Bull and Bear Bulletin

Gauging the Strength of the Consumer

With consumers being the largest component of the economy and the ultimate factor in corporate profits, we have gone to great lengths in our past issues and client meetings to discuss the importance of consumer psychology and spending. This month we will provide an update on the state of the consumer and what it may mean for the economy and the markets going forward. We have also opted to utilize more charts than normal in an effort to frame the data points on a historical basis and to provide a better picture of the existing landscape. This decision has led to a longer than normal issue.

Before assessing the current rate of consumer spending, an investor should look at the actual psychology of consumers. The more optimistic consumers are about their future, the more likely they are to reduce savings and increase spending. The University of Michigan conducts a monthly survey that attempts to quantify the actual level of consumer confidence as it relates to job prospects, inflation and other important household concerns. While the recent data points suggest that consumer confidence remains below pre-recession levels, it also depicts that confidence is much higher than a year ago and should be sufficient to maintain existing spending habits (Chart 1).

Even if consumers exhibit signs of confidence about their future prospects, there are specific items that can influence their outlook. The most notable influences on consumers are those assets that have the greatest impact on a household's net worth. A review of the recent stock market performance, the state of the housing market and the average wage rate allows an investor to determine the sustainability of consumer confidence.

With the major household asset values increasing and wage growth finally exceeding the rate of inflation, consumers should be experiencing a positive wealth effect and a benefit to their overall psyche (Chart 2); however, asset values and wages are only one part of the equation for household net worth. It is also important to consider the level of indebtedness and the state of job creation, which can more than offset an asset's value or the benefits of wage growth.

Over the past three and a half years, consumers have drastically reduced the amount of household debt by nearly $1 trillion, which lowered the estimated household debt servicing ratio, a measurement of disposable income versus household debt payments, to the lowest level since 1994 (Chart 3). While household balance sheets have dramatically improved since 2007, the labor market gains have been much slower.

Although businesses have been consistently adding jobs since 2010, the number of jobs created per month during this economic cycle has been below average. The major reason that the unemployment rate has been declining on a monthly basis is the reduction in the labor participation rate, which serves as the denominator in the unemployment rate equation. While there have been just over 4 million jobs created since the recession low versus the 8.6 million lost during the recession, nearly 4.5 million people have left the eligible labor force due to retirement, disability or because they became too discouraged with the job market and are no longer seeking a job. The net effect of the weak labor market has a diminishing effect on any benefit consumers receive from an improvement in their asset values, their household balance sheets and/or wage gains.

The diminished benefit to consumer confidence from a weak labor market is best captured in the difference in consumer credit growth and the personal savings rate in the United States (Chart 4). The lack of revolving credit growth, which is an indicator of credit card debt, reflects consumers' uneasiness about the state of the economy and their long-term job growth prospects; whereas, the growth among non-revolving credit, which represents student loans and automobile loans, reflects consumers' desire to invest in themselves through higher education and the need to replace aging vehicles despite sub-par economic growth. Lastly, the continuation of higher consumer savings, which is below the 2008 highs, reflects the fact that consumers remain at least cautiously optimistic regarding their future but are avoiding reckless spending in anticipation of better job prospects or higher pay.

Having concluded that consumers remain in a cautious, but stable, mind frame, we believe that this may act to limit the rate of economic growth going forward and to prevent the Federal Reserve from walking away from its stimulus measures. As long as the government and the Federal Reserve can work together in an organized and strategic manner, the diminished outlook of the U.S. consumer should still be sufficient to drive the economy and the markets higher. The main risk to our outlook is the degree to which further political gamesmanship and a Eurozone recession may have on the performance of the equity markets, the U.S. labor market and ultimately consumer psyche. Until consumer confidence is fully restored, any significant shock dealt to consumers is likely to have a greater, more magnified, impact on the overall economy and the markets.

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Chart 1

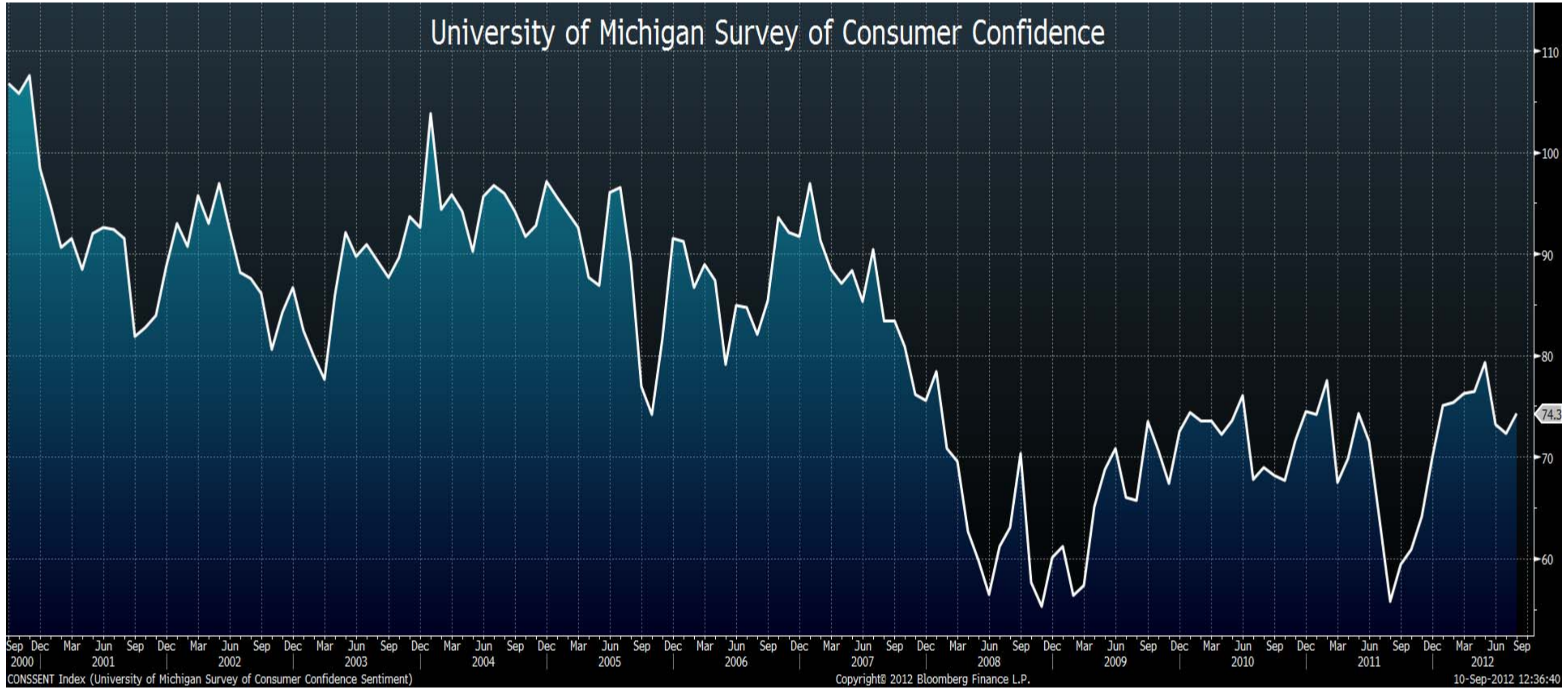

Chart 2

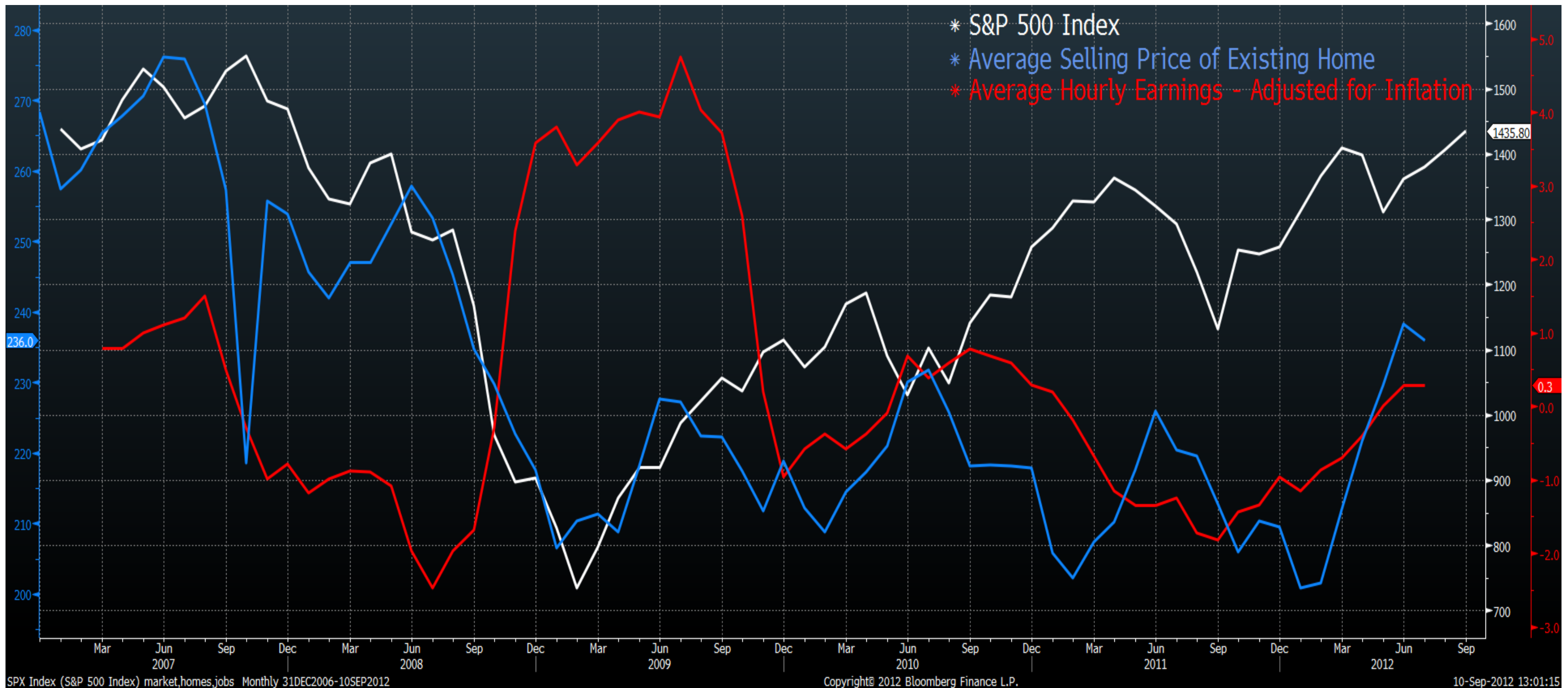

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Chart 3

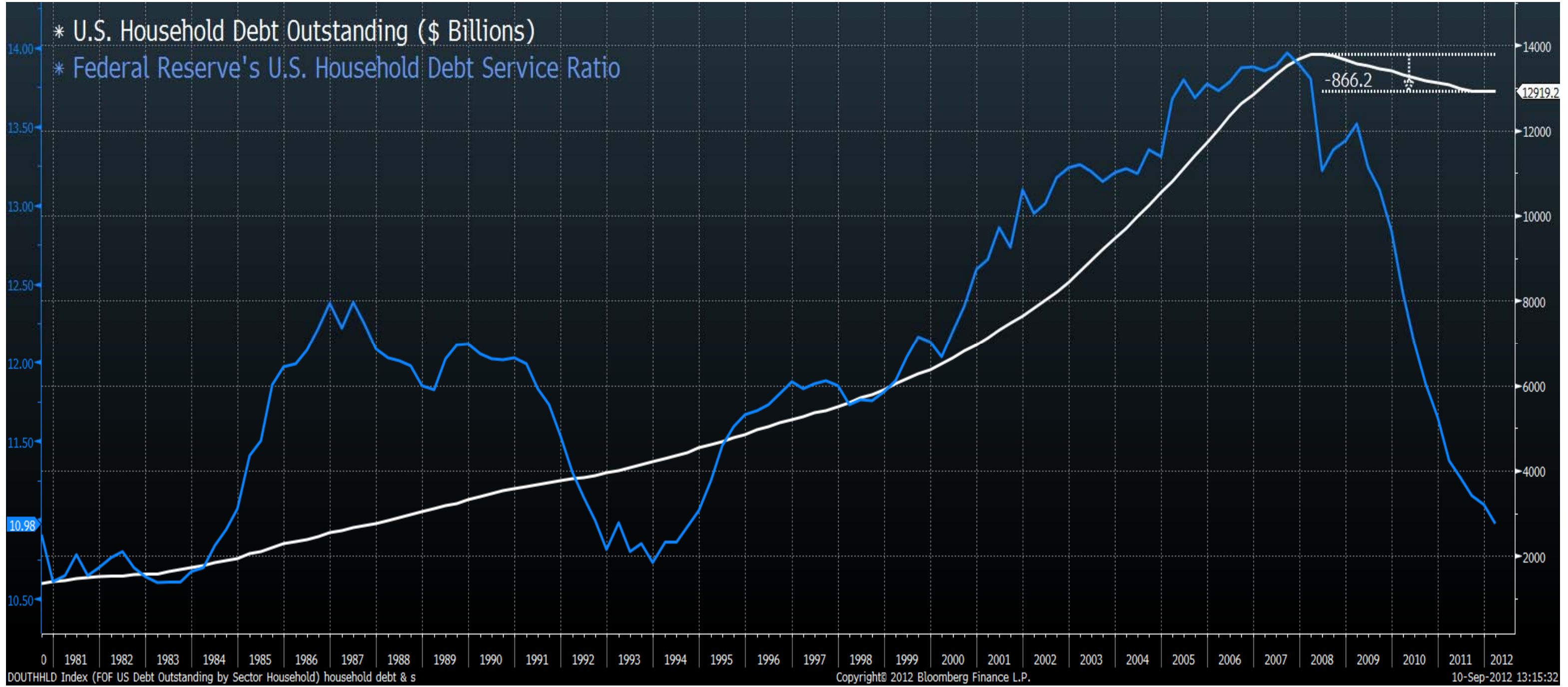
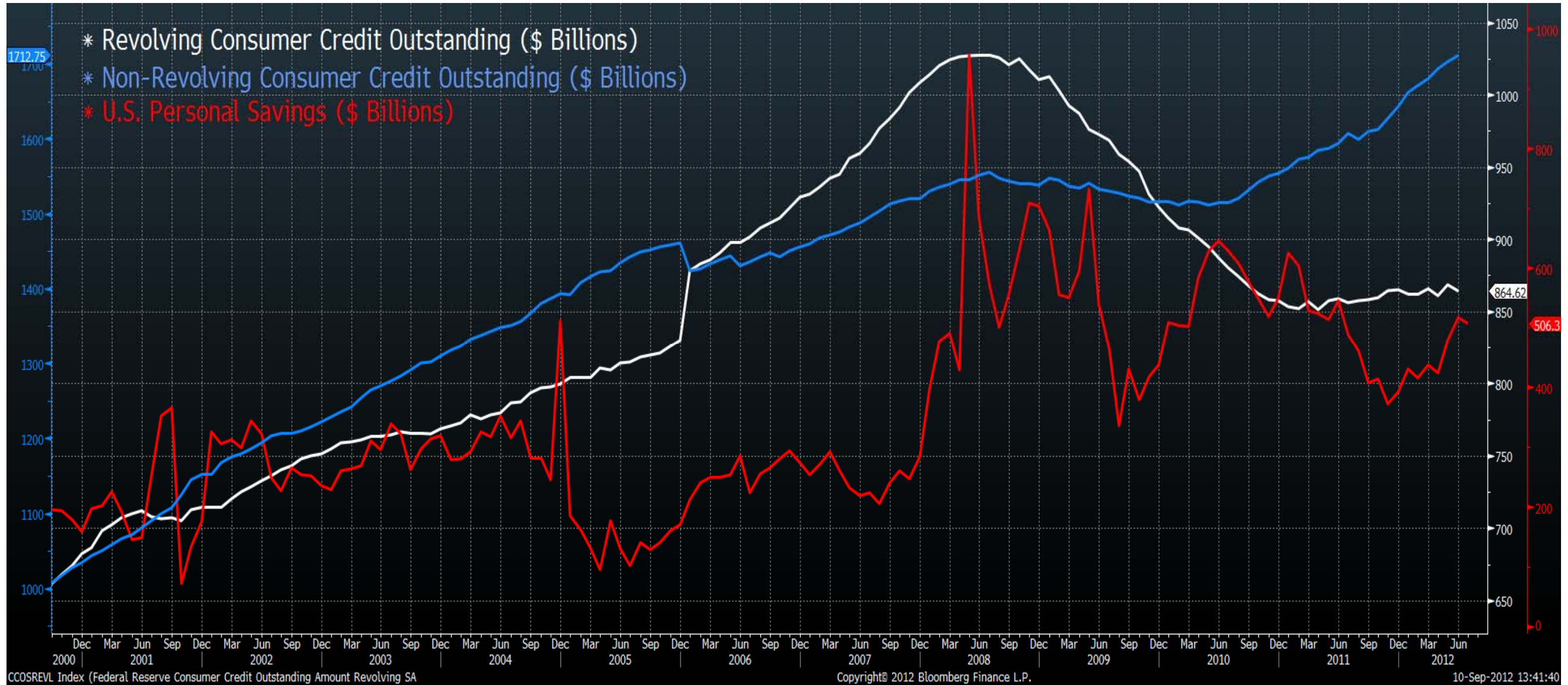


Chart 4



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