

April 14, 2011

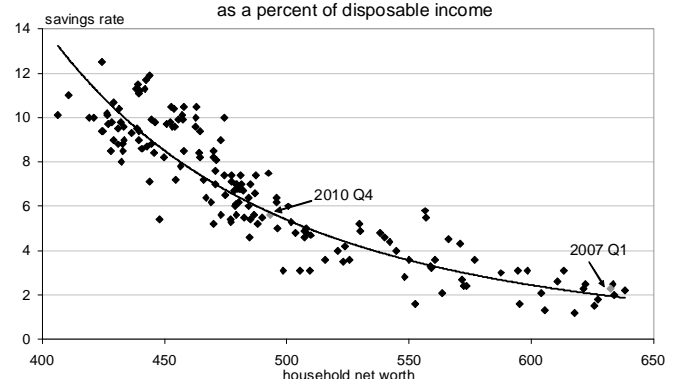
L. Douglas Lee
dlee@econfromwashington.com

- *Over the past year, consumers have overcome a variety of potential obstacles to spending growth. These obstacles include higher savings, low house prices, debt reduction and tight credit. Looking ahead, these obstacles will shrink or vanish.*
- *Income growth is the basic driver for consumer spending, and the underpinnings of income growth are becoming stronger. Wage income is likely to accelerate modestly, while other types of income keep pace.*
- *The first quarter slowdown in consumer spending will be temporary. A second quarter rebound is in store.*

In early 2010, investors worried about a variety of things that might restrict consumer spending: increases in the savings rate, deleveraging, a fall in home values, and credit restraints from banks were all issues of concern. In fact, none of these potential problems proved to be a real problem. Income and spending have increased at about the same pace, demonstrating once again that income (primarily wages and salaries) is the driving force behind consumption. The outlook for the balance of 2011 is for continued gradual improvement in both income and consumption.

By late 2007, the personal savings rate had fallen to about 2% of disposable income and many believed it was too low to be sustained. Yet, it was close to the level suggested by the historical relationship between savings and wealth. Wealth was at a very high level. In 2007, wealth declined; in 2008, it plunged an unprecedented amount. Consumers responded almost immediately by increasing savings. The personal savings rate increased from 2.1% in 07Q4 to 5.2% in 08Q4. Since then, the savings rate has been fairly stable, fluctuating in the 5 - 6% range.

Chart 1
Household Net Worth and Savings Rate
as a percent of disposable income



Source: Bureau of Economic Analysis, Federal Reserve Board

A question economists have not yet resolved is whether the composition of wealth matters for consumer spending. Because there had never been a period (prior to the past recession) when housing wealth declined, it has been difficult to separate the impact of housing wealth from financial wealth. Since financial wealth is highly concentrated among those with high incomes, while housing wealth is much more broadly spread across various income groups, there was concern that the first decline in home values would have a larger impact than suggested by historical relationships. In fact, this does not seem to have been the case. Financial wealth has recovered much of its decline, while housing wealth has only stabilized at a depressed level. Still, the current savings rate is quite close to that predicted by the relationship with total wealth levels. This strongly suggests that absent another large decline in wealth, the current savings rate is not likely to increase.

The rise in savings in 2008 undoubtedly played a role in the spending slowdown in late 2008 and 2009, but it was not a factor in 2010. Chart 2 illustrates the gap between income and spending growth in 2008 - 09. It also shows in 2008 - 09 income rose faster than wages because of large Federal tax cuts. By 2010, the impact of both the rise in savings and tax cuts was largely out of the data – consumption, income, and wages all increased at close to the same pace. With the savings rate now likely to remain stable near current levels, we expect income growth to determine spending growth.

Deleveraging was another major concern last year. It was clear debt levels needed to be reduced. Of course, a reduction in debt (aka negative savings) increases savings, so this is a refinement of the savings rate story. Still, debt levels have declined significantly while spending has increased, and this continues today. Several factors have contributed to this development. First, lenders have written off large amounts of bad debt. In 2010, banks alone wrote down about \$10 billion per quarter in mortgage debt and about \$15 billion per quarter in consumer loans (mostly credit cards). Second, house prices have fallen and downpayment requirements have increased. This combination means the average size of mortgages has declined. When new mortgages replace old ones, the new ones are smaller. Third, housing turnover is extremely low

Chart 2
Income and Spending

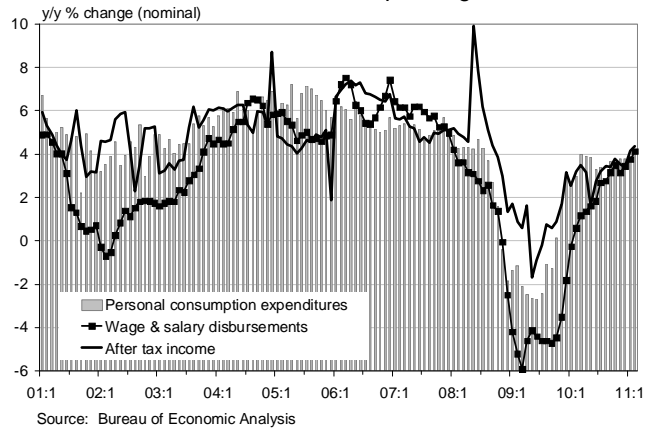


Chart 3

Consumption and Debt Growth

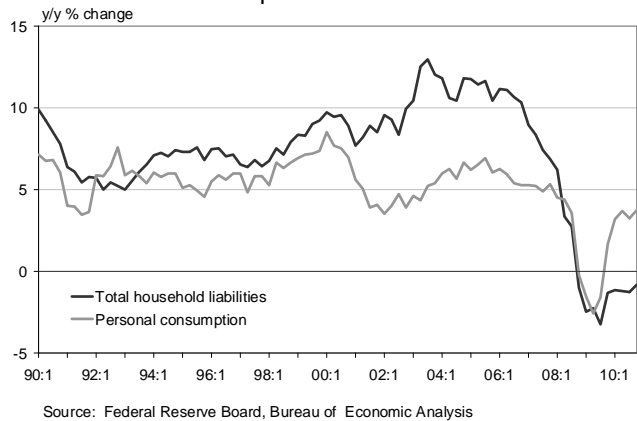
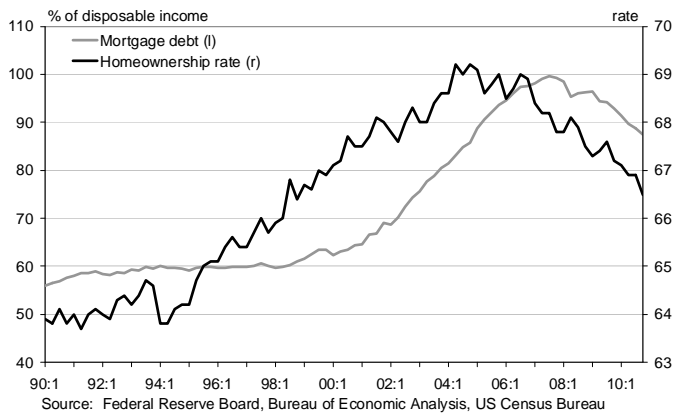


Chart 4

Mortgage Debt and Homeownership Rate



and homeownership rates are still falling. This means there are fewer new mortgages being initiated. Finally, net new lending to consumers has been very small, but old debt continues to be amortized at a steady pace. The result is a decline in total debt.

All types of debt declined in 2010, but a relatively small amount was in credit card and auto debt. The decline in mortgage debt was about five times as large as the drop in other types of debt. As a result, debt service has also fallen. From a peak of 13.87% of disposable income, debt service has declined to 11.75%, with about a 1 percentage point drop occurring in 2010. Looking at the amount of bad debt still carried on the banking sector's books and the backlog of foreclosures still to be processed, it will easily take another two years to normalize credit conditions. Over this period, debt and debt service will continue to decline. As long as deleveraging is primarily a mortgage story, there is no reason for it to obstruct consumer spending.

To date, credit has played a very minor role in consumer spending. Although consumer credit began to expand late in 2010, total consumption is growing substantially faster than credit as shown in chart 5. Retail sales are also growing faster than credit. These measures include auto sales where credit is growing the fastest, so the non auto portion is even less dependent on credit than the chart indicates. While it is true borrowing conditions remain difficult for some consumers, there is no evidence this is an obstacle to consumer spending.

As noted earlier, the decline in housing-related wealth (due to house price declines) has not had a disproportionate impact on savings behavior. Similarly, the inability to extract home equity (which declined along with house prices) has had little impact on consumer spending. In fact, homeowners have been adding to their equity positions since 2008 as the recovery in consumer spending has steadily gained strength. Most studies of the relationship between wealth and spending conclude the impacts are small and there is about a two year lag before changes in wealth reach their maximum impact on spending. If this is correct, the 2008 wealth decline had its impacts in 2009 and 2010. Since wealth increased in 2009 and 2010, there should be small, but positive impacts in 2011 and 2012.

Chart 5
Growth in Total Consumer Credit
relative to growth in consumer spending

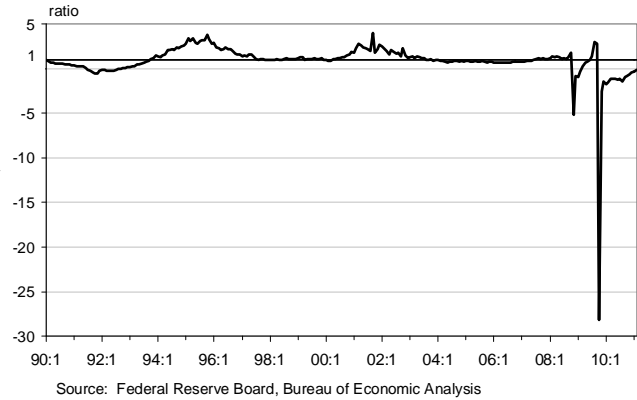


Chart 6
Home Equity Cashed Out

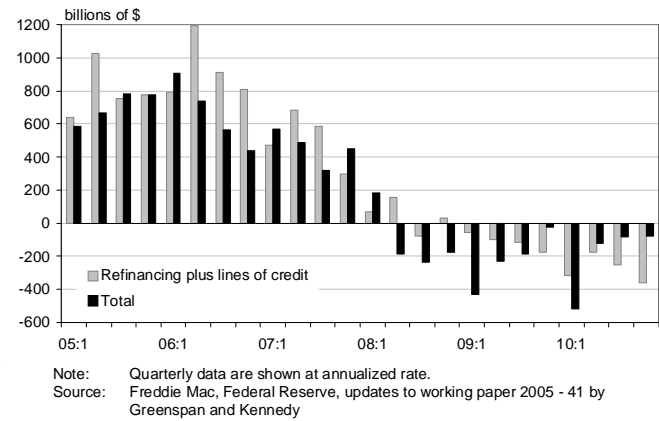


Chart 7
Growth in Wealth and Consumption

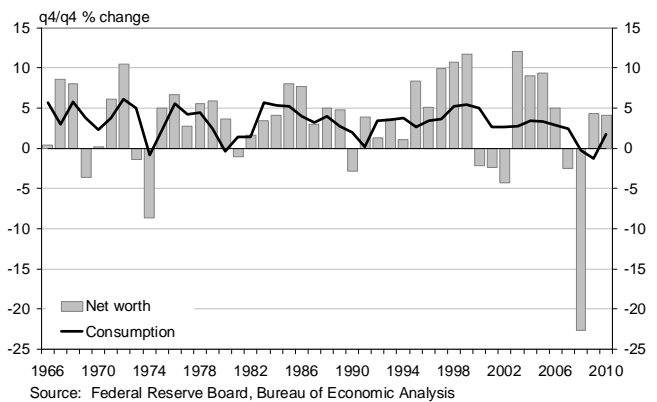
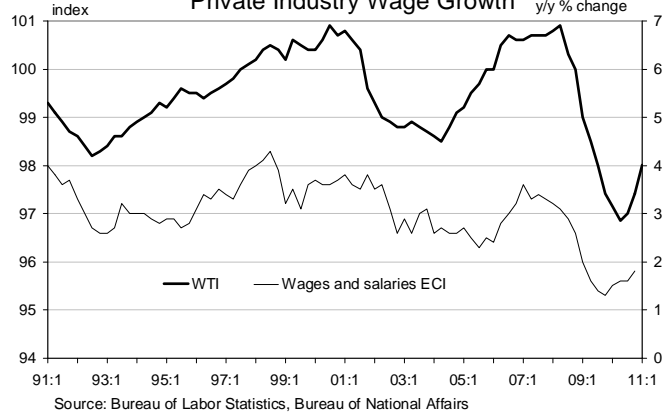


Chart 8
Wage Trend Indicator and
Private Industry Wage Growth



Reviewing various problems that might have restricted consumer spending brings us back to our original view: income (just over half of which comes from wages and salaries) is the primary driver of consumer spending. The outlook for continued income growth is quite positive. Jobs are expanding at a steady pace and some acceleration is likely, hiring plan surveys have improved and are at very positive levels, the Employment Trends Index is rising, hours worked have increased but remain at a relatively low level (which allows for additional increases), the firing rate is extremely low, job postings and job vacancies are rising. While wage rates are not likely to increase very much, the BNA Wage Trend indicator predicts private sector wages will rise about 2% in 2011, up from 1.8% in 2010. Wages have been increasing at about a 4% pace in nominal terms and about 2 ½ % after inflation. The combination of a small increase in hours worked, a small increase in wage rates, and a moderate increase in the number of jobs could easily push nominal wage growth to a 6% pace.

Other sources of income are also growing at solid rates. Proprietors' income has been especially strong, and interest and dividend income is likely to accelerate when interest rates begin to rise. Transfer payments are well below their recession peaks, but the aging population means the trend will continue to rise. Rental payments made by tenants are also rising as the rental vacancy rate declines. In short, total personal income is likely to increase at least as fast as wages and salaries and there is a good chance it will grow a little faster.

Of course, if inflation moves higher as we expect, this will absorb part of the rise in nominal income. Still, it is likely income will increase more than inflation. In addition, another small decline in debt service payments will allow consumers to shift some interest payments to the purchase of other goods and services. The bottom line is consumer spending is likely to grow somewhat faster in 2011 than in 2010 when it rose 2.6% (q4/q4).

In 11Q1, consumption growth appears to have slowed to a 1 ½ - 2% annualized rate – well below the 4% pace set in 10Q4. Given the underlying fundamentals for income growth, we view this slowdown as temporary and expect a rebound in the second quarter.

Economics from Washington, Inc. ■ T 301.365.6395 ■ F 301.365.2686

Economics from Washington, Inc.™ is a private consulting firm. This report is for private circulation and distribution in its entirety. Although the information herein has been obtained from sources believed to be reliable, we do not guarantee its accuracy, completeness, or fairness. Opinions and estimates may be changed or withdrawn without notice. The information contained in this report should under no circumstances be considered or relied upon as investment advice or recommendations for the buying or selling of any security or commodity. Forward-looking statements are inherently subject to multiple risks and uncertainties that could cause actual circumstances to differ from those that are expected.

© 2011 Economics from Washington, Inc.™ All rights reserved.