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Downunder Daily

It's Slow, But It's Happening…

It's happening slowly, but it does seem that the US consumer is weakening. The monthly data are noisy, but Friday's retail sales data show that real sales increased by just 0.75% at annual pace over the three months to August (I've assumed no retail-level price increase for the August month). The broader personal consumption expenditure series increased by 1.4% over the three months to July, down from 3.7% in the March quarter.

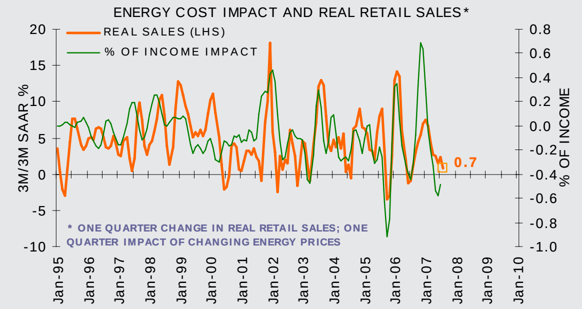
Detecting a change in trend, even when looking at growth over three months, is not straightforward. In particular, swings in real consumer spending are clearly affected by the swing in energy prices. Exhibit 1 shows the rolling three-month growth in real sales and a rolling three-month change in energy costs (inverted, so the line goes down when energy costs go up).

But not all the slowdown in real spending reflects an energy-inspired price squeeze. Nominal spending is also slowing at the margin: the dollar value of sales was up only 2.4% saar in the three months to April, while PCE was up 5.3%% in the three months to July, down from a recent peak of 7.3% in the March quarter. (This can be erratic: this series fell to 2.1% in the three months to last November.)

Moreover, energy prices were not a factor in the softer-than-expected July sales report. Despite the recent increase in oil prices, petrol (gasoline) prices were sharply lower in August compared to July (Exhibit 2).

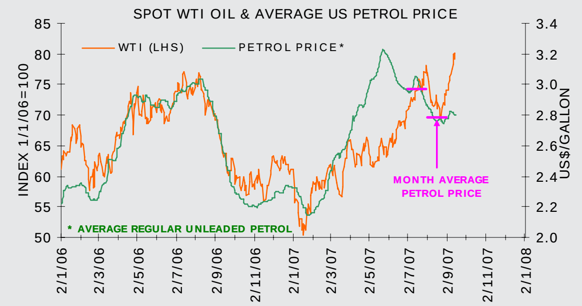
The most immediate implication of this is that it builds the case for the Fed to ease policy on macro-management grounds. A softer consumer almost always leads to a broader slowdown, for example amongst goods-producers (Exhibit 3). Our US team expects the Fed to ease by 25 points at this week's FOMC.

Exhibit 1
Is Energy Doing It?



Source: BLS, BEA; Morgan Stanley Research

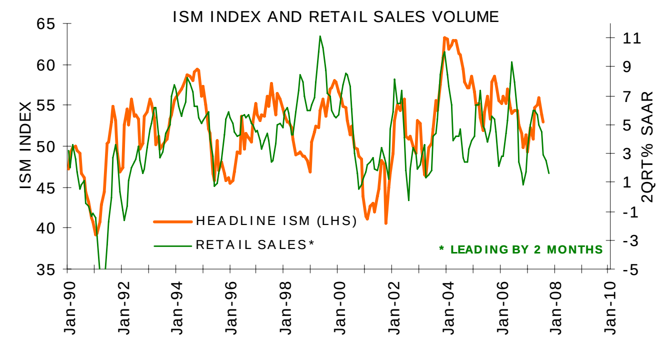
Exhibit 2
Not In August



Source: Bloomberg, AAA; Morgan Stanley Research

Taking a step back, we are now starting to see a significant divergence between consumer spending and the core of household income: wage payments (Exhibit 4). This is typical at most cycle turning points – either from acceleration to deceleration or vice versa – where spending leads income.

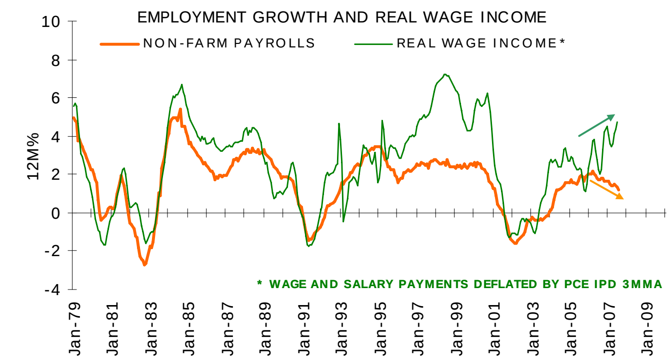
Exhibit 3
Lower Sales Point to Lower Production



Source: BLS, BEA, ISM; Morgan Stanley

The big issue, obviously, is whether this is the start of a slowdown that leads to recession. I'm more pessimistic than the consensus because I expect housing-related wealth effects will force a relatively sharp lift in household saving, undermining spending. Note that the critical issue is the pace of this adjustment: most expect the saving rate to rise, but if the rise is slow enough then it is possible that consumer spending growth holds at a high enough level to avert recession. This is our US economics team's base case.

Exhibit 5
Employment and Labour Income

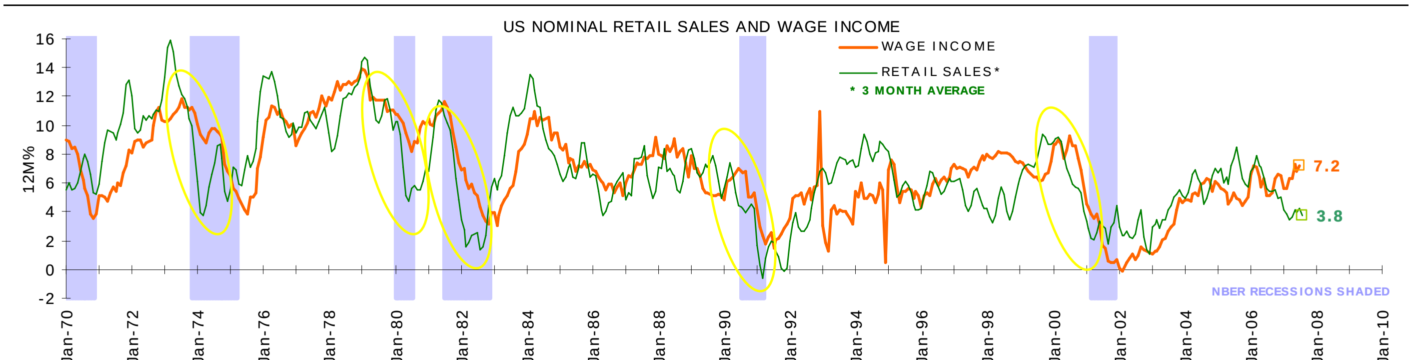


Source: BLS, BEA, Morgan Stanley Research

I certainly agree that it's almost impossible to see consumer spending growth fall to recession-type levels while income growth is as strong as it is now. In that context, while spending leads income, payroll growth remains an important indicator of hard-landing risk. The recent deceleration in payrolls should start to feed into slower income growth, but as Exhibit 5 shows, the two series can diverge for an extended period, as in the mid-1990s.

But low saving and high leverage mean that the US consumer is now, in my view, likely to be very sensitive to any labour market weakness. This in turn suggests that job losses could accelerate the now-slow adjustment in the saving rate, creating a self-reinforcing cycle that pushes the US into recession.

Exhibit 4
Sales Leading Income Again?



Source: BEA, BLS, NBER, Morgan Stanley Research

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