Economics from Washington

Consumers Underwrite Moderate Growth

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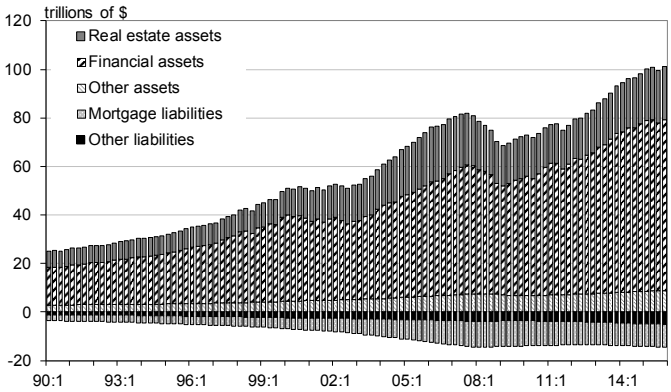
- *Consumer spending is set to expand at about a 2 ½ % pace in 2016, supporting modest growth in the overall economy.*
- *Household balance sheets are strong and stable.*
- *Income growth is adequate to support consumption without a decline in the savings rate.*
- *Employment growth will slow as 2016 unfolds.*
- *Higher interest rates will initially benefit consumers.*
- *Cash flow estimates continue to look more positive than the official data.*

In 2014, 2015 and 2016, the economy got off to a shaky start. Consumer spending looked soft in early reports and there were concerns about other sectors. For the past two years, we have reviewed the status of consumers and concluded they were in very solid condition and would provide the basis for moderate economic growth. In 2014, we projected consumption growth of 2 ½% vs. the actual result of 2.7%; in 2015, we estimated consumption would rise 3 - 3 ½ % vs. the actual outcome of 3.1% (see *Solid Consumer Outlook, March 31, 2014* and *Don't Write off the Consumer, March 19, 2015*). This year's review concludes consumers remain in excellent condition, which has improved very modestly across some dimensions and deteriorated slightly across others. Because we believe the savings rate will remain elevated and job growth will slow as the year unfolds, we expect consumption growth will slow in 2016 to about a 2 ½ % pace. This will provide the foundation for moderate growth in 2016, even though some parts of the economy are weak and others will be a drag on growth.

We begin by reviewing the household sector balance sheet. Neither assets nor liabilities have changed much over the past year; net worth rose a small amount. Wealth is approximately 6 ½ times disposable income and 6 times total liabilities. Financial wealth exceeded its pre-recession peak in 2011. By the end of 2015, real estate wealth was also well above its pre-recession peak.

Household Sector Balance Sheet



Source: Federal Reserve Board

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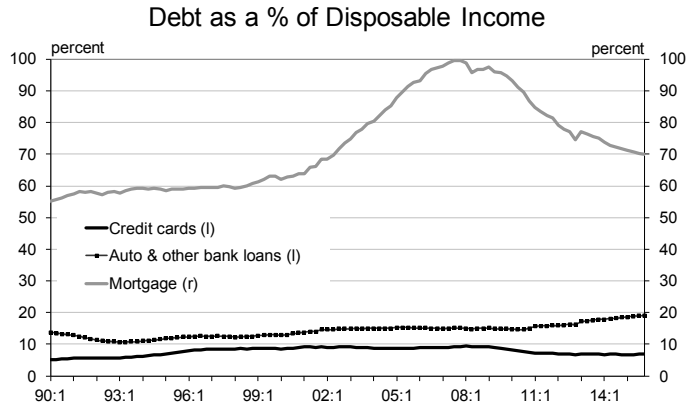
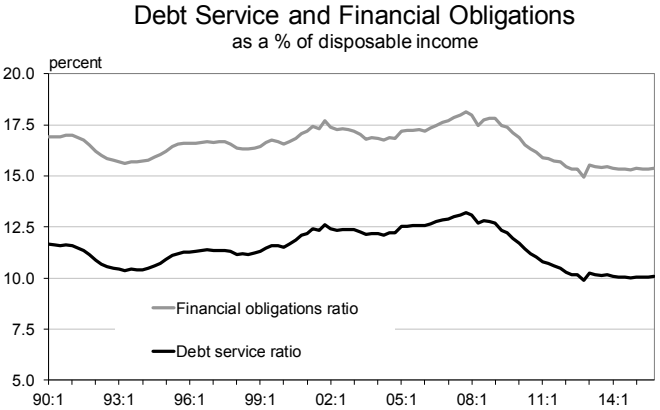


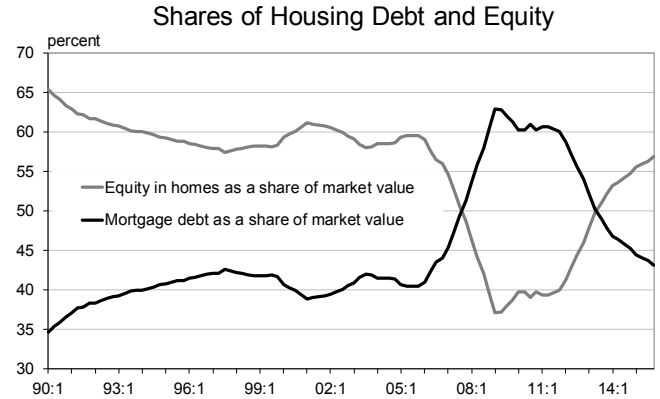
Source: Federal Reserve Board, Bureau of Economic Analysis

The total debt to income ratio changed little in 2015, although the composition continued to shift toward slightly more auto debt.



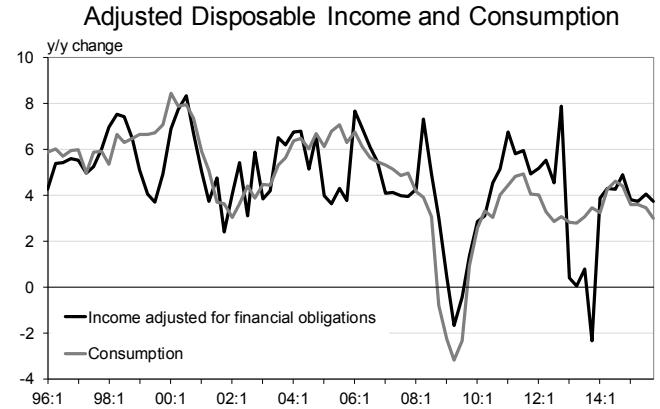
Source: Federal Reserve Board

Since neither debt levels nor interest rates changed much over the past year, consumers' debt service payments were steady as a share of income. The share of income devoted to total financial obligations (which includes rent, auto lease payments, homeowners insurance, and property taxes) was also stable.



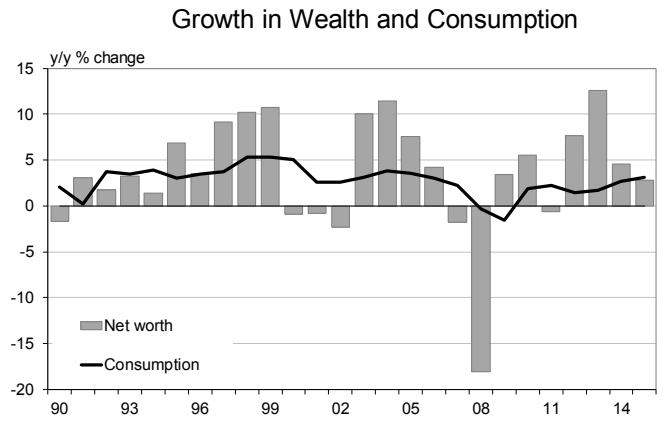
Source: Federal Reserve Board

As home values rose in 2015, homeowners' equity as a share of market value increased and mortgage debt as a share of market value declined. These metrics are on track to reach pre-recession levels in about two years. Private data sources estimate the number of homeowners with negative equity fell 19% (about 1 million) in 2015.

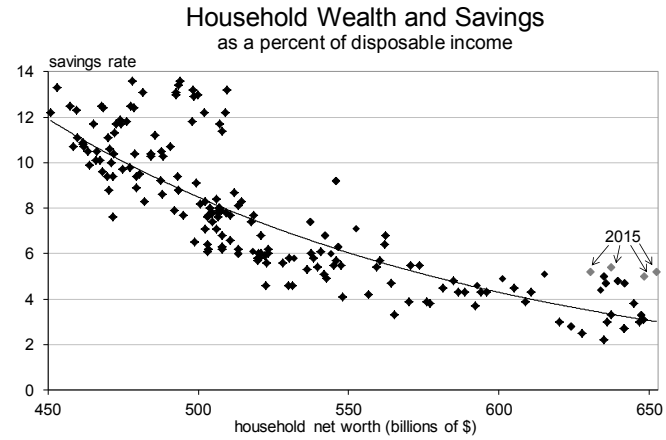


Source: Bureau of Economic Analysis, Federal Reserve Board

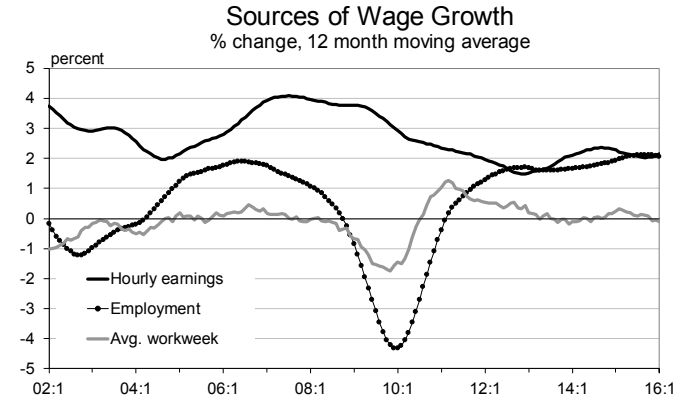
Consumers have continued the conservative financial behavior that has characterized this expansion. After adjusting income for tax payments and financial obligations, income has increased slightly more than consumption. Stated differently, debt has played no significant role in supporting recent consumption.



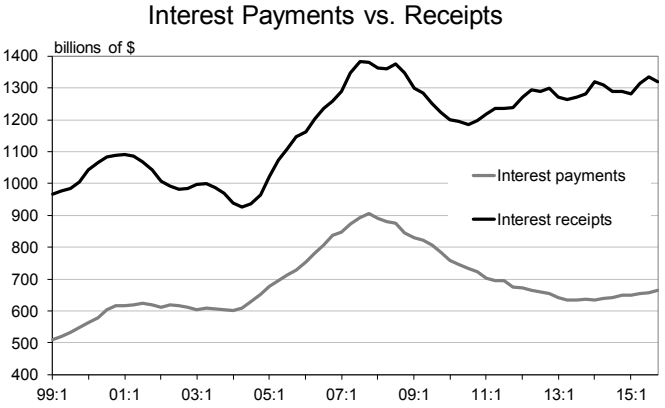
Source: Federal Reserve Board, Bureau of Economic Analysis



Source: Bureau of Economic Analysis, Federal Reserve Board



Source: Bureau of Labor Statistics



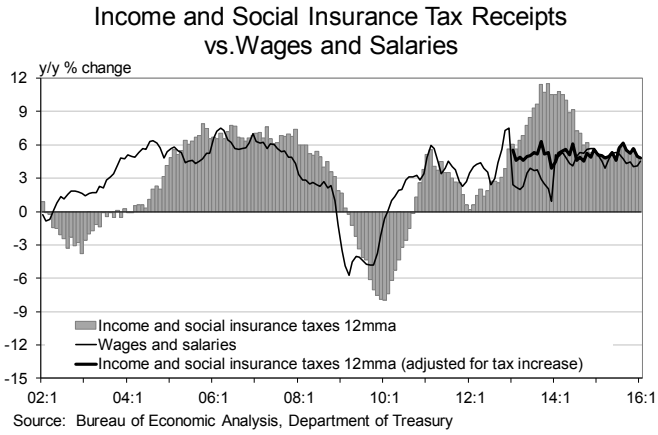
Source: Bureau of Economic Analysis

Given about a two year lag between an increase in wealth and an increase in consumption, the large increase in wealth in 2013 was a positive factor in consumption growth in 2015. Wealth rose about half as much in 2014 and even less in 2015, suggesting the impact on consumption will be quite small in 2016 and 2017.

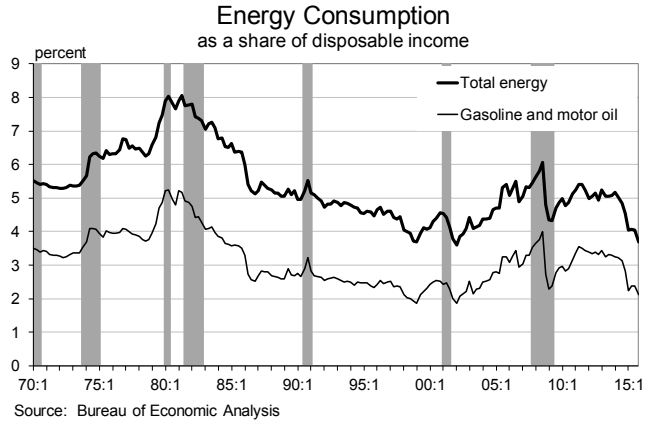
While savings behaved almost precisely according its historical relationship to wealth during the 2007 recession, it has been consistently higher than expected during the recovery. We believe there are two reasons for this. First, the disparity between high and low income groups has widened during the recovery. Since high income groups have higher saving rates, this disparity tends to raise overall savings. Second, there has been a shift in what consumers expect to earn on their savings. Interest rates have remained low for an extended period and many advisors are telling consumers they should expect them to remain low for the indefinite future. As a result, consumers need to save more to reach retirement or other goals. We see no reason to expect either of these factors to change in the near term and therefore expect saving rates to remain relatively high.

Turning to prospects for income growth, wages and salaries are just over 50%. The average workweek has been quite stable for several years, so increases have been generated by rising wage rates and new job growth. We expect the rate of wage growth to rise very little in 2016, while the rate of job growth slows. The rate of wage growth has been held down because retiring baby boomers who earn relatively high wages are being replaced by younger, less experienced workers who earn less. This offsets some of the pressure generated by a very low rate of unemployment. The net result is that wage and salary earnings will grow slightly less in 2016 than in 2015.

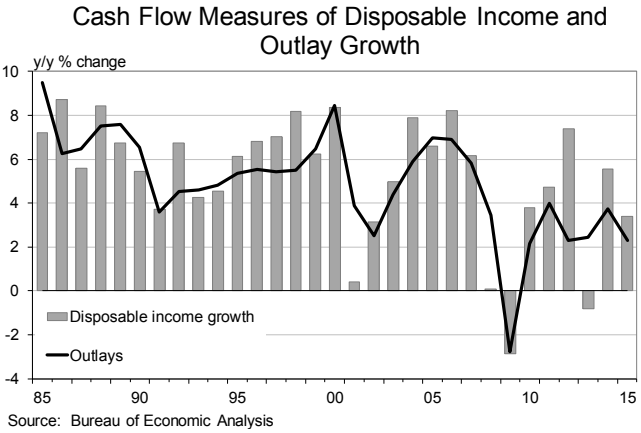
The other half of income is generated by interest and dividends, transfer payments, proprietors' income and rents. Transfer payments (17.3%) look like they will be stable. Interest and dividends (14%) are likely to increase faster if interest rates rise during 2016. As the chart shows, consumers earn roughly twice the amount of interest they pay out, so higher interest rates will be positive for income growth. Proprietors' income rose less than 2% in 2015 which is unusually low. There is a good prospect this will improve slightly. Rental income has been growing at about a 7% rate and will continue. On balance, we expect nominal income (after taxes) to grow a little more than 4% in 2016.



We have no strong reason to expect income estimates to be revised significantly. Tax collections have been rising at about the same pace as wages and salaries, which is to be expected when tax rates are unchanged. Hours worked and hourly earnings reports are also consistent with wage estimates.



The share of income consumers spent on energy in 2015 was about as low as it gets. While some of the energy savings were spent on other items, they also helped consumers maintain relatively high savings rates. If oil prices remain at current levels or move somewhat higher, this factor will be less helpful in 2016.



Cash flow estimates continue to provide a more optimistic picture than the official data. The official data show income and spending rising at about the same pace, but after adjusting to a cash flow basis, income has grown faster than spending for the past two years.

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