Omicron Setback to Growth to Be Temporary

Leslie Preston, Senior Economist | 416-983-7053

February 3, 2022

Highlights

- The wave of Omicron infections has resulted in reduced activity in some areas of the U.S. economy and is likely to hold growth to a modest 1.8% in the first quarter. The lull is expected to be brief, with growth bouncing back smartly in Q2.
- Omicron is likely to drive a decline in consumer services spending in January, and leave a mark on the employment report as well. By March, however, these impacts are expected to reverse.
- Other shifts have also contributed to slower real GDP growth in 2022. Inventory restocking was pulled forward into 2021, reducing its contribution to growth this year. Consumer's appetite for goods, aside from vehicles, has also cooled a bit more quickly than expected.

The wave of Omicron infections hit hard and fast at the end of 2021, prompting forecasters to revisit their outlooks once again. Our December forecast was finalized before the full virulence of the variant was appreciated, and so we did not explicitly incorporate it into our forecast. Each successive wave of the virus has had less of an impact on the economy, as people and businesses adjust to life in the shadow of Covid. That said, the high-frequency indicators for some activities have dropped off sharply at the end of December and into January, reflecting greater consumer caution (Chart 1, and see Covid tracker).

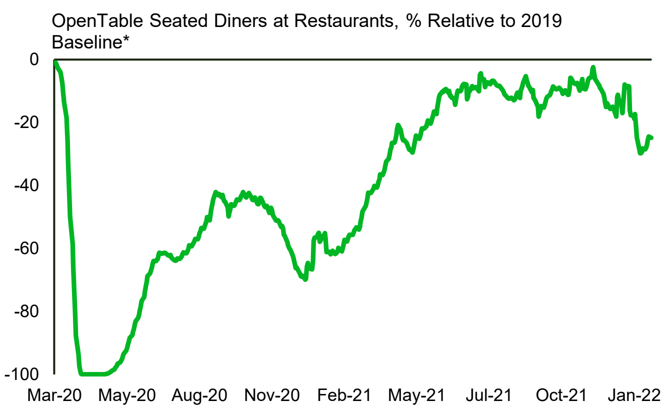
But increased cautionary spending is not the only factor where Omicron is likely to leave an imprint on first quarter growth. The pandemic also led to a temporary surge in absenteeism in the opening weeks of the year. Indeed, survey data shows that over 8 million people were not working last month because they were sick or caring from someone who was sick. Most of these workers likely received some pay over the two-week reference period, so they won't be counted as unemployed, but some impact on hiring is likely as well as hours worked and wages.

Given the combination of demand- and supply-side effects, we have cut our first-quarter growth estimate to a more modest 1.8% pace, well below the 3.5% gain we expected in mid-December.

Consumer spending freeze followed by spring thaw

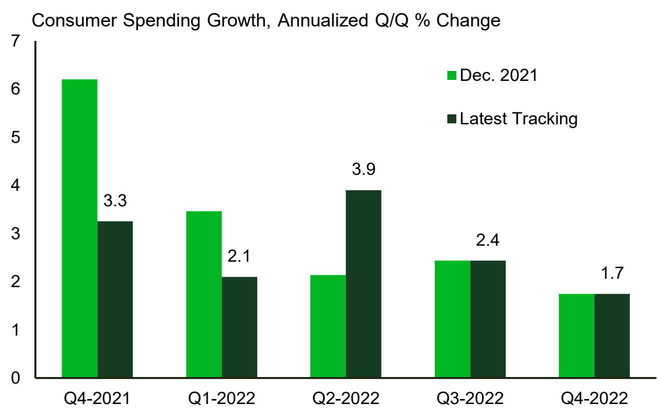
Consumer spending on services likely contracted in January, led by weakness in accommodation and food services, recreation, and transportation services. However, with cases and hospitalization on the downswing, we expect that by the time spring is in the air in March, consumers will be back in restaurants and taking spring break vacations, as people increasingly get on with life, despite the virus.

Chart 1: Consumer Caution Weighs on Dining Out



*2-week moving average.
Source: Open Table, TD Economics. Last observation: January 31, 2022.

Chart 2: Spending to Bounce Back in Q2



Source: BEA, TD Economics.

Overall consumer spending is expected to advance 2.1% in the first quarter, a step down from the fourth quarter's pace. However, we expect spending will bounce back strongly in the second quarter, driving a near 4% gain (Chart 2). Consumers still have a fair amount of savings cushion built up to start spending on travel once Omicron eases and people make spring and summer travel plans.

Given the quick rebound, we expect Omicron will likely shave about a tenth from annual average growth in 2022. We are currently tracking GDP to grow by 3.8% on an annual average basis in 2022, down from our 4.1% pace at the time of our December forecast. That pace is biased upwards by strong growth in the fourth quarter of 2021. On a Q4/Q4 basis, which is a truer representation of growth through the year, it is forecast to slow from a 5.5% pace in 2021 to 3.0% in 2022 (Chart 3). That slowing is driven primarily by consumer spending normalizing from its stimulus-driven pace in the first half of 2021. Higher interest rates will also weigh on momentum (see [Dollars & Sense]). While 3% is much slower than 2021, it is not a slow pace of growth. As consumers increasingly spend their pandemic-savings on travel and other services, it will help keep economic growth above trend through the year.

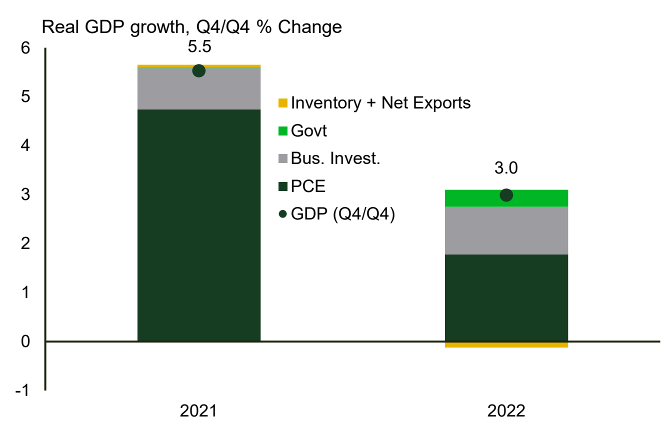
It's not all about Omicron

Some may have noticed that our 2022 forecast has actually been marked down more than the one tenth that can be chalked up to Omicron. That is because the sizeable inventory build in the fourth quarter of 2021 has pulled forward some of the inventory restocking we had in 2022. With that inventory build not expected to repeat in the first quarter, it will weigh on growth in the first quarter (Chart 4).

The other side of that inventory build was that consumers didn't spend at the pace we had expected in our December forecast. This slowing began in November, and cannot all be blamed on the Omicron variant, as the weakness was primarily on goods. October was a strong month for spending but real PCE fell in both November and December driven by declines in durable and nondurable goods spending. Some of this might be blamed on holiday shopping moving earlier in the quarter, but it may also be a faster cooling in demand for goods than we had expected.

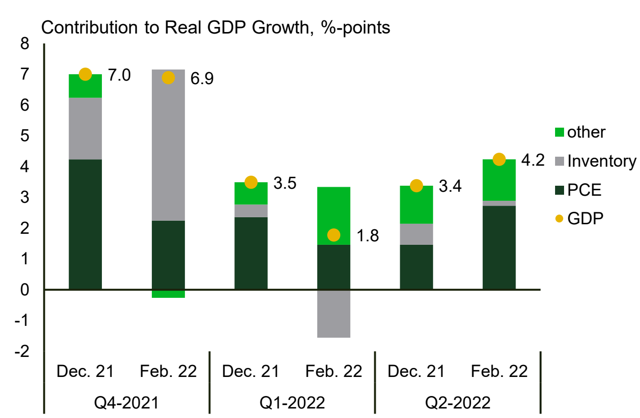
Goods consumption rebounded rapidly early in the pandemic as government support programs meant personal incomes were hurt less than in a typical recession. However, the ability to spend on services was curtailed (Chart 5). Real spending on goods had plateaued since the spring, and started falling faster at the end of the year. There are a vari-

Chart 3: Growth Slows from Stimulus Burst



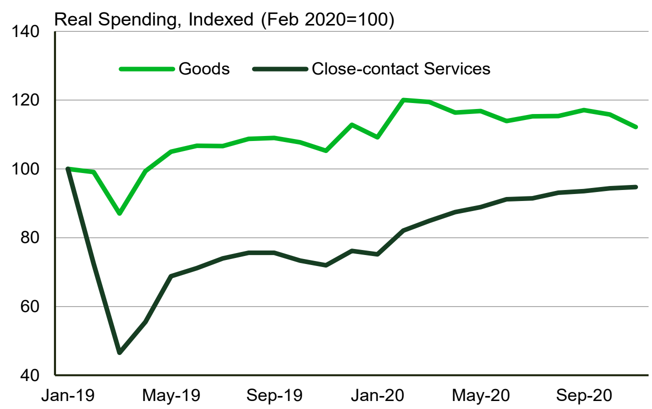
Source: BEA, TD Economics.

Chart 4: Omicron & Inventories Shift Growth Mix



Source: TD Economics.

Chart 5: Goods Spending Lost Momentum at Year End



Source: BEA, TD Economics.

ety of explanations: lack of inventory, higher prices putting off consumers, or that consumers don't need any more new stuff. The latter may be the case particularly as more generous child tax credit payments were set to expire. Also, some Americans may have been concerned about the potential hit to incomes from Omicron, knowing there was less government support to fall back on.

The path of goods consumption, and durable goods in particular, is an uncertainty in the 2022 outlook. Goods spending rose way above trend in the pandemic and it is uncertain how quickly it will return to trend, if at all. One mitigating factor has been shortages of new vehicles. We expect that situation to improve over the course of 2022. Growth in spending on vehicles is forecast to help offset weakness in other durables.

The Bottom Line

Despite a soft start to the year, the outlook for 2022 remains solid, supported by consumers and businesses. Labor markets are tight, arguing for continued wage growth which should help cushion the impact of inflation on purchasing power. Consumer incomes may not be bolstered by stimulus this year, but growth in wages and salaries is taking it's place, and combined with the pandemic savings cushion, consumers are in a good place to shoulder the burden of higher rates. Labor shortages, a healthy level of corporate profits and strong demand are also expected to support solid growth in business investment this year (Chart 3). Overall, 2022 looks set to see more balanced growth, which should also help alleviate supply chain challenges.