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ECONOMICS: US PERSPECTIVES

SUPPORTIVE ENVIRONMENT FOR US CONSUMER CONTINUES TO DRIVE GROWTH

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Consumer activity is the most critical variable in assessing the outlook for the US economy. Analyzing the health of the consumer using a framework of five key factors indicates a supportive picture for both consumption and the overall economy.

The consumer is the foundation of the US economy: consumption contributes roughly two-thirds of gross domestic product (GDP). It makes sense, then, that the health of the consumer sector provides a strong indicator of the overall health and trajectory of the US economy.

But what factors drive consumption? Based on our analysis, income, debt-servicing costs, household wealth, confidence and savings collectively go a long way toward creating the foundation for consumer spending patterns. And today, an assessment of these five factors suggests that consumption is on solid ground.

Steady Growth in Household Income

Households typically spend from their income first, which makes household income the most important variable in determining consumption: a stronger labor market means more income and more consumption.

We can proxy household income by multiplying the number of people working by average weekly hours and by average hourly earnings. This "paycheck proxy" correlates very well with spending over time and should be the starting point of any consumption forecast.

Based on this gauge, income growth has been a steady 4% year over year for essentially the last several years (*Display 1*). This stability is unusual, because incomes typically fluctuate with the business cycle. However, growth has been stable in payrolls, average weekly hours and wages, and we expect those trends to continue.

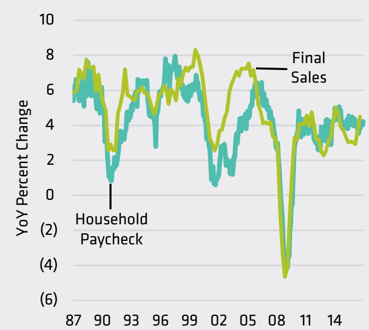
Changes in tax policy can also impact income, but the relationship usually isn't as dynamic. A permanent change in tax rates would impact consumption, but temporary tax changes typically don't have a lasting impact. Changes in consumption stemming from changes in the tax code move income around in the short term but don't have the same impact on spending—that's something to keep in mind as Congress considers changes to tax policy later this year.

Household Debt Service Is Low

Household debt also plays a substantial role in determining consumption. If consumption plans outstrip income, debt is the most common means to fund that

Display 1
Income Supports Consumption

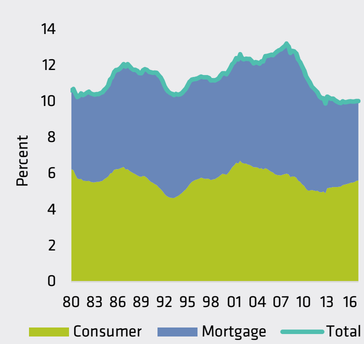
Household Paycheck and Final Sales



Through June 15, 2017
Source: Thomson Reuters Datastream

Display 2
The Cost of Debt Is Very Low

Household Debt Service Ratio



Through March 31, 2017
Source: Thomson Reuters Datastream

excess consumption. The more debt consumers take on and the costlier that debt is, the less money is available for consumption down the road. Consumer debt is cyclical: it rises during expansions and falls during and immediately after most recessions.

In the current cycle, consumer debt outstanding (not including mortgages) has risen to a record 20% of GDP. That shouldn't be surprising or alarming—rising leverage in the economy is a structural trend that dates back nearly 50 years. The ratio of consumer debt to GDP has reached a record high in every expansion since the late 1970s.

The growth in consumer debt hasn't been markedly different in this cycle. In fact, the rate of growth was much faster in the 1990s expansion—and that expansion ended in one of the mildest recessions on record. If we include mortgages, the total household-debt-to-GDP ratio has actually fallen—mortgage debt has stayed below precrisis levels as GDP has expanded in the post-crisis period.

The amount of debt is one thing, but the cost of servicing it is what really matters. With interest rates so low today, the household-debt-service ratio is the lowest since as far back as 1980 (*Display 2, previous page*)—with mortgage and nonmortgage obligations making up roughly equal proportions. The low cost of debt servicing supports consumption by leaving more income to spend.

Household Wealth at All-Time High

Households can also fund consumption by tapping into accumulated wealth. Much is made in financial markets about the "wealth effect," in which rising asset prices boost consumption—but the evidence suggests that this link isn't as strong as many assume.

This is largely because most US financial wealth accumulates to those who are already wealthy. Changes in their wealth are less likely to influence consumption choices than would be the case for lower-income households. And because lower-income households don't own many financial assets, they don't benefit from rising asset prices.

These disparities limit the overall impact of rising financial markets on economic activity, although wealth matters to a degree as a source of funding for some consumption. Today, household net worth is at an all-time high relative to both disposable income (*Display 3*) and GDP.

Above-Average Consumer Confidence

Right now, consumer confidence is above long-term averages. Confidence also impacts consumption, but more in the short term than in the long term. The factors mentioned earlier—the job market, for example—can influence confidence, but so can short-term political noise, gas prices and many other factors that can be ephemeral. So, consumer confidence can be a reasonable gauge of the general mood of consumers, but it isn't a reliable driver of the outlook for future consumption.

Stable Savings Rate

To some extent, the household savings rate is a residual of other factors. More income, higher asset prices and cheaper borrowing costs all reduce the need to save. And there's a structural factor at play: the impulse to save has declined steadily since the early 1970s.

More often than not, changes in savings behavior evolve so slowly that they don't play a big role in determining short-term or medium-term consumption changes. However, they can make a difference over long time horizons. Right now, the US savings rate is stable at a bit above 5% of disposable income.

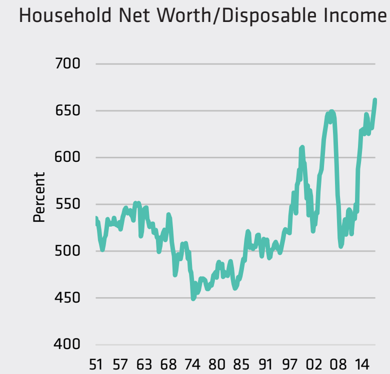
The Bottom Line on Consumption

Given the solid foundation produced by the variables above, it shouldn't be a surprise that US consumption has been solid. Both monthly and quarterly data that track personal spending are running at around 3% year-over-year growth (*Display 4*). That's faster than the growth rate of the economy as a whole, and it's consistent with ongoing expansion. Those same strong fundamentals are also keeping consumer defaults extremely low. In short, consumers have the wherewithal both to consume and to meet their debt obligations.

Our base case is that this benign outlook will persist over the next few quarters, continuing to support overall economic growth. We'll continue to monitor the variables above for signs of change, which is always possible. Labor markets could weaken, higher interest rates could increase debt costs or financial markets could falter and reduce wealth. Populism could shift the balance away from asset growth and toward income growth, which could reduce inequality but also push financial markets lower.

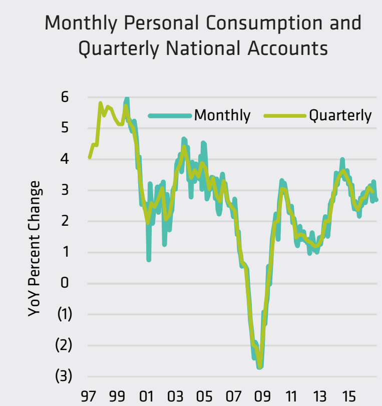
Still, the environment on the whole is sound for the US consumer to continue driving economic growth. That assessment underpins our view that the US economy will continue to thrive. Until this environment changes, there's no reason to be pessimistic about either the consumer or the US economy as a whole. ■

Display 3
Rising Financial Markets Generate Wealth



Through March 31, 2017
Source: Thomson Reuters Datastream

Display 4
Consumption Holds Steady



Through May 15, 2017
Source: Thomson Reuters Datastream