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MARKET SIGHT LINES

The Consumer Remains Strong: Good News Is Bad News … Again

By Michael O'Keeffe, *Chief Investment Officer*

Consumption makes up about two-thirds of GDP, so we monitor the consumer regularly as one way to keep tabs on the health of the economy. And while we are all on "recession watch," given the Federal Reserve (Fed)'s hawkish monetary policy and related higher interest rates, recent data shows the consumer remains strong. The economy may therefore be holding up, but as has been the case over the last year or so, this "good news is bad news," as a strong consumer gives the Fed room to push its hawkish policy further. Even higher rates should slow the economy further and serve as a headwind for earnings, and stocks have traded lower recently as a result.

In this week's Sight|Lines, we share an update on the strong job market, improving consumer confidence, and consumer activity and their possible influence on Fed policy.

THE TAKEAWAY: 2023 HAS BEEN GOOD FOR JOBS, SENTIMENT, AND SPENDING … SO FAR.

In some ways, consumption is the result of a "cause and effect" progression for the consumer. A strong job market supports higher wages, higher wages improve confidence/sentiment, and more money, with improved confidence/sentiment, fuels more spending. In summary:

- The job market in February remained firm, with unemployment coming in at 3.6%, for example.
- While a more negative sentiment index improved in February, a more positive confidence metric retreated.
- Retail sales rose 3% in January, more than offsetting declines in November and December.
- In his semiannual congressional testimony, Fed Chair Jerome Powell signaled that the Fed could accelerate its rate hikes, moving higher than previously thought, causing the stock market to decline.
- Higher rates could be just the thing to slow the consumer down, perhaps soon.

IN-DEPTH: JOBS, WAGES, SENTIMENT, AND SPENDING ARE ALL INTERRELATED, THESE INFLUENCE THE FED, AND THE FED SETS THE TONE FOR THE FUTURE.

The data in 2023 reinforces the relationships between the job market, wages, confidence/sentiment, and spending. And all of these, especially jobs, are influencing Fed policy. Going deeper:

- The job market in February remained firm:
  - Unemployment came in at 3.6%, still low by historical standards.
  - Nonfarm payrolls were 311,000, with market expectations for a rise of 225,000.
  - The ratio of the number of unemployed to the number of job openings came it at 1.8, still quite high by historical standards.

    - The annual growth of average hourly earnings on a yearly basis was 4.6%, but the monthly rate declined from 0.3% to 0.2%.
- February's sentiment and confidence measures showed mixed but modest improvements:
    - University of Michigan sentiment was higher at 67.0 from 64.9 in January, the highest level in a year.
    - The more positive Conference Board consumer confidence fell to 102.9 from 106.0 in January:
        - The Present Situation Index, which reflects the consumer's assessment of the current business and labor market, rose to 152.8 from 151.1.
        - The Expectation Index, which reflects the consumer's short-run outlook for income, business, and the labor market, fell to 69.7 from 76.0. It has been below 80 in 11 of the last 12 months, a reading often associated with a recession.
- Retail sales were strong in January, reversing a negative trend late last year:
    - Retail sales jumped 3.0% in January and were up 6.4% over the prior 12 months, more than offsetting declines of 1.1% in both November and December.
    - Broadly strong sales were led by a rise in motor vehicle, food, furniture, and electronics sales, and department store sales were positive too.
- In his semiannual congressional testimony, Fed Chair Jerome Powell signaled that the Fed could accelerate its rate hikes, moving higher than previously thought:
    - Said Powell, "The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated."
    - As measured by the S&P 500, stocks had risen 9% through February 2 on optimism the Fed may pause its rate hikes but have fallen 6.1% since then on worries the Fed may go higher for longer.
- Higher rates could be just the thing to slow the consumer down, perhaps soon.
    - As mentioned above, the Conference Board consumer confidence report shows the consumer is feeling good at the moment but worried about the near-term future.
    - Higher rates may dampen consumer sentiment and spending, just what the Fed may be looking for to bring inflation down.

CONCLUSION

Consumption is a big part of GDP, so the consumer is important. When it comes to jobs, confidence/sentiment, and spending, 2023 has been pretty good for the consumer. But this "good news is bad news," as a resilient consumer gives the Fed confidence to take rates even higher, an action that can slow the economy and dampen earnings. This policy shift could be the consumer's undoing.

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