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Think Strategically

6 Issues, and 1 Conclusion Stay Invested But Vigilant

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U.S. Consumer Spending Fuels Economic Growth Amid Inflation and Rate Hikes, but Signs of Fatigue Emerge

Over the past three years, the U.S. consumer has been the cornerstone of economic growth, fueling robust domestic momentum and supporting global expansion. This resilient spending is noteworthy given the challenges of high inflation and rising interest rates. While the Federal Reserve has paused further rate hikes, the impact of previous tightening is still unfolding, and early signs of consumer fatigue are beginning to show. In this context, we examine the six key issues and one conclusion to the current state of consumer spending, its future outlook, and the broader implications for the economy and markets.

Issue 1: Sentiment Versus Economic Data

On the surface, this year's investment and economic conditions suggest a confident and optimistic consumer base:

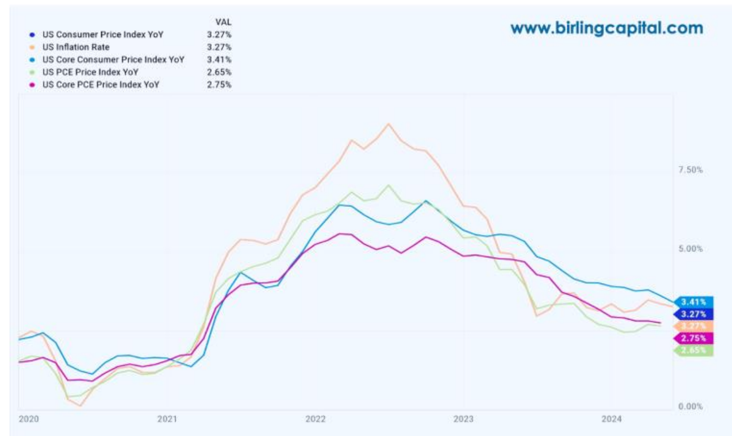
- U.S. stocks continue to hit new highs, with the S&P 500 recently marking its 31st all-time high of the year.
- The economy has been growing at a 2.9% pace (adjusted for inflation) over the past four quarters, outpacing last decade's average and exceeding its long-term potential.
- Unemployment remains low, at or below 4% for 30 straight months, the longest stretch since the mid-1960s.

Yet, consumer sentiment tells a different story. The University of Michigan Consumer Sentiment Index dropped to a seven-month low in June, reflecting a pessimistic view of personal finances and overall business conditions. This index is 30% below its pre-pandemic level and slightly above the 2008–09 average, marked by severe recession and high unemployment. Similarly, though more upbeat, the Conference Board's Consumer Confidence Index is still 20% below its pre-pandemic level. This disconnect between the solid macroeconomic environment and consumer sentiment raises essential questions.

Issue 2: The Impact of Inflation

Although inflation has significantly slowed since 2022, with the Consumer Price Index (CPI) cut by two-thirds from its peak, consumers are still grappling with high prices. This is especially true for low-income households, which spend a larger share of their income on essentials like food, gas, and rent. Prices have risen about 21% cumulatively since 2020, the most significant four-year increase in 40 years. While wage growth has recently outpaced inflation, personal income has grown faster than inflation thanks to government support during the COVID-19 pandemic. However, as excess savings are depleted, the impact of inflation intensifies.

US CPI, US Inflation Rate, US Core CPI, US PCE & US Core PCE

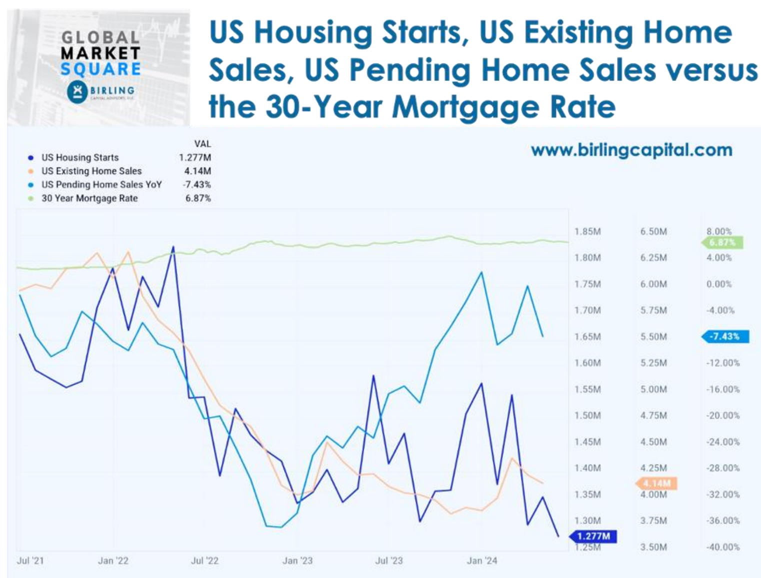


Issue 3: Housing and Labor Market Pressures

High mortgage rates and home prices have made home buying unaffordable for many, adding to consumer stress. The 30 Year Mortgage Rate fell to 6.87%, compared to 6.95% last week and 6.69% last year, and is lower than the long-term average of 7.73%.

The U.S. housing market faces a notable downturn, marked by declines in key metrics such as existing home sales, pending home sales, and housing starts.

As of the latest data, U.S. Existing Home Sales have dropped to 4.14 million, representing a 1.90% decrease from last month and a 1.90% decrease from last year. This consistent decline highlights a cooling market as fewer transactions occur than in previous months and years.



Pending Home Sales, a forward-looking indicator of housing activity based on contract signings, have also shown a significant decline. The year-over-year change is now at -7.43%, a sharp drop from last month's 0.26%. Although this marked improvement from last year's -21.11%, it remains well below the long-term average of -0.33%, indicating persistent challenges in the market's momentum.

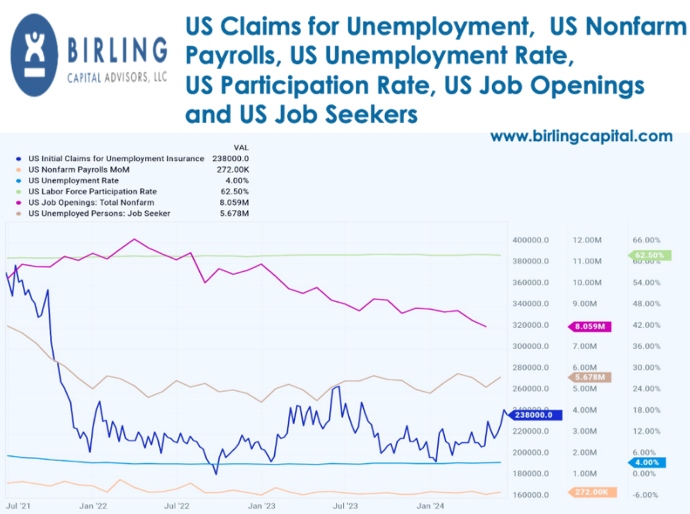
The decline in U.S. Housing Starts further underscores the market's struggles. Housing starts at 1.277 million, down 5.55% from last month's 1.352 million and a substantial 19.33% decrease from last year's 1.583 million. This decline in new home construction suggests builders are reacting to weaker demand and potentially higher costs, contributing to the overall slowdown in housing activity.

This confluence of negative trends suggests that the U.S. housing market is grappling with various headwinds. Factors such as rising interest rates, affordability issues, and economic uncertainty could

contribute to reduced activity across existing home sales, pending home sales, and new housing starts. As the market adjusts to these conditions, stakeholders must closely monitor these indicators for signs of stabilization or further decline.

Although still tight, the labor market is gradually loosening. Job openings have declined by a third from their peak, fewer workers voluntarily quit, and jobless claims have recently hit their highest level since September 2023.

The latest U.S. Jobs report rose 64.85%, showing robust job growth with 272,000 new nonfarm payroll jobs created in May, surpassing the estimates of 180,000, 51.11% higher than last month's 165,000, and 64.85% higher than the 12-month average of 232,000. The unemployment rate slightly increased to 4.0%, above the consensus estimate of 3.9%. The U.S. Initial Claims for Unemployment fell to 238,000, down from 243,000 last week, decreasing -2.06%.



Issue 4: Slower But Steady Spending

Recent retail sales data for May showed positive but slower-than-expected growth, suggesting consumers are becoming more cautious. Headline sales rose 0.1% from the prior month, while April's data was revised lower. Control-group sales, which exclude volatile categories and contribute to GDP, rebounded by 0.4%, though April's decline was also revised downward. Despite the slowdown, consumption growth is normalizing rather than signaling a downturn.

Issue 5: Wealth Effect and Spending Capacity

With pandemic savings largely exhausted and high interest rates discouraging borrowing, future consumer spending will likely hinge on real income growth. However, rising stock market and housing prices create wealth, encouraging spending even if incomes remain unchanged. Household net worth rose to $160 trillion in the first quarter, driven by equity and real estate appreciation. Yet, this wealth is unevenly distributed, with the top 10% of households owning the majority of assets.

Issue 6: Economic and Market Implications

As consumer spending growth moderates, GDP growth is also expected to slow, potentially prompting the Fed to cut interest rates later this year. On that point, the latest GDPNow update for the second quarter of 2024, projecting a robust 3.00% growth rate, carries significant implications for investors. With the economy expanding at this pace, businesses are likely experiencing increased demand for their products and services. This surge in demand can translate to higher revenues and potentially greater profits, positively impacting stock prices and investor returns.

Such strong GDP growth signals promising investment opportunities. Investors may find attractive prospects in sectors that typically thrive in a growing economy, such as technology, consumer discretionary, and industrials. These sectors often see heightened activity and profitability when economic conditions are favorable.

Moreover, a robust GDP growth rate can influence the Federal Reserve's monetary policy decisions. Should the growth remain strong and inflation stay controlled, the Fed might be more inclined to maintain or even ease interest rates. This approach can significantly affect bond and equity markets, making them more attractive to investors.

Positive GDP growth figures also have the power to boost investor confidence and overall market sentiment. As investors become more optimistic about the economic outlook, stock market performance could improve, further reinforcing the cycle of growth and investment.

GDP NOW

Date	GDPNow 2Q24	Change
4/26/24	3.90%	Initial Forecast
5/1/24	3.30%	-15.4%
5/2/24	3.30%	0.0%
5/8/24	4.20%	21.4%
5/16/24	3.60%	-16.7%
5/24/24	3.50%	-2.78%
5/31/24	2.70%	-22.86%
6/3/24	1.80%	-33.33%
6/6/24	2.60%	44.44%
6/7/24	3.10%	19.23%
6/18/24	3.10%	0.00%
6/20/24	3.00%	-3.23%

In summary, the projected 3.00% GDP growth rate for the second quarter of 2024 suggests a healthy and expanding economy. This environment is ripe with opportunities for investors, offering the potential for solid returns across various sectors and positively influencing market sentiment and Federal Reserve policies.

The Final Word: 1 Conclusion: Stay Invested But Vigilant

In conclusion, although the Federal Reserve has paused its rate hikes, the effects of earlier monetary tightening are still filtering through the economy, with early signs of consumer fatigue starting to emerge.

Cooling demand may help moderate inflation, potentially giving the Fed the confidence to cut rates later this year. Market expectations currently price in one to two rate cuts by the end of 2024.

The rise in stock market and housing prices has pushed household net worth to new highs, creating a wealth effect that supports consumer spending. However, this wealth is unevenly distributed, putting low-income consumers under increasing financial strain. As long as inflation continues to decline and employment remains steady, the economic expansion and the bull market will likely persist.

Market expectations suggest a possible rate cut in September and another in December, signaling the start of a multi-year easing cycle. The past few years have underscored the importance of holding appreciating assets during inflationary periods to maintain purchasing power. Despite pressures on low-income consumers, overall economic expansion and the bull market are likely to continue as long as inflation cools and employment remains stable.

Investor sentiment remains high, mainly driven by the excitement around artificial intelligence (AI) stocks. Nvidia recently surpassed Microsoft as the world's most valuable company, highlighting the sector's boom. However, the concentration of market gains in a few stocks increases the risk of a speculative bubble. Therefore, diversification remains crucial to manage risk and potentially enhance returns as the Fed's easing cycle approaches.

Diversification remains crucial for managing risk and potentially enhancing returns as we approach the beginning of a Fed easing cycle.

Therefore, the 1 Conclusion is to stay invested with opportunistic stock rotations and constantly vigilant of your holdings.

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