

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Don't Write Off the Consumer

We warned weeks ago that no one should write-off the consumer simply because of the two-percentage point hike in the payroll tax. Yes, it will sting a bit in the beginning. After all, households making \$50,000 a year will get \$38 less in their bi-weekly pay.

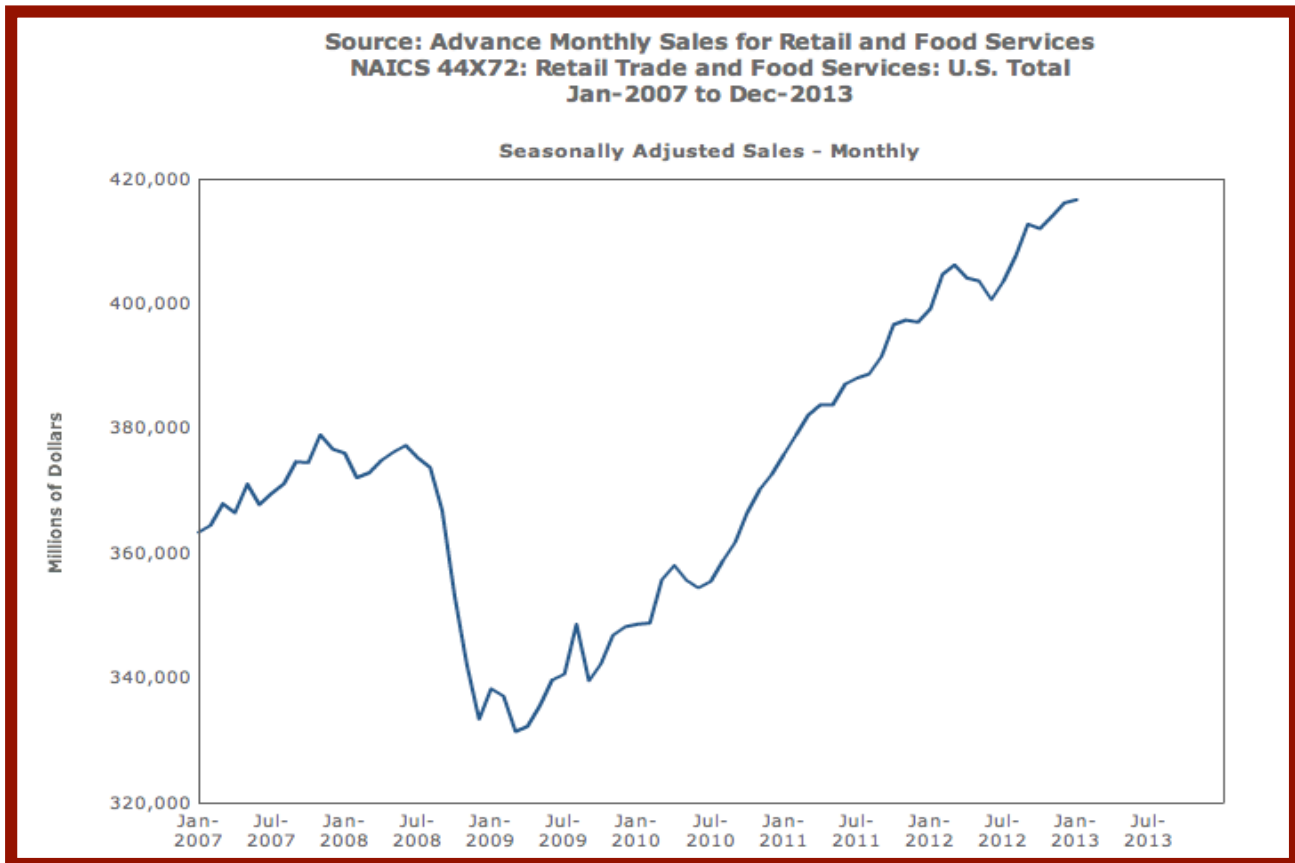
But those who argue the increase in payroll tax will restrain consumer spending enough to markedly hold back economic growth the first quarter, or even this year, have either ignored or underestimated the role of other important drivers of consumer behavior. For the calculus that goes into deciding when and how much Americans spend include a lot more variables than just the payroll tax rate.

Indeed, we've seen ample evidence recently that underscores how ready, willing and able consumers are to ramp up spending.

Let's begin with today's retail sales report, which admittedly inched up a modest 0.1% in January. It is interesting to note that even with the hike in the payroll tax last month, retail spending still managed to increase for a third consecutive month --- to a record \$416.6 billion. Remove autos from the numbers and sales grew for a seventh straight month to another all time high of \$339 billion.

Moreover, total January retail sales was 4.4% higher than its year ago level, a tad below the 4.8% year over year rise seen in December. By the

way, another major source that tracks consumer spending saw even better results for January. Retail Metrics tallies data from 20 large companies and reported that retail sales surged by 4.5% last month compared to January 2012, the biggest annual increase in 15 months.



Even the initial numbers for February from the International Council of Shopping Centers and Redbook show consumers are continuing to increase spending compared to year ago levels.

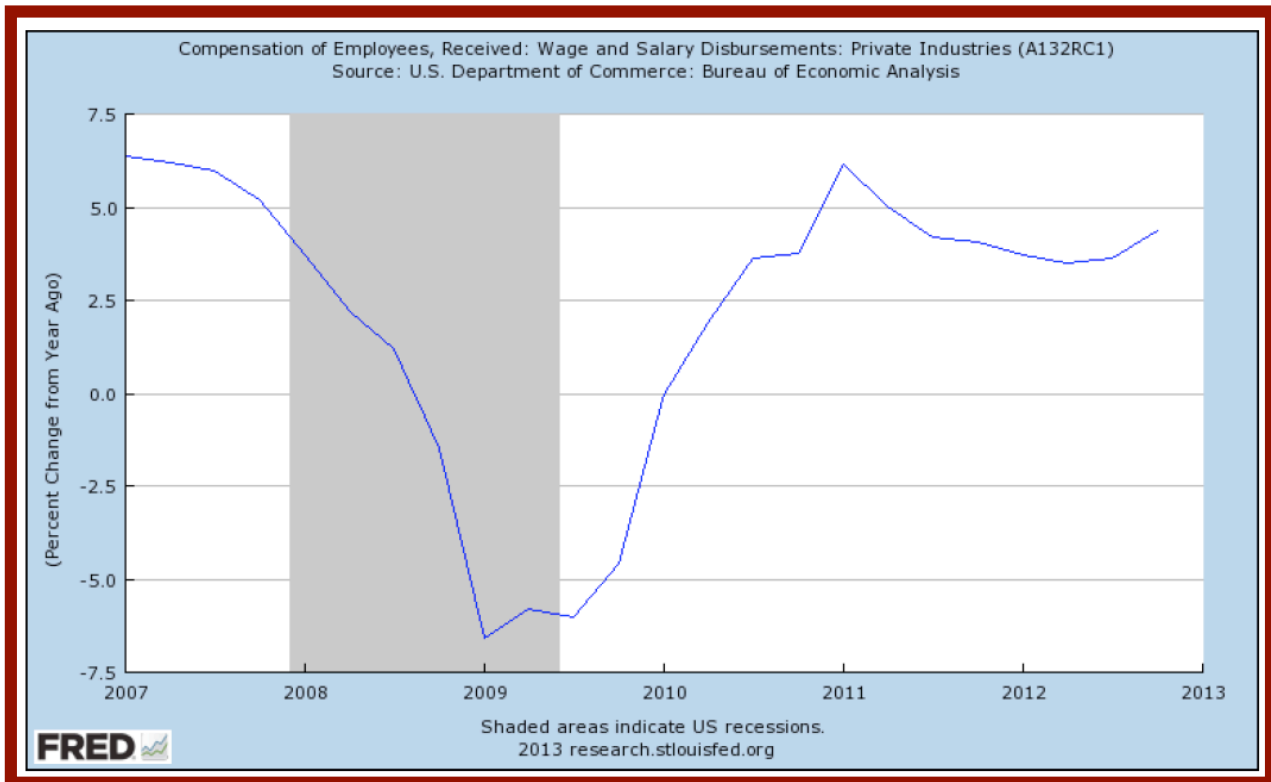
So what factors are the alarmists over consumer spending not taking into account?

Let's list some key ones below.

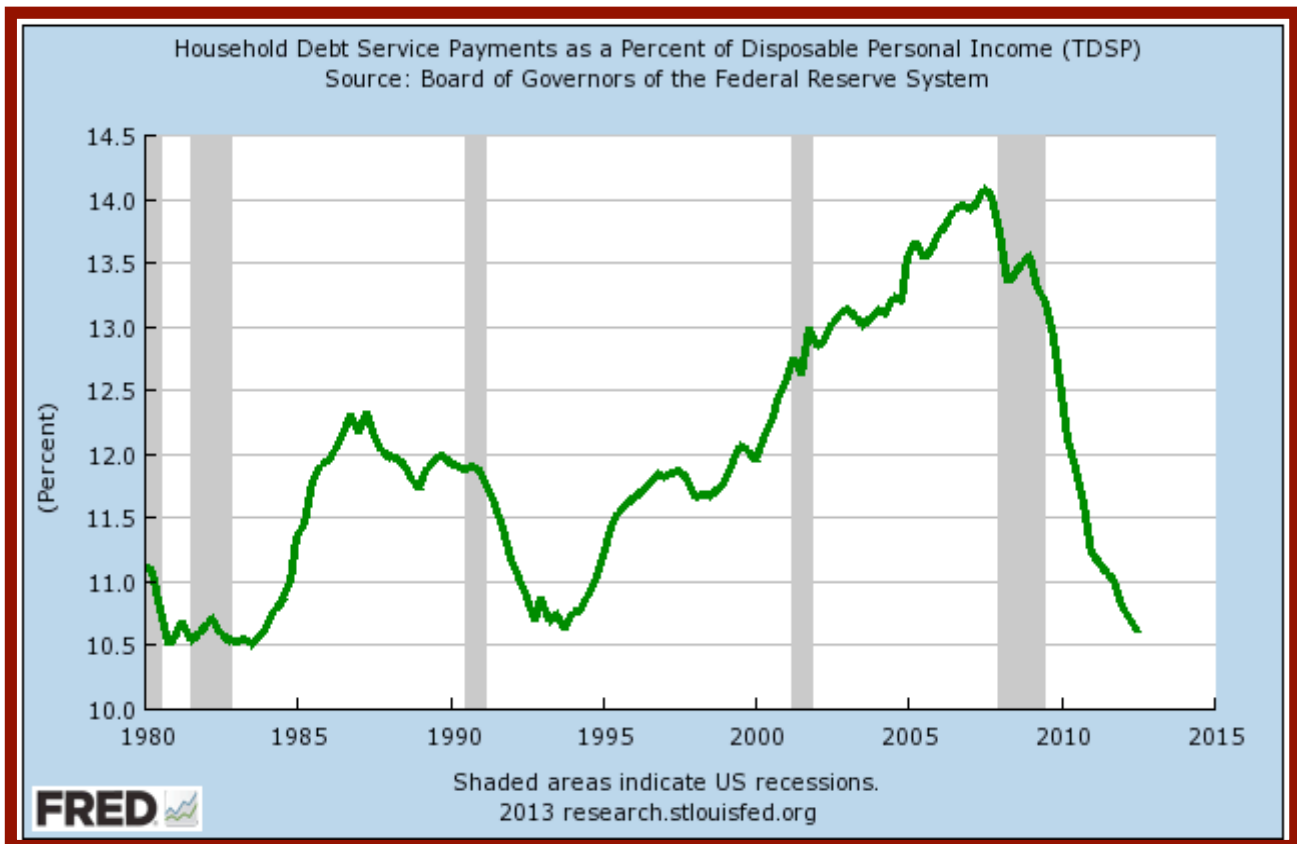
- 1. The job market is recovering and with it pay.** Companies have accelerated the pace of hiring in the second half of last year. The average monthly growth in private payrolls during the final quarter of 2012 was double that of the second quarter. Leading the charge continues to small and mid-size firms. January's ADP employment report, for example,

showed small firms that employ 1 to 49 workers hired more people that month than in **any** month in the last 7 years! (That seems to weaken the claim that Obama Care would hinder small businesses from adding to their payrolls.)

The improvement in the labor market allowed incomes to rise as well, with wages and salaries increasing 3.3% in the second half of 2012 from the same period a year earlier. That jump in pay is double that of retail price inflation, which means Americans are enjoying greater purchasing power.



2. **Household finances are in much better shape too.** Americans has been deleveraging for five straight years, an unprecedented stretch of time dedicated to repairing personal balance sheets. The combination of shrinking debt and historically low interest rates has allowed households to enjoy the lowest debt service burden (defined as the ratio of debt payments to disposable personal income) in 29 years! This makes more income available for shopping.



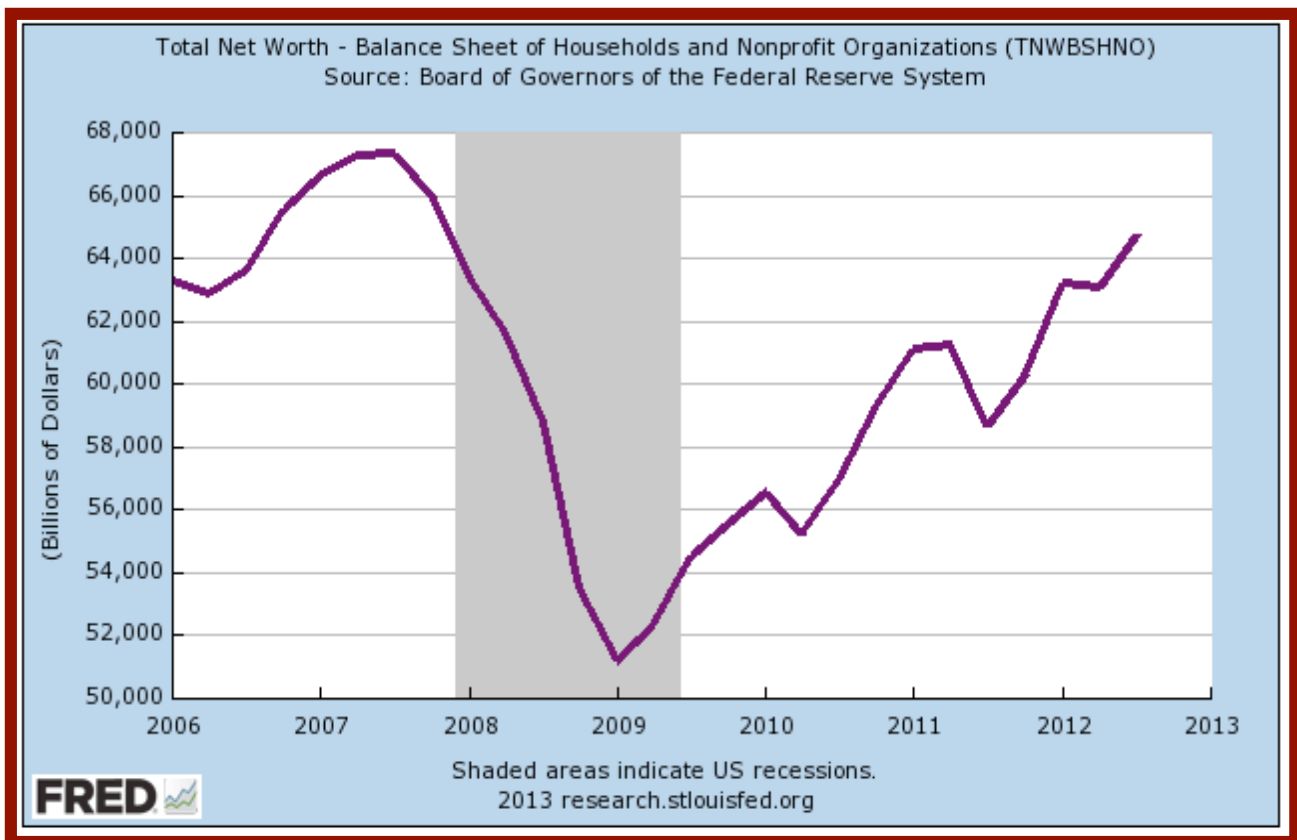
3. Americans have now recovered about 90% of the wealth lost during the recession. In the last four quarters alone (ending IIIQ 2012), households saw their net worth jump a hefty \$6 trillion. That trend has continued into the new year as real estate values keep climbing and the stock market on fire. This rebound in household net worth increases the propensity of Americans to spend by roughly three to five cents for each dollar increase in wealth. Even using the lower figure, we're still talking about a potential increase in expenditures of \$180 billion over the next four quarters. (That more than offsets the \$120 billion reduction in pay from the payroll tax hike.)

So why didn't shoppers let loose last year? They were probably worried about the economy falling off the fiscal cliff January 1st, and the recession and greater joblessness that would follow.

But the downside risks to the economy have since greatly diminished after a last minute deal made permanent the Bush tax cuts for 99% of Americans.

The result? We believe consumers are feeling more comfortable tapping the financial resources they have accrued from the improvement in

the job market, the reduction in their debt burden, and rebound in household wealth. More the point, Americans are more likely to finally unleash the pent-up demand that's been building for more than two years.



4. **Let's not forget the lesson from the Permanent Income Hypothesis.** Back in 1957 Milton Friedman argued that consumer spending patterns are only influenced when there is a *permanent* change in their take home pay. Transitory changes in income --- such as briefly tampering with the payroll tax rate --- **will have no material impact** on expenditures. Remember, the 2 percentage point drop in the payroll tax the last two years did not generate much excitement with consumers. For example, household expenditures grew an average of 3.4% a year in the decade prior to the last recession. But in the two years that consumers benefited from the increase in take home pay, spending rose just 2.5% in 2011 and an even weaker 1.9% in 2012. Instead of rushing out to malls, Americans chose to use the extra funds to pay off older debts, or they just saved it.

Since the temporary cut in payroll taxes did not bring on more spending, it is unlikely a return to the original tax rate would cause households to significantly pare back expenditures.

5. **Washington follies.** We have detected a shift in focus by consumers and business leaders away from the perennial budget battles in Washington (“a town where the circus never seems to leave”) to the emerging vitality in the US and international economy. No, Americans are not ignoring events in the nation’s capital. It is that the incessant battles over fiscal policy and the national debt will play a smaller role in the decision making process by consumers and businesses this year.

Clearly, there is still uncertainty over the sequestration cuts, the continuing resolution to keep the government operating, and the unresolved matter of the debt ceiling. But there is a sense among Americans that they have seen this movie before and they know how it ends. In August 2011, there was a last minute compromise to raise the debt ceiling and keep the country out of default. Then again late last year, just as the nation was about to plunge off the cliff and suffer a near certain economic downturn, another deal was struck at the midnight hour that avoided such a fate.

The point here is that the dynamics have changed.

First, Americans are just tired of Washington’s histrionics and ready to move on.

Second, the economic fundamentals look much better. The GDP decline of the last quarter will surely be revised in two weeks to show growth. But there is also so much more to show the economy gaining new traction.

- Housing has come back to life in most regions of the country (National Association of Realtors).
- Banks are widening the lending window to business and consumers (Federal Reserve, H.8 release).
- Corporate balance sheets have never been healthier (Commerce dept. and quarterly earnings reports).
- The cost of capital remains dirt cheap (the Fed and Treasury markets)
- Orders from manufacturers and service industries are expanding (ISM).
- Total spending on construction has surged to a three year high (Census dept.).
- Business sales at manufacturers, wholesalers and retailers just rose to record levels (Census dept.).
- Consumer sentiment is firming (Univ. of Michigan and Bloomberg’s consumer comfort measures).
- And the improvement in the international economy has lifted exports to its second highest level ever (BEA).

Bottom line:

While the melodrama in Washington inhibited economic growth the last two years, the upturn in the US and international economy will now take center stage and fuel growth. The partisan battles in Congress will continue, but political leaders have shown that in the final analysis they are disinclined to play Russian roulette with the economy.

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