ECONOMIC UPDATE

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May Personal Income/Spending: Consumers Still On Solid Ground, Inflation, Not So Much

- Personal income rose by 0.4 percent in May; personal spending rose by 0.1 percent, and the savings rate rose to 5.5 percent.
- The PCE deflator fell by 0.1 percent and the core PCE deflator rose by 0.1 percent in May. Year-on-year, the PCE deflator was up by 1.4 percent and the core deflator was up by 1.4 percent.

Total personal income rose by 0.4 percent in May following a revised increase of 0.3 percent in April (originally reported up 0.4 percent), while total personal spending scratched out a 0.1 percent increase. Our forecasts, which matched the consensus, called for a 0.3 percent increase in income and a 0.1 percent increase in spending. With income growth easily topping spending growth, the personal saving rate rose to 5.5 percent in May from 5.1 percent in April. The PCE deflator, the FOMC's preferred gauge of inflation, fell by 0.1 percent in May with the core PCE deflator up by 0.1 percent, though just barely as the unrounded increase was 0.067 percent. Both the total and core PCE deflators were up 1.4 percent year-on-year. Real consumer spending was up 0.1 percent in May.

Labor earnings were weak in May, with both private and public sector wage and salary earnings up just 0.1 percent. This leaves aggregate private sector earnings up 2.89 percent and public sector earnings up 3.26 percent year-on-year. This weakness, however, is more a reflection of the considerable noise that clouded the May employment report, in which job gains and wage growth were biased lower by calendar effects. The June data, starting with the employment report to be released on July 7, should bring payback. As such, we suggest to not put too much emphasis on either month's data but instead to look at the two months as a whole.

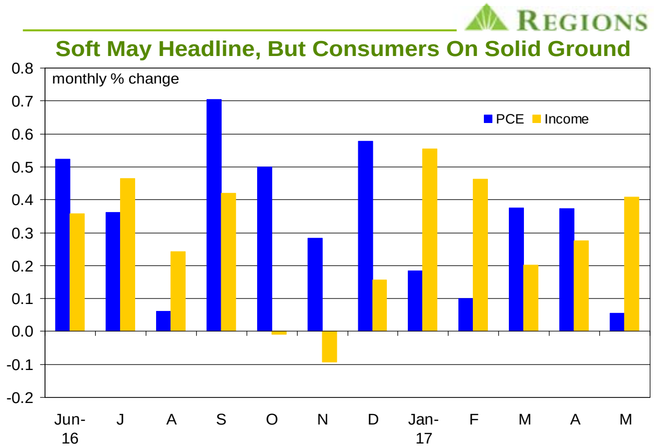
Growth in total personal income in May was driven by dividend income and rental income, with the former up 4.8 percent and the latter up 0.7 percent. The increase in dividend income was the largest monthly increase since December 2012, which came ahead of an increase in tax rates in January 2013. We cannot, however, isolate a special factor behind May's jump in dividend income. The increase in rental income is simply the latest in what has been a long string of solid monthly gains, though we wonder how much longer this strength will persist. Total personal income was up 3.49 percent, year-on-year, in May.

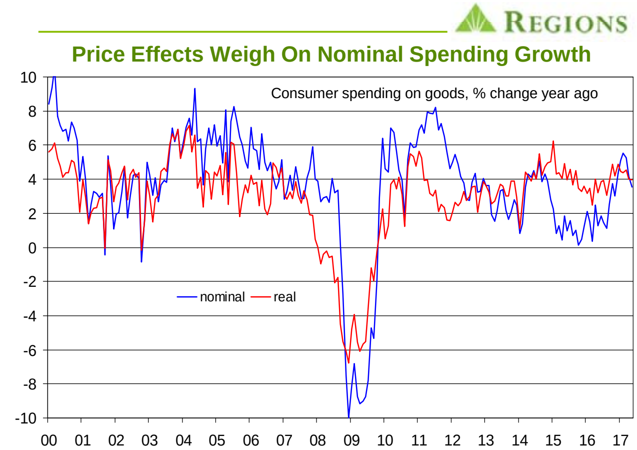
Consumer spending lived up to, or, if you prefer, down to expectations in May. Spending on both durable and nondurable consumer goods fell in May. A decline in unit motor vehicle sales helped sink spending on consumer durables, which fell 0.3 percent. With retail gasoline prices defying typical seasonal patterns, gasoline ended up being a significant drag on spending on nondurable goods, which fell 0.5 percent in May. Gasoline is not the only culprit here, however, as was evident in the performance of control retail sales, which were down slightly in May. Spending on household services, which account for roughly two-thirds of all consumer spending, rose by 0.3 percent in May.

As has been the case for some time now, one must account for price changes in order to put the data on consumer spending on goods in the proper context. Prices on core consumer goods have been falling year-on-year for over four years now, which has made the data on nominal consumer spending look much lower than is actually the case. While not nearly as pronounced of late as has been the case in recent years, this effect is still apparent in the data. There have been no shortages of those bemoaning "tepid" growth in consumer spending while at the same time noting that inflation seems to be retreating but who never seem to make the connection between the two.

The May data show inflation moving further from, rather than closer to, the FOMC's 2.0 percent target rate in May. While many FOMC members are inclined to dismiss the softer inflation data as being due to transitory factors, we're not convinced. One factor that, if sustained, would relieve some of the downward pressure on core goods prices is a weaker U.S. dollar, but the reality is that the globe is awash in idle productive capacity that could easily offset the impacts of further dollar weakness, while the shifting retail climate is likely to be a source of persistent downward pressure on goods prices for some time to come.

Even with May's tepid gain, growth in real consumer spending in Q2 is on pace to more than double Q1 growth. We see consumers as still being on solid ground, but, inflation, not so much. The latter, far more so than the former, will be the FOMC's main focus in coming months.





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