Economic INSIGHT

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Surging Retail Sales Indicate Consumer Resilience, For Now

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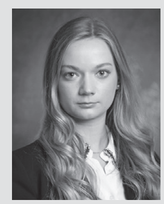

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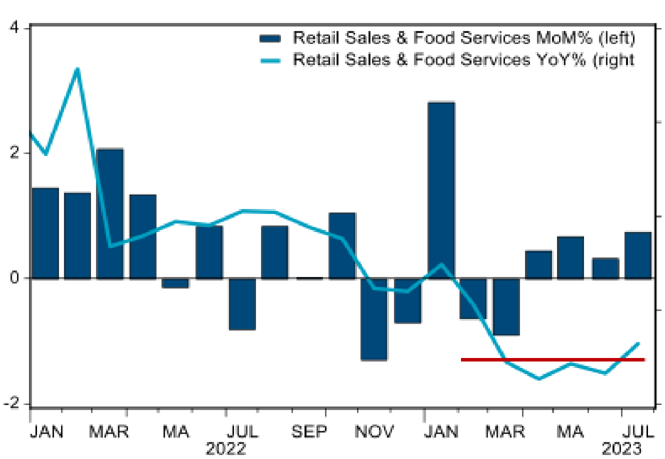
Retail sales figures in July showed U.S. consumers continue to spend despite higher prices and rising interest rates. In fact, the unexpected acceleration in spending activity was the primary driver in the second quarter that boosted topline growth to 2.4%. This has furthermore heightened expectations that the momentum from the first (Q1) and second (Q2) quarters is carrying forward into the third quarter (Q3).[1]

Such an outlook, however, may prove to be overly optimistic, as the Fed is expected to continue raising rates and consumer supports are showing signs of fatigue. After all, what is the source of the consumers' resilience? And more importantly, is it sustainable into the second half of the year as the Federal Reserve (Fed) presumably continues to tighten its grip on the economy in an attempt to tame inflation? There has been some organic support to household wealth, but many of the supplemental factors appear to be temporary in nature, suggesting that at some point the spending party will come to an end.

RETAIL SALES SURGE

The latest July retail figures indicated an unexpected rise in goods consumption at the start of the third quarter. Predicted to rise a modest 0.4%, sales surged 0.7% following an upwardly revised 0.3% gain the month prior. Year-over-year, retail spending jumped 3.2% at the start of Q3, up from a 1.6% pace the month prior.

Of course, broadly speaking, while better than expected and a welcome gain from a recent low of 1.3% in April of this year, on a nominal basis, spending remains subpar, averaging "just" 2.6% over the past six months. In fact, the pace of expenditures has slowed significantly, now less than half of the more robust 7.4% pace at the start of the year.



Source: Census Bureau/Haver Analytic

In the details of the report, health and personal care sales rose 0.7%, food and beverage sales gained

[1] The Atlanta Fed GDPNow model currently predicts a 5.8% increase in Q3 GDP.

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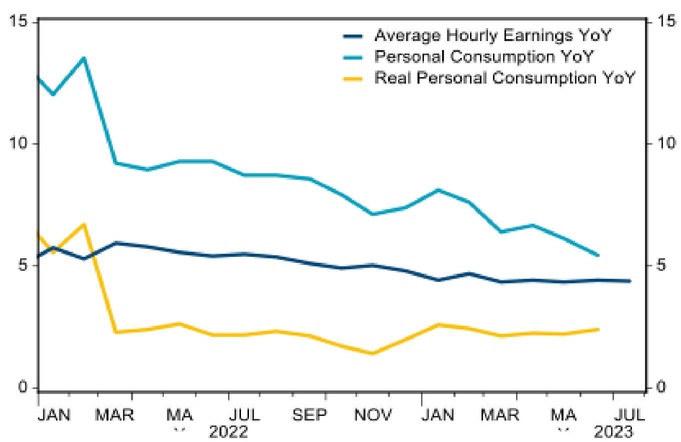
0.8%, and clothing sales jumped a full 1.0% in July. Also, building materials sales rose 0.7% in July and general merchandise sales gained 0.8% due to a sizable 0.9% increase in department store sales, the most in six months. Additionally, eating and drinking sales rose 1.4%, a two-month high, sporting goods sales increased 1.5%, and non-store retailer sales rose 1.9% in July, up from a 1.5% gain in June.

Of course, not all sectors are weathering higher interest rates equally well. As one would expect, the more interest-rate sensitive sectors, such as housing and larger-ticket items more reliant on credit, such as furniture, large electronics, and car purchases, remain lackluster. On the weaker side, miscellaneous sales decreased 0.3%, the third negative print in the last six months, and electronics sales fell 1.3% after two months of gains. Also, furniture sales dropped 1.8% in July, the largest monthly decline since April, and car sales fell 0.3%, a four-month low.

THE TOTAL CONSUMER

The monthly retail sales report from the Census Bureau offers only a partial view of consumer activity. Retail sales activity refers to the consumption of goods or "stuff," including electronics and vehicle purchases. It excludes services expenditures, such as medical services, travel, or financial services. The consumer income and spending report from the Bureau of Economic Analysis, on the other hand, gives a more comprehensive view of consumer expenditures including both goods and services.



Source: BLS, BEA/Haver

The latest June spending data showed a 5.4% increase in total consumer outlays, reinforcing the conclusion drawn from the July retail report that consumers accelerated spending activity in the latter part of Q2 and presumably now into the early stages of Q3. But while the consumer is still spending, month-to-month volatility aside, on a relative or trend basis, the pace of activity has waned markedly – just as it has in the retail sector. Overall topline consumer expenditures slowed from an 8.1% pace in January to 5.4% in June. Furthermore, adjusting for inflation, real consumer spending has seemingly flatlined, dropping from 2.6% at the start of the year to 2.4% as of June.

WHERE IS THE SUPPORT?

Much of the optimism surrounding the U.S. economy and the Fed's ability to navigate a soft landing is predicated on the continuation of consumer resilience. But are the supports for spending more fundamental and long lasting or are they superficial and temporary in nature?

Modest (Real) Income Gains

Nominal income growth remains positive but shy of the accelerated pace of consumer spending. In other words, consumers are still spending more than they make, suggesting the need for alternative funds to support the current pace of outlays. In June, personal income rose 5.3%, following a 5.5% annual gain the month prior. Additionally,

GLOSSARY

FOMC – Federal Open Market Committee

MMkt – Money Market

MoM – Month over Month

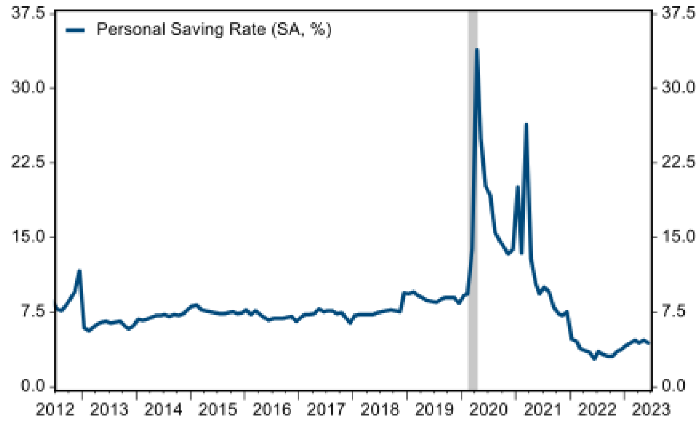
PPI – Producer Price Index

SA – Seasonally Adjusted

YoY – Year over Year

real income growth, while positive and off earlier lows, remains modest. With inflation subsiding (somewhat) and nominal wage growth trending at roughly 4.5% since the start of the year, the annual pace of real wage growth has ticked up over the past six months from 0.4% to 2.3% in June.

A Drawdown of Savings



Source: Bureau of Economic Analysis/Haver Analytic

During the pandemic, consumers had limited options to spend and ample opportunity to save both their hard-earned cash and funds doled out in the form of stimulus. According to the Federal Reserve Bank of San Francisco, excess pandemic savings totaled more than $2 trillion. Now three years later, much of that has already been spent buying new cars or taking vacations among other things. Estimates suggest 80-95% of the wealth stockpile has already been spent, and the personal saving rate of 4.3% in June is well below the pre-pandemic trend of 8.8% in 2019.

401(k) Hardship Withdrawal

According to the latest data, more and more Americans are tapping into their 401(k) accounts because of "financial distress."[2] In fact, Bank of America reported the number of people who made a hardship withdrawal during the second quarter surged by nearly 40% from this time last year, suggesting many households – by force or by choice – are prioritizing near-term spending needs at the expense of longer-term savings. A hardship withdrawal, while permitted, is not without a cost, as it is usually treated as taxable income and may be subject to an additional 10% tax.

A Last Sputtering of State and Local Stimulus

Federal stimulus largely concluded in 2021 and "unspent" dollars have since been repatriated to Capitol Hill, but monies are of course fungible. In other words, unspent is not synonymous with unallocated, leaving some available funds on state budgets even after the last of the federal outlays have dried up. In fact, as recent as the first quarter, roughly 15 states and major cities had initiated another round of stimulus or support payments to local constituents. And more recently, according to reports,[3] at least five states have already announced plans to send out new tax relief/stimulus in the coming months, a welcome notion for many facing a return of housing and/or student loan debt payments later this year.

Sizable Amount of Credit Card Debt

To supplement spending, consumers have turned to credit and other types of debt. Over the last 12 months, credit card debt jumped 16.2%, pushing total outstanding debt over $1 trillion for the first time ever. Typically, a massive run up in credit debt is a red flag for the consumer and will likely become such if it is sustained. However, in

[2] www.cnn.com/2023/08/08/economy/401k-hardship-withdrawals/index.html

[3] www.cbsnews.com/news/stimulus-check-payment-idaho-montana-illinois/

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the meantime, given the relative heath of the household balance sheet, as many paid down debt during the pandemic, putting it all on plastic appears to be a viable solution. That being said, it is an increasingly expensive option with the average credit card rate pushing north of 20%, the highest on record.

Interest Earnings

While higher interest rates retard borrowing and often hurt those most in need of credit, an increased cost of funding helps savers. According to data compiled from Bloomberg as well as the FDIC, money market fund assets ($5.5 trillion) and bank deposits ($17.4 trillion) are at a record high. And with money market funds paying an average 5.2%, that could potentially generate $286 billion of interest earnings on an annual basis and deposits at 2.0% could generate $350 billion. In total, that amounts to potentially $635 billion of interest back to the depositor, which is, as one analyst put it, "not nothing." Pre-Covid, money market funds and deposits stood at roughly $15 trillion and earned 0.25%, totaling only about $37 billion or 6% of today's potential.

CONCLUSION

The latest uptick in the July retail sales report reinforces the notion of a resilient consumer powering the U.S. economy, for the time being. One month's increase aside, however, while a broader picture of consumer activity suggests still positive activity, momentum is waning against the backdrop of modest real income growth and a softening of temporary supports. In other words, while spending activity may have picked up somewhat towards the end of the second quarter, as long as income growth continues to fall short, an eventual reduction in spending will result without alternative means to supplement expenditures.

For the Fed, the notion of cracks in the consumer is less a warning of a collapsing economy and more an indication that – finally – earlier policy initiatives are beginning to have the intended effect of curtailing demand. As the July Federal Open Market Committee (FOMC) meeting minutes showed, policy makers fear that a "significant" inflationary risk remains, one that cannot be tamed without a meaningful reduction in demand. An expiration of the consumer's access to artificial supports, coupled with still – significantly – higher rates may be the necessary combination to finally cool spending enough to reinstate price stability.

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[1]*Estimates vary widely with some suggesting the deadline could be as far off as November.*

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