The Addicted Consumer

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“We just came for one thing, too”.

Sari and I were meandering towards the checkout in a crowded Costco on Saturday morning and I was reflecting out loud on our accumulation of a substantial and diverse pile of goods, although we had come to buy just one thing. But we were not in the same league as the woman who’d overheard me. She may have come for just one thing too, but the lower rack of her cart was loaded, the little area at the front for babies or purses was full and the main body of the cart was stacked so high above her line of sight that her daughter was helping direct the vehicle to a checkout lane. Clearly the next innovation in cart design needs to be the installation of a periscope.

Despite a low saving rate, slow demographics, depressed confidence, a crippled housing market, rising interest costs and growing credit problems, we estimate that American consumers increased their inflation-adjusted spending by more than 4% annualized in the third quarter. This alone accounts for most of the resilience of the economy in the face of Fed tightening and is a significant factor in boosting long-term interest rates to their highest levels since before the Great

Financial Crisis (GFC). This raises two key questions for investors: (1) why is consumer spending so strong and (2) how long is this likely to persist?

Headwinds…

In order to address these questions, it is worth reviewing both the headwinds and tailwinds impacting consumer spending today. Starting with the headwinds:

Confidence: The index of consumer sentiment fell to 63 in early October, down from 68.1 in September and lower than it has been 93% of the time since 1978. It should be noted that the so-called "misery index" – calculated as the sum of the inflation and unemployment rates – is lower, and thus better, than it has been 75% of the time over the same period. Nevertheless, confidence is very low.

Demographics and Housing: Following a small pandemic bust and then a small rebound, the number of babies born in America is falling again. In the year ended in June, the Census Bureau estimates that there were just 3.643 million births, down 1% from a year earlier and the lowest annual total, apart from a 2021 pandemic slump, since 1983. The number of marriages also appears to have resumed a slow downward trend following a post-pandemic bounce. Meanwhile, thankfully, deaths are down substantially from their pandemic highs. However, even with this and a rebound in immigration, the U.S. population likely grew by just 0.5% in the year ended in June, hardly enough to fuel a consumer boom.

Housing: A slump in home-buying is also dragging on consumer spending. Existing home sales in September fell below a 4 million unit annual pace for the first time since 2010, as the highest fixed rate mortgage rates since 2000 cut into both sales and the number of homes on the market. Fewer home sales should be impeding purchases of furniture and appliances.

Fiscal Drag: While the federal deficit is continuing to rise due to higher interest costs, higher defense spending and legislation designed to promote investment spending, changes in federal policies are now a negative for consumers. The enhanced unemployment benefits, stimulus checks and rent assistance of the pandemic are long gone. Moreover, entering the new fiscal year, a resumption of student loan payments and an end to federal childcare subsidies are putting an extra strain on consumer budgets, particularly for younger households.

The Saving Rate: This week's report on consumer spending and income should reveal that the personal saving rate – calculated as the difference between disposable income and outlays, as a percent of disposable income – fell to 3.4% in September from 3.9% in August. Recent revisions cut estimates of the average saving rate for the five years before the pandemic from 7.6% to 6.2%. However, even with this, today's saving rate is very low by historical standards, implying that spending has been growing faster than disposable income – a trend which eventually has to halt and likely reverse.

Credit Issues: Of course, the decline in the saving rate in recent years doesn't so much reflect people eating into their checking and saving account balances as rising borrowing. Over the past year, total credit card debt has risen by 11%, as some consumers have tried to maintain a standard of living that they achieved over the pandemic by borrowing.

It should be emphasized, however, that this growth in debt is likely very far from a breaking point. As we show on page 21 of our *Guide to the Markets*, we estimate that servicing debt absorbed just 9.9% of household disposable income in the third quarter, similar to pre-pandemic levels and far below the 13.2% seen on the eve of the GFC. Similarly, loan delinquency rates, while rising, are still far below pre-GFC levels.

….and Tailwinds

Offsetting these drags, however, are two important positives.

Income: First, real disposable income is growing again. Following over two years of declining real wages, wage growth now exceeds consumer inflation, with average hourly earnings for all workers rising by 4.2% over the past year compared to a 3.7% increase in headline CPI. Combined with solid job gains and strong increases in consumer interest income, we now estimate that real disposable income grew by a very healthy 3.6% in the year ended in September. These gains should diminish going forward but they represent a strong tailwind for consumer spending.

Wealth: Gains in wealth represent a second powerful tailwind. Even after a small decline in the third quarter due to a stock market correction, we estimate that household net worth totaled $145.2 trillion, up $7.5 trillion or 5.5% from the start of the year and up $35.1 trillion or 31.9% since the fourth quarter of 2019. Of course, these wealth gains have overwhelmingly accrued to the highest income households who have a lower marginal propensity to consume than their lower income counterparts. However, these gains in wealth are very likely supporting spending, particularly in areas of leisure, travel and entertainment, as well as new vehicles and, to some extent, housing.

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All told, an assessment of these headwinds and tailwinds can probably explain both the current resilience of consumer spending and a prediction of a gradual loss of momentum. However, there is another issue that makes any forecast of consumer spending particularly difficult.

Many American consumers, whether we want to admit it or not, have an addiction to spending. It is, of course, by no means the most destructive of addictions. But, conditioned by decades of pervasive advertising, we have been taught to buy not just all that we need or even all that we want but all that we can. A prudent consumer, considering their hopes for their own future financial wellbeing, their retirement, and their aspirations for their children's education, might, at this point be ready to trim their spending. However, as was demonstrated in the years leading up to the GFC, consumers are likely to continue to spend well beyond the limits of prudence and right up to the limit of credit.

If this is the case over the next year or two, any major pullback in consumer spending may be delayed, allowing the economy to achieve stronger growth for longer than many expect. This could cause the Federal Reserve to delay any easing in monetary policy in 2024 even if, as we expect, inflation steadily heads back to 2%.

However, it should finally be noted that, if this transpires, consumers could well be running on less than empty if and when the economy finally topples into recession. At that point, much as was the case after the GFC, it may be very difficult to find newly-chastened consumers willing to borrow or banks willing to lend to them. In other words, a stronger-for-longer consumer-led expansion, will likely be followed by a weaker-for-longer recovery, allowing inflation to revert to its pace of a decade ago and interest rates to fall significantly from today's elevated levels.

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