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ECONOMIC TALKING POINTS

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Expect a Decent Holiday Shopping Season But Without the Jolly

We're going to focus on the latest retail sales report because in the final analysis the fate of the US economy will rest with the consumer. Today's release on retail sales tells an interesting, if disturbing, story.

Americans have increased spending on goods for a fifth straight month and many analysts believe this can foreshadow a fairly vigorous holiday shopping season. We agree with that view. Households many not be in especially celebratory mood, but they do seem willing to ramp up purchases in the final months of the year.

What is worrisome, however, is how these purchases are increasingly being financed. There's no free lunch here. With wages falling behind the cost of living all year, joblessness at 9%, and household wealth still eroding, a sustained pick-up in consumer spending has to be viewed with concern. The reason is Americans appear to be slashing savings again and returning to debt to pay for it.

Let's quickly run by the numbers. Retail sales climbed 0.5% in October, which followed a hefty 1.1% increase in September. That's the strongest back-to-back pace since the start of the year. Moreover, consumers are content to increase purchases even of big ticket discretionary items. Spending on pricey electronics and appliances surged 3.7% in October, the biggest monthly increase in nearly two years. In addition, outlays for building materials jumped 1.5%, sales of sporting goods, hobbies, book and music stores was up 1.3%, and autos rose 0.4% as did restaurants and bars.

Clearly, consumers are heading into the holiday period with some decent momentum, Indeed, we even believe the National Retail Federation's forecast for household spending in November and December is too low. The NRF predicted a 2.8% rise in sales for the two months compared to the same period last year. That is half the growth pace seen during the 2010 holiday period. Our estimate shows a larger 3.6% increase in sales this season, a fairly decent performance.

But it comes at a hefty price.

First, retailers are sharply elbowing each other to get to out in front of the calendar shopping schedule. Stores are opening up earlier than ever before. Forget, Black Friday. More large retailers will break with tradition and open their doors 10 PM Thanksgiving Day, a move that has raised considerable ire among savings-hungry consumers (who will now have to disrupt their holiday to take advantage of heavy discounts) and employees (who dislike the idea of being forced to work that day).

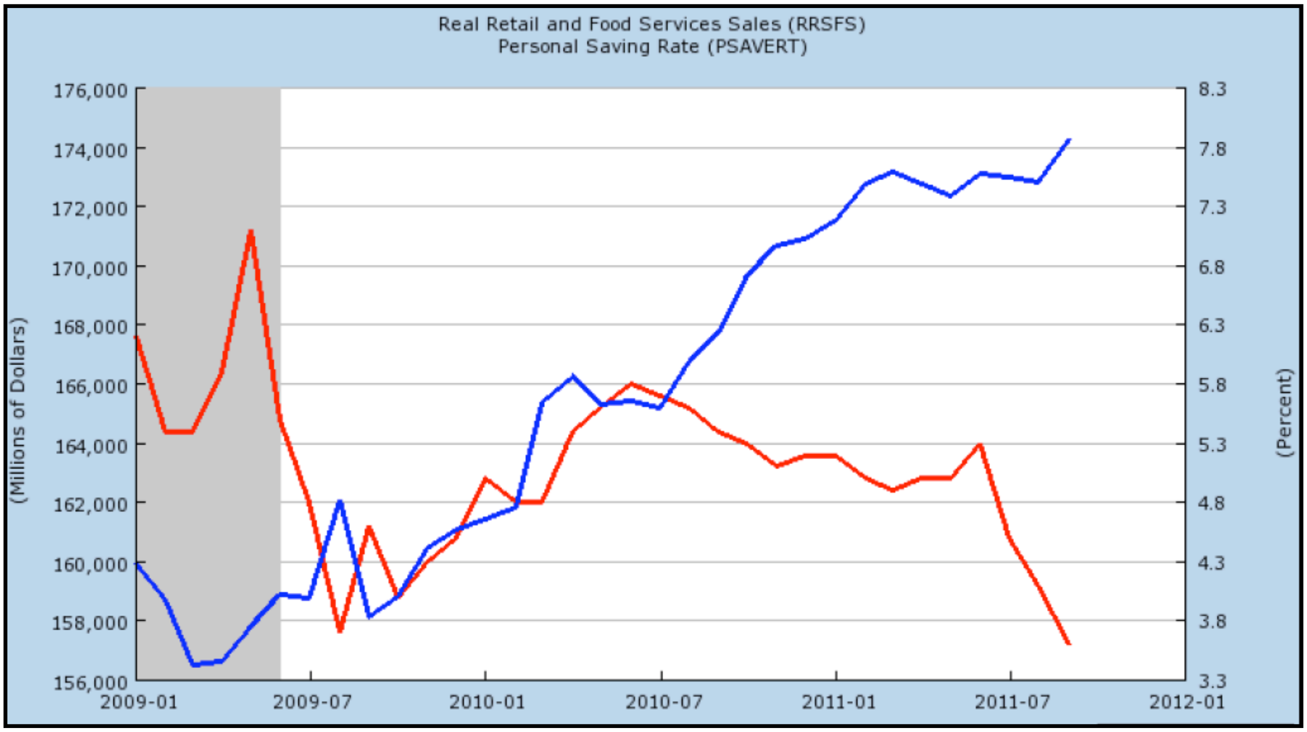
Second, this is the fourth straight holiday shopping season when the economy was either in recession or in a technical growth recession. There is still lots of angst over Europe and never ending talk of a double-dip recession in the US economy. It is not quite the backdrop you would expect to encourage households to ramp up holiday shopping. Indeed, we have concluded that this pick up in spending is temporary and that retailers will see a more violent retrenchment by consumers in the first half of 2012, a change that does not augur well for the economy.

What's behind this assessment? Simple. Americans often resist scaling back their standard of living when times are tough and that behavior is never more present than during the holidays. But with wages stagnant and the cost of living rising, the effort to maintain one's lifestyle means shoppers will somehow have to make up the gap between dismal pay and rising prices. History has shown the two most common ways to do this is to dramatically curb savings and increase borrowing. That is precisely what has been happening as you can see from the two charts below.

Savings

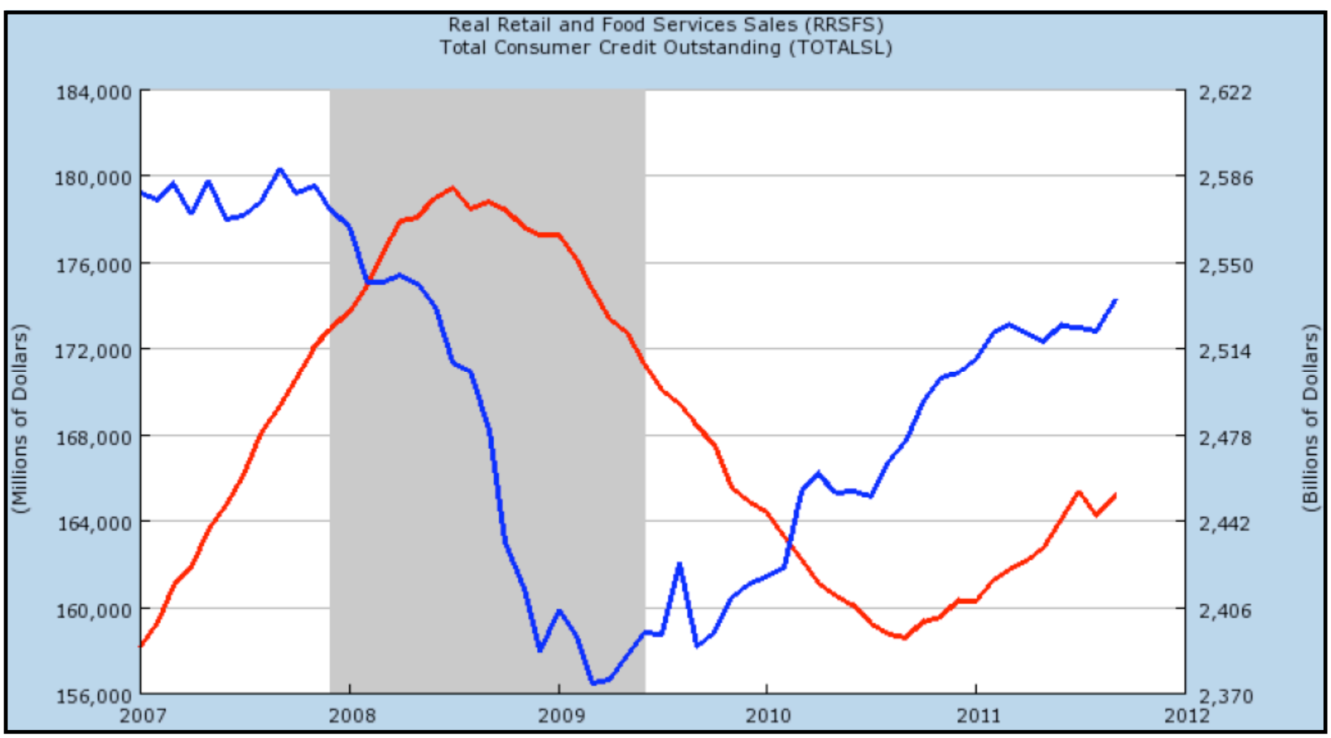
(1) Americans smartly chose to stockpile their savings during the recession as a way to strengthen household finances. But that behavior has come to an abrupt end this year. Even though the economic outlook remains as cloudy as ever, households seem quite willing to tap savings as a way to finance more consumption, as Table 1 illustrates. The savings rate, which was close to 6% a year ago, is now down to 3.6% (red line), the lowest since December 2007 when the recession started. Saving serves as an important financial buffer for households, especially now when so many economic and geopolitical events have stunted US growth to below 2% this year and held unemployment to 9%. The fact household savings has fallen so far so fast in this environment, puts consumers and in an extremely vulnerable position next year.

Table 1. Real retail sales and the personal savings rate



(2) Another important source of funding for consumers has been debt. In recent years households have worked hard to fix their balance sheets by deleveraging. But that process may be winding down. Consumer debt outstanding has risen by $60 billion in the last 12 months. Table 2 shows how Americans have turned to borrowing again (red line) as they accelerate real spending (blue line).

Table 2. Real retail sales and total consumer outstanding debt



Again, higher real spending in the absence of real income growth means the extra money ultimately has to come from somewhere. For the moment, the extra funding for all this shopping is coming out of savings and by ratcheting up borrowing, dangerous combination in this economic climate. It is why we worry so much about the first months of 2012 when the bills finally come due. The weak job market, a politically crippled Congress, and the real threat of a sovereign debt collapse in Europe, makes the current pace of consumer spending unsustainable once we get past the 2011.

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