

ECONOMICS: US PERSPECTIVES—DECEMBER 3, 2010

Consumers Start Spending but Cheer Is Absent

■ **Joseph G. Carson**

US Economist and Director—Global Economic Research, (212) 969 6886

During the first shopping weekend of the holiday season, US retailers reported an increase in consumer traffic and spending. Although consumer confidence surveys remain weak, we think sentiment may soon improve if labor markets continue to strengthen and if current tax rates are extended by Congress.

The US holiday shopping season got off to an encouraging start over the critical Thanksgiving weekend. Retail sales exceeded analyst expectations, online business boomed and there are even signs that consumers are beginning to spend more on big-ticket items such as cars.

Despite the improved sales data, consumer confidence surveys remain especially weak (**Display 1**). This is not entirely surprising. History shows that what people say in surveys is not always consistent with what they do. However, we think sentiment may soon improve if labor markets continue to strengthen and if Congress extends current tax rates for a few years, averting the possibility of an increased tax burden that has worried consumers.

Sales over the Thanksgiving weekend rose 6.4% from year-earlier levels, according to estimates from the National Retail Federation (NRF). In addition, online shopping sales, which are not captured by the NRF survey, posted gains in the mid-teens, also above consensus expecta-

tions. Online sales account for about 8% to 10% of overall retail sales and are an important barometer of holiday season shopping trends.

Strong Sales in Stores and Online

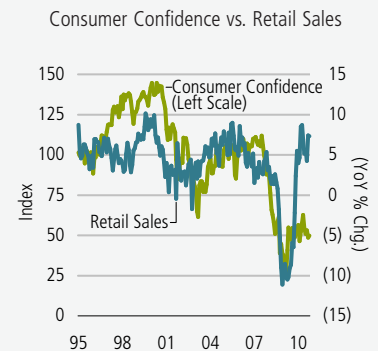
Retailers were also encouraged by the increase in traffic and the mix of sales.

According to the NRF survey, an estimated 212 million shoppers visited a store or shopped online over the weekend, an increase of 8.7% from 2009 levels. Although many shoppers were enticed by sales promotions, retailers noted that holiday shoppers also spent more on discretionary items that are not specifically holiday purchases.

The strong sales in late November followed relatively solid gains by retailers during the first half of the month. Momentum was already building in October, when overall retail sales increased 1.2%.

Sales of big-ticket items, which were especially depressed during the downturn, have also been improving. For example,

Display 1
Strong Sales Despite Poor Sentiment



As of October 2010
Source: Census Bureau, Conference Board and Haver Analytics

sales of light vehicles totaled 12.2 million units annualized in November. This was slightly above the annualized figure for October and marked the strongest month for car sales in 2010. Combined sales data for October and November indicate that real consumer spending is running well above our fourth-quarter forecast of 2.5%, and should easily exceed 3%, making it the strongest quarterly gain since the economic recovery began in mid-2009.

Consumer Confidence Is Weak

While the recent pickup in consumer sales is a welcome development, the mood of consumers remains subdued. Indeed, although the consumer confidence index compiled by the Conference Board rose

four points to 54.1 in November, the overall level of consumer confidence remains relatively low. There's been no material change in the national mood over the past year, with consumer confidence stuck at about half the level it was at before the financial crisis erupted in the summer of 2007.

High unemployment is clearly continuing to weigh on the consumer psyche. But we think other issues are also restraining consumers. When we look at consumer confidence by income and age groups, we find that all categories are depressed. However, the declines are above average in consumers older than 55, as well as in the highest income group.

Older workers have been directly affected by the substantial erosion of wealth during the financial crisis, which has in turn extended the number of years that people must work, pushing off plans for retirement and making it less financially secure. Among higher-income workers, the continued low level of confidence is also linked to wealth loss, as well as the prospect of large tax increases, in our view. Upper income groups would benefit most from a congressional decision to extend the Bush tax cuts, as this group was most vulnerable to a tax hike starting in 2011.

Wages and Salaries Post Solid Gains

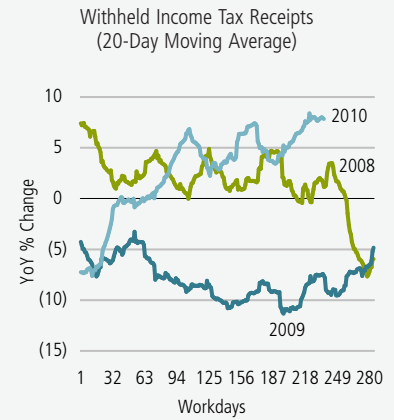
Although the consumer mood remains cautious, improving income growth

appears to be the key driver behind the recent uptick in spending patterns. Private payroll employment growth picked up in the three month period ending in October, rising about 140,000 per month, although preliminary data for November show a gain of only 50,000 (a figure we expect to be revised upwards next month).

Wage growth remains modest at 2.0%, but the gains in jobs and hours worked have produced the strongest wage and salary income growth in the current cycle. In our view, reported income numbers may actually be understating the scale of improvement. Increases in tax deducted from workers' pay (withheld income tax) have been running in the solid 6.5% to 7.5% range, and growth in taxes rarely exceeds gains in earned income (**Display 2**).

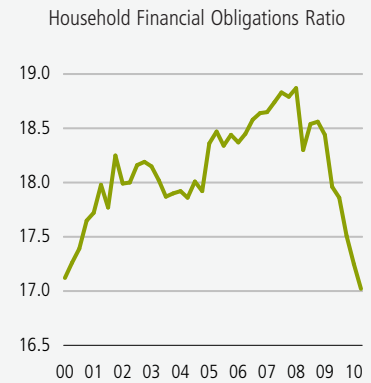
Despite the weak labor markets, we think that, on balance, the outlook for consumer spending in 2011 is improving. Household balance sheets are in much better shape than a year ago, as net worth increased by about \$3 trillion this year. Debt servicing has dropped to its lowest level in a decade (**Display 3**). For the moment, our forecasts remain cautious, with real consumer spending expected to rise by 2.7% in 2011. But the recent retail numbers bolster our confidence that consumer spending may exceed our current expectations, especially if there is a favorable outcome on tax issues in Washington. ■

Display 2
Tax Receipts Suggest Income Growth Is Understated



As of November 2010
Source: Haver Analytics and US Treasury

Display 3
Lower Debt Service Boosts Cash Flow



As of September 2010
Source: Federal Reserve Board and Haver Analytics

Levels (2000 Dollars)	Quarterly					Annual			
	1Q:10	2Q:10	3Q:10	4Q:10	1Q:11	2008	2009	2010	2011
Real GDP	13,138.8	13,194.9	13,277.4	13,385.8	13,473.8	13,228.9	12,880.6	13,249.2	13,692.6
Consumption	9,225.4	9,275.7	9,340.3	9,403.8	9,463.8	9,265.0	9,153.9	9,311.3	9,560.1
Durables	1,138.9	1,157.8	1,178.6	1,190.0	1,200.0	1,136.4	1,094.6	1,166.3	1,218.8
Nondurables	2,053.5	2,063.4	2,072.4	2,090.0	2,110.0	2,041.2	2,017.4	2,069.8	2,136.3
Services	6,029.6	6,053.4	6,090.5	6,125.0	6,155.0	6,082.3	6,032.7	6,074.6	6,206.3
Investment									
Nonresidential Structures	319.3	318.9	314.2	316.0	320.0	464.2	369.6	317.1	330.3
Nonresidential Equip & Software	989.7	1,046.0	1,087.3	1,115.0	1,140.0	1,082.0	916.3	1,059.5	1,180.0
Res Structures	330.7	350.1	323.1	325.0	333.0	444.2	342.7	332.2	349.3
Change in Inventories	44.1	68.8	111.5	75.0	55.0	-37.6	-113.1	74.9	60.0
Net Exports	-338.4	-449.0	-506.7	-465.0	-455.0	-504.1	-363.0	-439.8	-416.3
Exports	1,616.4	1,652.1	1,677.5	1,710.0	1,745.0	1,647.7	1,490.7	1,664.0	1,811.3
Imports	1,954.8	2,101.1	2,184.2	2,175.0	2,200.0	2,151.8	1,853.8	2,103.8	2,227.5
Government	2,540.2	2,564.9	2,590.1	2,598.4	2,599.4	2,502.7	2,542.6	2,573.4	2,611.7

Percent Changes	Quarterly % SAAR					% 4Q/4Q				Annual			
	1Q10	2Q10	3Q10	4Q10	1Q11	2008	2009	2010	2011	2008	2009	2010	2011
Real GDP	3.7%	1.7%	2.5%	3.3%	2.7%	-2.8%	0.2%	2.8%	3.9%	0.0%	-2.6%	2.9%	3.3%
Consumption	1.9%	2.2%	2.8%	2.7%	2.6%	-1.9%	0.2%	2.4%	2.7%	-0.3%	-1.2%	1.7%	2.7%
Durables	8.8%	6.8%	7.4%	3.9%	3.4%	-12.3%	4.8%	6.7%	4.6%	-5.2%	-3.7%	6.6%	4.5%
Nondurables	4.2%	1.9%	1.8%	3.4%	3.9%	-2.9%	1.1%	2.8%	3.3%	-1.1%	-1.2%	2.6%	3.2%
Services	0.1%	1.6%	2.5%	2.3%	2.0%	0.3%	-0.8%	1.6%	2.1%	0.9%	-0.8%	0.7%	2.2%
Investment													
Nonresidential Structures	-17.8%	-0.5%	-5.8%	2.3%	5.2%	-1.5%	-26.5%	-5.8%	8.2%	5.9%	-20.4%	-14.2%	4.1%
Nonresidential Equip & Software	20.5%	24.8%	16.8%	10.6%	9.3%	-11.8%	-4.9%	18.0%	9.4%	-2.4%	-15.3%	15.6%	11.4%
Res Structures	-12.3%	25.6%	-27.5%	2.4%	10.2%	-24.6%	-13.4%	-4.9%	11.4%	-24.0%	-22.9%	-3.0%	5.1%
Net Exports													
Exports	11.4%	9.1%	6.3%	8.0%	8.4%	-2.9%	-0.1%	8.7%	9.6%	6.0%	-9.5%	11.6%	8.8%
Imports	11.2%	33.5%	16.8%	-1.7%	4.7%	-6.0%	-7.2%	14.3%	3.7%	-2.6%	-13.8%	13.5%	5.9%
Government	-1.6%	3.9%	4.0%	1.3%	0.2%	3.1%	0.8%	1.9%	0.9%	2.8%	1.6%	1.2%	1.5%
Domestic Demand	3.9%	5.1%	4.2%	2.1%	2.3%	-3.3%	-0.9%	3.8%	3.1%	-1.1%	-3.6%	3.4%	3.1%

Key Macro Indicators	Quarterly					Annual			
	1Q10	2Q10	3Q10	4Q10	1Q11	2008	2009	2010	2011
Nominal GDP (Levels)	14,446.4	14,578.7	14,750.2	14,946.6	15,118.5	14,369.1	14,119.1	14,680.5	15,462.4
%QoQ SAAR	4.8%	3.7%	4.8%	5.4%	4.7%				
%Y-o-Y	2.8%	3.9%	4.5%	4.7%	4.7%	2.19%	-1.74%	3.98%	5.33%
Industrial Production (Index)	90.7	92.2	93.4	96.0	97.5	96.7	87.7	93.1	99.5
%QoQ SAAR	7.2%	7.1%	5.2%	11.6%	6.4%				
%Y-o-Y	2.7%	7.4%	6.6%	7.7%	7.5%	-3.3%	-9.3%	6.1%	6.9%
Housing Starts (Millions)	0.62	0.60	0.60	0.60	0.70	0.90	0.55	0.60	0.77
Industry Auto Sales (Millions)	11.0	11.3	11.6	12.0	12.2	13.2	10.4	11.5	12.5
Personal Savings Rate	5.5%	6.2%	5.8%	5.5%	5.5%	4.1%	5.9%	5.8%	5.5%
Unemployment Rate	9.7%	9.7%	9.6%	9.4%	9.0%	5.8%	9.3%	9.6%	8.7%
Operating Profits (%Y-o-Y)	37.6%	37.0%	27.8%	18.1%	9.2%	-16.4%	-0.4%	29.5%	7.8%
After-Tax Profits (%Y-o-Y)	27.0%	26.5%	17.2%	13.3%	9.2%	-10.4%	5.1%	20.6%	7.8%

Inflation (%Y-o-Y)												
GDP Deflator	1.0%	1.9%	2.3%	2.0%	2.0%	2.2%	0.9%	1.1%	1.9%			
Consumer Price Index	1.5%	-0.7%	1.5%	2.3%	2.2%	3.8%	-0.3%	1.6%	2.0%			

Key Interest Rates (End of Period)												
Federal Funds Rate	0.13%	0.13%	0.13%	0.13%	0.13%	0.13%	0.13%	0.13%	0.50%			
Three-Mo T-Bill (BEY)	0.16%	0.18%	0.16%	0.15%	0.18%	0.11%	0.06%	0.15%	0.50%			
Two-Yr Note	1.02%	0.61%	0.42%	0.55%	0.70%	0.76%	1.14%	0.55%	1.25%			
10-Yr Note	3.84%	2.97%	2.53%	2.75%	3.00%	2.25%	3.85%	2.75%	4.25%			
30-Yr Bond	4.72%	3.91%	3.69%	4.00%	4.25%	2.69%	4.63%	4.00%	5.25%			

Source: AllianceBernstein

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