United States
The American Consumer: Stronger Now, Weaker Later
June 17, 2008

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American consumers have kept on spending despite a perfect storm of adverse forces, most evident in consumer sentiment falling to a 28-year low. The most likely reason is that the impact of tax rebates on spending is occurring sooner − and the impact possibly will be bigger − than I anticipated. Nonetheless, I think a renewed slowdown is coming for the American consumer. He/she is using lines of credit to postpone it − literally living on borrowed time. In that vein, the bigger the pop from rebates now, the bigger will be the payback after they are spent, unless energy prices tumble or consumers get addition lines of credit. Here's why.

The Indefatigable American Consumer

Incoming data on consumer spending have been mixed, but there's no mistaking the relative strength in retail sales. Before inflation adjustment, retail sales excluding motor vehicles and building materials (this grouping is the so-called retail "control," because statisticians and we use it as one of several indicators to estimate overall consumer spending) rose by a stunning 12.1% annual rate in the three months ended in May, a two-year high. Of course, this subaggregate includes food and energy, for which prices have soared. Adjusted for inflation, however, I estimate that the pace was still a robust 6.6% annualized. In contrast with those retailing results, light vehicle sales (especially of light trucks) have dropped 11% below their 2007 average. Moreover, both in-hand and anecdotal evidence suggests that services outlays have slackened. For example, over the three months ended in May, real outlays for recreation, domestic and foreign travel have declined respectively by 1.8%, 8.7% and 7.5% annualized. And according to two surveys, nearly half of polled consumers say that record-high gasoline prices have pushed planned summer vacation outlays down. Nonetheless, we estimate that consumer spending accelerated to a 1.7% annual clip in Q2 from an upwardly-revised 1.2% in Q1.

Although mixed, those results are surprisingly robust, given the headwinds facing consumers: Among them: higher energy prices, an ongoing housing downturn, falling home prices, slipping real incomes and tighter financial conditions (for details, see "The Double-Dip Supply Shock," *Investment Perspectives*, June 12, 2008). The results suggest that tax rebates are probably lifting consumer spending sooner and by more than I've expected. Previously, I assumed that, faced with falling home prices and restraints on borrowing, consumers would spend only 20% of their tax rebates, and that the influence would be lagged.

More Bang for the Buck or Just Sooner?

We've always agreed with the consensus that the tax rebates would offer only a temporary boost for after-tax income and thus for consumer spending, followed by a subsequent "payback" in growth (see "Upping the Ante on Stimulus," *Global Economic Forum*, January 28, 2008). Studies of the three past rebate episodes in 1974, 2001 and 2003 suggest that consumers spent anywhere from 15 to 66 cents of the rebate dollar. This analysis also suggests that when consumers lack other resources − they are at the low end of the income scale or they have difficulty getting access to credit or both − they will spend rebates (for a summary, see "Options for Responding to Short-Term Economic Weakness," Congressional Budget Office, January 15, 2008).

Initially, I agreed with others' estimates that consumers would spend 40 cents of each rebate dollar (for example, see "How Much Stimulus from Income Tax Rebates," Macroeconomic Advisers, January 25, 2008). Unlike the rebates in 1975, today's targeted lower-income households, including those who paid no tax, which should increase their potency. However, the recent sharp declines in home prices and in consumer attitudes prompted me to trim that estimate by half to 20 cents. Recent evidence now suggests 40 cents could be closer to the mark. That the improvement seems centered in spending on nondurables is consistent with past statistical evidence (see David S. Johnson, Jonathan A. Parker and Nicholas S. Souleles, "Household

Expenditure and the Income Tax Rebates of 2001," *American Economic Review*, Vol 96, Issue 5, December 2006). But that judgment is still subject to revision because the timing of the impact is also uncertain.

Courtesy of existing credit lines and widespread publicity about the rebates, consumers may even have spent some rebates in advance of receipt. That fits the script that increased access to credit − even following the subprime meltdown and greatly increased lender caution − has enabled consumers to "smooth" their consumption in the face of adverse shocks to income or wealth (see Karen E. Dynan, Douglas W. Elmendorf, and Daniel E. Sichel, "Can Financial Innovation Help to Explain the Reduced Volatility of Economic Activity?" FEDS Paper 2005-54 November 2005). Indeed, despite the declines in home prices, home equity loans at all commercial banks have accelerated this year − to 17.8% annualized in the thirteen weeks ended June 4.

As I see it, however, three factors imply that the follow-on or "multiplier" effects from the rebates on the overall economy will be small. First, unlike in 2001, there is no permanent tax reduction, so there will be a "payback" later this year after the rebates are spent and the credit lines are tighter. In addition, imports and inventories will likely satisfy some of the pickup in demand, so it will not translate completely into output. Third, firms aware of the transitory nature of the stimulus probably won't step up hiring much to satisfy new demands.

Hawkish Fed Talk but Action Not Needed Soon

Elevated inflation expectations, hawkish talk from Fed officials and stronger-than-expected data have convinced market participants that the Fed may tighten as soon as August, with at least 75 bp expected by year-end. Small wonder: The University of Michigan's consumer canvass suggests that 5-10 year median inflation expectations stayed at 3.4% in early June, a 13-year high. The surge in energy prices clearly accounted for much of the recent escalation; it also lifted 1-year median inflation expectations to 5.1% − a 26-year high. To be sure, there is so far little evidence that surging energy, food, and import prices have lifted the underlying trend in inflation, much less that those expectations have affected wage setting. But with little slack in the economy, officials cannot be sure that inflation will remain low.

The Fed response was swift and made their resolve clear. Fed Chairman Bernanke noted that "the Federal Open Market Committee will strongly resist an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for inflation." Vice-Chairman Kohn's concern was equally transparent: "Any tendency for these longer-term inflation expectations to drift higher or even to fail to reverse over time would have troublesome implications for the outlook for inflation." What is less clear is under what circumstances and thus when the Fed would be prepared to act.

In our view, the Fed won't ease further, despite the risk of persistent economic weakness. But we strongly doubt that the Fed will tighten soon. In our opinion the economy will remain weak and economic slack will increase, with operating rates likely to decline by another 100-150 bp and the unemployment rate expected to hit 6% later this year. That increased slack will help to contain inflation pressures even if they arise from global sources over which the Fed has little control. And a weak housing market will promote a further deceleration in rents, especially in owners' equivalent rent.

Rising global inflation and Fed rhetoric turned the steady climb in two-year yields that began in mid-March into a rout, with a consequent dramatic flattening of the yield curve from 2s to 10s over the past week. According to MS rates strategy head Jim Caron, two technical factors magnified the selloff at the front of the curve. First, investors aggressively unwound curve-steepening trades that they had crowded into over the past several months. In addition, when the Eurozone curve inverted in the wake of hawkish talk from the ECB, dealers found themselves in massive curve steepening trades resulting from their sales of so-called "yield curve accrual notes" − structured notes that are bets on the curve using options − and they had to hedge with flattening trades. The US curve has flattened in sympathy with this move. But Jim believes that with these technical factors now subsiding, and inflation uncertainty still high, steady Fed policy may reverse the recent

massive flattening in the US yield curve.