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Checking In On U.S. Consumers – Are They Checking Out?

It has become a monthly routine. First comes the monthly report on retail sales with a lousy headline number. Next comes a flood of reporting and "analysis," the general theme of which is "what's wrong with U.S. consumers?" Then comes our reaction, which basically consists of our screaming at people on financial talk TV while hurling objects from our desk at the television (which, for the record, our co-workers no longer even take notice of, save for the occasional "what is it today?" inquiry). To close out the routine, we gather our composure, within reasonable limits of course, and answer the "what's wrong with U.S. consumers?" question with our standard two-word answer: not much.

Okay, that may be an exaggeration, but not much of one. For whatever reason, there seem to be a considerable number of those who think the monthly retail sales report is the best measure of the pulse of the U.S. consumer. The reality, of course, is neither as simple nor as dire as the string of soft headline prints on the monthly retail sales reports implies. So, as we do from time to time, we'll check in on the state of the U.S. consumer in this month's *Outlook*. On the whole, we find little to complain about, unless of course one finds something wrong with building up savings or paring down debt which, oddly enough, seems to be the case with some observers.

As always, we find the Federal Reserve's quarterly "Z1" statistical release *Financial Accounts of the United States* (or, if you prefer, the *Flow of Funds Accounts*) to offer the best and most thorough look at the financial condition of the household sector. The drawback is the Z1 release comes with a bit of a lag, so that at present the latest data run through Q4 2015 (it will not be until late next month that the Q1 2016 update is released). Of course, the regular monthly flow of data on consumer spending and personal income helps bridge the gap, but these data tell an incomplete story on the state of U.S. consumers.

This is especially true of the monthly retail sales report, which actually tells us very little about growth in real consumer spending as measured in the GDP data. For openers, the retail sales data are reported in nominal terms, or, they are not adjusted for price changes, which is not a trivial point. To a large extent, the run of "soft" headline prints on the monthly retail sales reports are a function of what have been falling prices for a wide swath of consumer goods, even if the only one some observers seem to have observed is gasoline. Second, the retail sales data do not account for personal and household services, which account for roughly two-thirds of all consumer spending.

As to those lower gasoline prices, they seem to be part of the problem, in the sense that they seem to have led many analysts

to promise more than consumers have delivered in terms of the impact on spending. But, as we discussed in the March 2015 edition of our *Outlook*, the problem from the start was those expectations, far more so than it was the response by consumers. As we discussed, it was simply not reasonable to translate a dollar of saving from lower gasoline prices into a dollar of spending on other goods/services, let alone to then layer on "multiplier" effects to arrive at an economy-wide impact.

The reality is consumers had three options for each dollar freed up from lower gasoline prices – spend it, save it, or use it to pare down debt, if not some combination of the three. There is evidence in the data that consumers have engaged in all three of these activities. Again, these are the same options fostered by falling prices for consumer goods other than gasoline, though this point is often missed.

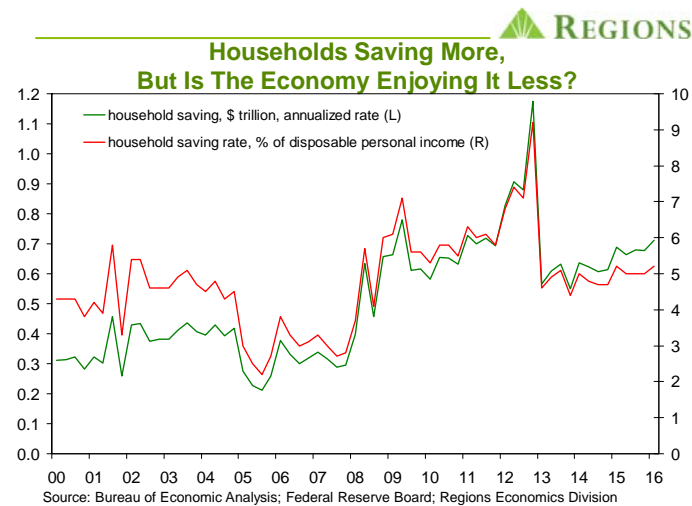
What we find oddly disturbing, however, is that we actually find ourselves noting the other two options, saving and paring down debt, are not actually bad things. That is no exaggeration, and we've actually seen more than one piece on how consumers are "killing" economic growth by building up their savings. Sure, if consumers spent every dime they earned, or even if they came much closer to doing so than is actually the case, we'd have seen a faster trend rate of GDP growth over the current expansion than has actually been the case. And, if consumers were to top off that lower level of saving with layers and layers of debt, they could spend even more, and GDP growth would be even faster.

Okay, sure, that's just crazy talk. There's no way consumers would even behave in that manner, so we'd never actually see such a scenario play out. Wait, what, you mean we have seen a scenario like this play out before? Surely it went smoothly and ended well, right? Wait, what, you mean it didn't? We actually do know the answer to that, but sometimes we wonder if others have forgotten it. Yes, on average, real consumer spending grew at a much faster rate in the years leading up to the 2007-09 recession than it has over the present expansion. But, that faster growth was underpinned by a significant, and unsustainable, expansion in the level of household debt, while at the same time the saving rate fell to lows not ever seen in the life of the data, which go back to the 1940s.

In contrast, the present expansion has been characterized by household deleveraging and rising savings. So, while consumer spending has been growing at a slower trend rate, that growth has been built on a more honest, not to mention sustainable, foundation than was the case during the past expansion. We'll take that any day. As for consumer spending, well, as we often find ourselves pointing out, in light of all the "what's wrong with U.S. consumers?" discussion, keep in mind that 2015 saw the fastest growth in inflation adjusted consumer spending since 2005. But, as we discussed the details of consumer spending

during the present expansion in the February 2016 edition of our *Outlook*, we'll leave it at that and in what follows look more closely at trends in household saving and household debt.

As for household saving, we find it ironic that during the years leading up to the 2007-09 recession consumers were routinely chided for spending as though there was no tomorrow. But, now that consumers are saving as though there is a tomorrow, well, they're either being chided by some for doing so or characterized by others as downtrodden or afraid, if not both. Which is all the more curious when one actually looks at the behavior of the personal saving rate over time.

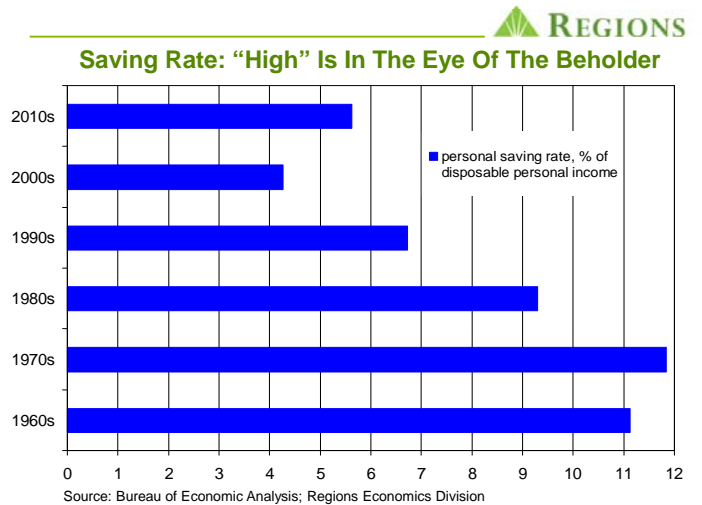


The above chart shows the level of household savings as well as the saving rate as a percentage of disposable personal income (both are annualized rates) As we look at the chart, we can't help but ask what's all the fuss about? When you look at the chart, does it make you wonder what's wrong with consumers? We'd venture the answer to that question is "no," unless of course you are in the camp that thinks the saving rate in the years leading up to the 2007-09 recession should be seen as the norm rather than an outlier in 70 years of data.

There is one element of the chart that may look odd – the spike in the saving rate over the latter half of 2012 and subsequent plunge in early 2013. This is nothing more than a reflection of the tax increases that took effect on January 1, 2013, which led to some forms of personal income being pulled forward into 2012. As a result, the saving rate jumped to 9.2 percent in Q4 2012. Also notable is the behavior of the saving rate during and in the aftermath of the 2007-09 recession, which can largely be attributed to the "precautionary motive" for saving kicking into high gear in a time of extreme economic and financial distress. Though perhaps not vanishing entirely as a motivation for saving, we'd argue the precautionary motive has become less of a driver of household saving decisions over the past few years.

To help put the current saving rate in more perspective, the following chart shows the average saving rate by decade. Again, whether the saving rate is "too high" or "too low" is in the eye of the beholder but, given that no one, at least that we know of, expects the saving rate to return to the heights seen prior to the mid-1980s or to the lows seen prior to the 2007-09 recession,

one could plausibly argue the saving rate is pretty much where it ought to be. Indeed, we would, and do, argue the saving rate is still on the low side and will ultimately settle closer to six percent than five percent.

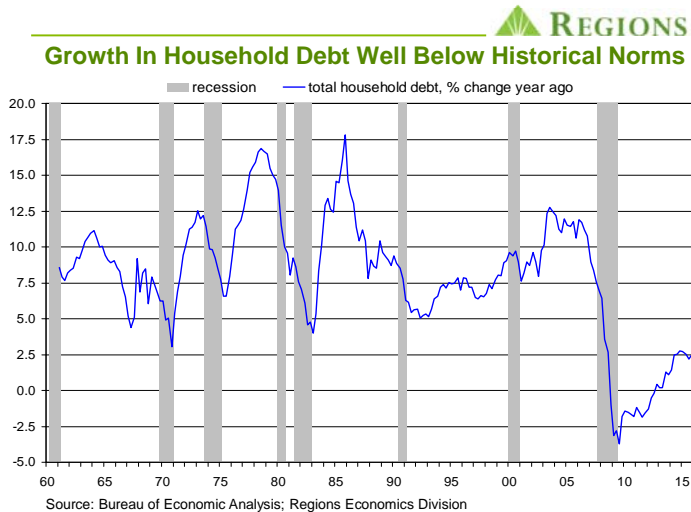


The 1980s was a transitional decade for the behavior of the saving rate. In Q4 1984 the rate stood at 10.7 percent, which was the average over the 1980-84 period, but then embarked on a steady and sustained decline, "culminating" in the all-time low of 2.2 percent in Q3 2005. The longer-term behavior of the saving rate is something we discussed in great detail back in the November 2012 edition of our *Outlook*. While we won't revisit that discussion in detail here we will note empirical work, ours and others', offers considerable evidence to suggest rising household net worth, much of it in the form of housing equity, and greater access to credit – especially the enhanced ability to extract housing equity – basically gave consumers the incentive to dispense with traditional saving. Not entirely, of course, but over the span of many years the level of household saving barely budged even as household income was steadily rising – hence the falling saving rate.

Clearly, there were changes in behavior, and in risk tolerance, on the part of both lenders and households, that contributed to the declining saving rate. This came to a head in the years leading up to the 2007-09 recession. Enabled by cheap and readily available credit, many households extracted significant portions of their housing equity. Others even borrowed against equity they didn't actually have but were sure, because house prices only go up, right, they someday would have. The bottom line, however, is that the extraction of housing equity acted as a considerable boost to consumer spending in the years leading up to the 2007-09 recession. Our empirical work back in the day (in the interest of full disclosure, we've been playing the role of nags on the topic of household debt since the early 2000s) showed that, at its peak, housing equity extraction was equivalent to around ten percent of disposable household income.

That was clearly not a sustainable path for consumers, or the economy, to be on. Yet, there are those who look at trend growth in consumer spending in the current cycle and find it lacking because it doesn't stack up with that of the prior cycle,

somehow managing to miss the extent to which that earlier growth was being fueled by the accumulation of debt. And, if all of this seems like ancient history, our contention is the level of debt remains a constraint on the growth of consumer spending, even if that is to some extent a constraint consumers are imposing on themselves.

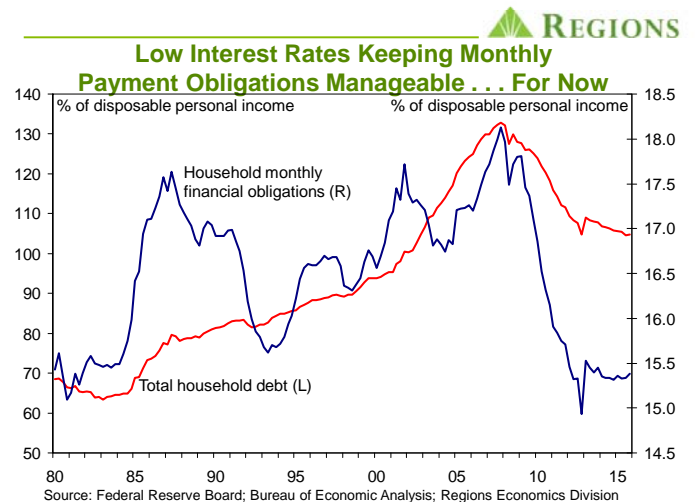


The chart above shows growth in total household debt over time, and helps illustrate our earlier point about debt not being a primary fuel for growth in household spending. To be sure, the broad aggregate masks the interactions amongst the various components of total debt. For instance, mortgage debt is easily the largest individual component of household debt and has barely grown over the past two years after having declined steadily (on an over-the-year basis) from 2009 through 2013, while home equity debt is still contracting (absolutely and year-over-year). In contrast, auto debt and student loan debt have grown steadily for some time now, though the former is now growing more rapidly than the latter. The two combine to account for roughly 19 percent of total housing debt per data from the Federal Reserve Bank of New York and Equifax.

Credit card debt is growing at a moderate rate but accounting for growth in the number of open accounts suggests growth in outstanding balances remains modest, i.e., consumers are not utilizing credit card debt to facilitate current consumption to the degree seen in the past. To be honest, we had thought we would have seen more of this by this point in time. This has not been the case, but whether this reflects a lack of confidence on the part of consumers or a more disciplined approach to credit, on the part of consumers and lenders, remains an open question. Keep in mind the distinction between transactions and balances – many consumers use reward cards for the bulk of their day-to-day transactions, but this does not mean they are carrying balances from month-to-month; our discussion here revolves around balances as opposed to transactions (nerdy banker pun intended).

The extent to which households have the willingness and the capacity to take on new debt is a topic of considerable debate, and the side of this argument on which one comes down shapes their view on the outlook for growth of consumer spending. The following chart is a succinct way to present the two sides of this

debate, as it shows the ratio of household debt to disposable personal income as well as the Federal Reserve's measure of household monthly financial obligations (a broader counterpart to the more commonly cited debt service burden metric).



The question is which of these metrics represents the manner in which households, and to some extent lenders, view debt and, by extension, the capacity to take on additional debt. There are some who argue that, thanks to low interest rates, households are having little difficulty meeting current monthly payments and have the capacity to take on even more debt. In other words, the binding constraint is reflected in the financial obligations ratio. Our view is that the level of debt is the more binding constraint, in that households are well aware of their overall level of debt, and the decision as to whether to take on more debt comes down to a far greater degree on the willingness to add to that debt than it does to the ability to make the payments which, of course, will in many cases diminish as interest rates rise.

In short, while some analysts argue household deleveraging has run its course, we take the other side – we simply do not believe a debt-to-income ratio of over 104 percent (as of Q4 2015) is sustainable and that the ratio has further to go on the down side. This doesn't mean there will be no growth in household debt, it simply means trend debt growth will remain below trend income growth, at least in the near term. We argue that consumers are taking advantage of lower interest rates to help them further pare down, not add to, existing debt loads. It follows, then, that we see a lower trend rate of growth of consumer spending than do those analysts who argue consumers are ready, willing, and able to take on more debt to facilitate current consumption.

What Does It All Mean?

Time will tell how this turns out. But, clearly, this is not merely some academic debate, as the rate of growth of consumer spending is a main determinant of the rate of GDP growth. As such, the paths of the saving rate and the debt-to-income ratio have clear implications for broader economic growth.

We see a number of factors that help explain the recent behavior of the saving rate and help shape our expectations of how the saving rate will behave over coming quarters. We noted above

the precautionary motive for saving, and it is possible that the severity of the 2007-09 recession has fostered a structural change so that this component for saving is stronger than it was prior to the recession. And, perhaps paradoxically, a prolonged period of low interest rates may have led to a greater level of saving than would have been the case in a more normal interest rate environment. In other words, with any given level of saving earning a lower return, thanks to the magic of extraordinarily low interest rates, those savers targeting a level of assets over a given time period must compensate for this lower return by increasing the level of saving.

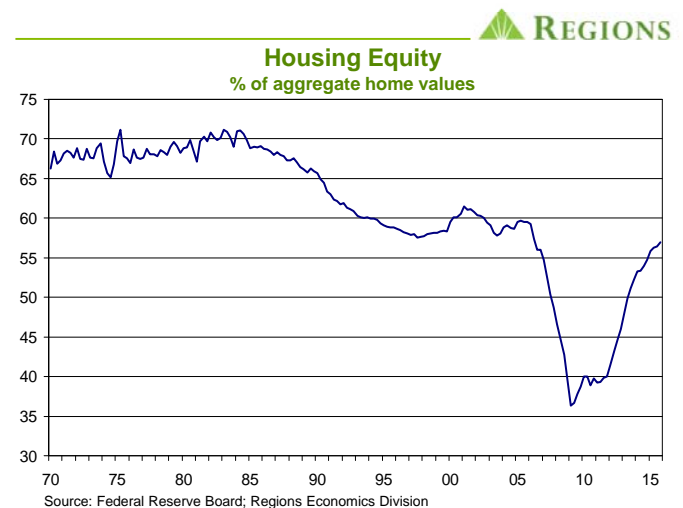
Think about those nearing retirement making such decisions, many of whom may still be carrying scars, emotional and financial, from the 2007-09 recession. To be sure, equity prices have regained the ground lost, and then some, since then, but at the same time heightened risk aversion may have altered the saving vs. investment math for many households. This would argue that the saving rate will remain around its current value, and maybe rise further, particularly to the extent interest rates stay lower for longer.

And, since it seems you can't have a discussion about the saving rate without bringing up housing (okay, maybe you can, but we can't), some argue that in a more stringent mortgage lending environment, prospective home buyers, particularly first-time buyers, are saving more in order to meet down payment requirements. While this may indeed be the case, we're not convinced it would be a primary mover of the overall level of household saving in the economy. All is not lost, however, in finding a role for housing in the path of the saving rate.

More specifically, we'd argue that the manner in which a home is viewed is impacting the path of the saving rate. In the years leading up to the 2007-09 recession many viewed their home as an investment, one which would only appreciate in value. This, as noted above, led many to put less emphasis on traditional saving, let alone those who came to view their home as a piggy bank to be dipped into to finance current consumption. After a blunt and often painful lesson from reality, however, there are likely very few households still clinging to that notion.

How would that impact the saving rate? In short, to the extent that the "a house is an investment" argument has been discredited, it would follow that households, at least those owning their homes, would put more emphasis on traditional saving, which would have helped push the saving rate higher. This becomes, at least in our view, a stronger argument when one looks at the level of overall housing equity and how that equity is distributed across owner occupied households.

The following chart shows aggregate housing equity as a percentage of aggregate home values, per the *Flow of Funds* data (aggregate home values are based on the CoreLogic House Price Index). As seen in the chart, while having risen steadily over the past few years, housing equity as a percentage of aggregate housing value is still shy of the pre-recession peak. To be sure, there is nothing magical about that peak – for many, "evil" may be a more accurate description given that peak was an artificial construct stemming from cheap and readily available mortgage credit.



In any event, keep in mind that roughly one-third of owner occupied households carry no mortgage debt (the annual number as reported in sources such as the *American Community Survey* varies, but one-third is a reasonable longer-term average) so, were we to look at the above chart on the basis of only those owner occupied households with mortgage debt, equity as a share of total value would be considerably lower. Indeed, though down considerably from the cyclical peak, the number of owner occupied households underwater on their mortgage, i.e., the level of outstanding mortgage debt is higher than the value of the home, remains above historical norms. The point here is that there is even less ground on which to argue homes are a substitute for traditional savings when breaking down the distribution of housing equity. So, in addition to helping sustain a higher level of saving, this would also help account for the ongoing contraction in home equity debt. Just as this form of debt was utilized by so many prior to the 2007-09 recession to facilitate an unsustainably high level of consumption, its absence from the scene at present is helping contribute to a slower, but more sustainable, trend rate of growth of consumer spending.

To be sure, we have a more conservative view of household behavior, in terms of spending, saving, and debt, than do other analysts. As we noted above, time will tell which view is closer to the mark. But, our view at least helps account for why we are so fatigued by the "what's wrong with U.S. consumers?" narrative. As we see it, consumers are using the opportunity offered by falling goods prices, low interest rates, and healthy growth in disposable income, to facilitate further repairs to household balance sheets. Quite contrary to this being a sign that something is amiss, we see it as perfectly rational behavior. The question, however, is how this behavior will change once prices for consumer goods stop falling and begin to rise and once interest rates begin to rise (admittedly, we have more confidence in the former happening than the latter). If our view that the saving rate will settle at closer to six percent than to five percent is on the mark, it would suggest an even slower trend rate of growth in consumer spending than we have seen thus far in the expansion. Which of course will only serve to amplify the "what's wrong with U.S. consumers?" chorus, not to mention amplifying our voice as we scream at financial talk TV in response.

ECONOMIC OUTLOOK

Q4 '15 (a)	Q1 '16 (p)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
1.4	0.5	2.2	2.1	2.1	2.2	2.2	2.0	Real GDP ¹	2.4	2.4	1.7	2.1
2.4	1.9	2.6	2.3	2.3	2.1	2.1	2.1	Real Personal Consumption ¹	2.7	3.1	2.5	2.2
								Business Fixed Investment:				
-1.3	-4.6	3.0	3.1	3.2	3.1	3.1	2.3	Equipment, Software, & IP ¹	5.6	4.1	0.6	3.0
-5.1	-10.6	-2.1	4.0	4.8	4.4	4.6	4.2	Structures ¹	8.1	-1.5	-3.9	4.0
10.1	14.9	9.8	7.8	6.9	10.5	9.9	7.9	Residential Fixed Investment ¹	1.8	8.9	10.4	8.8
0.1	1.2	0.9	0.9	0.8	0.5	0.7	0.8	Government Expenditures ¹	-0.6	0.7	1.0	0.7
-551.9	-566.6	-569.7	-580.8	-590.0	-595.3	-605.4	-614.1	Net Exports ²	-442.5	-543.4	-576.8	-608.7
1.135	1.133	1.136	1.164	1.201	1.246	1.269	1.296	Housing Starts, millions of units ³	1.001	1.107	1.158	1.286
17.8	17.1	17.3	16.9	16.8	16.5	16.5	16.4	Vehicle Sales, millions of units ³	16.4	17.3	17.0	16.4
5.0	4.9	4.9	4.8	4.8	4.7	4.7	4.7	Unemployment Rate, % ⁴	6.2	5.3	4.9	4.7
2.0	1.9	1.9	1.7	1.6	1.4	1.4	1.3	Non-Farm Employment ⁵	1.9	2.1	1.8	1.3
1.1	1.3	1.2	1.4	1.6	1.8	1.8	1.7	GDP Price Index ⁵	1.6	1.0	1.4	1.7
0.5	1.0	1.0	1.3	1.7	2.2	2.2	2.1	PCE Deflator ⁵	1.4	0.3	1.3	2.1
0.4	1.1	1.0	1.4	1.7	2.3	2.2	2.1	Consumer Price Index ⁵	1.6	0.1	1.3	2.2
1.4	1.7	1.7	1.7	1.8	1.8	1.8	1.8	Core PCE Deflator ⁵	1.5	1.3	1.7	1.8
2.0	2.3	2.2	2.3	2.2	2.0	1.9	1.8	Core Consumer Price Index ⁵	1.7	1.8	2.3	1.9
0.17	0.38	0.38	0.55	0.67	0.88	0.91	1.16	Fed Funds Target Rate, % ⁴	0.13	0.14	0.49	1.08
2.19	1.92	1.84	1.95	2.00	2.21	2.28	2.49	10-Year Treasury Note Yield, % ⁴	2.54	2.14	1.93	2.40
3.90	3.74	3.63	3.71	3.74	3.88	3.98	4.13	30-Year Fixed Mortgage, % ⁴	4.17	3.85	3.70	4.07
-2.8	-3.0	-2.9	-2.8	-2.9	-3.0	-3.0	-3.1	Current Account, % of GDP	-2.3	-2.7	-2.9	-3.1

a = actual; f = forecast; p = preliminary

- Notes:
- 1 - annualized percentage change
 - 2 - chained 2009 \$ billions
 - 3 - annualized rate
 - 4 - quarterly average
 - 5 - year-over-year percentage change