Economic Viewpoint

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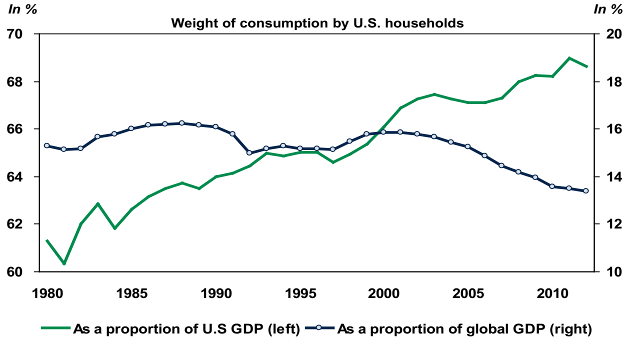
The state of mind of U.S. consumers

The arrival of the holiday season means that U.S. consumers will most likely increase their spending in the coming weeks. This period is therefore crucial for retailers, but it is also very important to the U.S. economy, the global economy and the financial markets, which will want to know how household spending is doing, and what interpretation the Federal Reserve leaders will make of it. This *Economic Viewpoint* seeks to determine where U.S. consumers stand. What are the current drivers of household spending growth, and what are the impediments that continue to undermine it? The analysis shows that real consumption growth will most likely remain relatively modest and hopes for stronger growth will have to be deferred to 2015.

THE IMPORTANCE OF U.S. CONSUMERS

According to the national account calculations, personal consumption by Americans accounted for 68.6% of GDP in 2012. In 1980, that proportion was 61.3%. Despite the problems that households faced during and after the recession of 2008–2009, we note that consumption is crucial for the economy. And what is true of the United States is also true of the rest of the world in general: U.S. consumption represents 13.4% of global GDP. That ratio is down from what it was at the end of the 1980s, when it exceeded 16% (graph 1).

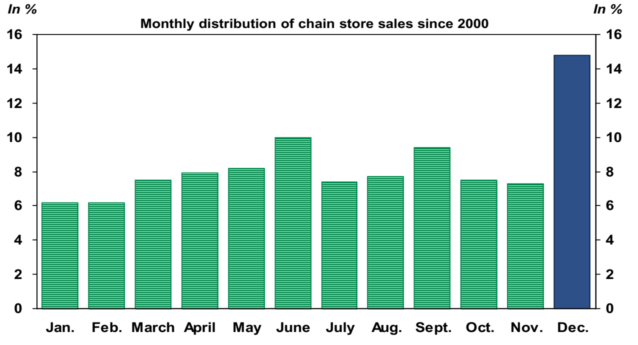
Graph 1 – U.S. consumption carries a good deal of weight for the United States and for the world



Sources: Bureau of Economic Analysis, International Monetary Fund and Desjardins, Economic Studies

The strength of consumption matters even more in the period leading up to the holiday season. The days just after Thanksgiving are known to be one of the most important shopping periods of the year. Retailers sell more during the month before Christmas than they do in each of the other months (graph 2). A healthy Christmas season is therefore vital for retailers.

Graph 2 – The holiday season is very important for U.S. retailers



Sources: International Council of Shopping Centers and Desjardins, Economic Studies

MODERATE GROWTH

The recent growth in spending by U.S. households mirrors the general state of the economy quite closely: modest and disappointing. In the third quarter of 2013, real consumption growth was 1.5% (annualized), the weakest figure seen

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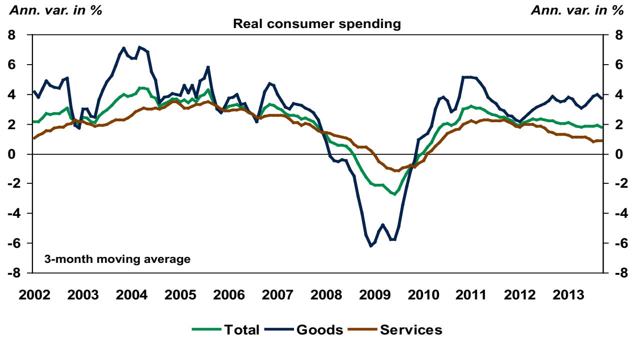
since spring 2011. However, consumption of goods did relatively well, with growth of 4.3%. As has frequently been the case since the recession, the weakness lies primarily in the anaemic growth in consumption of services.

This divergence between the strength of goods consumption and that of spending on services is one of the important characteristics of the current recovery cycle in the United States. Personal demand for goods already seems to have matched the annual rate of growth that was recorded before the recession (between 2002 and 2007), while growth in services is falling short of the mark (graph 3). It is mainly the consumption of durable goods that is especially strong. But this performance is not attributable to the automotive sector, although it is now doing quite well after crumbling during the recession. The purchases that stand out are mainly technological goods associated with leisure (real annual growth around 12.0%) and, to a lesser extent, equipment for the home (real annual growth around 7.0%). As for non-durable goods, sales growth comes mainly from pharmaceutical products, which show an annual change of approximately 7% in real terms. Real consumption of gasoline is currently in the doldrums.

Graph 3 – Growth in goods consumption is advancing quite quickly



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

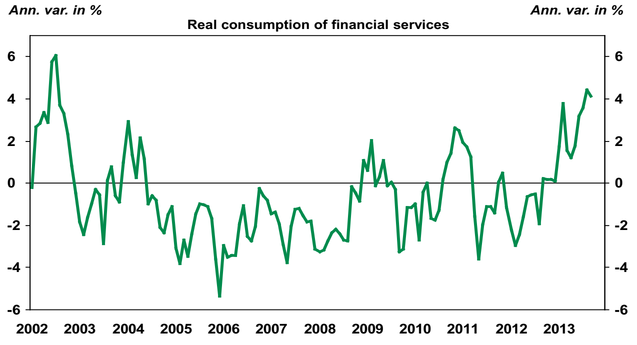
The annual change in real consumption of services is far smaller: around 1.0%. Between the recession of 2001 and that of 2008–2009, growth in spending on services usually stayed above 2%, so the weakness in total consumption comes mainly from the consumption of services. But what are the reasons behind it?

First of all, everything having to do with housing is still very depressed, with the exception of rents paid by tenants. The rent equivalent paid by owner-occupants is still down slightly in real terms, whereas it grew very sharply in the mid-2000s, when the real estate bubble was in full swing. Secondly, growth in spending on utilities associated with housing is currently very weak. One of the factors behind this weakness is the temperature. Summer 2013 was less hot than normal, so demand for air conditioning—hence, electricity—declined. This largely accounts for the weakness in spending on services in recent months, but not the underlying trend.

A more structural factor is the healthcare sector: the annual growth in real spending on medical services is hovering around 2%, whereas it was formerly above 3%. Despite the current weak price gains in this sector, waning demand for healthcare services reveals the decline in private-sector insurance coverage caused by the job losses that occurred during the recession. There were eight million fewer Americans covered by an employer-paid health plan in 2012 than there were in 2008. President Obama's healthcare reform is seeking to solve this problem of deficient coverage to some extent, but its effectiveness remains to be seen.

Growth in Americans' spending on services tied to leisure activities has also slowed considerably. In the mid-2000s, this category was growing at a rate of approximately 4% per year, while the most recent gains show an annual change of just 0.2%. It took five years for this type of spending to get back, in real terms, to its peak of July 2007. It would therefore appear that purchases of goods linked with leisure activities have replaced those of services in the same category. Growth in the hotel sector is also weaker. Surprisingly, spending on financial services has recently regained its cruising speed of the mid-2000s, whereas, last year, such growth was still lagging to a large extent (graph 4). A positive performance by the U.S. stock market and improvement in the housing market this year seem to be reviving this category of spending. However, growth in spending on insurance is three times less.

Graph 4 – Consumption of financial services has accelerated recently



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

So not all consumption is growing too slowly to be deemed satisfactory. However, the relative weight of services (about 66% of total spending) means that they currently constitute a significant burden.

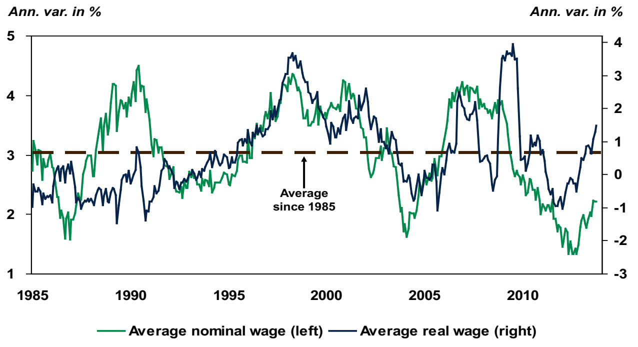
INCOME TRENDS

One of the factors behind the general weakness in consumption growth is the slow pace of income growth. While real personal disposable income rose by around 2.8% per year between 2002 and 2007, in the past year it has grown by just 1.6%.

At first glance, one might think that the slow pace of job creation accounts for this poor performance. However, an average of 167,000 jobs per month were created during the four years prior to the previous recession, while the monthly average in the past year has been 194,000 jobs, a figure that should command sharper growth in personal income.

Small salary increases are probably doing more to keep income in check. In the past year, the average hourly wage has risen by a mere 2.2%, while the average growth during the 10 years prior to the recession was 3.4%. On the other hand, today's low inflation means that real wage growth compares more favourably with that seen in the past (graph 5).

Graph 5 – Nominal wage growth is historically slow



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis and Desjardins, Economic Studies

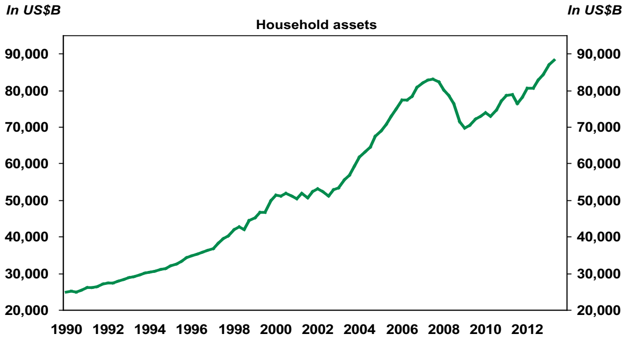
The tax increases arising from the fiscal cliff agreement that was negotiated in the last hours of 2012 are another factor weighing down disposable income. However, the inflated dividends and special bonuses that were paid in the fall of 2012 in apprehension of the fiscal cliff considerably tempered the harmful economic effects.

As the job market keeps improving and the constraining effects of tax policies fade, the headwinds that did damage to the recovery of household income will die down. In fact, employment levels are expected to match their peak of January 2008, in the spring of 2014.

REBUILDING WEALTH

One of the main causes behind the scope of the recession was the plunge in the value of household assets. The decline in home prices from their peak of 2006 to the nadir of 2012 subtracted US$6,758B from household wealth. The drop in the value of financial assets held by Americans wiped out US$8,619B, mainly due to stock market losses. Consequently, households' total assets fell by 16.3% compared to their peak of 2007. Fortunately, those losses have been recouped (graph 6) mainly thanks to strong performance by the U.S. stock market. A faster pace of growth in wealth should continue to improve the net financial position of households. By allowing proportionally smaller growth in savings than in income, greater household wealth will help consumption to grow faster.

Graph 6 – The assets lost during the crisis have been recovered



Sources: Federal Reserve Board and Desjardins, Economic Studies

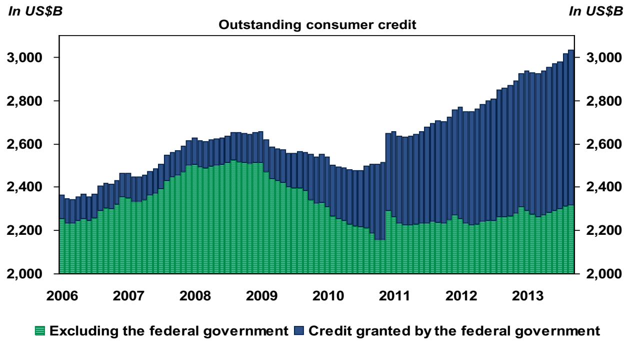
A MUCH HEALTHIER BALANCE SHEET

Besides holding assets that are regaining their value, U.S. households are carrying less and less debt. After reaching historic peaks in 2008, i.e. US$18,542B or 168% of disposable income, debt levels have fallen to US$17,628B or 142% of income. Combined with the current low interest rates, Americans have been able to reduce their debt servicing allocations from 13.46% of disposable income to 9.89%. So some leeway is shaping up. Obviously, this process of repairing balance sheets, combined with job losses, has been painful, but households now find themselves in a position that is highly conducive to greater economic growth.

The debt reduction stems mainly from mortgage loans. The decline in loan values was not achieved without injury and, in many cases, these financial repairs were accomplished more by write-offs than by repayments. As a result, many families are now faced with a poor credit history that will limit their ability to take out new loans. We also note that financial institutions are still very hesitant about lending, and credit conditions are still far from flexible after the tightening that was carried out during the crisis.

In addition to mortgages, we also note a pullback in consumer loans. On one hand, revolving credit (lines of credit and credit cards) is continuing to shrink. On the other hand, term loans are expanding, but this is again largely attributable to student loans issued by the federal government (graph 7). In fact, student loans bear watching as, according to data from the New York Federal Reserve, the rate of overdue payments is rising.

Graph 7 – The increase in consumer credit comes mainly from student loans issued by the federal government



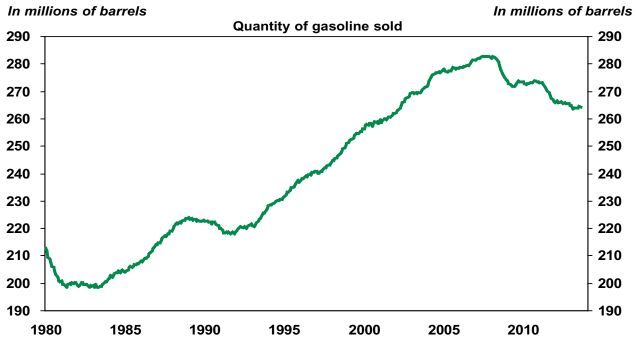
Sources: Federal Reserve Board and Desjardins, Economic Studies

Obviously, a healthy and convincing expansion of credit would provide an indication that consumption is on the verge of accelerating. However, we see very little sign of this.

THE UPS AND DOWNS OF GAS PRICES

Energy prices, in particular gas prices, often have a substantial impact on the vitality of consumption. Several successive months of increases in gas prices can have a considerable negative effect on other consumer spending and on confidence in general. Conversely, several months of falling prices, as we are currently seeing, can have positive effects. It should be noted, however, that gasoline consumption is lower now than it was before the recession (graph 8). Several factors have generated a fundamental change in Americans' habits relating to gasoline: job losses reducing the need for transportation, online shopping, less worker mobility and more fuel-efficient vehicles.

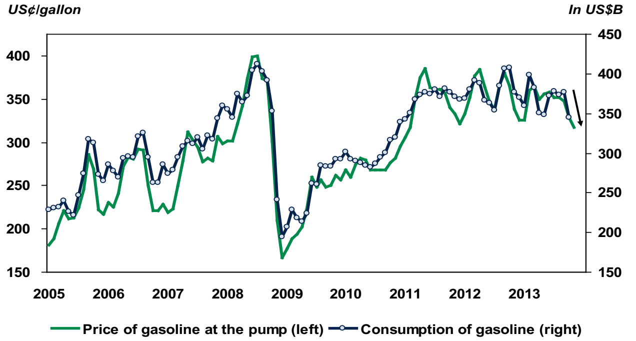
Graph 8 – Consumption of gasoline is very low



Sources: Energy Information Administration and Desjardins, Economic Studies

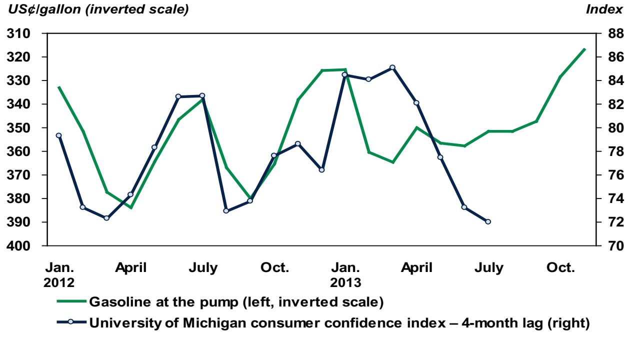
The national average gas price reached a recent peak of US$3.72 per gallon in April, a peak lower than those seen in 2012 and 2011. Since then, prices have not stopped falling. Since the start of November, the average has been just US$3.168. This price slump means an extra US$37B, approximately, in U.S. consumers' pockets (at an annualized pace) (graph 9). Less money spent on gasoline gives a boost to other categories of spending. Moreover, gas price fluctuations have historically been linked to swings in consumer confidence (although the correlation has been much weaker since the crisis). We may therefore assume that lower prices will allow confidence to improve (graph 10). However, we should expect prices to climb back

Graph 9 – Lower gas prices are providing relief to consumers' wallets



Sources: Energy Information Administration , Bureau of Economic Analysis and Desjardins, Economic Studies

Graph 10 – Low gas prices could promote a surge in consumer confidence

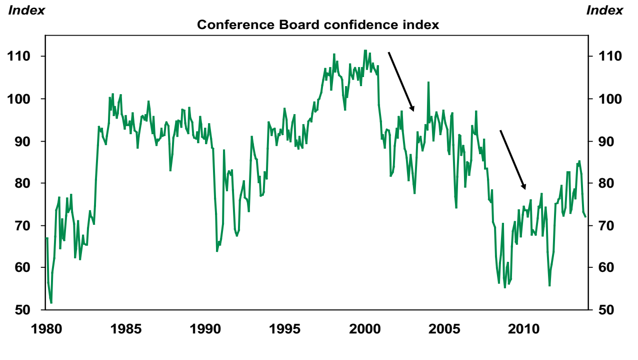


Sources: University of Michigan, Energy Information Administration and Desjardins, Economic Studies up somewhat, because the margins compared with crude oil prices are currently very slim.

CONSUMER CONFIDENCE

Consumer confidence is still a major factor in the health of consumption. The state of mind of U.S. households has been severely tested in recent years. Slumping home values, the financial crisis, job losses, the weakness of the economic recovery, fluctuations in energy prices, hurricanes, the crisis in Europe, military conflicts in Libya (including the Benghazi drama) and in Syria, and, most importantly, the numerous budget impasses stemming from the political divide in Washington have all undermined confidence. We must bear in mind, though, that throughout the 2000s, even before the 2008 recession, confidence levels never did reach their peaks of the late 1990s (graph 11). The historical highs of the Conference Board and University of Michigan confidence indexes were reached in January 2000, supported by low oil prices (US$12 per barrel in 1999), a strong labour market (an average of 264,000 new jobs per month in 1999) and by a stock market boom thanks to tech stocks (nearly 20% growth in the S&P 500 in 1999). Consumption growth reached an average of more than 5% between the beginning of 1998 and the end of 2000. The burst of the tech bubble, the highly polarized presidential election of November 2000 (including the recount), the terrorist attacks of 2001 and the ensuing wars put an end to the euphoria.

Graph 11 – Consumer confidence is still weak



Sources: Conference Board and Desjardins, Economic Studies

Even compared with the more modest confidence levels of the 2000s, the current picture of household sentiment leaves something to be desired. In the past two years, the Conference Board index has stood, on average, at 68.9. Between 2002 and the end of 2007, the average was 97.0. Thus, the current confidence level is closer to the lows reached during the recessions that preceded that of 2008.

We can feel, nevertheless, that in the absence of overly strong headwinds, confidence is striving to improve. This did in fact happen, with a gain of nearly 24 points between January and June 2013, and a gain of 33 points between the fall of 2011 and the same period of 2012. What do these two recent periods have in common? A lull in the threats of budgetary impasse following the debt ceiling crisis in the summer of 2011 and the fiscal cliff in the winter of 2013. This does not signify that all political tension has been eliminated—the 2012 election proves the contrary—but rather that political threats to the smooth operation of the economy have been set aside.

The shutdown of October 2013 reminds us that confidence is still sensitive to crises fabricated in Washington. A lull on that front for a while could only do some good. Unfortunately, the agreement that resolved the shutdown merely defers the problem by a few months, and the negotiations on the funding of the federal government apparatus and on the debt ceiling should be wound up in January and February 2014. This respite is too short to really generate any remarkable improvement in household sentiment. We can only hope that these negotiations will result in more lasting solutions. The economy needs them, because the current level of confidence does not bode well for greater consumption.

NO SHARP ACCELERATION IN SIGHT IN THE SHORT TERM

As we can see, many factors push consumption growth up and down. On one hand, certain factors that have discouraged household spending just recently, such as lower demand for air conditioning, will likely be short-lived; but we should also expect gas prices to head up sooner or later. On the other hand, the trend factors dictate a degree of caution. The healthier state of personal finances is indeed very encouraging, but there is a feeling that Americans are wary of falling back into the excesses of the past. Therefore, in order for consumption to pick up steam, two factors must come into play: a) better income growth, in particular through wages, and b) a lull in the budget crises that have dominated U.S. politics in recent years. It is still too soon to hope for such a turnaround in the next few quarters. Consequently, real consumption growth will most likely remain relatively modest next year; an annual gain of just 1.9% is expected in 2014, after an estimated 1.8% increase in 2013. Hopes for stronger growth will have to be deferred to 2015.

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