Weekly Economic Commentary

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Consumer Conditions

John Canally, CFA
Chief Economic Strategist
LPL Financial

Highlights

The drop in gasoline prices over the fall and summer months has been a plus for spending, but other factors have a much bigger impact on the consumer.

The better tone to the labor market, the sharp rise in household net worth, and prerecession levels of consumer confidence all act as supports for the consumer.

However, stubbornly weak wage and income growth remain as key constraints on spending.

Sustained economic growth is the best way to ensure solid employment growth.

The U.S. Department of Commerce will release its report on October 2014 retail sales later this week (November 10–14, 2014). Of course, with "Black Friday" (the Friday after Thanksgiving)—the unofficial start to the 2014 holiday shopping season—less than three weeks away, the market's attention is not so much on October sales, but on the holiday shopping season, and beyond that, the outlook for the consumer in 2015.

Priming the Pump

The big drop in gasoline prices over the summer and fall months has led to predictions by some that the long-dormant consumer sector (which accounts for two-thirds of the U.S. economy) is poised for better growth as we approach the 2014 holiday season and into 2015. The better tone to the labor market, the sharp rise in household net worth (which is the result of the recovery in housing prices, all-time high equity market levels, and consumers' paying down of debt), and prerecession levels of consumer confidence all act as supports for the consumer. However, stubbornly weak wage and income growth—which have a far bigger impact on consumer spending than any of the positives listed above—remain key constraints on spending.

Gasoline prices peaked this year at the end of April at close to $3.80 per gallon, remained near that level until the end of June, and have fallen sharply since then. They now stand at just over $3.00 per gallon as of the start of November 2014, their lowest level since late 2010, just prior to the run-up in oil prices triggered by the Arab Spring in early 2011. Although on balance the drop in gasoline prices is a plus for spending, other factors have a much bigger impact on the consumer, given that gasoline accounts for only 3% of personal spending.

Home Is Where the Assets Are

Rising household net worth may provide additional support to the consumer. Household net worth is households' holdings of assets (real estate, automobiles, and computers; but also financial assets, such as stocks, bonds, annuities, retirement plans, savings accounts, etc.) minus the debt taken on to finance the purchase of those assets. Household net worth [Figure 1] at the end of the second quarter of 2014 (the latest data available) stands at an all-time high of $81 trillion. Household net worth has

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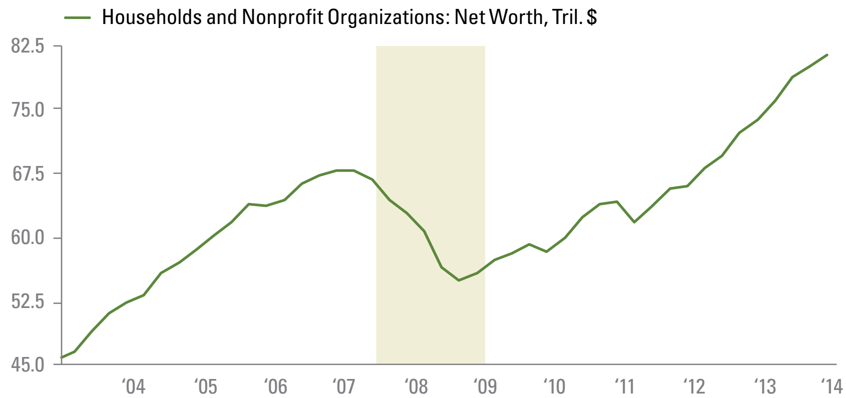
increased by $8 trillion (or around 10%) over the past year, and by more than $26 trillion (or nearly 50%) since early 2009, providing solid support for consumer spending. With gains in stocks, bonds, and real estate prices in the third and fourth quarters of 2014, and the continued reluctance of consumers to take on too much debt, household net worth is likely to continue to move higher through year end 2014, and into 2015.

1 Rising Equity and Home Prices, and Declining Debt, Have Sent Household Net Worth Up by 50% Since 2009

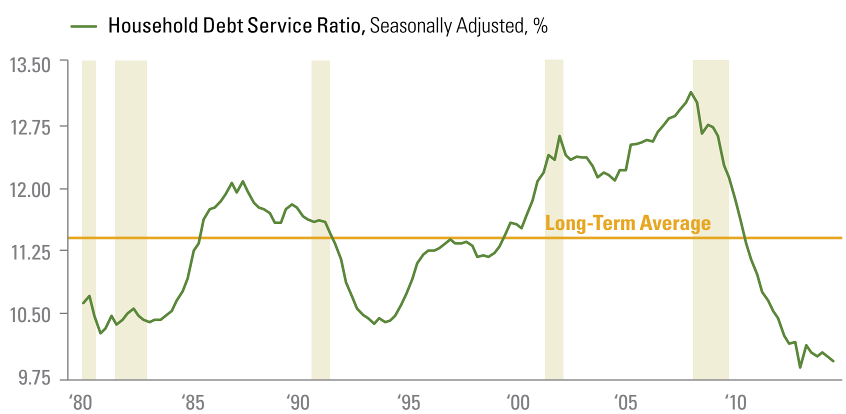


Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 11/06/14

Shaded areas indicate recession.

The combination of low interest rates and ongoing consumer balance sheet repair has led to a big drop in the percentage of consumer incomes dedicated to debt service, including mortgages [Figure 2]. (The Federal Reserve [Fed], the lack of inflation, global economic weakness, and geopolitical threats have all played a part in keeping rates low.) Just prior to the onset of the Great Recession in late 2007, more than 13% of household income was dedicated to debt service. As of Q2 2014, that percentage

2 Low Rates and Less Debt Sent Household Debt Payment Burdens to an All-Time Low



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 11/06/14

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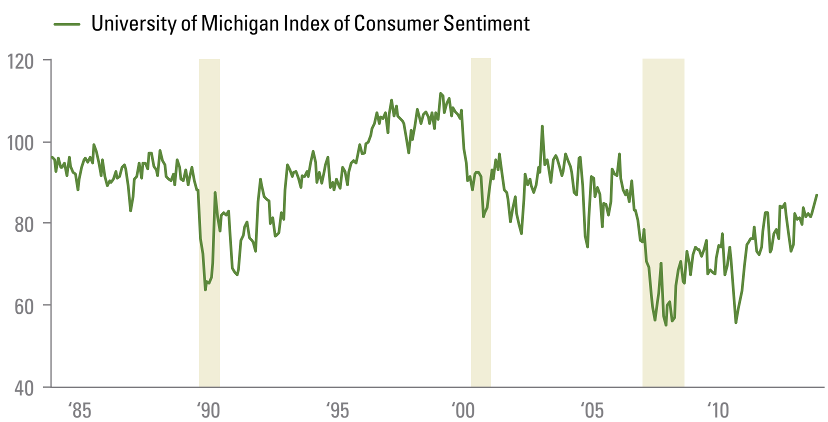
has dropped to just under 10%, an all-time low. Although rates paid by households on consumer-related debt and consumer debt levels are likely to rise in the next several years as the Fed raises interest rates, the low level of consumer debt burdens, relative to incomes, should continue to support modest consumer spending growth.

Changes in consumer sentiment have a bigger impact than gasoline prices, household net worth, or consumer debt levels on consumer spending.

In recent months, readings on consumer sentiment, such as the University of Michigan's Index of Consumer Sentiment, hit their highest levels since the onset of the Great Recession [Figure 3]. The better labor market has contributed to this increase in sentiment, despite the recent Ebola scare and the flare-up of geopolitical risk related to Iraq, Syria, and Islamic State militants. Changes in consumer sentiment have a bigger impact than gasoline prices, household net worth, or consumer debt levels on consumer spending. While still well below its all-time highs (seen in the late 1990s), the level of consumer sentiment is now in-line with levels seen during the 2002–2007 economic recovery, suggesting a modest increase in the pace of consumer spending is likely in the period ahead.

3 Despite Ebola, Global Unrest, and Market Volatility in Recent Months, Consumer Sentiment Is at a 7-Year High



Source: LPL Financial Research, University of Michigan, Haver Analytics 11/06/14

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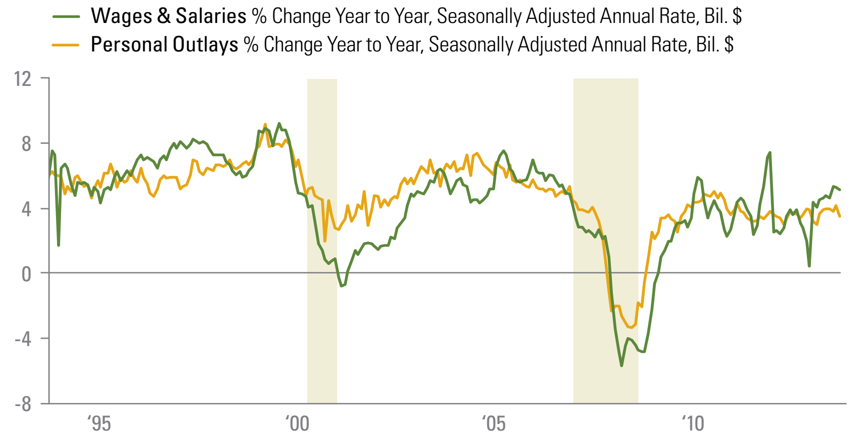
Biggest Driver: Consumers' Incomes

Although the items discussed above get a great deal of attention from the media and the markets, by far the biggest driver of consumer spending is consumers' incomes, represented in Figure 4 by wage and salaries, which are by far the biggest components of incomes. Incomes, of course, are a function of employment and wage levels. Wage and salary growth is running at around 5%, still below where it was in the middle of the last two business cycles (6–7%). Personal spending growth is running closer to 4%, well below the pace seen in the middle of the past two economic expansions (mid-1990s and mid-2000s). The sluggish pace of consumer spending, in turn, has been the main cause of the tepid pace of the economic recovery that began in 2009.

4 Consumer Spending Growth Tracks Wage and Salary Gains



Source: LPL Financial Research, Bureau of Economic Analysis, Haver Analytics 11/06/14

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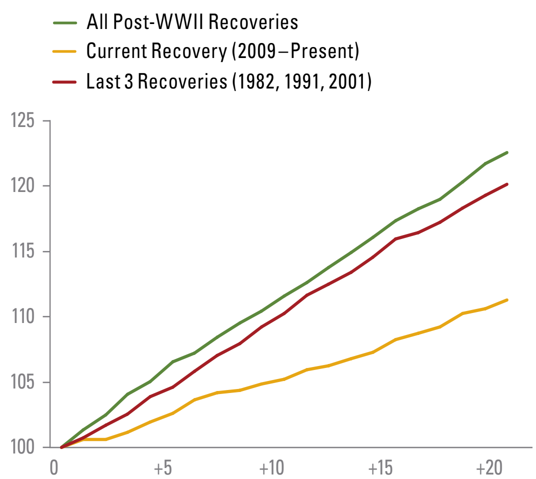
5 Consumer Spending in This Economic Expansion Has Been Running at About Half the Normal Pace



Source: LPL Financial Research, Bureau of Economic Analysis 11/06/14

Since the end of the Great Recession, consumer spending has increased by a cumulative 11%, half the pace seen at this point in all post-WWII economic recoveries and just over half the pace seen in the last three economic recoveries, which are the most comparable to today's recovery [Figure 5].

Looking ahead, for spending to increase further—and there has been some acceleration over the past year or so from the extraordinarily sluggish pace witnessed earlier in the expansion—the recent gains in the labor market must be sustained, and those gains must be accompanied by an acceleration in wage rates. However, all of these metrics are closely intertwined, and sustained economic growth—above its long-term potential growth rate of around 2.5%—is the best way to ensure solid employment growth. This may require an uptick in business capital spending (on plant, equipment, research and development, intellectual property, etc.), housing, and government spending as well, which may generate more demand for labor, higher wages, and eventually a faster pace of consumer spending. ■

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