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ECONOMIC TALKING POINTS

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Behind the Consumer Spending Numbers. It's not "Resiliency."

A common---if vacuous--- term used to crack the mystery of why consumers keep on spending these days is that they are *"resilient."*

It appears most often in the following context: "Yes, they have to pay more for gasoline. Yes, people have to dig deeper into their pockets to buy more expensive food. And yes, they are unable to offset these expenses with a bigger paycheck from employers. But don't worry; consumers are… *resilient*!" That's why they are blissfully shopping even as their finances get squeezed.

Brace yourself. You will hear that same meek rationalization today with the release of March's retail sales numbers. Americans continued to shop last month, with retail spending up another 0.4%, after a strong 1.1% increase in February. They did cut back on auto purchases by 1.7% but that only distorted the impressive jump in spending in all other areas. Take out the auto component and retail sales rose an even stronger 0.8% --- after a 1.1% jump the previous month.

And when you look at the individual retail categories of spending, they rose just about everywhere. Outlays for home furnishings climbed 3.6%, electronics and appliance stores saw revenues rise 2.1%. Even restaurants and bars rang up 1% more sales. Not bad for a month that

also saw drivers cringe each time they drove into a gas station.

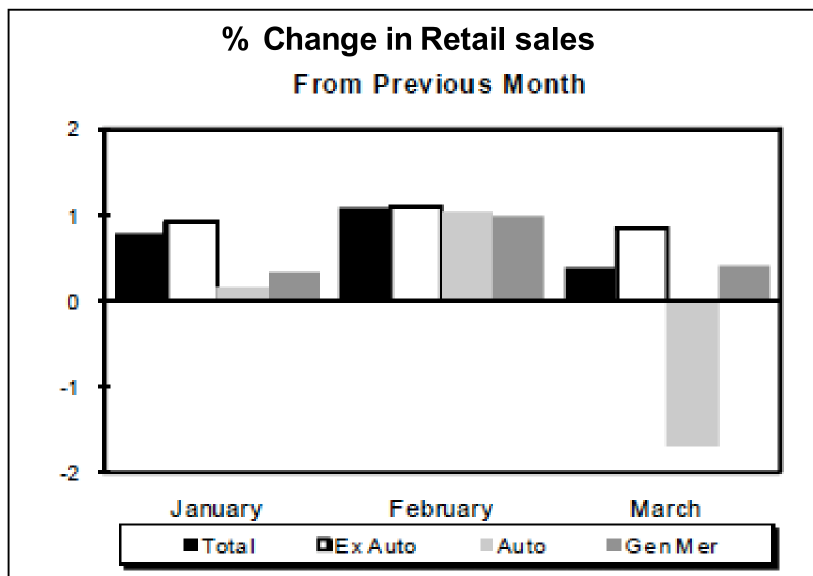
So how can Americans seem so unfazed and keep shopping? It's not the blather heard about US consumers being extraordinarily…. "*resilient*." That explanation tells you nothing about the dynamics behind this spending behavior and it is usually uttered by those who are clueless how it is that households spend more---even as disposable income is being squeezed between the acceleration in the cost of living and lackluster growth in income. For the fact is the increase in retail spending by Americans has to be financed somehow.

Are they using up more of their savings? Have they resorted to borrowing again? Does the rise in spending merely reflect more Americans at work?

We raise these questions because business leaders, investors, and policymakers need to know what 70% of the economy is thinking and doing. Settling on the vapid conclusion that Americans are *resilient* just doesn't do it.

A turning point for consumers

Our assessment is that that consumers are not impervious to rising inflation, especially when it drives up cost of fuel and food, and that spending is already in the process of slowing down. When the GDP report comes out for the first quarter (April 28), it will show a marked deceleration in the broader measure of consumer outlays, with real personal consumption expenditures rising only half the 4% we saw in the final quarter of 2010. The March retail sales increase of 0.4%, for example, turned out to be the weakest since last June.



So we go back to the basics, with household finances being squeezed, how are shoppers paying for these purchases. Well, one way is to tap savings. The latest monthly report on personal savings showed a decline in the savings rate from 6.1% in January to 5.8% in February. (We'll get March numbers at the end of this month, but we're looking for a further decline in the rate of savings.)

Are Americans relying more on debt to help finance spending? Yes. Last week, the Federal Reserve reported that consumer debt increased in February for the fifth straight month --- and by the largest monthly amount since June 2008! The sharp jump took most forecasters by surprise.

Are consumers once again over-reaching? It's starting to look that way. One of our favorite data points is to compare what Americans spend in a month with the amount of wages and salaries earned that period. Thus, a 1.1 ratio means the amount Americans spend is the same as the level of wages and salaries for the month.

What emerges is a stark warning that consumers could back substantially in coming months. In the latest month (February), total consumer expenditures was 1.63 times the size of wages and salaries for the month. In December 2007, the peak of the last business cycle and the moment the economy turned south, that ratio was 1.53. In other words, spending was more in line with wages and salaries at the onset of the last recession than it is now. Are Americans thus becoming overstretched? We believe they are. With interest rates likely to rise in coming months, oil prices elevated, and workers possessing little leverage to demand more pay from employers, we expect consumers to retrench in the second quarter.

It has already hurt consumer psychology. Confidence levels have sharply deteriorated. The Michigan survey of consumer sentiment in March dropped to the lowest in more than a year. The Conference Board also detected a significant deterioration on mood.

Yesterday we got word that employment growth may start to wane too. The National Federation of Independent Business reported that small business confidence --- a sector responsible for nearly 70% of all new hiring in the economy --- plummeted to a five month low this month. With the outlook for profits, sales, costs --- and employment looking worse, this survey further foreshadows a marked slowdown in hiring--- and that is not encouraging for future consumer spending.

Business Inventories

Today's release on business inventories has also corroborated the emerging softness in sales. Indeed, companies may be scaling back on inventory orders too in anticipation of a slower economy. Total business sales rose just 0.2% in February, less than economists had expected and far below the 2% increase in January. The inventory build-up also turned out to be smaller than estimated, up 0.5%, compared with a 1% rise in the previous month.

Percent Changes for Sales and Inventories -- Manufacturers, Retailers, and Merchant Wholesalers

	Adjusted						Not Adjusted					
	Sales			Inventories			Sales			Inventories		
	Feb. 11/ Jan. 11	Jan. 11/ Dec. 10	Feb. 11/ Feb. 10	Feb. 11/ Jan. 11	Jan. 11/ Dec. 10	Feb. 11/ Feb. 10	Feb. 11/ Jan. 11	Jan. 11/ Dec. 10	Feb. 11/ Feb. 10	Feb. 11/ Jan. 11	Jan. 11/ Dec. 10	Feb. 11/ Feb. 10
Total business............	0.2	2.0	10.9	0.5	1.0	9.1	-0.3	-11.3	11.3	1.1	1.7	9.5
Manufacturers[3]...........	0.3	1.7	9.6	0.8	1.5	9.4	1.2	-5.3	10.2	1.9	3.8	9.9
Retailers......................	1.0	0.8	9.6	-0.4	0.3	5.5	0.6	-22.9	9.9	0.0	-0.7	5.5
Merchant wholesalers[4]..	-0.8	3.3	13.7	1.0	1.0	12.7	-2.7	-5.9	14.1	1.1	1.6	13.2

Bottom line:

Forget about consumer "*resiliency*." It's a distraction. US economic activity has decelerated in the first quarter, with consumers tapping the brakes. The economic slowdown will extend into the summer and likely beyond. Just how severe it will be depends on several factors from this point:

- **The price of oil**. Given the anarchy in Libya and the protracted unrest throughout the Middle East, the risk premium tacks on an additional $20 to $25 to the price of oil per barrel. We raised back in February that $100 to $140 a barrel oil may be the new normal. The two troubled regions supply one out of every three barrels of oil in the world, have seen numerous military conflicts, breed terrorist groups, have no experience transitioning to a more representational government, and they may be on the verge of a nuclear arms race. Geopolitical shocks from this part of the world pose serious risks for the global economy.

- **What will Federal Reserve policy be post QE2.** If there is no additional quantitative easing, then yields on treasury securities are headed higher, thereby making the cost of borrowing more expensive for consumers and businesses. Remember, we will have two major purchasers of US government debt back away from the treasury market,

the Fed and the Japanese government (which needs to raise yen to finance rebuilding efforts).

• **The partisan debate on raising the national debt ceiling.** If Republicans choose to bring negotiations right up to the ultimate July deadline, it could scare away foreign investors and force the credit rating agencies to issue their strongest warning yet the US may lose its triple-A credit rating.

• **The pace of employment growth.** If firms can advance net hiring to more than 200,000 a month, that will help sustain consumer spending. But if employers turn apprehensive about adding workers because the outlook for the economy is so uncertain, then the threat of consumers shutting down looms large.

• **Market correction.** Finally, we believe the probability has increased for a correction in the stock market this quarter as rising commodity prices, fewer sales and the lack of pricing power combine to cast doubt on future earnings. A market correction damages household net worth and that will also work to dampen spending.

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