and in the most recent print released this morning for the week of July 16, claims rose to their highest since May.

ISM new orders added 0.21 in June. While the new orders sub-component actually fell a point last month, the level, which factors into the calculation for LEI, remains elevated at 66. Similarly, the spread between the 10-year treasury yield and the fed funds rate narrowed in June but still contributed positively on the month, as the level remained positive and consistent with continued expansion.

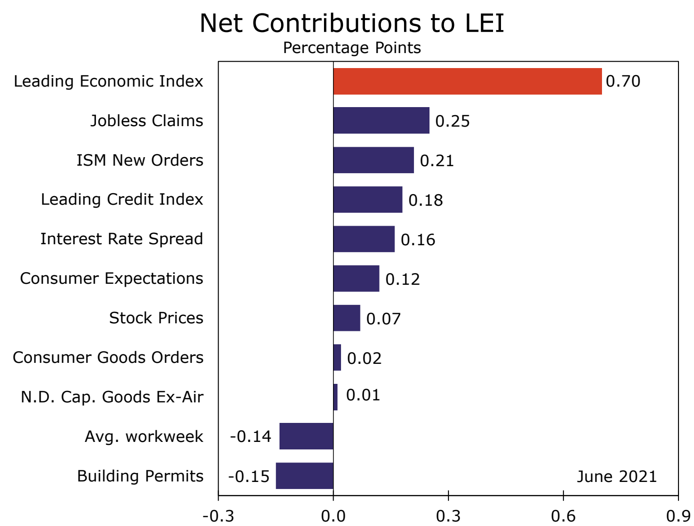


Source: The Conference Board and Wells Fargo Securities

Dip in Building Permits May Only Be Temporary

On the other side of the ledger, building permits and average weekly hours for manufacturing workers subtracted 0.15 and 0.14 points, respectively, from the headline. Building permits fell 5.1% in June, as slowing sales and supply-chain challenges weighed on new projects. While housing activity has undoubtedly cooled from its fever-pitch earlier in the year, the drop in permits is not the death knell for residential construction activity. Indeed, some decline in permits was to be expected, given the growth in homes authorized but not started over the past year. With demand for single-family homes far out-stripping supply, builders began to fill the gap, but shortages of materials and skilled labor have hampered construction and led to a backlog of projects. To the extent that supply-chain challenges continue to bedevil builders, permits could slip further, but the recent downturn in lumber prices comes amid greater supply, offering at least one example of transitory price increases. We expect home construction to remain elevated over the next few quarters, as the country rebuilds its depleted housing stock.

Average weekly hours for manufacturing employees also fell in June. Like building permits, this pullback likely has more to do with ongoing supply disruptions that are hampering activity rather than the beginning of a sustained decline. Hours worked is seen as a leading indicator based on the idea that employers reduce hours before they cut headcounts, but there does not seem to be much indication of producers trimming payrolls. In fact, it seems that employers can not find enough workers. Job openings and wage growth in the manufacturing sector are running above the level for all industries.



Source: The Conference Board and Wells Fargo Securities

Elsewhere, Supply Chains Holding Back Growth

We began warning last year about the material and labor shortages facing the supply side of the economy, and it has worsened in recent months. While these backlogs may start to clear at some point, it is evident they are crimping activity now. It is important to note, however, that the economy's momentum remains intact and the LEI's 0.7% increase in June suggests growth should continue, albeit at a slower pace than during the initial reopening. The expectation for continued expansion despite these headwinds rests on the strong demand outlook. Consumers, businesses and state & local governments have ample cash to spend and invest over the next year. Moreover, the scope of the recovery still has room to widen, with millions still out of work and several industries still below their pre-COVID trend in activity.

One important risk to this view is inflation, particularly as it relates to people's confidence in the recovery and their willingness to spend. Consumers' outlook on the economy was still sanguine in June and the component added 0.12 percentage points to the headline LEI. As we noted in a recent report, however, consumer sentiment has shown some signs of wilting in the face of recent price increases. The longer it takes the supply side of the economy to catch up with the robust demand, the greater the risk that inflation begins to undermine businesses' and consumers' willingness to spend.

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