Consumer spending on life support?

By: Richard Maparura, Senior Portfolio Manager, Asset Management, Butterfield

Even though the US economy has already recorded two consecutive quarters of negative Gross Domestic Product (GDP) in the first half of 2022, confirmation of a recession is still pending.

According to renowned economist Julius Shiskin, an economy is in a recession if two consecutive quarters of declining GDP occur. Shiskin argued that a healthy economy expands over time, so two quarters in a row of contracting output suggests that there are some serious underlying problems.

For the National Bureau of Economic Research (NBER), the authority that is generally recognised as confirming a recession in the US, a significant decline in economic activity across the economy that lasts for more than a few months is a major part of what constitutes a recession.

This dual reference to GDP makes it a critical factor.

Consumer spending contributes close to 70% of total US production, a number which is built into the GDP calculation and makes consumer spending a significant driver of US economic growth. If consumer surveys show a sustained drop in confidence, it could be a sign of impending trouble for the economy overall. When consumer confidence declines, consumers feel less certain about spending money. Consequently, if they follow through on their fears by spending less, the economy will slow down and possibly be forced into a recession. Evidently, it is imperative to take a closer look at consumer behavior in an inflationary environment.

Inflationary environment

Inflation is not a bad thing per se, but excessive inflation is dangerous territory. Central banks are fighting current excessive inflation by raising interest rates. Bruno Le Maire, France's Finance Minister, recently said that inflation is the main focus for the nations of Europe in the short term. The increase in headline inflation in the Eurozone from 8.9% in July to 9.1% in August pushed it to a new record high. Food, alcohol and tobacco inflation rose in the double digits for the first time. Even though there is some evidence from business surveys that supply chain problems have eased, core goods and services inflation has continued to accelerate. Germany, the Eurozone's largest economy, saw inflation reach its highest level in almost half a century at 8.8% year-on-year in August. The European Central Bank recently delivered its biggest single-day rate hike on record and warned that inflation in the single-currency area is likely to remain elevated for an extended period of time and will lead to a substantial slowdown in economic growth.

US inflation has shown some signs of peaking from a 40-year high of 9.1% year-on-year in June this year but remains extremely high on a historical basis. Americans are having to battle with higher price increases than they have in decades. For example, most grocery prices have jumped by the largest year-over-year since 1979. Out-of-control inflation was an ongoing problem in the US in the 1970s. To break the cycle, the Federal Reserve rapidly raised interest rates, which caused a recession. During the recession, the US economy struggled, jobs were lost, companies sold less and the country's overall economic output declined. With more people unable to pay their bills, lenders tightened standards for mortgages, car loans and other types of financing which negatively impacted the ability for consumers to spend.

UK inflation recently entered into two-digit figures, continuing to notch to new 40-year highs based on latest publications. Food and energy prices continue to spiral, intensifying the country's squeeze on households spending. Supermarkets have had little choice but to pass on price increases from suppliers, who themselves are contending with unprecedented inflation in raw material and ingredient input costs. The Bank of England (BoE) has already implemented six consecutive hikes to interest rates including one of its largest single increase since 1995 as it looks to fight inflation.

The BoE expects inflation to reach north of 13% in October while projecting that the economy will enter its longest recession since the global financial crisis in the immediate future. The newly elected UK Prime Minister Liz Truss recently announced a broad stimulus package to help Brits with soaring energy bills and attract investment into the energy sector. The stimulus includes energy price guarantees (caps) that will give people certainty on energy bills and the Prime Minister expects that this move will curb inflation by up to 5%.

Consumer behavior

Consumer confidence has taken a hit this year amid the highest inflation in a generation which will likely force consumers to cut back on discretionary purchases and big-ticket items. This cut back on spending will contribute to a slowdown in economic activity. The grimmer outlook is being driven by increasing concerns about inflation, in particular rising gas, rent and food prices. As central banks raise interest rates to curb price pressures, higher borrowing costs risk denting consumer purchasing power. Consumers can adjust to inflation in various ways, from cutting back on spending across goods and services to consolidating debt. When individuals or businesses take on too much debt, the cost of servicing the debt can grow to the point where they can't pay their bills. Growing debt defaults and bankruptcies can capsize the economy.

In the US, the recent increase in the unemployment rate from 3.5% to 3.7% in August was the highest since February and above market expectations of a muted increase in unemployment. The increase in unemployment was due to an increase in the labour force, a sign that more Americans are now actively looking and willing to come back to work. As a result of the increase in the labour force, the labour force participation rate also increased to a five-month high, taking it to above pre-pandemic levels. Apprehension about the direction of the economy has increasingly influenced consumer confidence and Americans are beginning to look for more opportunities to supplement their incomes to sustain spending.

During the pandemic, Americans piled up as much as $2.5 trillion in extra savings. However, those savings are dwindling as consumers start to use their cash reserves to deal with the worst inflation in over 40 years. According to a recent Forbes Advisor survey, Americans said that they are raiding their savings as prices of goods and services spike. Americans who had little or no savings from the pandemic have turned to debt to supplement spending, with revolving credit balances increasing at an alarming pace in 2022.

Households have been withdrawing home equity at the fastest pace since 2008 and loan demand continues to increase, which could raise concerns about the sustainability of household spending. The main financial risk to the macroeconomic outlook is that households could run out of borrowing capacity and be forced to cut back on spending. Debt growth is significantly outpacing spending growth in 2022 as consumers are now needing more money to afford the same amount of goods due to price rises. Spending would likely have been significantly lower if households couldn't borrow and will likely decline once debt limits are reached.

Eurozone consumer pessimism remains elevated, with confidence continuing to tumble. Rising prices have outpaced the Ukrainian war as the primary worry and consumers are also seemingly less worried about COVID-19. Across the continent, consumers hold a negative view of the state of the economy and any prospects for a recovery. Recent surveys reveal that most consumers have no immediate plans to spend on luxuries. Household budgets continue to evolve, with basic needs such as food, transport, and energy accounting for the highest share. Consumer spending in the Eurozone decreased by over 65 bps in the first quarter of 2022. A strong dollar has also not been helpful as the Euro continues to weaken to levels not seen in decades. The importing purchasing power of consumers in the Eurozone has been seriously affected.

Consumer spending was poised to drive growth in 2022, but diminishing consumer confidence has made this expectation highly unlikely. Headwinds are mounting for the rest of the year, contrary to expectations of a rebound as the economy emerges from COVID-19. In particular, soaring energy prices are squeezing real incomes and eroding the purchasing power of savings. The eurozone is facing its biggest energy crisis in decades with natural gas supplies from Russia becoming volatile and unpredictable. Supplies from Russia are probably coming to a complete halt as the country claims that the punitive economic sanctions imposed on it by the West are responsible for the indefinite halt to gas supplies through the Nord Stream 1, Europe's main pipeline.

UK consumers have been so focused on inflation, with seven in 10 people naming inflation as their biggest worry, according to a recent survey. Consumer credit card debt has been surging at its fastest pace since 2005, also sounding the alarm about the health of the economy as households are already taking on more debt to cover the basic cost of living. More than likely, more indicators will be flashing red, along with house prices as the effect of inflation and higher borrowing costs starts to feed through the economy. With the expectation of inflation rising even more, spending will continue to suffer as negative real wages continue to widen the gap between earnings and costs of goods and services.

The extreme firm credit growth and increased demand for consumer loans is potentially concerning because it is happening at the same time that households are feeling increased financial pressure from higher inflation. This pressure has been most acute for lower-income households that have been hit the hardest by high inflation and are finding it increasingly difficult to pay normal expenses. Given the relatively small savings buffer for most lower-income households, the current pace of household debt growth may be unsustainable if such households are relying on credit to finance spending. It is probably no surprise that savings are shrinking as well.

Conclusion

Overall consumers' view of the current economy is becoming bleak. Spending on discretionary items has been on the decline, and savings are depleting. Consumers are buying smaller quantities or delaying purchases even on necessities. Most consumers are now supplementing income with debt, an avenue that may not be sustainable given the higher interest rate environment. Should pressure on consumer spending persist, the NBER definition of what constitutes a recession may be triggered. The key swing factor to watch is if inflation across the G-7 countries starts to peak. The direction of commodity prices, particularly in the Eurozone given the potential energy shock has a significant impact on inflation.

However, should a recession become a reality, it is worth remembering that recessions do not last forever. Even the Great Depression eventually ended and, when it did, it was followed by arguably the strongest period of economic growth in US history.

Sources
Goldman Sachs – Economics Research & Bloomberg Economics