February 21, 2012

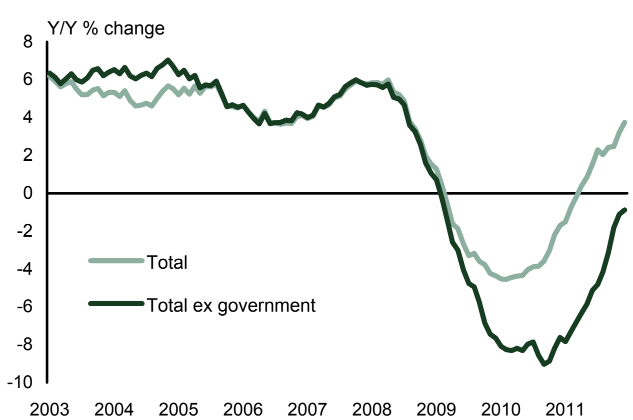
SCRATCHING THE SURFACE ON U.S. CONSUMER CREDIT OFFERS REASON TO BE CAUTIOUS

Amidst the recent string of positive economic data releases, there's one nagging element – the mixed underpinnings for consumer spending. Earlier in the month, a rebound in consumer credit was celebrated by financial markets. The December data came in more than double market expectations. It was a good-news report any way you slice it, but there is one important detail to keep in mind. Roughly 17% of consumer credit stems from the government, largely in the form of student loans. Since these are targeted to education, this component is not an ideal guide of underlying consumer spending potential. As captured in the graph below, stripping out government loans reveals a less robust improvement in consumer credit, though the rebound is certainly still evident.

Pealing back the data another layer, the largest provider of consumer credit is commercial banks. They account for just over half of all private sector credit disbursement. Unfortunately, the weekly tracking of this credit is showing a reversal of fortunes since the economy-wide monthly data was released two weeks ago. Not only did commercial bank lending activity come to an abrupt halt in January, but it practically fell off a cliff. However, it is unclear how much of this drop-off will get picked up in the economy-wide January monthly statistics due to the timing of the credit shift. For the first week of January, consumer credit remained strong. The weakness became entrenched immediately thereafter, but this trend will likely be masked in the monthly aggregate figure. If so, the weakness will be apparent in the February data.

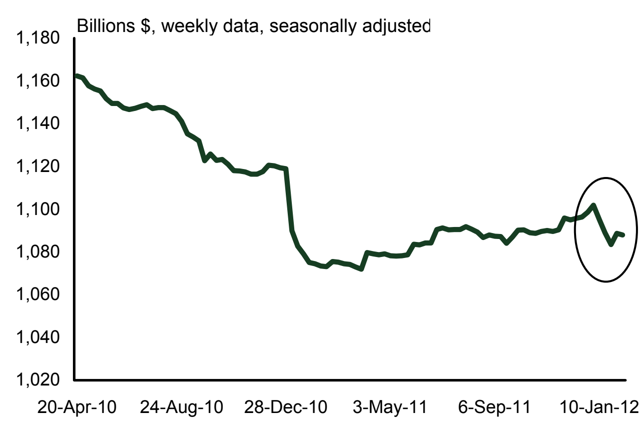
So, what do the different layers of credit mean? Simply put, for those expecting a strong rebound in consumer spending in the first half of the year based on December's rebound in credit demand and the recent new job hiring activity, think again. In fact, the weekly credit data offers some insight into why January's retail sales data did not carry the buoyancy many had

TOTAL CONSUMER CREDIT



Source: Federal Reserve

COMMERCIAL BANK CONSUMER CREDIT



Source: Federal Reserve

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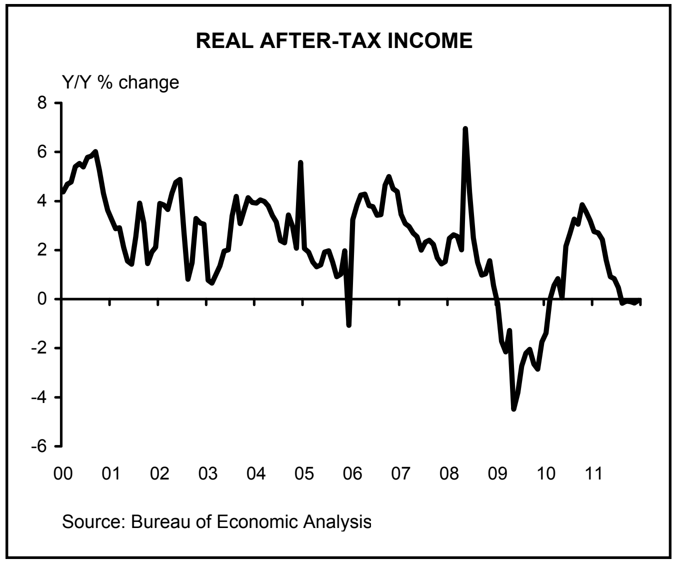
been expecting given the strong gains that occurred on both the credit and job fronts. Real consumer spending for the first quarter is currently tracking less than 2%. This also raises the prospect that the consumer deleveraging process has not run its full course.

To be clear, the rebound that is unfolding in the labor market is undeniably positive for the consumer outlook. However, floundering real after-tax incomes alongside fluttering strength in credit demand means that consumer spending is firing only on one cylinder. For the true potential of pent-up demand unleased in the economy, it will likely take the data to fire on all cylinders.

If upturn in job market momentum witnessed in recent weeks is sustained and the US economy consistently posts monthly job gains of roughly 250,000 this year, a more robust expansion in income and credit will surely follow. This would position the economy for a stronger rebound in the second half of this year, with real spending growth potentially in the 2.5-3% range. This upturn would be welcomed relief. There is little doubt that 2013 will mark the dawn of fiscal tightening in America. While much uncertainty persists over the exact magnitude, the new government will have to contend with the expiration of temporary payroll tax cuts, the termination of unemployment insurance benefit extensions, sequestration from the Budget Control Act, and the expiration of the Bush income tax cuts. In other words, the fiscal drag has the potential to be enormous, slicing off anywhere from 1.5-2 percentage points from real GDP. If the US economy is going to push against this massive headwind, it will need the private sector to be fully engaged in the recovery cycle.



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