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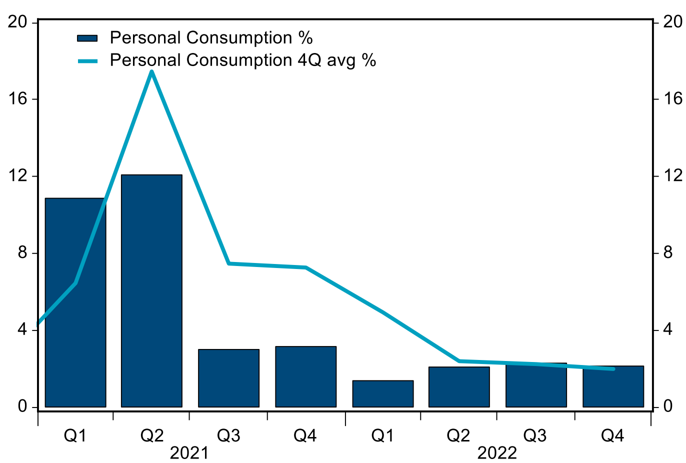
Consumer Spending Props Up Growth for Now, but Weakness Lies Ahead

Economic INSIGHT

Early in the second half of last year, consumers were able to maintain and, in some cases, increase spending as they were still flush with pandemic savings and fiscal support. Now, however, as savings dwindle, fiscal support fades, and consumers increasingly shift from goods purchases to service consumption, the weight of rising prices is undermining real wage growth. Subsequently, spending activity is slowing.

There was enough positive spending in October and early November to keep end-of-the-year growth in the black. However, looking out on the rest of 2023, sustaining such positive momentum is less likely. Without a healthy consumer base spending in the marketplace and the trajectory of rates continuing upward, negative topline growth will likely occur sooner than later, increasing the possibility of recession.



Source: Bureau of Economic Analysis/Haver Analytic

For the Federal Reserve (Fed), the prospect of a weakened economy will add momentum to the argument for a more controlled ascent in rates. With that being said, inflation remains the Fed's primary concern, as it is still well above its intended target. As such, prolonged pain in the economy is not only likely, but also arguably necessary to ensure price stability is reinstated.

CONSUMER WEAK-ISH

The U.S. consumer has been unexpectedly hardy over the course of the last year despite weathering an earlier global pandemic, forced economic shutdown, and four-decade high

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inflation. Drawing down savings and adjusting monthly purchases, as well as ramping up credit card and other forms of debt, offered welcome support to modest, but still positive, spending activity. Retail – or goods – purchases alone rose an impressive 2.0% at the start of 2022, averaging 1.0% across the first six months of the year. In fact, despite weakness elsewhere in the economy resulting in back-to-back quarters of negative topline activity, consumer spending on goods and services rose 1.7% January to June last year, contributing an average 1.0% to headline GDP. Furthermore, stripping out the weakness from net exports and inventories, final sales to domestic purchasers rose an average of 0.7% in the first half, reflecting the underlying strength of the consumer.

Positive consumer activity continued into the second half of last year, however at a somewhat reduced pace and with increased volatility. Flat in the third quarter, retail activity once again jumped in October, reigniting optimism of a sustainable positive pattern of purchases, if not an outright resurgence. The 1.1% monthly rise at the start of the fourth quarter (Q4), however, proved short-lived with November sales falling 1.0% followed by a 1.1% decline at year end, the weakest two-month period since the spring of 2020 when the economy was in the early stages of a lockdown. Year-over-year, goods purchases remain in the black, up 6% as of December, however, the downward momentum is undeniable with growth already slowing 200 basis points from an earlier peak, and real retail activity trending negative since November.

Solid spending at the start of Q4, particularly on services, was nevertheless enough to maintain a positive trend in overall consumption. According to the latest Bureau of Economic Analysis report, fourth quarter GDP rose 2.9%, thanks in good part to a 2.1% rise in consumer spending. Down from a 2.3% pace July to September, the consumer nevertheless contributed 1.4% to the headline rise in the fourth quarter. Of course, with topline activity negative across the first six months, even with a stronger-than-expected report at year end, annual growth was a meager 2% last year compared to a near 6% rate in 2021.

Looking forward, without further fiscal initiatives or a massive taming of inflation, consumers will expectedly continue to slow the pace of expenditures as the household balance sheet becomes increasingly fragile under the weight of rising price pressures and modest income gains. A further draw down of savings or additional accumulationof credit card debt may offer a short-term supplement to spending, but neither is a sustainable or indefinite support. A growing inability by the consumer to shoulder an increased burden of costs will undermine the upside potential to economic growth – not to mention complicate expectations for monetary policy.

GDP – Gross Domestic Product

MoM – Month over Month

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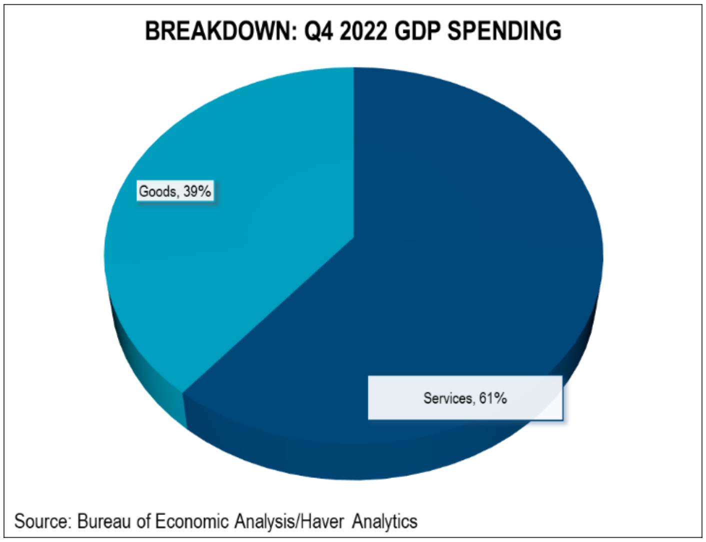
BUY THIS, NOT THAT. WHERE ARE CONSUMERS SPENDING?

While the nominal pace of expenditures has clearly slowed – and will expectedly continue to slow – at least for now, consumers are still shopping. But what exactly are consumers buying – or not buying?



During the pandemic years, there was a significant increase in consumer demand for goods or things. Electronics, exercise equipment, toys, anything and everything that could provide entertainment or distraction as many normal outside activities were restricted or unavailable. Now, in the post-pandemic era, the pendulum has swung in the opposite direction. While overall consumption continues to slow from earlier levels, the composition of spending is increasingly being fueled by services consumption. Trending positive for the prior nine months, at the end of the year, services spending rose 2.6%. Goods consumption, meanwhile, rose "just" 1.1% in Q4, an unexpected rise after three consecutive quarters of outright decline. In fact, looking at the divide based in nominal dollars, 61% of expenditures in Q4 were directed to services relative to 39% spent on goods.

Within the category of goods expenditures, there are also clear winners and losers, albeit with a rapidly rising membership to the latter. While largely still positive on an annual basis, monthly weakness in goods consumption is growing markedly. First and foremost, as the Fed continues to tap the proverbial monetary policy brake, the most interest rate sensitive sectors of the economy are understandably taking a hit. Auto sales and housing purchases, for example, have slowed markedly as rising interest rates crimp demand for auto or mortgage loans. Car sales fell 1.2% in December, following a 2.6% drop in November, marking the worst fourth quarter for dealers since 2009.

Even with the majority of the weakness concentrated in a handful of categories, there was enough of a decline elsewhere to keep core sales growth trending further into the red at the end of the year, at least on a monthly basis. Excluding autos, retail sales fell 1.1% in December, pulling the annual pace down to a 6.1% gain. Gasoline station sales also fell at year end, dropping 4.6%, the second month of decline, and reflecting a 37% decline in pump prices since a peak in June. Nevertheless, excluding cars and gasoline, retail sales declined 0.7% in December, up 7.2% year over year.

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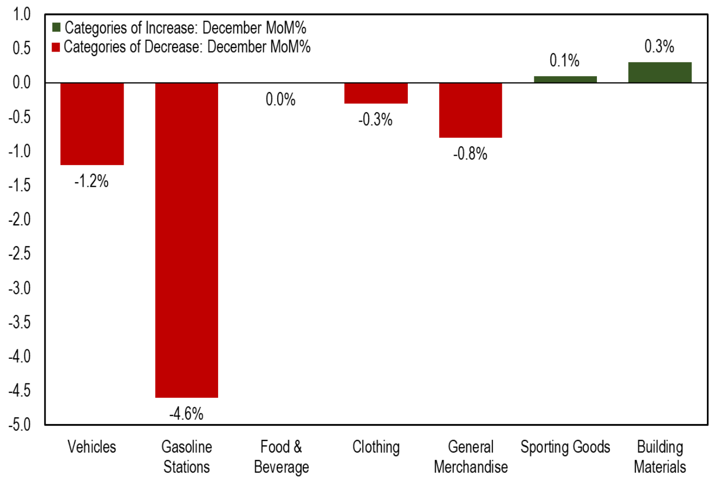
Meanwhile, food and beverage sales were flat in December, the second consecutive month of waning momentum, slowing from an earlier peak of 8.7% in December 2021 to a 6.9% annual pace in December 2022. Clothing sales declined 0.3% in December, and general merchandise sales decreased 0.8%, both marking the third consecutive month of negative growth, although still gaining on an annual basis, up 2.9% and 3.8%, respectively.



Source: Census Bureau/Haver Analytics

On the stronger side, sporting goods sales rose 0.1% and building materials sales increased 0.3% in December, up 3.9% and 2.3% year over year, respectively.

ENOUGH FOR Q4, BUT WHAT ABOUT THE FUTURE?

With savings declining and fiscal support fading, the notion of a reduced or evaporated wealth cushion is causing an outright shift or reduction in spending habits. This is an expected but somewhat delayed outcome. The drop in retail sales at year end, however, is more worrisome than simply falling short of expectations. It is a reflection of growing unease about household financials. A meaningful decline in key categories, coupled with a downward revision to spending the month prior and a slowing rate of services consumption, signals growing weakness on part of the consumer, the key driver of the economy.

While there was enough spending momentum early in the fourth quarter to support still-positive growth at year end, without shoppers out in the marketplace today spending on goods and services, such positivity will be increasingly unlikely.

The Fed appears willing to tolerate weakness or even an outright recession to achieve its goal of price stability. The market is less convinced the Fed will have the resolve to continue increasing rates if consumer and domestic activity continue to decline. The latest policy commentary has indicated an intention to lessen the size of future rates hikes, however, with inflation still well above the desired level, there is more work to be done to stem price pressures. The current destruction in demand should not deter the Fed, but rather embolden policy makers that earlier policy actions are having the intended effect of slowing market activity.

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