SPECIAL REPORT

TD Economics

February 25, 2015

CONDITIONS ARE RIPE FOR AMERICAN CONSUMERS TO LEAD ECONOMIC GROWTH

Highlights

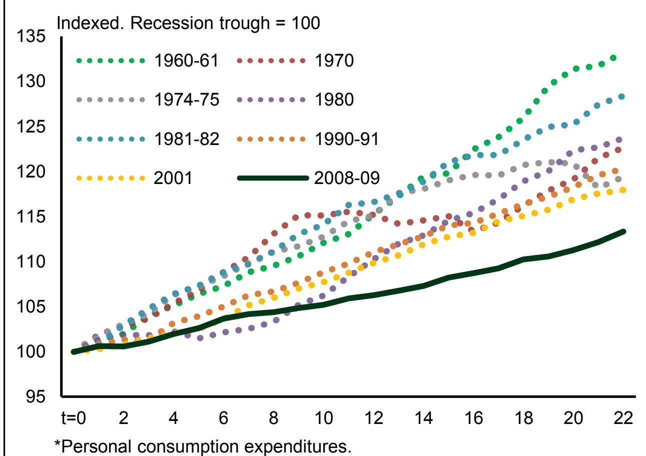
- American consumers have has had a rough go of things over the past several years. After plummeting during the recession, personal spending has grown slower than in any recovery in the post-war period.
- The fall in consumption during the recession reflected the unwinding of the preceding increase in household leverage during the housing boom. When home prices plunged, levered households suffered the greatest losses.
- The rise and fall in leverage also explains the poor pace of consumption growth over the past several years. Home prices continued to drop through the first three years of the recovery. Prices have been rising since 2013, but many households remain underwater and access to credit has improved only slowly.
- The prospects for consumer spending over the next year are brighter. Consumption growth will benefit from a combination of faster wage gains, lower gasoline prices and the ongoing recovery in home prices.
- Personal consumption expenditure growth is expected to accelerate to 3.5% in 2015 – the best growth in a decade. With external headwinds continuing to blow, the improvement in consumer spending will be the main force behind the acceleration in overall economic growth.

It is impossible to talk about the American economy without talking about household spending. Personal consumption expenditure (PCE) represents the majority of U.S. economic activity at just under 70% of GDP. When the U.S. consumer is doing well, so is the economy. Unfortunately, consumers have struggled over recent years. Personal spending experienced the largest decline since the Great Depression in the aftermath of the financial crisis. Since then, real PCE has grown by just over 2% annually, roughly half the average rate experienced in the past eight economic recoveries over the same period.

The weak pace of consumption growth has several explanations, including damaged balance sheets, stagnant wage growth, and tight credit conditions. Adding to the difficulty, the rise and fall of income and wealth has not been evenly distributed. Losses during and after the crisis fell more heavily on lower income households, while gains since have disproportionately gone to the top of the income distribution. The rebound in wealth has been similarly unequal, occurring primarily in financial assets, which tend to be disproportionately held by the wealthy.

The good news is that the prospects for consumer spending

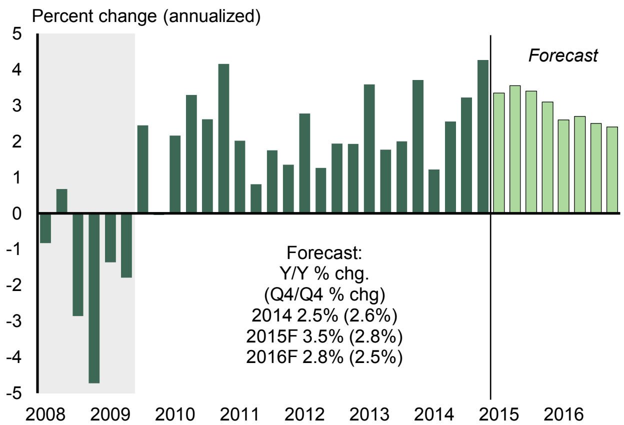
CHART 1: REAL CONSUMER SPENDING* FOLLOWING RECESSIONS



*Personal consumption expenditures.
Source: Bureau of Economic Analysis, TD Economics

James Marple, Senior Economist, 416-982-2557

CHART 2: REAL CONSUMER SPENDING*



*Personal consumption expenditures.
Source: Bureau of Economic Analysis. Forecast by TD Economics

over the next year are considerably brighter. Consumption growth will benefit from a combination of faster wage gains, lower gasoline prices, and the continued housing recovery. This will support spending not only by increasing aggregate income and wealth, but also by benefiting lower-income households that are most likely to spend their gains. All told, we expect PCE growth to accelerate to 3.5% in 2015 – the best growth in a decade. With external headwinds continuing to blow, the improvement in consumer spending will be the main force behind the acceleration in overall economic growth.

From boom to bust…

The fall in consumer spending during the recession cannot be separated from the boom that preceded it. The period prior to the recession was marked by a decline in household saving and a rise in both household debt and assets. The personal saving rate hit an historic low point of 2.5% in 2005. One year later, the debt-to-income ratio hit an all-time high.

The decline in personal saving was even greater among lower income households. According to data from Mark Zandi of Moody's Analytics, the saving rate fell into negative territory from 2005 through 2007 for all but the top 5% of income earners.[1] Just as important, the increase in leverage during the housing boom was disproportionately concentrated among households at lower levels of wealth.

Economic research has found a strong relationship between increasing household leverage during the housing boom and subsequent declines in consumption during the recession. This is evident not only in the data over time, but also geographically. Counties that had the greatest run ups in household leverage from 2002 to 2006 saw the largest drop in spending from 2007 to 2009.[2]

The decline in consumption during the housing crash and recession reflected the unwinding of the preceding increase in household leverage. When home prices plunged, levered households suffered the greatest losses. In 2008, a period of "deleveraging" began and the personal saving rate turned sharply upward, especially among lower income households.

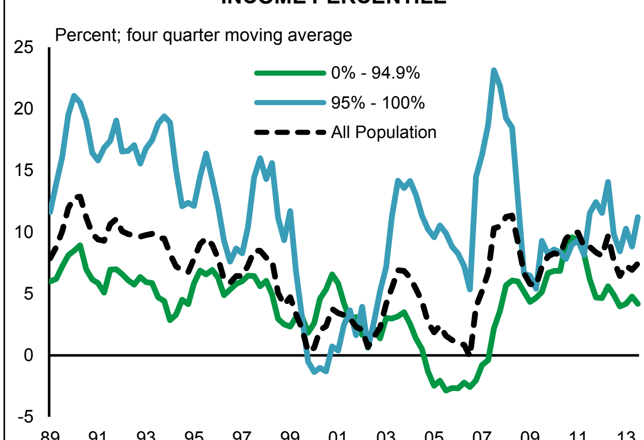
Disaggregating spending and income patterns between households at the top 5% of the income distribution and the remaining 95%, the behavior of consumption (relative to income) was different for high and low income households during this period.[3] Whereas high income households increased spending relative to income – in other words, smoothing consumption, even as their incomes fell during the recession – lower income households cut spending even more than the drop in their incomes.[4]

…to slow recovery

The rise and fall in leverage also helps to explain the poor pace of consumption growth during the economic recovery. Home prices continued to slide through the first three years of the economic recovery. As they did, the number of homeowners that were underwater – owing more on their mortgages than the value of their homes – continued to rise. At the peak in 2012, over 30% of single-family homes had mortgages with negative equity.

Home prices have been rising over the last few years, but remain 13% below their peak level in 2006. As a result, the share of mortgages in negative equity has fallen, but

CHART 3: CONTRIBUTION TO SAVING RATE* BY INCOME PERCENTILE



*Flow of funds concept. Source: Mark Zandi, Economy.com currently sits at a still high 17%. For households who are still under water, the positive impact of rising home prices is muted. A household's ability to extract equity from their home is non-existent and their negative equity position remains a barrier for accessing credit.

Still, households who stayed in their homes have at least seen some improvement in their balance sheets as a result of rising home prices. The same cannot be said for households who defaulted during the housing crisis and moved from the ranks of homeowners to renters. This is not a small number. At the peak, over 4 million mortgages were either in foreclosure or more than three months past due on their payments. The increase in foreclosures explains the magnitude of the decline in the homeownership rate, which fell 5.5 percentage points over the past decade. As a result, there are currently close to 2 million fewer home-owning households than there were during the housing boom.

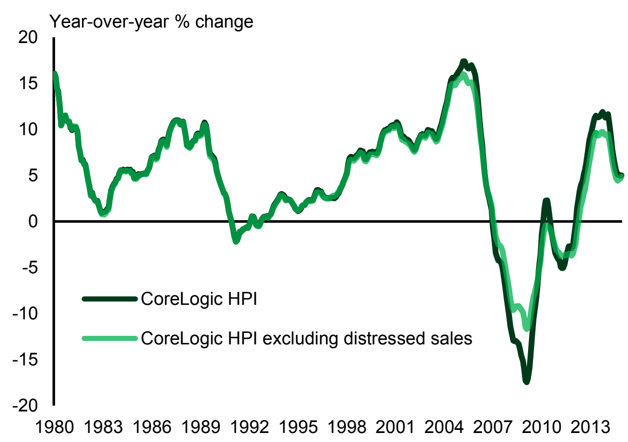
The overall result of the housing crisis and recovery has been a sharp drop in leverage alongside a further concentration in household wealth. The Federal Reserve's Survey of Consumer Finances shows that between 2010 and 2013 average net worth increased only for households at the high end of the income and wealth distribution. It continued to fall for households in the bottom 60%. This is in part because the rebound in wealth was primarily financial wealth. Economic research on the wealth effect suggests that the impact on consumption of an increase in financial wealth is considerably smaller than an increase in housing wealth.

Fortunately, there has been an improvement in these factors over the past two years. Home price growth accelerated in 2013, especially in the most depressed housing markets across the country. The initial rebound in home prices reflected strong investor demand, which then faded as prices moved up. The rise in interest rates in mid-2013 acted to slow the housing market and weaken price growth through the last year.

Nonetheless, home prices have continued to rise at a modest pace. With interest rates reversing course and falling over the past year, demand for housing, especially among first-time homebuyers, will continue to improve. We expect home prices to rise by 3.5% over the next year and continue to advance in 2016 and 2017, leading to further improvement in household balance sheets.

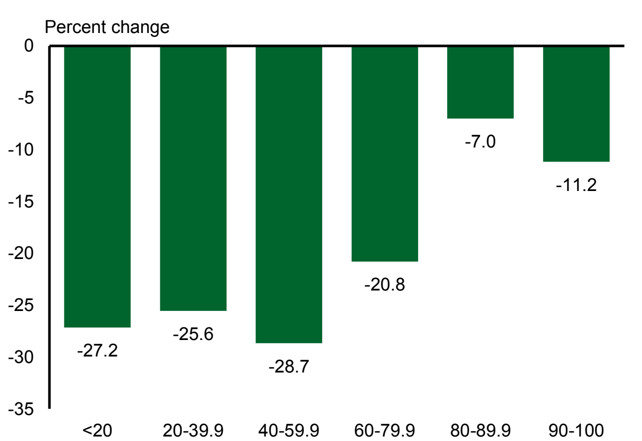
Just as important, it has now been more than five years since the peak in foreclosures. The current level of new foreclosures is in line with its pre-crisis historical average

CHART 5: HOME PRICES



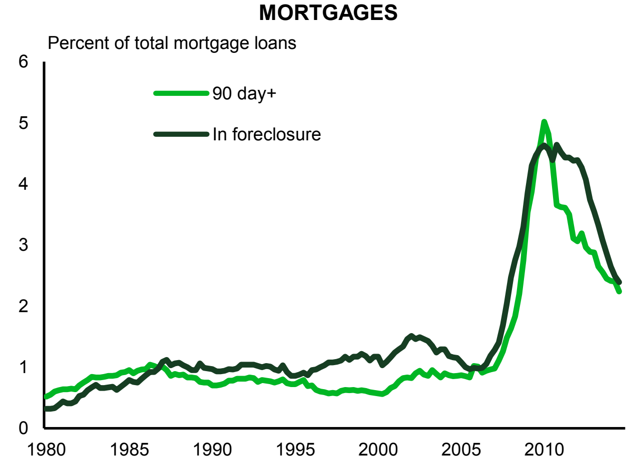
Source: CoreLogic

CHART 4: CHANGE IN REAL MEAN FAMILY NET WORTH BY INCOME QUINTILE, 2007-2013



Source: Federal Reserve Survey of Consumer Finances

CHART 6: SERIOUSLY DELINQUENT MORTGAGES



Source: Mortgage Bankers Assocation/Economy.com and the inventory of foreclosures is now half its peak level. The further this crisis moves into the rear-view mirror the smaller its impact on credit availability and consumer spending. It typically takes between three and seven years to re-enter the housing market following a foreclosure event. Access to other types of credit is quicker to rebound. Credit availability already appears to be improving, as evidenced by the Federal Reserve's Senior Loan Officer Survey as well as consumer credit originations (excluding mortgages), which have rebounded, even for the lowest credit scores. This should continue to improve going forward, especially as income and job growth gains speed.

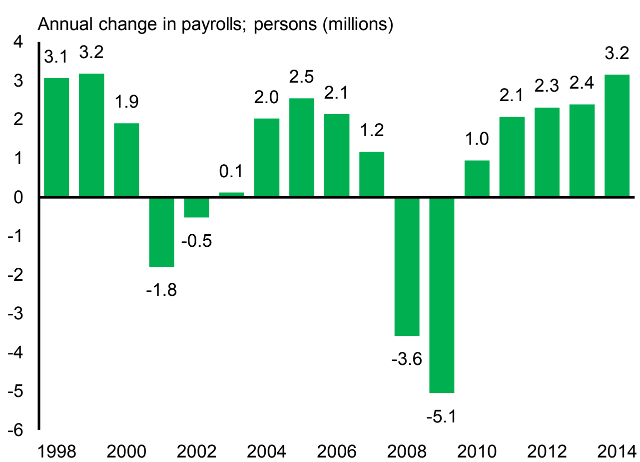
Brighter prospects ahead supported by rising income

The outlook for consumer spending is brighter over the next few years. The two primary reasons of optimism for consumer spending are a stronger job market and the reduction in debt service costs, due to past deleveraging and falling interest rates.

First, in terms of the labor market, we have seen a broad improvement in the level of job creation over the last year. The American economy generated over 3 million jobs in 2014 – the most since 1999. As a result of the increase in employment, aggregate wages rose 5.5% last year, the fastest pace in nearly eight years. Adjusting for inflation, real aggregate wages were up 4.2%, the fastest rate since 2006.

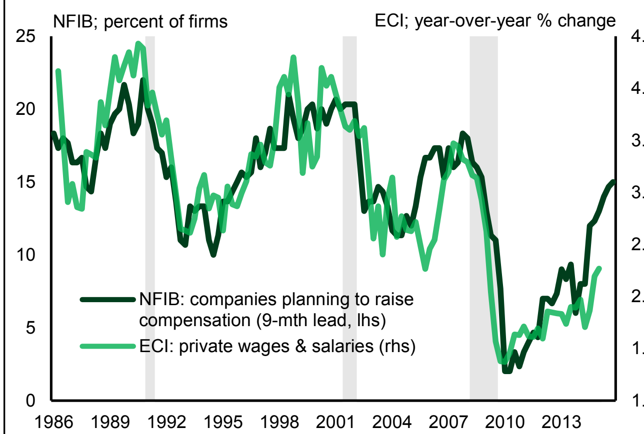
While aggregate wage growth has improved due to robust job gains, average hourly wage growth per worker has been slow, growing at only 2.0% over the past several years, which is close to zero after removing inflation. Fortunately, a number of indicators point to faster wage growth in the months ahead. In December, the number of job openings reached the highest level since 2001. In the same month, the National Federation of Independent Business (NFIB) small business optimism survey, showed the largest share of small businesses planning to raise worker compensation since 2007. We expect average hourly wage growth to rise from its current pace of around 2.0% to 3.0% by the end of 2015. This will lead to even greater aggregate income growth.

CHART 7: EMPLOYMENT GROWTH



Source: Bureau of Labor Statistics

CHART 8: EMPLOYMENT COST INDEX & WAGE EXPECTATIONS OF SMALL BUSINESSES



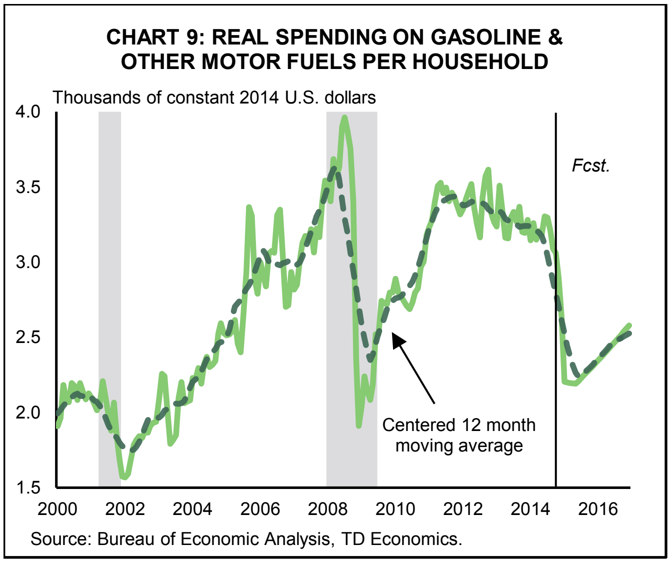
Source: Bureau of Labor Statistics, National Federation of Independent Business

Importantly, the improvement in wages is likely to lead to more evenly distributed income gains. Because the majority of Americans earn their income from wages, an acceleration in wage growth is likely to lead to greater median income growth, which is still 8.7% below its pre-recession peak. The rise in income growth should in turn fuel further gains in the housing market, leading to a virtuous cycle for household balance sheets.

Secondly, even without a significant leveraging up of U.S. households, the continued decline in interest rates has reduced the amount of payments going to debt. The share of household income devoted to debt service fell to the lowest on record (data going back to 1980). With interest rates trending downward into early 2015, the household debt-service ratio will continue to plumb new lows, freeing up income to be spent elsewhere.

Fall in gasoline prices will further support real income gains

The other source of optimism for consumer spending is the increase in purchasing power due to lower crude oil and gasoline prices. Since June, gasoline prices have plunged 55%, which, if sustained, will save the average household



over $900 over the next twelve months, representing savings of 1% of disposable personal income. The total savings are even greater than this, since many households heat their homes with fuel tied to the price of crude oil.

All told, the fall in energy prices is comparable to a tax cut or a stimulus check. It will bring overall consumer price inflation into negative territory, implying that real wage gains will be even stronger than nominal wage gains. Since households at lower income levels spend a higher share of their budgets on gasoline, the savings are progressive – benefitting lower income households more than higher ones. As noted above, given that the saving rate increases with income, this suggests a high propensity to consume, and should be expected to provide a significant lift to real consumer spending over the next year.

Bottom line

Consumer spending has struggled to gain traction over the last several years. The weakness explains why overall economic growth has been considerably slower than its historical precedent, especially following a deep economic downturn. The causes of the lackluster pace of spending are not hard to find – a huge income and wealth shock that led to a swift reversal in household leverage. This reversal concentrated losses on borrowers and magnified the consumer spending response during and after the recession.

The good news is that on several fronts, the situation appears to be improving. For households who have continued to own their homes, the drag from negative equity is diminishing due to rising home prices. For all households, the improvement in job and income growth, alongside falling gasoline prices, should translate into the fastest real income gains in over a decade.

All told, after several years of sluggish growth, consumer spending is likely to accelerate firmly over the next year. Unlike the previous rise in spending that took place during the housing boom, it will not require an increase in leverage or drawing down of savings. Instead it will be supported by rising wages and lower energy prices.

James Marple
Senior Economist
416-982-2557

Endnotes

1 Saving rate measured on a flow of funds basis.

2 Mian, Atif & Amir Sufi. "Household Leverage and the Recession of 2007-2009." IMF Economic Review. Vol. 58, No. 1. 2010, http://www.palgrave-journals.com/imfer/journal/v58/n1/pdf/imfer20102a.pdf

3 Cynamon, Barry Z & Steven M. Fazzari. "Inequality, the Great Recession, and Slow Recovery." Working paper. October 24, 2014. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2205524

3 Ibid.