Goldman Sachs | Economics Research

4 December 2021 | 12:01AM EST

US Economics Analyst

Updating Our Outlook to Incorporate Omicron (Briggs)

- The emergence of the Omicron variant increases the risks and uncertainty around the US economic outlook. While many questions remain unanswered, we now think a moderate downside scenario where the virus spreads more quickly but immunity against severe disease is only slightly weakened is most likely. In this scenario, we see three main effects on the US economy.
- First, Omicron could slow economic reopening, but we expect only a modest drag on service spending because domestic virus-control policy and economic activity have become significantly less sensitive to virus spread.
- Second, Omicron could exacerbate goods supply shortages if virus spread in other countries necessitates tight restrictions. This was a major problem during the Delta wave, but increases in vaccination rates in foreign trade partners since then should limit the scope for severe supply disruptions.
- Third, Omicron could delay the timeline for some people feeling comfortable returning to work and cause worker shortages to linger somewhat longer.
- We have updated our GDP forecasts to incorporate our updated virus outlook as well as the latest GDP tracking data. These changes result in a +0.5pp (qoq ar) boost to our Q4 growth forecast based mostly on stronger inventory data, and a -1.5pp cut to growth in Q1 and -0.5pp cut in Q2 due to virus-related drags on reopening and goods supply. We now expect GDP growth of +6.5%/+3.0%/+3.5%/+3.0%/+2.0% in 2021Q4-2022Q4. This implies 2022 GDP growth of +3.8% (vs. 4.2% previously) on a full-year basis and +2.9% (vs. +3.3% previously) on a Q4/Q4 basis.
- We see mixed implications for inflation. Reduced demand for virus-sensitive services such as travel could have a disinflationary impact in the near term, but prior virus waves suggest that such pressures would be temporary and reverse as demand recovers. In contrast, further supply chain disruptions due to Omicron or further delays in the recovery of labor supply could have a somewhat more lasting inflationary impact.

Jan Hatzius
+1(212)902-0394 | jan.hatzius@gs.com
Goldman Sachs & Co. LLC

Alec Phillips
+1(202)637-3746 | alec.phillips@gs.com
Goldman Sachs & Co. LLC

David Mericle
+1(212)357-2619 |
david.mericle@gs.com
Goldman Sachs & Co. LLC

Spencer Hill, CFA
+1(212)357-7621 | spencer.hill@gs.com
Goldman Sachs & Co. LLC

Joseph Briggs
+1(212)902-2163 |
joseph.briggs@gs.com
Goldman Sachs & Co. LLC

Ronnie Walker
+1(917)343-4543 |
ronnie.walker@gs.com
Goldman Sachs & Co. LLC

Updating Our Outlook to Incorporate Omicron

In a note earlier this week, our global economics team outlined four potential scenarios for the Omicron variant and the macro outlook, including 1) a downside scenario where Omicron transmits more quickly than Delta but causes similarly severe disease, 2) a severe downside scenario where both disease severity and immunity against hospitalizations are substantially worse than for Delta, 3) a false alarm scenario where Omicron has little incremental effect on virus spread, and 4) an upside scenario where Omicron is slightly more transmissible but causes much less severe disease.

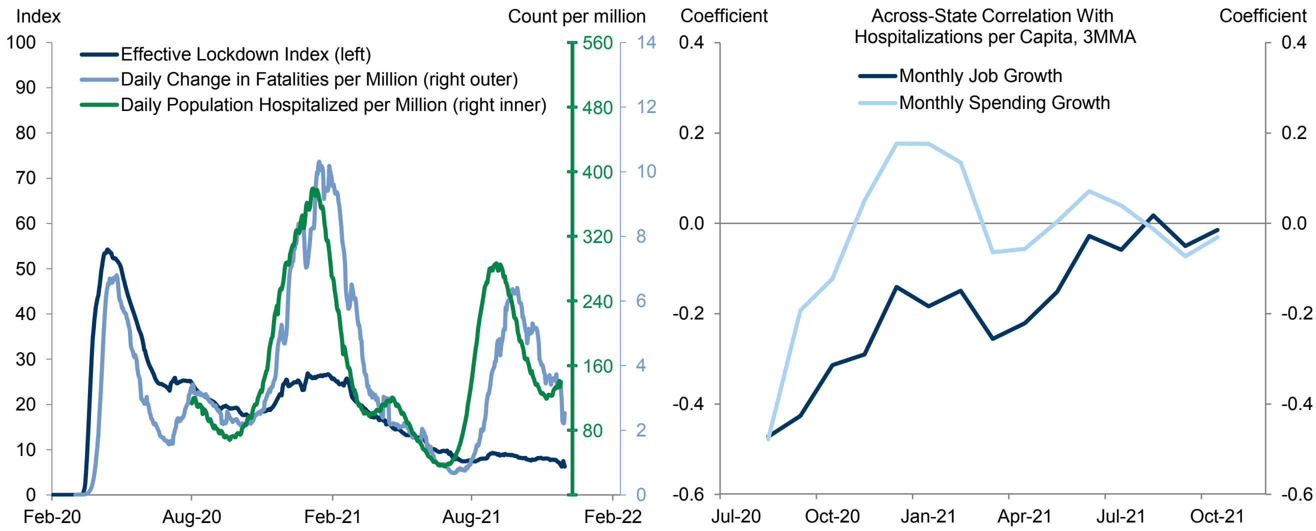
A wide range of outcomes are still possible, but in a note earlier today our global team analyzed early data and concluded that Omicron is spreading rapidly in South Africa—making the third "false alarm" scenario less likely—but that early data and expert opinion do not point to sharp deterioration in vaccine efficacy against hospitalizations and disease severity—making the "severe downside" scenario also less likely. The latter view—if confirmed by further and more complete data—is particularly good news, since the disease severity or degree of protection offered by existing vaccines is likely the key determinant of the effect that Omicron will have on the US economy. Our global economics team concluded that the "downside" scenario—where the virus spreads more quickly but immunity against hospitalizations declines only slightly more—is the most likely Omicron outcome.

Based on these findings, we have assumed this moderate downside Omicron scenario as our baseline outlook. In this *US Economics Analyst*, we therefore examine three main effects that Omicron may have on the US economy and update our GDP forecasts accordingly.

A Reopening Slowdown

First, Omicron could slow economic reopening of the virus-sensitive service sector if state governments implement policies to control virus spread or if consumers become less willing to engage in normal economic activity. Risks from this channel appear limited for two reasons. First, government policy in the US has become much less sensitive to virus spread since vaccination rates increased this spring, and the US Effective Lockdown Index (ELI) only rose by 2pts during the Delta variant surge in late summer (left chart, Exhibit 1). Second, consumer spending and job growth have become much less sensitive to local virus spread (right chart), likely due to lower Covid risk aversion in the US.

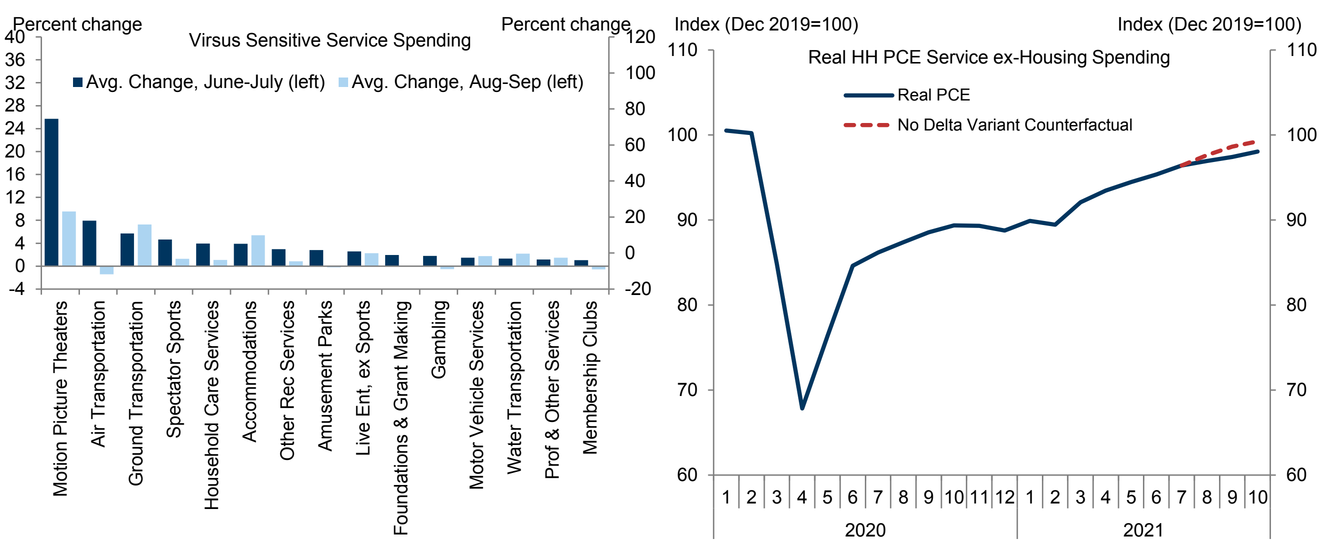
Exhibit 1: Virus-Control Policy and Economic Activity Have Become Increasingly Less Affected by Virus Spread



Source: Centers for Disease Control and Prevention, US Bureau of Labor Statistics, Bureau of Economic Analysis, Goldman Sachs Global Investment Research

To quantify the potential effects of a fourth virus wave on service spending, Exhibit 2 compares service spending growth in the run-up to and during the Delta wave. Although spending growth slowed down somewhat, it remained positive for most service categories outside of air transportation, amusement parks, gambling, and membership & sporting clubs, and declines for those categories were small, suggesting that only the most virus-sensitive services were affected by virus spread (left chart). Furthermore, the right chart shows that service spending ex-housing grew at an 11% annualized rate in 2021Q3, and total real PCE growth would only have been 1.1pp (qoq ar) higher if service spending in August and September (when COVID case numbers reached local highs) continued to grow at its June and July pace.

Exhibit 2: Service Spending Only Pulled Back Modestly Due to the Delta Variant



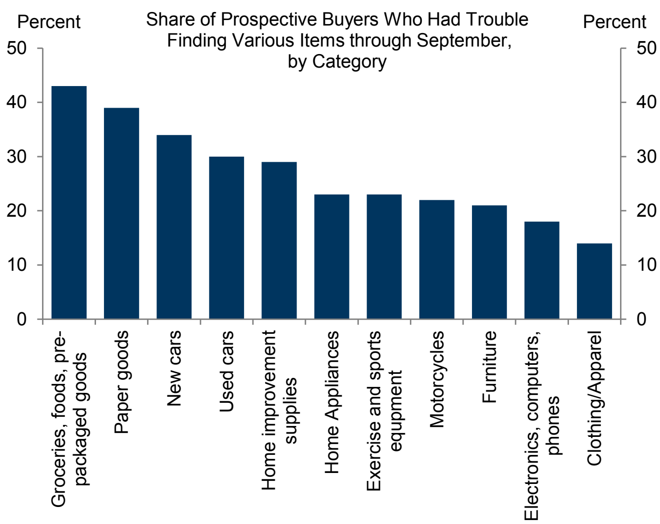
Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

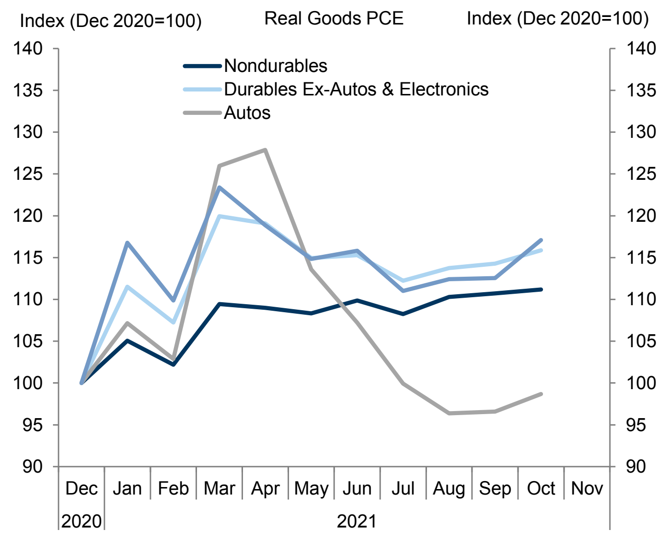
It is possible that geographic differences in vaccination rates and risk aversion explain some of this low sensitivity. After all, the Delta variant mostly spread in areas with low vaccination rates where individuals may be predisposed to not adjust behavior due to virus spread, a point raised recently in a research note from the San Francisco Fed. Nevertheless, we expect that there will be little political appetite for tighter virus-control policies, and taken altogether, our findings suggest any spending slowdown due to lower service demand will probably be moderate under our new virus assumption.

A Delay in Supply Chain Normalization

Second, Omicron could exacerbate goods supply shortages if virus spread in other countries has negative spillover effects on the US through supply channels, as happened during the Delta wave in 2021Q3. Survey data from Morning Consult suggests that many prospective buyers had trouble finding various goods (left chart, Exhibit 3), with over half of respondents choosing not to purchase products when confronted with supply shortages. The effects of these shortages were especially pronounced for automobiles, where a sharp decline in real motor vehicle spending (-50.2% qoq ar) drove much of the overall decline in real goods spending (-8.4% qoq ar) in Q3.

Exhibit 3: Goods Spending Was Constrained by Product Shortages, Particularly For Autos…

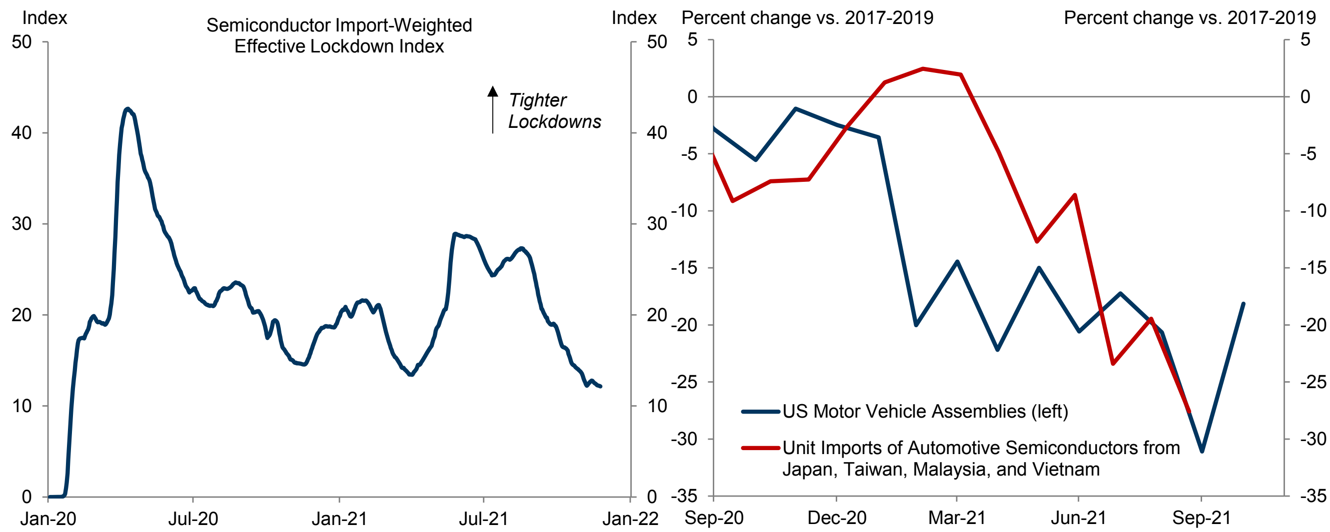




Source: Morning Consult, Bureau of Economic Analysis, Goldman Sachs Global Investment Research

As we've previously documented, supply shortages largely reflected supply chain spillovers from Southeast Asia, where increased virus spread led to factory shutdowns that limited the supply of semiconductors, which in turn limited US automobile production and led to a sharp drawdown in inventories. This can be seen in Exhibit 4, where a sharp increase in the semiconductor import-weighted ELI this spring (left chart) coincided with a decline in imports of automotive semiconductors and US motor vehicle assemblies (right chart).

Exhibit 4: … As Policy Tightening to Control Virus Spread Weighed on Semiconductor Imports from South East Asia



Source: Census Bureau, Federal Reserve, Goldman Sachs Global Investment Research

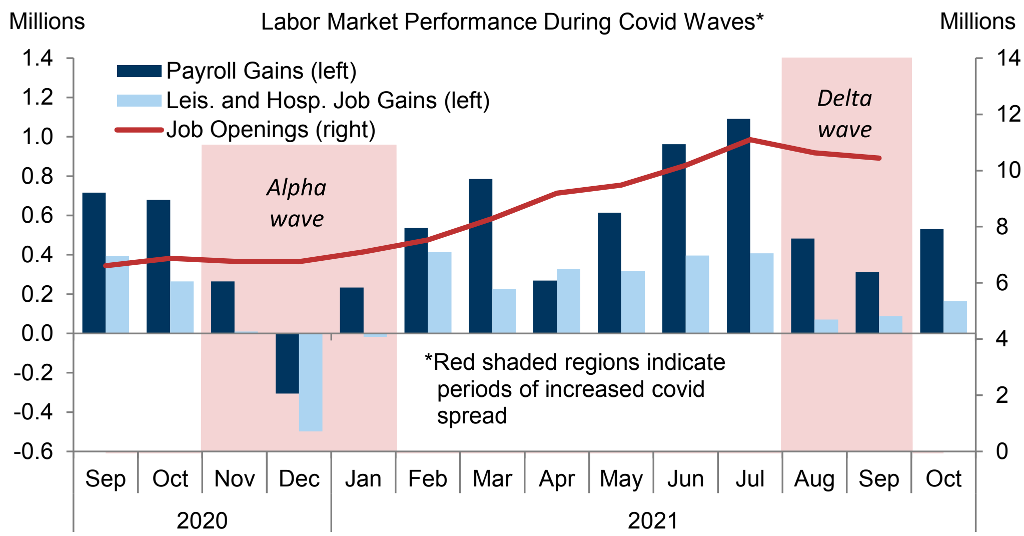
The good news is that vaccination rates in Southeast Asia have increased dramatically since mid-March, suggesting that virus spread today will likely not result in as much policy tightening as we saw following the spread of the Delta variant earlier this year. For example, the fully-vaccinated population share in Malaysia—the largest exporter of semiconductors and electronic components to the US—increased from less than 10% in June to 78% today, while the share in Taiwan—the second-largest exporter—has increased from 0% to 56%. As a result, we see less scope for severe supply chain disruptions and expect only a moderate hit to the supply of goods, but note that downside risks from this channel are potentially large.

A Slowdown in the Labor Market Recovery

Third, based on patterns from the last two Covid waves in the US, Omicron could slow down the labor supply recovery. As shown in Exhibit 5, hiring slowed significantly—particularly for leisure and hospitality jobs—during the Alpha and Delta waves, despite labor demand remaining quite firm. This pattern suggests that labor supply is the main driver of hiring slowdowns during Covid waves.

As we've previously noted, 2.5mn workers still report that concerns about getting or spreading Covid-19 are their main reason for not working, including around 1.6mn prime-age workers. If Omicron delays the timeline for some people feeling comfortable returning to work, worker shortages may linger longer than expected.

Exhibit 5: Hiring Slowed but Labor Demand Held up in Previous COVID Waves, Suggesting the Main Labor Market Risk of a Fourth Virus Wave Comes From a Slower Labor Supply Recovery



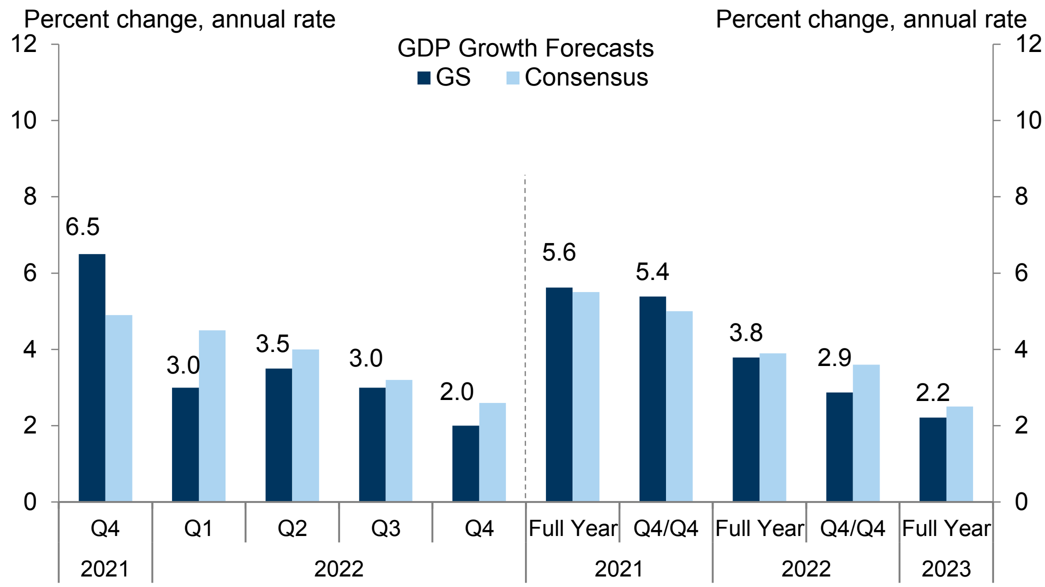
Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

Updating our GDP Forecasts

We've updated our GDP forecasts to incorporate our updated virus outlook and new GDP tracking data (Exhibit 6). First, for Q4, the sequential easing of supply constraints—including better Southeast Asian chip supply and progress towards unclogging US ports—argue for an increase in our Q4 inventory forecast, and we therefore have boosted our 2021 Q4 growth forecast by +0.5pp (qoq ar) to 6.5%. This upgrade implies 2021 annual growth of +5.6% (unchanged) and Q4/Q4 growth of +5.4% (vs. +5.3% previously).

Second, we've cut our GDP growth forecasts for 2022Q1 by 1.5pp and 2022Q2 by 0.5pp to incorporate Omicron-related drags on reopening and goods supply that we expect will weigh on consumption growth in these quarters. We now expect GDP growth of +6.5%/+3.0%/+3.5%/+3.0%/+2.0 in 2021Q4-2022Q4, which implies 2022 annual growth of +3.8% (vs. 4.2% previously) and Q4/Q4 growth of +2.9% (vs. +3.3% previously).

Exhibit 6: We Now Forecast GDP Will Grow by +3.8% on an Annual Basis and by +2.9% on a Q4/Q4 Basis



Source: Bloomberg, Goldman Sachs Global Investment Research

Risks to Inflation

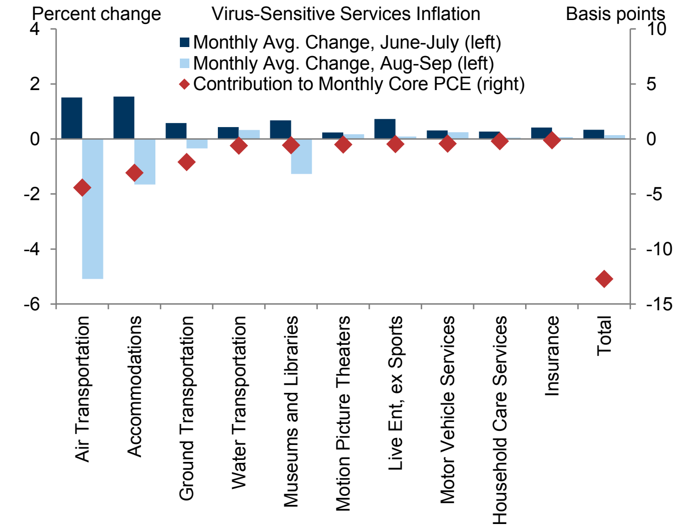
Additionally, each of the three effects of Omicron discussed above poses a distinct risk to our inflation forecast that makes it difficult to determine the net impact.

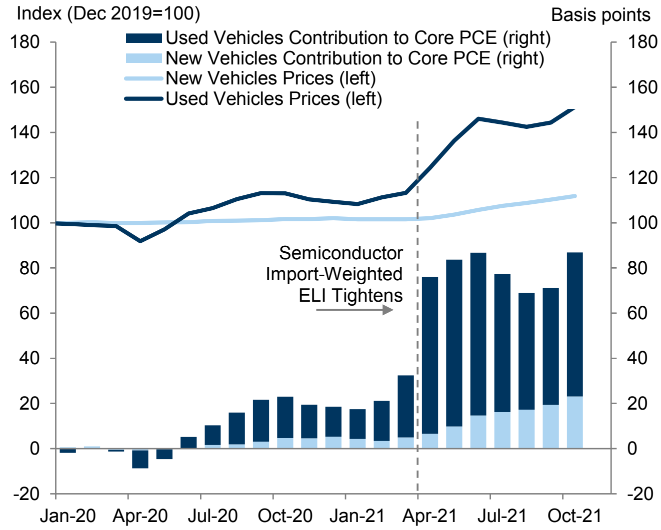
A drop in demand for virus-sensitive services would likely result in price declines for services like air and ground transport and accommodation. The left chart of Exhibit 7—which compares inflation in these categories pre- and post-Delta wave—shows that these disinflationary pressures subtracted roughly 12bps from monthly core PCE inflation in August and September relative to the reopening trend, although the monthly drag relative to a no-price-change counterfactual is only 6bps. However, we expect any drag on inflation from lower service demand to mostly reverse after virus spread slows, following the reflation patterns of prior virus waves.

In contrast, we see upside inflation risk from more persistent supply and worker shortages. For example, the right chart of Exhibit 7 shows that auto prices surged around the time semiconductor imports collapsed (Exhibit 4), and the contribution from motor vehicles to core PCE has remained elevated since. While we continue to expect an over-100bp decline in the contribution to core PCE inflation from auto prices alone between now and end-2022, a delay in the easing of supply constraints could keep core goods prices elevated well into the second half of 2022.

Additionally, delays in the easing of worker shortages could mean that the acute wage pressures from 2021Q2 and Q3 persist for longer than expected, with our most recent estimates suggesting that a 1pp acceleration in wage growth boosts core PCE price inflation by about 35bps.

Exhibit 7: We See Some Downside Inflation Risk Due to a Drop in Demand for Virus-Sensitive Services, but Upside Inflation Risk from Delayed Easing of Supply and Worker Shortages





Source: Bureau of Economic Analysis, US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

Taken altogether, we see the near-term effect of Omicron on inflation as ambiguous due to the potentially offsetting effects from lower service and higher goods and labor demand, but we see medium and longer-term risks as mostly inflationary due to potential delays in supply chain normalization and easing of worker shortages.

Still on Track for a Faster Taper and an Early Liftoff

Although we now expect moderate economic impacts from Omicron, we do not believe that these changes are large enough to affect our call for a faster pace of tapering and an early liftoff. The November employment situation report—in which the unemployment rate fell to 4.2%—was sufficiently strong that we continue to expect that the Fed will announce at its December meeting that it is doubling the pace of tapering to $30bn per month starting in January.

A slowdown in the labor market recovery due to Omicron could make it harder for some participants to square a still-large employment gap relative to the pre-pandemic level with the guidance in the FOMC statement that the committee will not raise interest rates until the labor market reaches maximum employment—which we saw as the largest risk to our Fed forecast even before Omicron emerged. However, we continue to expect the unemployment rate will fall to 3.7% by May of next year, which should be low enough for the FOMC to hike for the first time at the June meeting.

Joseph Briggs

The US Economic and Financial Outlook

THE US ECONOMIC AND FINANCIAL OUTLOOK
(% change on previous period, annualized, except where noted)

	2019	2020	2021 (f)	2022 (f)	2023 (f)	2024 (f)	2021 Q1	2021 Q2	2021 Q3	2021 Q4	2022 Q1	2022 Q2	2022 Q3	2022 Q4
OUTPUT AND SPENDING														
Real GDP	2.3	-3.4	5.6	3.8	2.2	2.2	6.3	6.7	2.1	6.5	3.0	3.5	3.0	2.0
Real GDP (annual=Q4/Q4, quarterly=yoy)	2.6	-2.3	5.4	2.9	2.0	2.2	0.5	12.2	4.9	5.4	4.6	3.8	4.0	2.9
Consumer Expenditures	2.2	-3.8	8.0	3.2	2.0	2.2	11.4	12.0	1.7	4.9	2.0	2.5	2.0	2.0
Residential Fixed Investment	-0.9	6.8	9.3	1.2	2.6	2.0	13.3	-11.7	-8.3	4.5	4.0	4.0	3.0	3.0
Business Fixed Investment	4.3	-5.3	7.5	4.5	3.4	3.7	12.9	9.2	1.5	4.8	5.9	4.2	3.4	3.2
Structures	2.1	-12.5	-7.6	-0.3	1.6	2.6	5.4	-3.0	-5.0	-0.5	1.0	1.0	1.0	1.0
Equipment	3.3	-8.3	13.2	4.8	2.7	2.8	14.1	12.2	-2.4	5.1	8.0	5.0	3.0	2.5
Intellectual Property Products	7.2	2.8	10.0	6.6	5.0	5.2	15.6	12.5	9.3	7.0	6.0	5.0	5.0	5.0
Federal Government	3.8	5.0	0.9	-1.8	-0.8	-0.1	11.3	-5.3	-4.9	-1.0	-1.0	-1.0	-1.0	-1.0
State & Local Government	1.3	0.9	0.5	2.3	1.6	1.0	-0.1	0.2	4.7	0.6	2.5	2.5	2.5	2.5
Net Exports ($bn, '12)	-905	-943	-1,275	-1,386	-1,357	-1,325	-1226	-1245	-1312	-1319	-1356	-1384	-1399	-1404
Inventory Investment ($bn, '12)	75	-42	-75	139	109	60	-88	-169	-73	30	70	130	180	175
Industrial Production, Mfg.	-2.0	-6.6	6.5	5.1	2.3	1.8	2.8	4.9	4.7	8.3	5.0	4.5	3.8	2.5
HOUSING MARKET														
Housing Starts (units, thous)	1,292	1,397	1,612	1,679	1,726	--	1,599	1,588	1,555	1,706	1,687	1,661	1,640	1,728
New Home Sales (units, thous)	683	828	817	908	934	928	896	737	713	923	931	890	867	946
Existing Home Sales (units, thous)	5,327	5,658	6,070	6,159	6,247	6,324	6,303	5,833	6,057	6,086	6,117	6,146	6,175	6,200
Case-Shiller Home Prices (%yoy)*	3.4	9.5	15.1	9.0	2.7	3.5	12.3	16.9	19.7	15.1	12.5	11.3	10.1	9.0
INFLATION (% ch, yr/yr)														
Consumer Price Index (CPI)**	2.3	1.3	6.8	2.9	2.6	2.5	1.9	4.8	5.3	6.6	6.4	5.3	4.4	3.2
Core CPI **	2.2	1.6	5.4	3.3	2.6	2.5	1.4	3.7	4.1	5.0	5.9	4.9	4.4	3.6
Core PCE** †	1.6	1.5	4.5	2.3	2.1	2.2	1.7	3.4	3.6	4.4	4.4	3.5	3.0	2.4
LABOR MARKET														
Unemployment Rate (%)^	3.6	6.7	4.1	3.5	3.3	3.2	6.0	5.9	4.8	4.1	3.8	3.7	3.5	3.5
U6 Underemployment Rate (%)^	6.8	11.7	7.5	6.8	6.4	6.2	10.7	9.7	8.5	7.5	7.2	6.9	6.8	6.8
Payrolls (thous, monthly rate)	168	-785	547	211	120	99	518	615	651	402	300	214	167	163
Employment-Population Ratio (%)^	61.0	57.4	59.4	60.0	60.1	60.0	57.8	58.1	58.9	59.7	59.7	59.8	60.0	60.0
Labor Force Participation Rate (%)^	63.3	61.5	62.0	62.2	62.1	62.0	61.5	61.6	61.6	62.0	62.0	62.1	62.2	62.2
GOVERNMENT FINANCE														
Federal Budget (FY, $bn)	-984	-3,129	-2,800	-1,200	-1,250	-1,300	--	--	--	--	--	--	--	--
FINANCIAL INDICATORS														
FF Target Range (Bottom-Top, %)^	1.5-1.75	0-0.25	0-0.25	0.75-1	1.25-1.5	1.75-2	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0.25-0.5	0.5-0.75	0.75-1
10-Year Treasury Note^	1.92	0.93	1.70	2.00	2.40	2.50	1.74	1.45	1.52	1.70	1.80	1.90	1.95	2.00
Euro (€/$)^	1.12	1.22	1.13	1.15	1.20	1.25	1.17	1.18	1.16	1.13	1.13	1.14	1.15	1.15
Yen ($/¥)^	109	103	113	111	107	104	111	111	112	113	115	113	112	111

* Weighted average of metro-level HPIs for 381 metro cities where the weights are dollar values of housing stock reported in the American Community Survey. Annual numbers are Q4/Q4.
** Annual inflation numbers are December year-on-year values. Quarterly values are Q4/Q4.
† PCE = Personal consumption expenditures. ^ Denotes end of period.
Note: Published figures in bold.
Source: Goldman Sachs Global Investment Research.

Source: Goldman Sachs Global Investment Research

Economic Releases

Date		Time (ET)	Indicator	Estimate GS	Estimate Consensus	Last Report
Tue	**Nov 07**	**8:30**	**Nonfarm Productivity (Q3 final)**	**-4.9%**	**-4.9%**	**-5.0%**
			Unit Labor Costs (Q3 final)	**+8.3%**	**+8.3%**	**+8.3%**
		8:30	**Trade Balance (October)**	**-$67.5bn**	**-$66.8bn**	**-$80.9bn**
Wed	**Nov 08**	10:00	JOLTS Job Openings (October)	n.a.	10,500k	10,438k
Thu	**Nov 09**	**8:30**	**Initial Jobless Claims**	**200k**	**225k**	**222k**
			Continuing Claims	n.a.	1,910k	1,956k
		10:00	Wholesale Inventories (October final)	n.a.	+2.2%	+2.2%
Fri	**Nov 10**	**8:30**	**Consumer Price Index (November)**	**+0.82%**	**+0.7%**	**+0.9%**
			Ex Food and Energy (November)	**+0.60%**	**+0.5%**	**+0.6%**
		10:00	**UMich Consumer Sentiment (December preliminary)**	**68.4**	**68.0**	**67.4**

Source: Bloomberg, Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Joseph Briggs and Ronnie Walker, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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