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ON OUR MINDS

All Hail the American Consumer

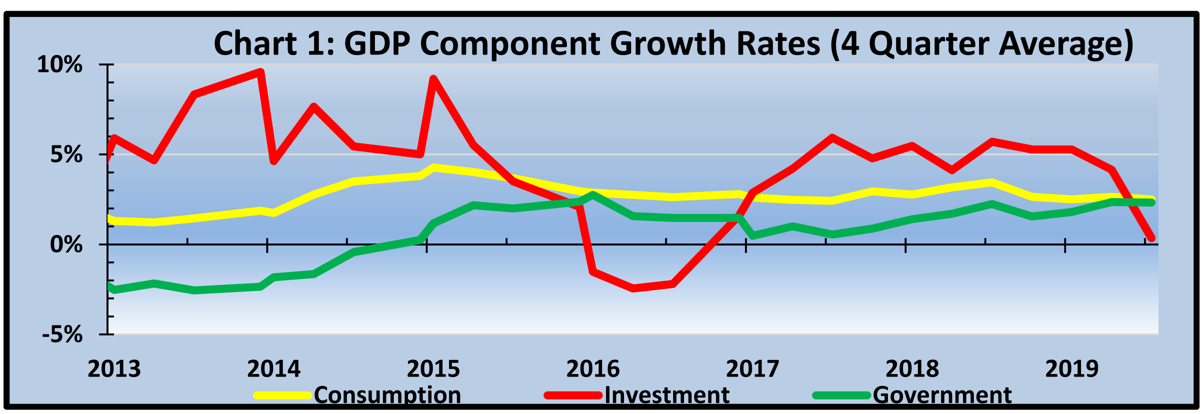
Michael A. Tyler, CFA®, Chief Investment Officer

November 7, 2019

Here's a news flash from the glass-half-empty school of economic research: "This is likely as good as it gets for the consumer. There's nowhere to go but down." That opinion is shared by many mainstream economists, but few would have put it as bluntly as SSGA chief strategist Michael Arone did in a note to clients last week.[1] His basic argument is that consumers are riding a wave of "lower taxes, massive gains in financial assets, a robust job market, and falling interest rates." All of that has contributed to robust consumer confidence and therefore to higher spending levels. In Mr. Arone's opinion, this wave will abate, and the resulting undertow will drag our consumer-led economy into recession.

Mr. Arone is widely respected for his insights and analysis, but I would respectfully reach a different conclusion.[2] There is no evidence yet that the wave is about to crest any time soon, and indeed the economy has capacity for consumers to remain upbeat well into the future. That's a very good thing, because other facets of the U.S. economy – most notably the manufacturing and export sectors – are clearly shaky.

The Commerce Department reported last Wednesday morning that overall U.S. economic growth was 1.9% in the third quarter (net of inflation), modestly better than most analysts had forecast but still a tick slower than the first half's rate. The number was still considered good news, and the stock market rallied in response. Yet the report raised some yellow flags as well, the most prominent of which is readily evident in Chart 1:



Source: Commerce Department

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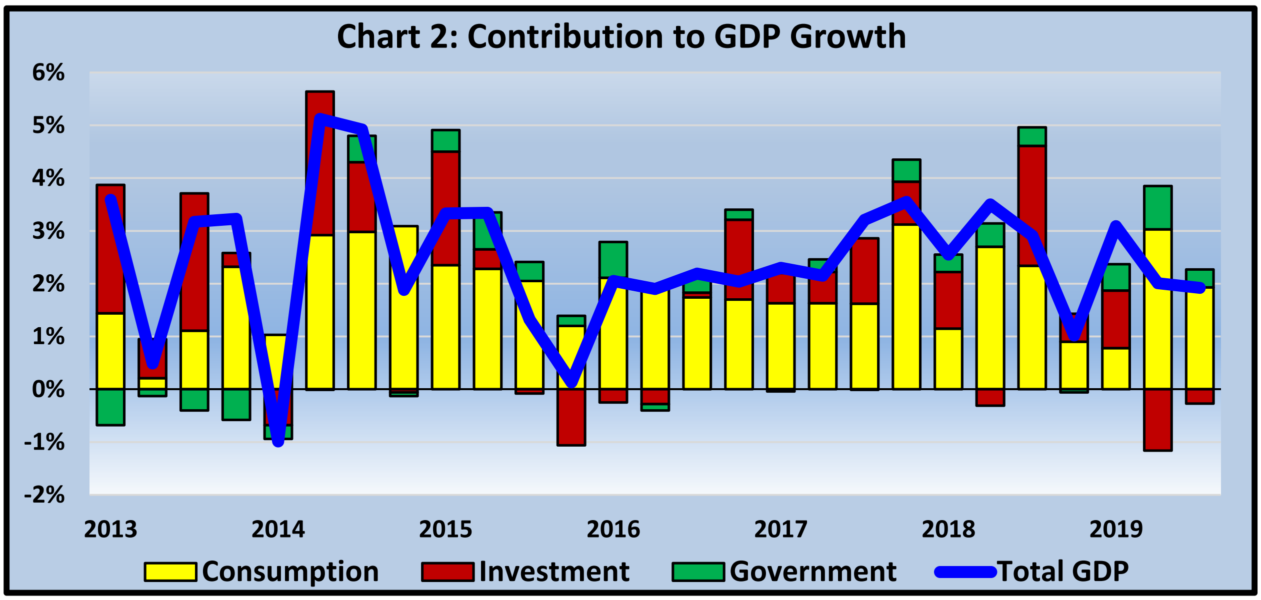
[1] Michael Arone, CFA, "Shop 'til the Economy Drops: Slowing Consumer Spending Could Signal Trouble Ahead," published by State Street Advisors, October 31, 2019. Reprinted with permission.

[2] I know Mr. Arone and value his work; we talk periodically. But as the old Dave Mason tune goes, "we can't see eye-to-eye. / There ain't no good guy, there ain't no bad guy, / There's only him and me, and we just disagree." I have appended his complete article here so readers can judge for themselves.

Business investment has slowed dramatically through the course of this year, as corporate managers have struggled to adapt their budgets to ever-changing assessments of the global tariff and trade regime. In countless conference calls and meetings with investors, executives at America's largest public companies have complained that they cannot manage their supply chains nor target their marketing efforts without having more confidence in the direction of our national trade policy.

With capital spending frozen by trade policy uncertainty[3] and exports shrinking due to higher foreign tariffs on American goods, consumer behavior is increasingly critical to our economic growth. As Chart 2 shows, consumer spending (yellow) generated *all* of our economic growth in the June and September quarters, as gains in government expenditures (green) were completely offset by erosion of capital investment (red).



Source: Commerce Department

It is reasonable to argue, as Mr. Arone did last week, that weak business investment puts the overall economy at risk of entering a recession; that nearly happened in late 2015 and early 2016, when the collapse in oil prices led to sharply reduced energy investment and weaker consumer spending. Yet the contrast between 2015 and today is instructive: Business investment had been much more robust five years ago, so its collapse in late 2015 had a large impact on the economy; concurrently, consumers were coming off a year-long spending binge and were hit with rising interest rates, a weaker jobs market, and tight fiscal policy. Today, by contrast, business spending hasn't been a big contributor for more than a year, interest rates are falling, the labor market is robust, and fiscal policy is constructive. That's why consumer spending contributed about 240 basis points (2.4 percentage points) to GDP growth through the first nine months of 2019, twice the contribution of the earlier period.

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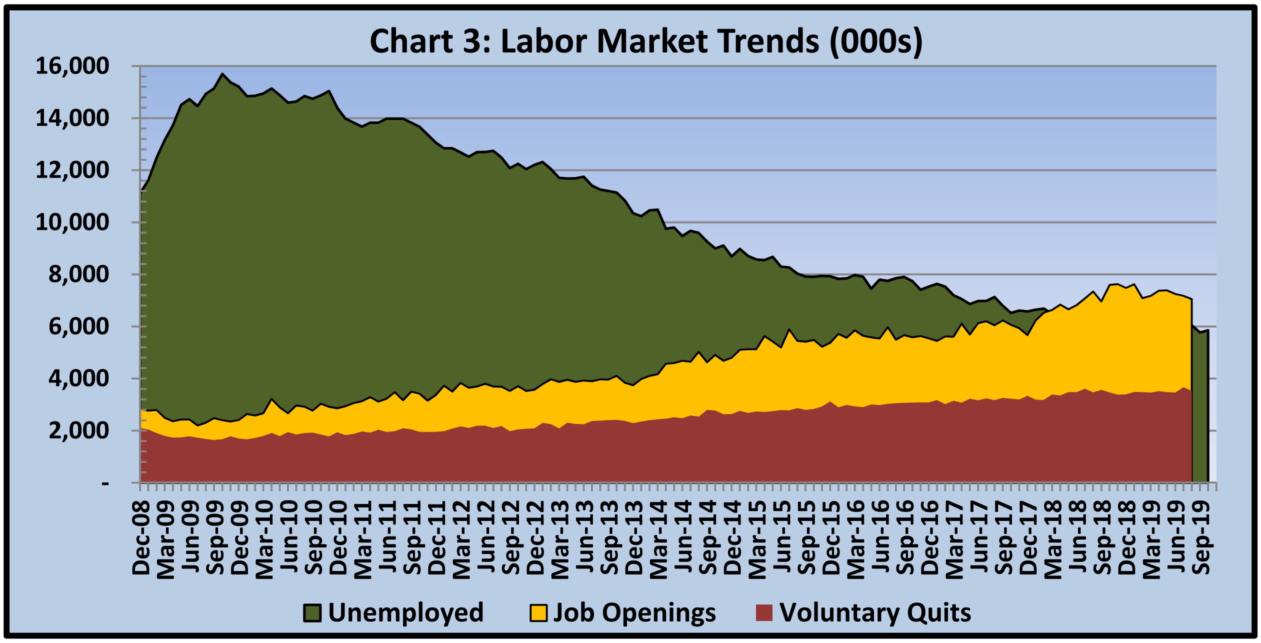
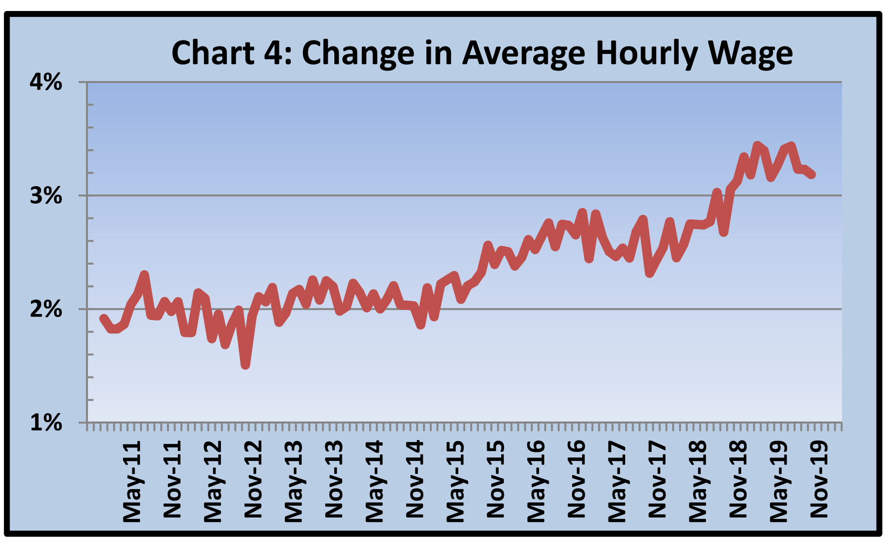
[3] I find it both amusing and dispiriting that the Trump administration's erratic tactics have created so much "trade policy uncertainty" that Federal Reserve Chair Jerome Powell now simply uses the acronym "TPU" to describe it. The Fed, too, is hamstrung by not knowing how the ongoing trade negotiations will ultimately pan out.

Consumers also have every reason to be confident about the outlook. Chart 3 shows that for the past year the American economy has had more posted job openings than unemployed people; jobs are indeed plentiful, and workers know it. That's why the "voluntary quits" rate has continued to rise, as people are more confidently leaving their jobs to take better opportunities elsewhere.



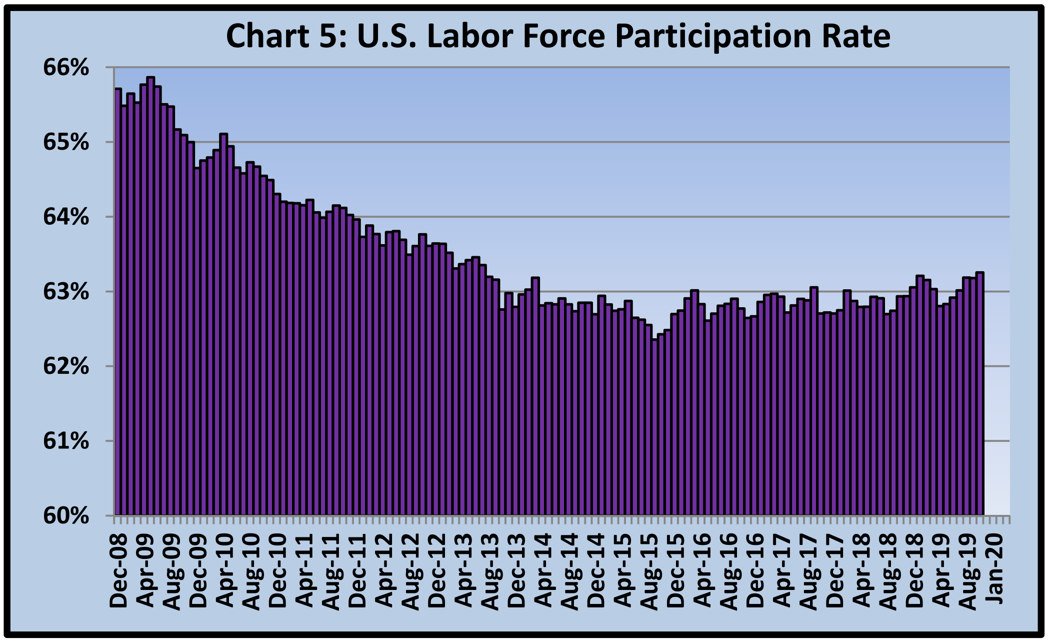
Source: Bureau of Labor Statistics

The market for human capital – for labor – operates much like any other freely functioning market. Rising demand and falling supply typically lead to higher prices. In the case of the U.S. labor market, more job postings and fewer available workers have combined to nudge the price of labor higher. Chart 4 shows that average hourly wages have been climbing by about 3% annually over the past year. That's not much, to be sure, but for the first time in a decade it's higher than the inflation rate (currently about 2%). In other words, workers are finally seeing real gains in their purchasing power. That certainly can spur further spending.



Source: Bureau of Labor Statistics

One reason that the flood tide of new job openings has led to only a small increase in wages is that it has also attracted more people to enter (or re-enter) the workforce. Chart 5 shows that labor force participation has begun to increase again in the past couple of years, after two decades of gradual decline. Previously-retired (or long-term unemployed) people, drawn by more opportunities and higher pay, have begun returning to work. This, too, contributes to economic growth and suggests that consumer spending will remain healthy for the foreseeable future.



Source: Bureau of Labor Statistics

The available evidence, then, suggests that consumers have all the reason in the world to be confident about their futures and to be happily contributing to GDP growth: More workers than ever are employed, their incomes are rising ahead of inflation, demand for their services remains strong, taxes are lower, their 401(k) plans have grown in value, and interest rates remain low. But the key question for forward-looking markets remains: Is this sustainable? Or, as Mr. Arone suggested, is the only path downward?

It's entirely possible that interest rates or taxes could rise, but neither seems at all likely over at least the next year.[4] In the absence of a dramatic change in monetary or fiscal policy, it's also unlikely that the stock market would plunge into a deep bear market in the foreseeable future. And with a strong dollar keeping import prices low, there doesn't seem to be any reason consumer spending should shrivel. Perhaps the only serious threat to consumer confidence might come from continued weakness in the manufacturing sector; yet manufacturing represents only 8% of all non-farm jobs in the United States today – too small for weakness to spread widely across the entire economy.

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[4] Both of these outcomes would become more likely in 2021 if a Democratic socialist were to win the Presidency *and* if the Democrats also were to take control of the U.S. Senate. One outcome without the other would not be sufficient to change the interest rate or tax outlook, and securities prices are not currently reflecting the prospect of a complete Democratic sweep.

Still, there are some concerns, and investors should be aware of them. At the least, it’s worth noting that sluggish economies in Europe and elsewhere are dampening demand for U.S. exports; not only that, but the strong dollar makes such exports less competitive. Conceivably, a slowdown in export-driven industries could lead to layoffs and erosion of consumer spending. As with manufacturing, however, the numbers are just too small to affect the entire economy. (There is also substantial overlap between manufacturing and exports, of course.)

It’s also possible that the long-simmering trade conflict with China could devolve into much nastier open hostility between the world’s two largest economies, which could inflict substantial pain onto corporate America’s global supply chains and end markets – which could drive stock prices down and unemployment higher. Yet the headlines this week suggest the opposite, namely that China and the U.S. are so close to an agreement that the two countries are even discussing rolling back existing tariffs. Still, corporate managers would be wise to remember that this long-running saga has had many twists along the way. In this respect, a closer look at Chart 3 indicates that the number of job openings has begun to drift downward in the past couple of months, as employers appear to be rethinking hiring plans in light of a murky trade outlook.

These are the sorts of concerns that Mr. Arone had in mind when he wrote that the consumer economy can only deteriorate from here. The basic problem with his argument, however, is that there isn’t any real evidence to support it – in fact, the available evidence mostly suggests the opposite: Prevailing conditions can be maintained well into next year and may even improve further. But perhaps most importantly, the data in Chart 1 show that the American consumer has maintained remarkably steady behavior through all sorts of economic ups and downs; there simply exists no good reason to believe that consumer spending will collapse any time soon.

Insights

October 2019

Uncommon Sense

Shop ‘til the Economy Drops: Slowing Consumer Spending Could Signal Trouble Ahead

Michael Arone, CFA
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“If you think the United States has stood still, who built the largest shopping center in the world?”

— Richard M. Nixon

Retail Therapy

Americans love to shop. American Dream, the most expensive US mall ever built, opened last week in New Jersey, complete with theme-park rides and a 16-story ski hill. Who says the mall is dead? Shopping is a national pastime, and our insatiable appetite for goods and services makes the US economy unique. China may be the world’s manufacturer and India its service center, but the US consumer is the world’s undisputed bargain hunter. Our shopping obsession makes some nations green with envy, while others find it disgustingly indulgent.

Regardless, typically, about two-thirds of the US economy is driven by personal consumption. That amounts to roughly $13 trillion in consumer spending superpower. Where would the US economy be without the consumer? Simply, spiraling toward recession. Future economic growth and stock market gains depend on the US consumer’s willingness to keep shopping.

However, a rare shift is under way that will put pressure on the tireless consumer. The Atlanta Federal Reserve GDPNow model is forecasting that underwhelming third-quarter US GDP growth of just 1.8% will be driven *completely* by personal consumption. Not two-thirds, but 100%. The other three components of GDP — business investment, government spending, and net exports of goods and services — will likely contribute a big fat goose egg to the economy. Zero, bupkis, squat. How can the entire GDP figure be concentrated in a single component?

Alarmingly, while future growth depends on Shopapalooza continuing, we may now be witnessing the peak of US consumer strength. Given that economic and corporate profit growth peaked in the middle of last year, it seems naïve to expect the US consumer to continue to carry the burden of economic growth for too much longer.

The Customer Is Always Right

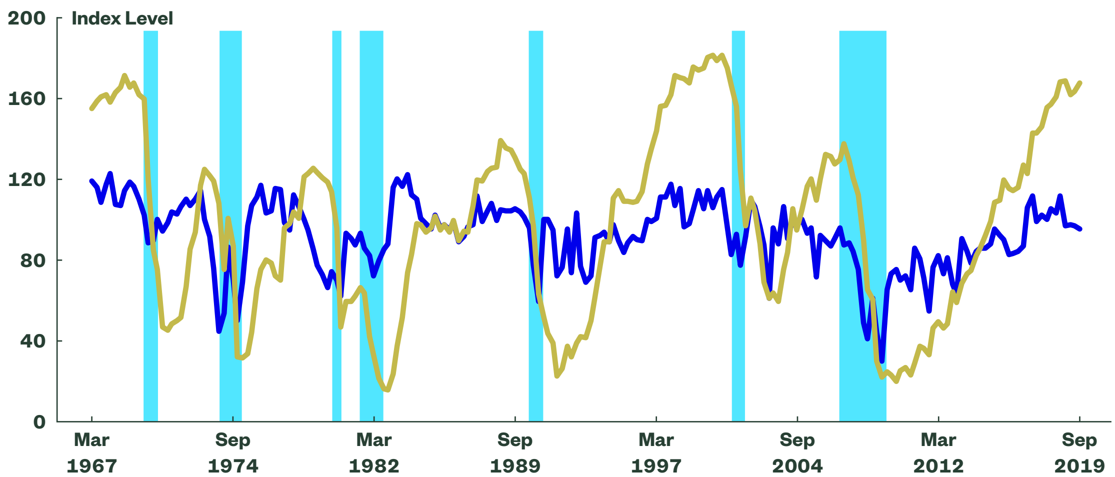
The US consumer has been strengthened by lower taxes, massive gains in financial assets, a robust job market and falling interest rates. It’s difficult to imagine a more pro-consumer environment.

Economists and market observers continue to point to consumer strength as the primary reason that the US economy won’t finally succumb to recession. Solid evidence supports their view. The US unemployment rate hasn’t been this low in 50 years. Jobless claims are also at multi-decade lows. The stock market is near all-time highs. The reasonably stable housing market is likely to receive additional support from falling interest rates. Measures of consumer confidence remain elevated, with the University of Michigan Consumer Sentiment Index released on October 25 reaching a three-month high. So, what's not to like?

For the US economy to accelerate, something other than the consumer needs to stimulate growth. Unfortunately, given today's challenges, it is difficult to identify exactly what that something might be. The global economic slowdown, US-China trade war and contentious US political environment have been major headwinds for the other three components of GDP. And near-term solutions to these major challenges remain elusive. So it's unlikely that any other GDP component will fill the void of a future slowdown in consumer spending.

Figure 1

The Gap Between Future Expectations and Present Consumer Confidence Has Been Widening, Reaching its Fifth-Widest Reading on Record Last Quarter



Source: Bloomberg Finance, L.P., as of September 30, 2019.

A Case of Buyer's Remorse

This is likely as good as it gets for the consumer. There's nowhere to go but down for the outstanding consumer data. Recently, cracks have started to form in consumer confidence. Despite the strength shown in the University of Michigan Consumer Sentiment Index, the data reveals that Americans are more cautious about the US economic outlook amid persistent trade tensions and global economic weakness. And a number of additional risks could eventually dampen consumer spending:

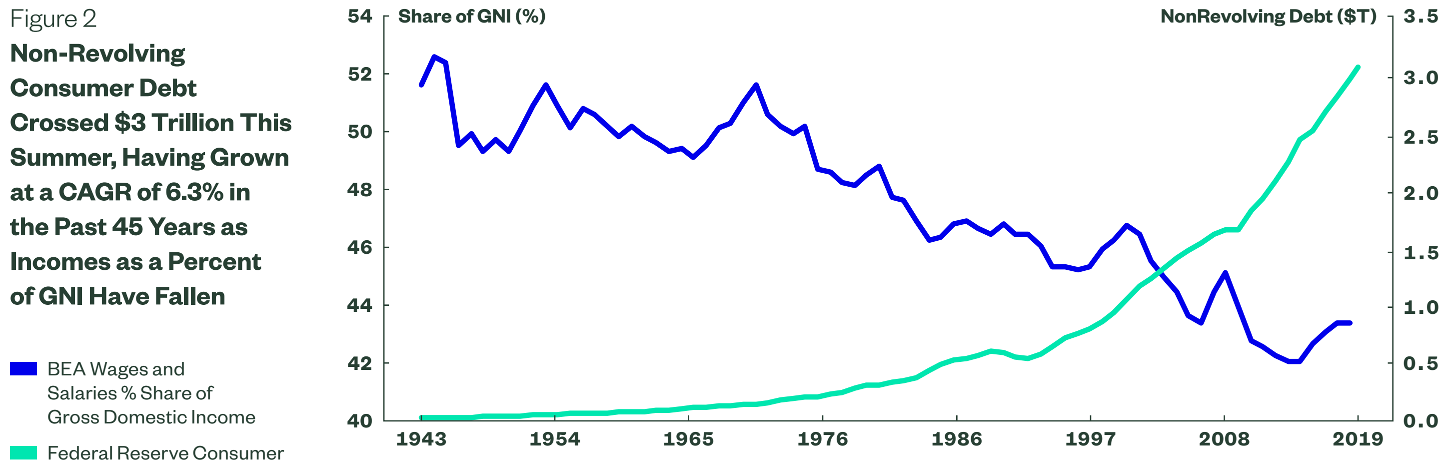
- **Plummeting corporate profits.** Many measures of manufacturing are now signaling an economic contraction. Rising input costs combined with decelerating top-line revenues are squeezing corporate profit margins. The Bureau of Economic Analysis (BEA) measure of US National Income and Product Accounts (NIPA) profits (before tax) has been flattening. And FactSet earnings data suggests that year-over-year earnings per share growth for the third quarter will suffer its third consecutive quarterly decline.

- **Stagnant income levels.** Falling profits mean corporate executives aren't boosting their hiring plans, increasing capital expenditures or hiking wages. With the pace of job gains slowing this year, the year-over-year average hourly earnings data dipped below 3% for the first time in a while. Not surprisingly, the Commerce Department reported on October 16 that retail sales fell 0.3% in September compared with a month earlier — well short of the 0.2% gain economists were expecting.

- **US-China trade conflict.** Investors were quick to celebrate a mid-October preliminary trade agreement between the US and China, but we've yet to see specific details of the agreement. And although additional tariffs on Chinese imports scheduled to begin on October 15 have been delayed, more tariffs are scheduled for December 15. According to Reuters, the mid-December tariffs target Chinese goods not previously covered and will hit the consumer technology market hard, including cellphones, laptops and tablet computers, which amounted to $80 billion in imports last year. The December list also includes tariffs on a wide range of consumer goods that totaled $156 billion in imports in 2018.[1]

Figure 2

Non-Revolving Consumer Debt Crossed $3 Trillion This Summer, Having Grown at a CAGR of 6.3% in the Past 45 Years as Incomes as a Percent of GNI Have Fallen



Source: St. Louis Federal Reserve FRED, Bloomberg Finance, L.P., as of August 31, 2019.

They Came, They Saw, They Shopped

Consumers' unabashed optimism has been primarily fueled by the long-running bull market and job growth. Until now, that's enabled shoppers to turn a blind eye to the global slowdown and tariff wars. However, at the same time the consumer is spending with abandon, corporate America is tightening its belt. Based on a September poll, the Conference Board Measure of CEO Confidence™ registered the lowest reading since the first quarter of 2009. In addition, 67% of CEOs expect economic conditions will get worse, up from 44% last quarter.[2]

Given the disparity between positive consumer sentiment and negative business confidence, something has to give. If business spending doesn't pick up, consumer data will likely decline. Already, job gains are losing momentum, income levels are stalling and retail sales are weakening.

The consensus opinion is that the strength of the US consumer will persist and enable the economy to avoid recession. Much of the current consumer data validates that conclusion. However, the limitation of using that data is that it is backward looking. So although lower taxes, financial asset appreciation, a strong jobs market and low interest rates have resulted in still-high measures of consumer sentiment, there are growing signs that not all is well in consumer paradise. The US consumer, the last bastion of economic might, could be in trouble. If that happens, will there be anyone left to hold the bags?

Endnotes

1 Reuters, Factbox: *Nearly all goods traded by US and China will have tariffs by December 15,* October 10, 2019.

2 The Conference Board, *Measure of CEO Confidence,* October 2, 2019.

ssga.com

spdrs.com

Glossary

Gross Domestic Product (GDP) The total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period. As a broad measure of overall domestic production, it functions as a comprehensive scorecard of the country's economic health.

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