





## U.S. Economic Forecast

# Is The Consumer Really Cutting Back?

**O**ne of the major questions in the current recovery is whether American consumers will be able to fulfill their historical role of leading the world economy out of recession. As of now, it looks like they may not anytime soon.

Americans entered the recession with record-high debt and a record-low saving rate. Since then, they've begun saving more, and borrowing and spending less—out of caution, because banks won't lend to them and one in 10 U.S. workers is jobless.

By nearly every measure, in fact, consumers are under the most stress in a generation. The U.S. saving rate in September was only 3.3%, higher than the 1.7% of 2007, but still extremely low compared with its historical average. At the same time, U.S. household debt has declined for an unprecedented four consecutive quarters, as worried consumers cut back.

These trends threaten to hamper the recovery, in our view. A good example of this is U.S. auto sales, which are expected to be only 10.2 million this year, the lowest level since 1970. Combined with moderating gas prices, the U.S. government's "cash for clunkers" program helped rescue automakers by temporarily boosting sales in July and August. And even

after it ended, light-vehicle sales bounced up to an annual rate of 10.4 million units in October, suggesting that the worst may be over for the industry. However, that doesn't mean the good times are back since October car sales remain less than two-thirds their prerecession norm of 16.8 million units—and may take years to get back to that level.

The third-quarter real GDP growth of 3.5% was higher than we expected, and it improves our outlook for the U.S. economy (see table). But the weak employment data still make us nervous about the consumer. Layoffs appear to be slowing, but the jobless still can't find work because employers remain uncertain about future growth and are delaying hiring. And unless employment

and incomes both rise, consumers can't lead the recovery.

The Federal Reserve will play a key role in what happens next. On Nov. 4, it decided to hold the federal funds rate constant, keeping short-term interest rates low. But it has also announced its intention to withdraw from the special facilities it set up over the last year. It has already stopped purchasing commercial paper and long-term treasury securities and has announced that it will stop buying mortgage-backed and other Fannie Mae and Freddie Mac debt by the end of 2010's first quarter. We expect the Fed to stop these programs before it hikes the funds rate, which implies that it could start to raise rates late next year.

### Saving And Borrowing

Still, there appear to be limits on how far consumers will cut back. The 3.3% September saving rate was higher than the 2.8% in August, when people bought cars to get clunker rebates, but lower than the 5% we had feared would stunt GDP growth. It now seems likely to settle near 3%, far below the 8.9% average from 1960 to 1990. There's still a chance that the saving rate could increase more than we expect, which could hurt growth. But even if it stabilizes around its current level, we think that consumer spending will lag GDP growth over the coming years. From 2010 through 2013, we expect real GDP to rise 3% per year, while real consumer spending may rise only 1.8% per year.

A worrying sign is that consumer confidence has faltered in recent months. After bouncing up from its spring low, consumer sentiment (according to the University of Michigan consumer sentiment survey) rose to a peak this summer, but slipped to 70.6 in October from 73.5 in September. The decline may reflect the weakness of labor markets, as the unemployment rate jumped to 10.2% in October, but also reflects households' reassessment after some false optimism over the summer about the speed of the recovery. Although the recession may be

Chart 1 Households Borrow Less

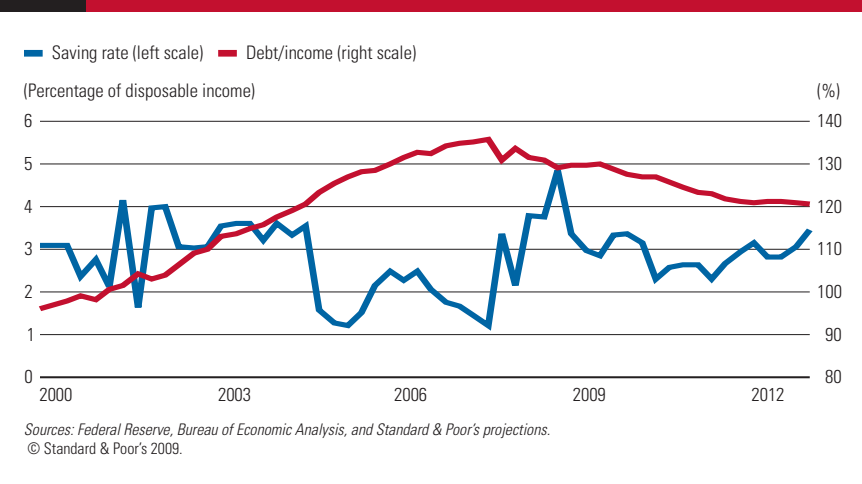
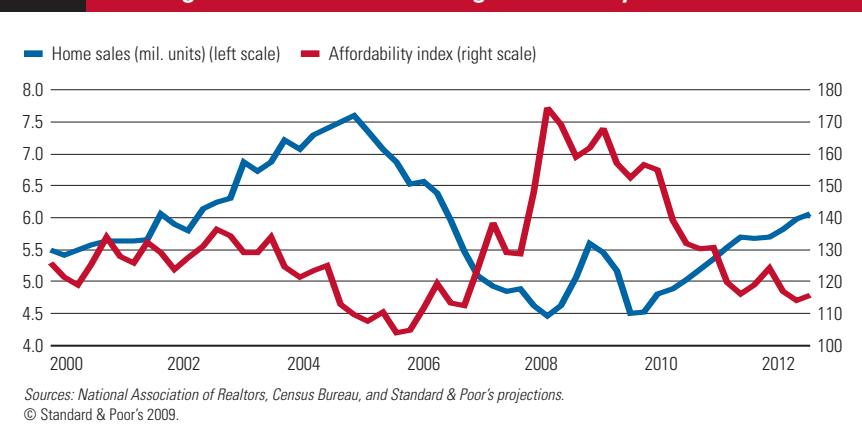


Chart 2 Housing Sales Recover On Strong Affordability



over, we think it will take labor markets and the economy a long time to return to normal.

How long depends on when employment comes back. Households spend more out of income than out of wealth, and their largest problem remains the lack of jobs. The surge in the unemployment rate to 10.2% in October was greater than we expected. The drop of 589,000 in household employment was far greater than the 190,000 drop in payroll employment, with most of the discrepancy due to sharp declines in self-employed (down 181,000) and teenage (down 207,000) employment. But any way you measure it, job growth is lagging the recovery more than usual. People who don't have jobs can't spend, and those afraid of losing their job won't spend. Although we expect employment to begin to rise around year-end, we don't expect the unemployment rate to peak until next summer, at 10.6%.

In that kind of environment, many people don't borrow. Over the past four quarters, household debt has dropped by nearly \$500 billion, according to the Federal Reserve's flow-of-funds data. As a percentage of after-tax income, household liabilities have dropped from 136% in the first quarter of 2008 to 129% in the second quarter of this year. We expect the debt-to-income ratio to edge downward further, to 120% by 2012, back near its 2004 level.

Some of the reduction in debt reflects write-offs rather than payment of loans. This is difficult to disentangle in the Fed data, but most of the \$145 billion reduction in mortgage debt may have been write-downs. The \$117 billion drop in consumer credit, by contrast, seems due primarily to reduced borrowing. But some of this was at the behest of the bank, not the borrower. It's difficult to distinguish between supply and demand effects on credit. Banks have clearly tightened, as the Fed's survey of senior loan officers shows, but consumers are also cutting back (*see chart 1*).

The new credit card regulations have also restricted Americans' ability to

borrow. Banks have cut back on new credit card issuance and have raised rates on many outstanding cards because the new rules will restrict their ability to do so next year. If banks can't raise rates sharply for riskier credits, they will raise rates somewhat for all borrowers. They are also cutting off the riskier borrowers, or simply refusing to issue cards in the first place. This isn't necessarily a bad thing in the long run—encouraging people to live beyond their means isn't good finance or economics. However, it does cut back on consumer spending.

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The decline in household wealth caused some of the cutback in spending. Last year, households lost 19% of their net worth because of the drops in stock and house prices—one year's income. The ratio of household net worth to after-tax income fell to 521% in the second quarter from 632% two years earlier. The oldest boomers are now 63, the average retirement age in the U.S. The drop in wealth means that 55% of boomers cannot expect to retire at their current standard of living, according to the Center for Retirement Research at Boston College, versus 40% before the recession.

We expect boomers to react to the loss of wealth in three ways: by retiring later, saving more, and maintaining a lower standard of living after retirement. Surveys now show that Americans intend to retire at age 65, on average, up from 63 two years ago. They also intend to save more, although that has been more intent than reality. If they don't do the first two, the third is inevitable. In either of the last two options, they will spend less, either now or soon.

Even for those further from retirement, the loss of wealth affects their willingness to spend and their ability to borrow. Households look at their wealth as the primary indicator of whether they are behaving prudently. If I'm richer now than I was a year ago, I must be doing OK; if my wealth hasn't increased, I need to spend less. Economists may disagree about the strength of the wealth effect, but most estimates suggest that at the margin,

households spend between 3% and 6% of their wealth each year.

Up until two years ago, households did that partly by borrowing against their assets. Banks like lending against assets—perhaps too much, based on recent events. Home equity loans in particular were an easy and cheap source of funds for homeowners. But these loans are no longer available. Many homeowners have no equity left in their homes to borrow against. And even for

those who do, banks have become more leery of making such loans because their repayment performance in the current downturn has been dismal.

### Driving Car Sales

The U.S. government took up some of that slack in July and August by paying rebates of up to \$4,500 to get consumers to trade in old low-mileage vehicles for new higher-mileage ones. Our view remains that such sales were largely bor-

## Standard & Poor's Economic Outlook—November 2009

| (% change)                                     | —2009— |       | —2010— |        | 2007   | 2008   | 2009e   | 2010f   | 2011f   | 2012f | 2013f |
|--|--------|-------|--------|--------|--------|--------|---------|---------|---------|-------|-------|
|  | Q3     | Q4e   | Q1e    | Q2e    |        |        |         |         |         |       |       |
| Real GDP                                       | 3.5    | 1.7   | 1.8    | 2.2    | 2.1    | 0.4    | (2.5)   | 1.9     | 3.1     | 3.9   | 3.0   |
| Consumer spending                              | 3.4    | 0.3   | (0.4)  | 0.7    | 2.7    | (0.3)  | (0.6)   | 0.8     | 1.7     | 2.6   | 2.3   |
| Equipment investment                           | 1.1    | 7.8   | 10.2   | 12.2   | 2.6    | (2.6)  | (17.2)  | 8.4     | 13.7    | 11.4  | 7.2   |
| Nonresidential construction                    | (9.0)  | (9.5) | (21.3) | (23.4) | 14.9   | 10.3   | (18.3)  | (17.0)  | 0.7     | 19.1  | 9.8   |
| Residential construction                       | 23.6   | 12.1  | 7.0    | 13.1   | (18.8) | (23.2) | (20.0)  | 7.4     | 15.4    | 16.8  | 7.0   |
| Federal Government                             | 7.9    | 1.7   | 3.7    | 4.6    | 1.3    | 7.7    | 5.3     | 3.2     | (3.7)   | (3.2) | (1.8) |
| State and local governments                    | (1.1)  | 0.6   | (0.2)  | 0.2    | 2.0    | 0.5    | (0.1)   | 0.2     | (0.1)   | 0.5   | 1.6   |
| Exports  | 14.7   | 6.4   | 8.1    | 9.0    | 8.7    | 5.4    | (10.8)  | 8.2     | 10.7    | 10.7  | 9.1   |
| Imports  | 16.3   | 11.1  | 9.3    | 4.4    | 2.0    | (3.2)  | (14.6)  | 6.6     | 5.3     | 7.1   | 5.1   |
| CPI  | 3.6    | 2.8   | 1.0    | 1.2    | 2.9    | 3.8    | (0.4)   | 1.9     | 1.8     | 1.8   | 1.5   |
| Core CPI                                       | 1.5    | 1.6   | 1.1    | 1.5    | 2.3    | 2.3    | 1.7     | 1.5     | 1.7     | 1.5   | 1.4   |
| Nonfarm unit labor costs                       | (4.3)  | (1.6) | 0.3    | 0.3    | 2.3    | 1.0    | (2.2)   | (0.8)   | 1.2     | 1.1   | 1.8   |
| Nonfarm productivity                           | 7.0    | 3.8   | 2.1    | 1.8    | 1.9    | 1.8    | 2.8     | 3.0     | 0.9     | 0.9   | 0.8   |
| <b>Levels</b>                                  |        |       |        |        |        |        |         |         |         |       |       |
| Unemployment rate                              | 9.6    | 10.3  | 10.4   | 10.5   | 4.6    | 5.8    | 9.3     | 10.5    | 10.2    | 9.3   | 8.7   |
| Payroll employment (mil.)                      | 131.2  | 130.3 | 129.9  | 130.0  | 137.6  | 137.0  | 131.8   | 130.0   | 132.2   | 135.8 | 138.9 |
| Federal funds rate                             | 0.2    | 0.1   | 0.1    | 0.1    | 5.0    | 1.9    | 0.2     | 0.2     | 1.3     | 3.1   | 3.5   |
| 10-year Treasury note yield                    | 3.5    | 3.4   | 3.6    | 3.7    | 4.6    | 3.7    | 3.2     | 3.9     | 5.4     | 6.7   | 6.7   |
| 'AAA' corporate bond yield                     | 5.3    | 5.2   | 5.3    | 5.4    | 5.6    | 5.6    | 5.3     | 5.5     | 6.8     | 7.8   | 7.7   |
| Mortgage rate (30-year conventional)           | 5.2    | 5.0   | 5.2    | 5.4    | 6.3    | 6.0    | 5.1     | 5.5     | 6.9     | 8.2   | 8.3   |
| 3-month T-Bill Rate                            | 0.2    | 0.0   | 0.2    | 0.2    | 4.4    | 1.4    | 0.1     | 0.4     | 1.8     | 3.1   | 3.6   |
| S&P 500 Index                                  | 997    | 1061  | 1102   | 1122   | 1477   | 1221   | 940     | 1134    | 1227    | 1328  | 1405  |
| S&P operating earnings (\$/share)              | 15.56  | 13.75 | 13.56  | 14.32  | 82.54  | 49.51  | 53.23   | 58.11   | 65.53   | 79.41 | 89.59 |
| Current account (bil. \$)                      | (456)  | (509) | (549)  | (529)  | (727)  | (706)  | (444)   | (534)   | (568)   | (621) | (575) |
| Exchange rate (major trade partners)           | 82.4   | 80.5  | 78.7   | 77.6   | 89.0   | 93.0   | 83.3    | 77.2    | 75.1    | 77.9  | 84.9  |
| Crude oil (\$/barrel, WTI)                     | 68.14  | 74.87 | 72.97  | 72.99  | 72.18  | 99.76  | 61.48   | 74.70   | 78.09   | 83.65 | 87.77 |
| Saving rate (%)                                | 3.4    | 3.0   | 2.8    | 3.3    | 1.7    | 2.6    | 3.7     | 3.2     | 2.5     | 2.8   | 3.0   |
| Housing starts (mil.)                          | 0.59   | 0.64  | 0.75   | 0.79   | 1.34   | 0.90   | 0.57    | 0.80    | 1.18    | 1.49  | 1.62  |
| Unit sales of light vehicles (mil.)            | 11.5   | 10.3  | 10.0   | 10.2   | 16.1   | 13.2   | 10.2    | 10.8    | 13.5    | 15.3  | 16.2  |
| Federal surplus (fiscal-year unified, bil. \$) | (331)  | (405) | (469)  | (160)  | (162)  | (455)  | (1,417) | (1,370) | (1,112) | (932) | (783) |

e—Estimate. f—Forecast.

rowed from the future—eventually those trade-ins would have been scrapped anyway, but perhaps not for a couple of years. However, the plan clearly succeeded in reducing dealer inventories, which may have justified the cost. Now that dealer inventories are down, extending the program seems like a bad idea.

That means it could be a while before U.S. car sales climb back to the 16.8 million units they averaged from 2000 through 2007, for several reasons. Cars last longer than they did in the past, and a longer replacement cycle means fewer annual sales. The driving-age population will rise more slowly, by less than 1% per year over the next five years, compared with 1.3% during the late 1990s. And there already are more registered vehicles in the U.S. than there are licensed drivers. So we don't expect annual U.S. auto sales to approach even 16 million units until 2013.

So far, credit availability appears to have had little impact on consumers' decision to buy a new car, since the Federal Reserve and Treasury have taken actions to keep loans available. The Fed reported that the average interest rate on a new car loan was only 3.5% in September, with a 64-month maturity and a 91% loan-to-value ratio. Not much sign of credit tightness here.

## Housing And Consumer Spending

Weak housing sales have also put a damper on consumer spending: The purchase of a house often inspires related purchases of furniture, hardware, and electronics.

The recent recovery in sales is thus a positive factor for consumer spending. And we expect home sales to continue to rise from their first-quarter low of 4.5 million (annual rate). Yet we also expect sales to remain well below their recent peak of 7.5 million in 2005, recovering only to six million by 2013. Housing starts will recover even more slowly, since the bulk of sales are of existing homes and many existing homes remain unsold.

Congress' recent decision to extend the homebuyer tax credit through next June should continue to help sales. We think

the extension of the \$8,000 first-time homebuyer credit is a good idea, but we believe that granting a credit to current homeowners who trade up (or down) isn't. Although the new credit is supposed to be for owner-occupied homes, there is little to prevent a buyer from using it to buy a second home or an investment property. If I'm looking for a retirement home, a \$6,500 tax credit combined with the current low home prices could convince me to buy it a little early and use it as a vacation home or rent it out in the meantime. These are precisely the houses that have been most likely to be foreclosed in the current turmoil.

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In any case, homes are extremely affordable even without the credit, with prices down 30% (S&P/Case-Shiller data) from their 2006 peak and 30-year conventional mortgage rates at 5% (see chart 2). For someone who wants to buy a home, this is a great time to get into the market. The affordability index from the National Association of Realtors, which is based on the ratio of the median income to the monthly payment required to buy the median-priced home, rose to 162.7 in September, slightly below the record 176.9 in January but far above its 1981 to 2007 average of 113.7. For someone who wants to buy an investment, the picture is less clear, since we don't expect future home prices to appreciate at anything like the 72% of 1997 to 2005. [CW](#)

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