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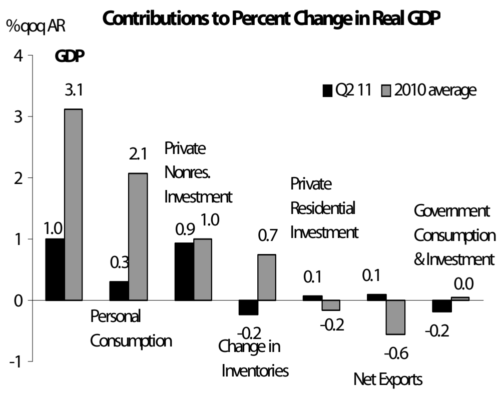
The dip in the US consumer sentiment and future prospects for the US consumer

- Real economic activity disappointed in the first half of the year, a shortfall largely attributed to personal consumption growth deceleration.
- The weakness of the US consumer is, in our view, due to the continuing labor market slack, the erosion of household net worth and heightened economic uncertainty.
- We expect a rebound in real consumption growth in Q3 from the weak pace recorded in Q2, due to the fading effect of Japanese-related automotive supply disruptions and higher oil prices.
- However, the automatic tightening of fiscal policy, combined with a weak labor and housing market, implies that consumption growth will be modest relative to historical averages for years to come. Our estimates include a 2.1% y-o-y consumption growth in 2011 and 1.6% in 2012.

Real economic activity disappointed in the first half of the year, as real output growth slowed remarkably from an annual rate of 2.8% in H2 2010 to 1.0% in H1 2011. Apart from the government sector retrenchment, the shortfall was largely attributed to personal consumption growth, which plunged from 3.6% q-o-q saar in Q4 2010 to 2.1% and 0.4% in Q1 and Q2 2011, respectively (Figure 1). The recent deceleration in personal spending primarily reflected a sharp drag from higher oil prices and Japanese-related automotive supply disruptions, two temporary factors that seem to be fading in the second half of the year. Indeed, the personal income and spending report in July revealed a 1.8% m-o-m annualized rise in real consumption, reporting the strongest monthly reading since December 2009. Strength was broad-based, with a 2% gain in services and a 1.6% rise in goods, driven mainly by an 8% bounce in durable goods due to a rebound in vehicle sales.

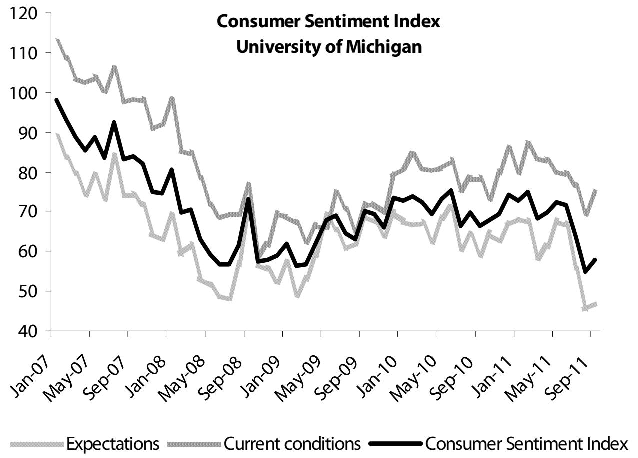
Figure 1



Source: US Bureau of Economic Analysis (BEA), EFG estimates

However, US consumer sentiment has recently posted a sharp decline from its peak at the beginning of the year, hovering near levels historically associated with recession. The Conference Board's index of consumer confidence has gradually fallen to 44.5 in August (from a peak of 72 in February), while the US consumer sentiment from the University of Michigan has fallen to 54.9 (from a peak of 75.1 in February). The recent sharp downward trend in both consumer sentiment indices was driven by a sharp fall in the expectations component, reflecting partially consumer reactions to the debt ceiling debacle and S&P downgrade of US sovereign debt (Figure 2). That said, the University of Michigan survey of consumers, which gauges the public's opinion regarding government economic policy, showed in August the greatest degree of pessimism since the series started in 1978. In particular, 57% of the survey participants reported that government economic policy is doing a poor job, versus a 5% reporting policy is doing a good job.

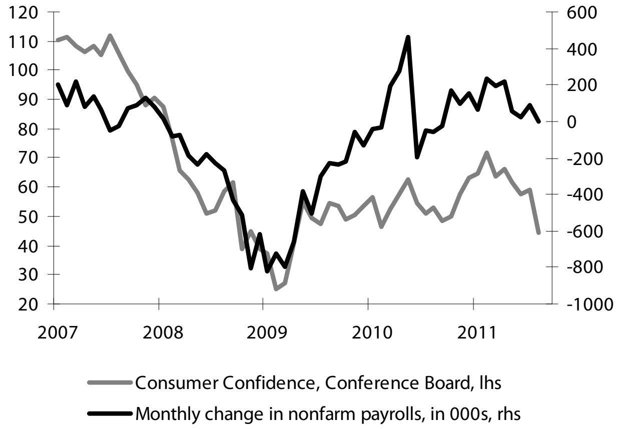
Figure 2



Source: Thomson Reuters, University of Michigan

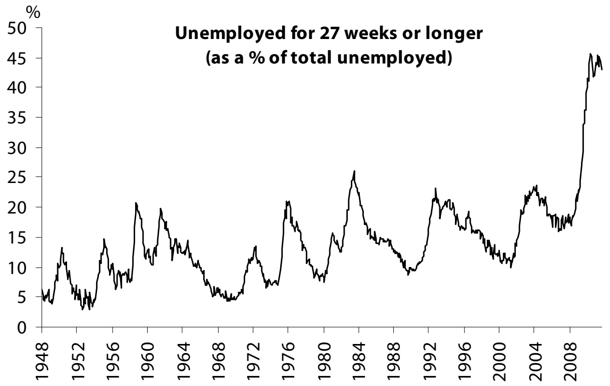
Apart from the political uncertainty, continued labor market weakness appears to be restraining disposable income and personal spending and exerting downward pressure on consumer sentiment. Over the past three summer months, the payroll survey has revealed very poor growth, averaging gains of just 35,000 per month. In August, nonfarm payrolls were unchanged, with net revisions to the two previous months subtracting a further 58k from payrolls (Figure 3). As a result, the unemployment rate has been fairly steady at 9.1% over the past few months, up from the recent low of 8.8% recorded in March 2011. The median duration of unemployment has ranged between 20 and 22 weeks since mid-2010, with about 6 million people being out of work and looking for a job for more than six months. As Chairman Bernanke and other Fed officials have recently said, FOMC participants have become increasingly concerned about long-term unemployment, as it constitutes not only hardship for many US households, but also a risk to supply-side potential of the economy. With nearly half the unemployed having been unemployed for 27 weeks or longer (Figure 4), the gradual erosion of skills of the labor force could lead to a permanently unemployed class of workers, weighing on the long-term performance of the US economy. Weak employment growth and persistent economic slack are holding back employees' wages, denting households' disposable income. The trend in hours and earnings is softer relative to previous trends, with average weekly earnings of all private employees declining by 5.1% m-o-m saar in August, pulling the annual growth down to 1.9% from its most recent peak of 2.7% in February 2011 (its previous peak was 3.4% in October 2010, see Figure 5).

Figure 3



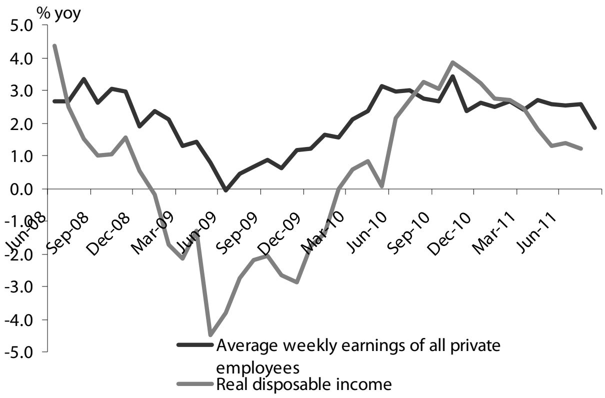
Source: US Bureau of Labor Statistics, Conference Board

Figure 4



Source: US Bureau of Labor Statistics

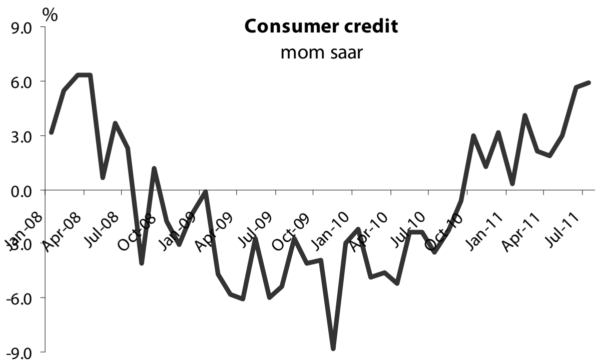
Figure 5



Source: US Bureau of Labor Statistics, US Bureau of Economic Analysis

In addition, the substantial erosion of household net worth seems to be contributing to the elevated level of consumers' cautiousness. The Federal Reserve's Flow of Funds report revealed that household net worth -the difference between the value of assets and liabilities- shrunk about $150bn in Q2 2011, reporting a 1% q-o-q annualized decline. Household debt, which has been steadily decreasing since Q3 2008, fell 0.6% q-o-q annualized, primarily reflecting declining levels of mortgage debt. On the contrary, consumer credit, which increased for a third consecutive quarter in Q2 2011, continued its upward trend in July 2011, reporting the strongest monthly increase since April 2008 (5.9% m-o-m annualized, Figure 6). This is probably one reason why the current conditions consumer index has hold up relatively well compared to the consumer expectations.

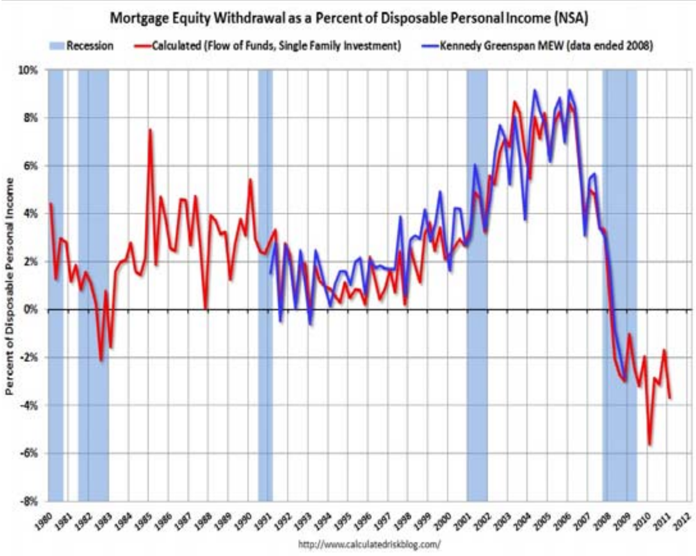
Figure 6



Source: Federal Reserve

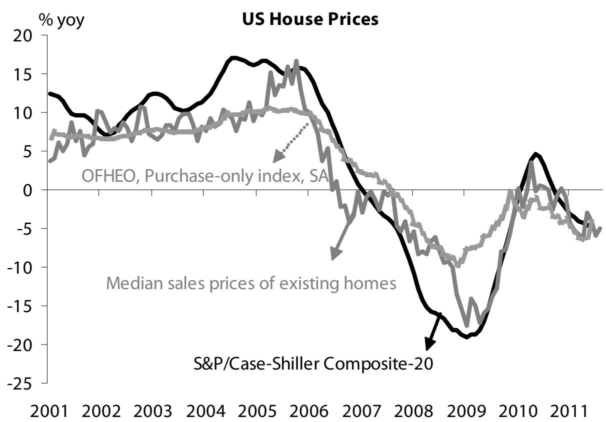
On the asset side, households and nonprofit organizations realized a $153bn decline in total assets, due to a $14bn decline in nonfinancial assets and a $139bn decline in financial assets. On the nonfinancial front, the significant decline in real estate property (-$90bn) provides evidence for the negative wealth effect between changes in house prices and total consumer demand for goods and services. The strength of the housing market in the 1996-2006 decade has allowed millions of homeowners to borrow extra money secured on the value of their property (mortgage equity withdrawal, see Figure 7). The housing market dip that followed had exactly the opposite effect, with mortgage equity withdrawal turning negative in 2008. The double-dip in US house prices in 2010-11 has affected the willingness of people to make major spending commitments and their confidence about their personal finances and the prospects of the US economy (Figure 8).

Figure 7



Source: www.calculatedriskblog.com

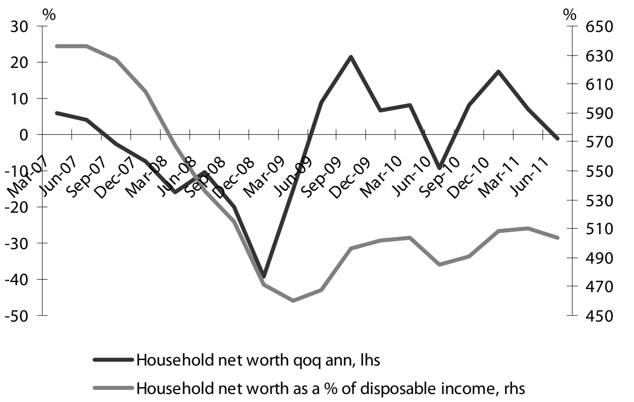
Figure 8



Source: Bloomberg, Federal Housing Finance Agency

On the financial front, households and nonprofit organizations reduced their holdings of Treasury securities ($173bn), but increased their holdings of checkable deposits and currency, as well as time and savings deposits, signifying concerns over the debt ceiling debate. Corporate equities declined $45bn and pension fund reserves decreased $74bn. The damage to consumer confidence from the ongoing equity market losses is undoubtedly large, given that US equity indices have lost over 10% since May 2011. Overall, although the recent decline in net wealth is more than offset by gains of the previous three quarters, household net worth still stands $7.4tr below its most recent peak of $65.9tr in Q2 07, weighing on the consumer expectations sentiment indices. Besides, as Figure 9 illustrates, household net worth as a percentage of disposable income has only recaptured about one fourth of the loss reported in the 2008-09 recession.

Figure 9

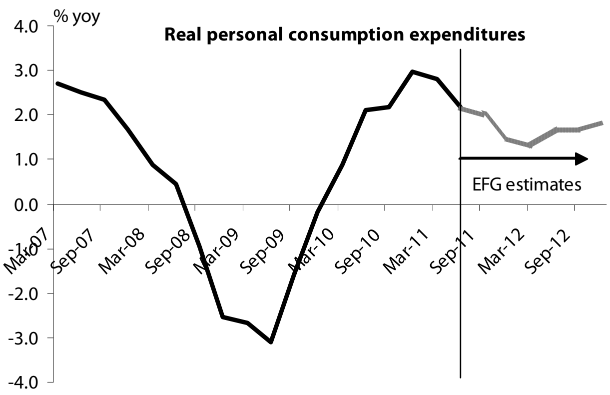


Source: Federal Reserve

Looking ahead, given the strong rebound in personal expenditures in July, growth in real consumer spending is expected to be comfortably stronger in Q3 from the low bar set in the previous quarter. Although the slowdown in retail activity in August hints that the significant weakening in consumer confidence during Q3 may have had an effect on consumer demand, it may be partially attributed to Hurricane Irene and could turn stronger in the following month. Besides, the preliminary estimate of the US consumer sentiment index from the University of Michigan increased modestly to 57.8 in September, from 55.7 in the previous month. The increase was driven entirely by the current conditions component, while the expectations component continued to decline, standing at its lowest level since the early 1980s. Key for household expectations ahead, as well as the personal consumption outlook, will be trends in unemployment, which remains one of the most worrying aspects of the US economy, future changes in household net wealth including movements in house and share prices, as well as anticipated changes in government economic policy that puts public debt on a sustainable path over the medium-term, while supporting short-term recovery.

Overall, we expect a rebound in real consumption growth to about 2% q-o-q saar in Q3 from the weak pace of 0.4% recorded in Q2, boosted by a rebound in auto sales and softer consumer price inflation. However, in the medium to longer term, fiscal consolidation, combined with a weak labor and housing market, implies that growth will be modest relative to historical averages for years to come. Our estimates include a 2.1% annual consumption growth in 2011 and 1.6% in 2012, half the average consumption growth during the post war II period since 1947 (Figure 10).

Figure 10



Source: US Bureau of Economic Analysis, EFG estimates

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