THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Personal Income & Spending: A Good Start to a Data-Filled Week

An abundance of new clues on the economy will be out this week and they should go a long way to shape our understanding on how strong the recovery will be in the second half of the year. After the recession ended last summer, GDP growth averaged a 3.9% annual pace in the final six months of 2009. Economic activity then downshifted in the first half of this year to a 3.3% rate and we foresee that general pace continue for the rest of the year.

Clearly, the economy's bounce back has been sub par given the severity of the last contraction. Nevertheless, we see no evidence of a double dip on the horizon, nor the kind of lackluster growth of 1% to 2% those in the "New Normal" camp have warned.

We got off to a particularly good start this week with the release of the personal income and spending report. You might recall how, a few weeks back, investors and pundits declared the recovery in dire shape after the government reported that retail sales fell 1.2% in May (utterly ignoring the fact that sales had already been climbing for eight straight months). While many viewed the decline with dread, we advised clients not to be caught up in the growing pessimism precipitated by that release and argued that consumers are not about to retrench. Today's broader measure of consumer expenditures lends support to our view.

Personal spending rose by 0.2% in May, beating the expectations of forecasters, and it was accompanied by an even larger increase in income, up 0.4% for the month, which will help finance future expenditures. Even the savings rate lurched back up to 4%, lifting such funds to the highest ratio since September 2009. Remember, as incomes increase, Americans can simultaneously raise BOTH spending AND savings.

But these are the mere headlines. Let's drill down farther and see just how much consumers have truly bounced back after spending hit a cyclical low at the end of 2008.

• Personal spending rose to a $10.43 trillion annual rate last month --- the most ever!

• In terms of real spending (adjusted for inflation), it jumped 0.3% to $9.43 trillion, the highest ever! Can this trend possibly be sustained?

• Well, let's take a look at the change in actual take-home pay (disposable personal income). If, after taxes, Americans are earning more, it stands to reason they are likely to continue shopping. Take home pay rose 0.4% in May (after leaping 0.6% month before) to $11.25 trillion, again a record high.

• And if we strip out inflation, disposable personal income now stands the highest level in a year.

• **In stark contrast to all the hand wringing that followed the drop in the narrower May retail sales report, today we get an entirely different perspective about what consumers are up to. Not only did May's personal spending numbers turn out to be better than consensus expectations, if you look at the change in "real" expenditures over the last 12 months, consumer outlays have been accelerating every single month this year.**

• Another positive sign is the upturn in spending on durable goods, typically expensive items like furniture, autos, appliances and flat screen TVs. These big-ticket products are often bought on credit and tend to reflect the comfort level of consumers to take on fresh debt. In May, real durable goods purchases rose 1.1%, and over the past 12 months such spending surged 11.4%.

• Why take on such big-ticket purchases now? Well, in part because household finances are improving. According to today's personal income/spending release, interest payments (excluding mortgages) by consumers fell to a $199 billion annual pace last month, the lowest of the year! Another reason is that consumer confidence keeps improving. Americans have looked past the shaky stock market and European debt crisis and believe that economic conditions in the US are, and will continue, to improve. Last Friday, the University of Michigan released its numbers on consumer sentiment for this month and it rose to the highest level in more than two years. The indexes for both current conditions and the six-month outlook registered healthy increases.

Tomorrow, we'll get the Conference Board's measure of consumer confidence for June. Their survey may be more heavily influenced by people's reaction to the disappointing May job numbers released earlier this month, so don't be surprised if that confidence gauge slips a bit.

In any event, come Friday when the June employment report is released, we're expecting good news on at least two fronts. While the overall numbers may show a decline in payrolls for the month now that the government has begun to dismiss its army of census workers, much more meaningful will be the latest trends in private sector hiring. We believe May's soft 41,000 increase in private payrolls will be revised upwards, and that firms filled 130,000 additional positions this month.