GW&K INVESTMENT MANAGEMENT

GLOBAL PERSPECTIVES

NOVEMBER 2023

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HIGHLIGHTS

US CONSUMER SPENDING: RESILIENT TODAY, UNCERTAIN TOMORROW

- Sentiment surveys have shown notable caution about the economic outlook among US consumers. However, consumer spending has remained relatively robust despite higher interest rates.
- Resilient spending has challenged 2023/2024 recession forecasts and prompted Fed officials to move towards "higher-for-longer" interest-rate projections.
- Despite special factors that have supported the consumer in 2023, headwinds are growing. Markets expect the Fed to cut interest rates next year in response to slower spending and jobs growth.

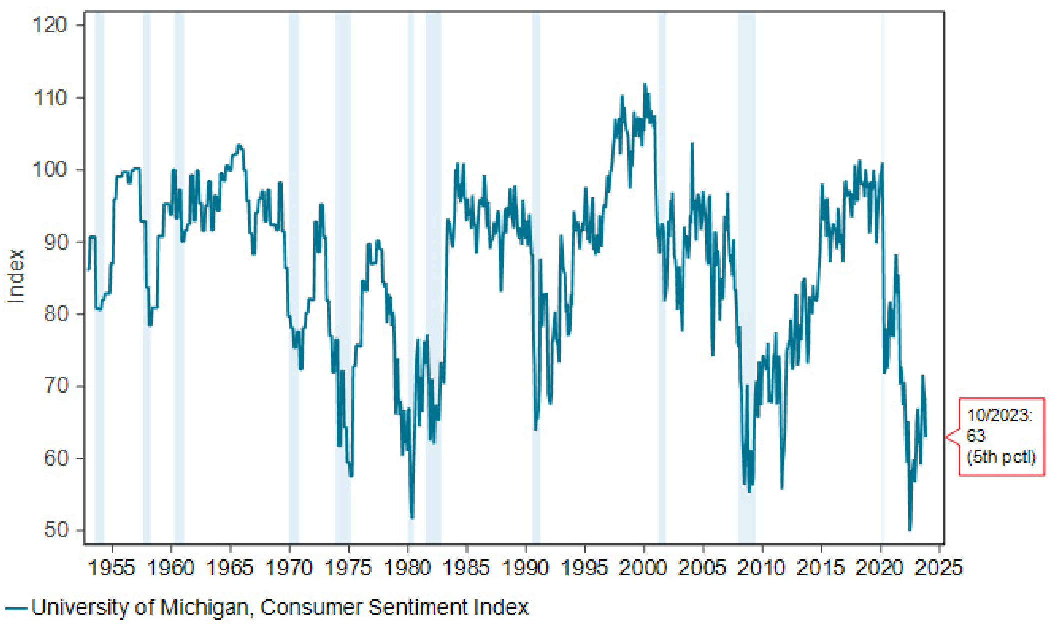
GLOOMY CONSUMERS KEEP ON SPENDING

While US consumers have displayed notable gloom in sentiment surveys this year, their actual spending paints a different picture. One might question, given the prevailing consumer sentiment, why spending remains robust.

The University of Michigan's consumer sentiment survey, a bellwether since the early 1950s, reached historic lows in June of 2022, largely attributed to rising inflation and interest rates. These conditions led consumers to hesitate when it came to big purchases such as homes or cars, citing unfavorable prices and financing terms. The sentiment index has remained at recession-like levels through this October **(Figure 1)**.

FIGURE 1

Consumer Sentiment Fell in October and Remains Near the Bottom of its Historic Range



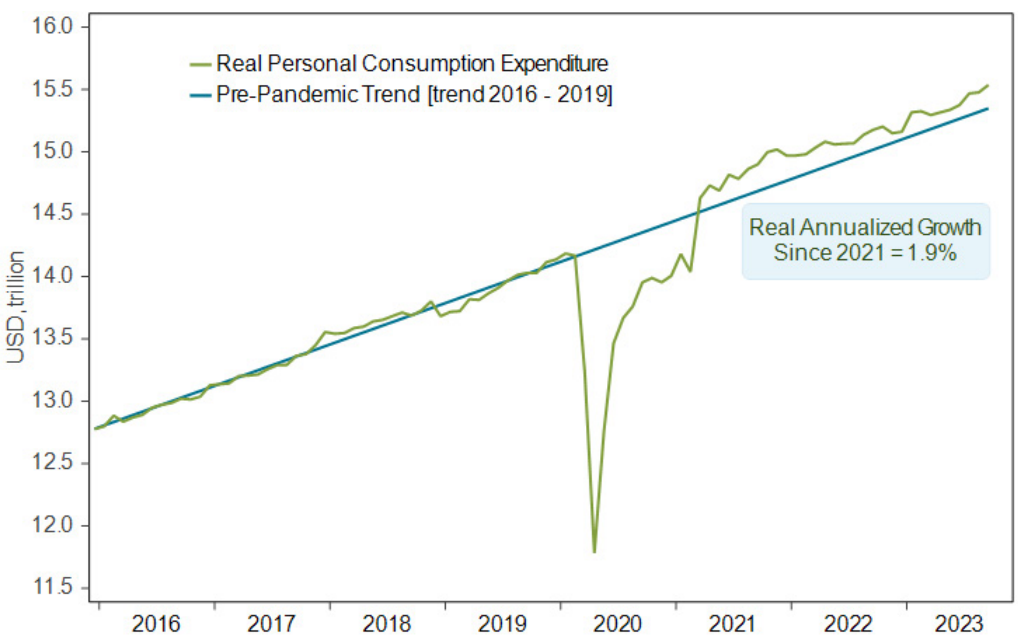
Note: Shaded areas denote NBER recession periods.
Sources: GW&K Investment Management, University of Michigan, and Macrobond

For well over a year, the University of Michigan's survey has been at levels associated with past recessions, but consumer spending has remained resilient.

Contrary to this sentiment, spending patterns from hard data, including government reports on retail sales and personal consumption expenditures, indicate resilient consumer behavior. For instance, from 2021 through the second quarter of 2023, real personal consumption expenditures have grown at a steady 1.9% annual rate. The level of spending has also remained notably higher than the pre-pandemic trend **(Figure 2)**.

FIGURE 2

Despite Gloomy Consumer Sentiment, Growth in Consumer Spending Has Remained Solid



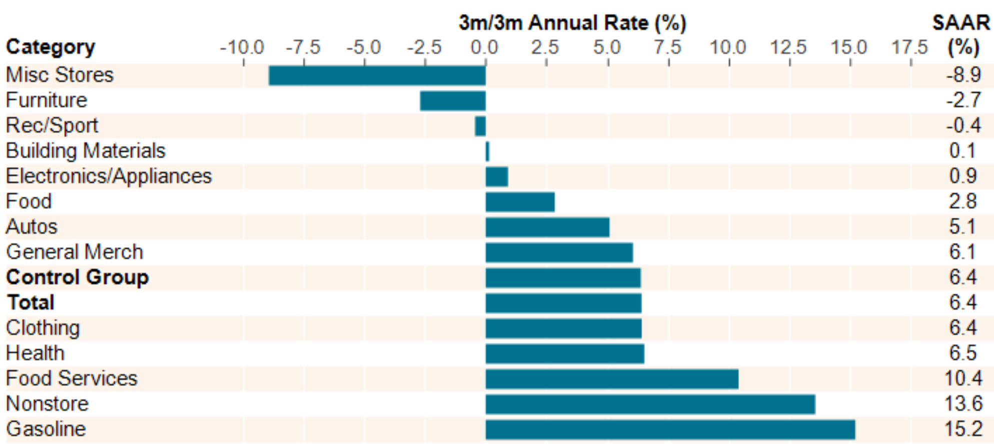
Sources: GW&K Investment Management, BEA, and Macrobond

American consumer spending has so far remained solid with real personal consumption expenditure having grown at an average annual pace of 1.9% since 2021. This has defied predictions for a slowdown.

The momentum has, if anything, quickened. Third quarter GDP data shows that real personal consumption expenditure surged to a 4.0% annual rate. And the most recent retail sales data for September handily surpassed economists' predictions, showing widespread gains in retail sales for the third quarter **(Figure 3)**.

FIGURE 3

Spending in Housing-Related Areas Still Struggling: US Retail Sales by Category for 3Q2023



Sources: GW&K Investment Management, US Census Bureau, and Macrobond

Gains in retail sales in the third quarter of 2023 were broad-based, although spending in housing related areas was struggling. Still, the core control group, which feeds directly into GDP estimates, grew at a solid 6.4% annual rate.

This unexpected robustness in consumer spending surprised both private-sector economists and Federal Reserve officials. Many had anticipated a mild recession in the latter half of 2023, expecting a modest contraction in real GDP, near-stagnant consumer spending, and rising unemployment. But recent adjustments by Federal Reserve officials and many economists reflect a more positive outlook for this year and next. The changed outlook has also prompted Fed officials to move toward "higher-for-longer" interest-rate projections.

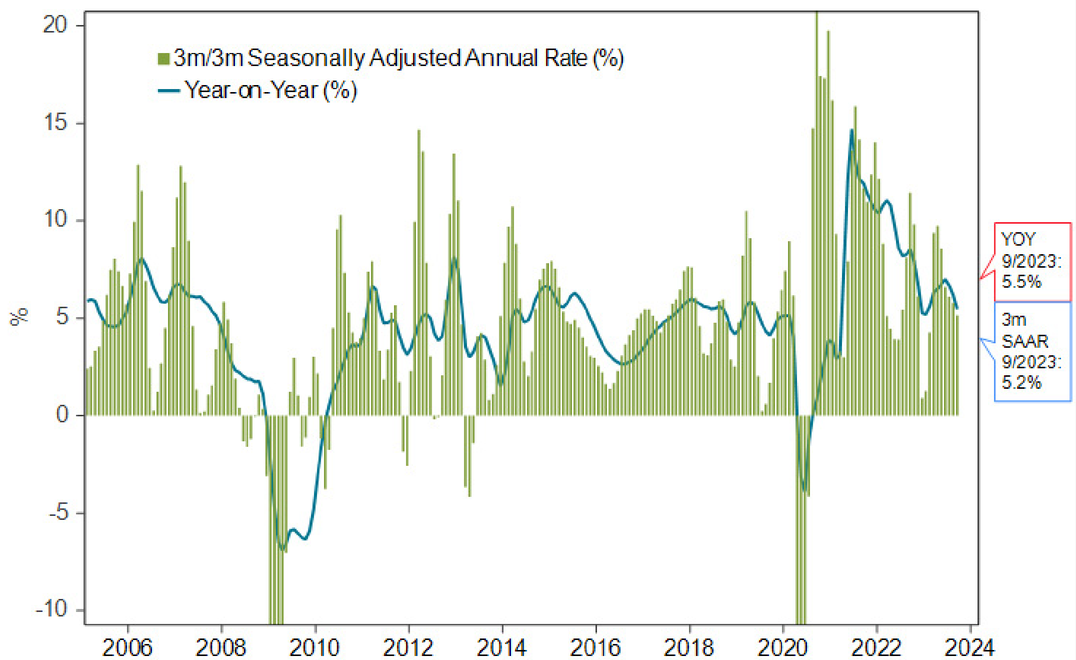
UNDERPINNING THE RESILIENCE

Several factors contribute to the surprising resilience:

1. **Strong Labor Market:** A consistently low unemployment rate and an accelerating growth in nonfarm payroll employment have driven wage income up by 5% over the past quarter and year, boosting consumer spending **(Figure 4)**.

FIGURE 4

Personal Income Growth Remains Robust: Wage and Salary Disbursements



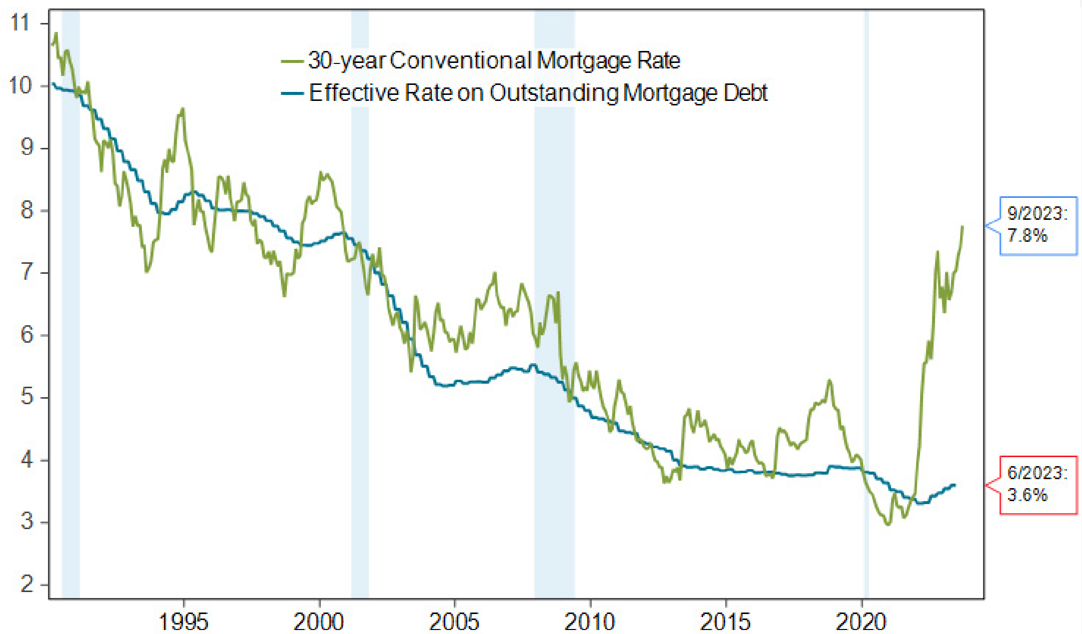
Sources: GW&K Investment Management, BEA, and Macrobond

Robust growth in personal income at a 5.5% annual rate has been a key factor supporting the solid growth in consumer spending, despite headwinds like higher interest rates and resumed student debt payments.

2. **Insulation from Interest Rates:** Despite rising interest rates, many households and businesses locked in lower rates during the pandemic, ensuring minimal impact on spending. For example, while the current 30-year mortgage rate approaches 8%, the average rate on outstanding mortgage debt was only 3.6% as of mid-year **(Figure 5)**.

FIGURE 5

The Legacy of Low Rates:
Effective Outstanding Mortgage Rate Is Around 3.6%



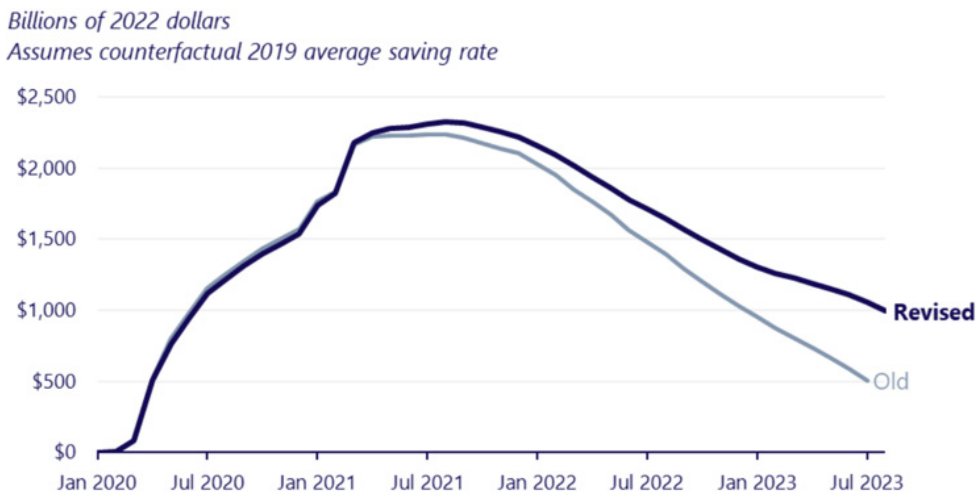
Note: Shaded areas denote NBER recession periods
Sources:GW&K Investment Management, BEA, Mortgage Bankers Association, and Macrobond

One reason for the continued resilience of consumer spending is that the effective rate on outstanding mortgages is just 3.6%, despite the recent spike in new 30-year mortgage rates to near 8%.

3. **Healthy Balance Sheets and Savings:** Households and businesses fortified their financial positions during the pandemic. Even with concerns about dwindling pandemic-era savings, it's estimated that households still have around $1 trillion in excess savings **(Figure 6)**.

FIGURE 6

Real Excess Savings During the Pandemic



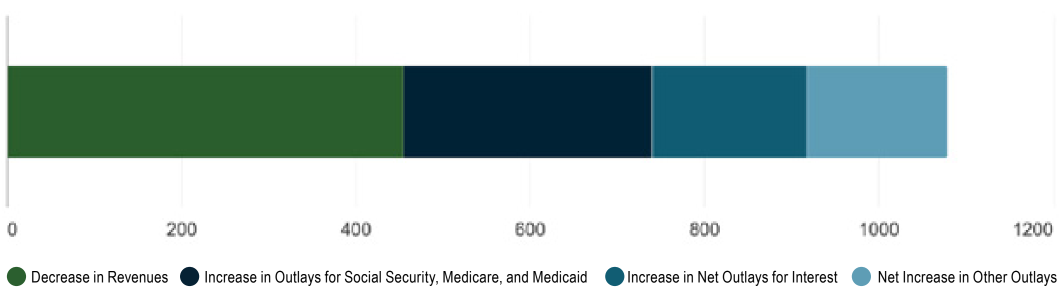
Source: Bureau of Economic Analysis; CEA calculations. As of September 29, 2023 at 8:30am

As of August 2023, households held excess savings of $1 trillion, or 3.7% of GDP. That is double the previously estimated amount, illustrating economic data uncertainty in the wake of the pandemic.

4. **Federal Budget Stimulus:** An expansion of the federal budget deficit, doubling from $0.9 trillion to $2.0 trillion over the past year, has acted as a significant fiscal stimulus, benefiting households and bolstering corporate cash flows **(Figure 7)**.

FIGURE 7

Increase in the Deficit From 2022 to 2023 (Billions of US Dollars)



Note: Values exclude the effects of timing shifts and of the Administration's plan to cancel student loans.
Sources:Congressional Budget Office and Department of the Treasury

Consumers benefited from a $1.1 trillion increase in the federal budget deficit in the 12 months through September, driven by lower tax revenues and higher outlays including net interest payments.

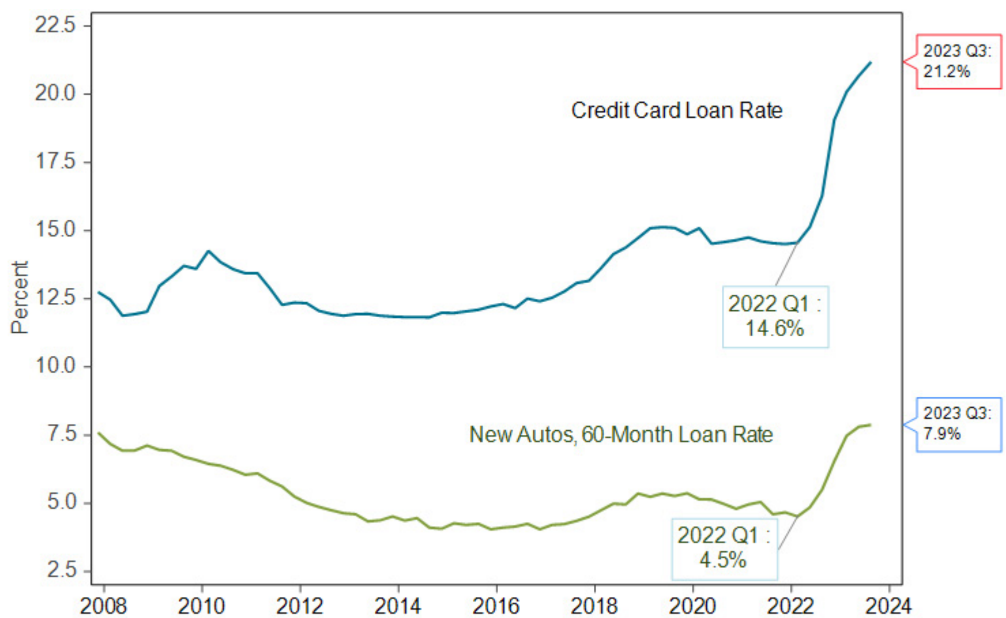
POTENTIAL HEADWINDS

As we look to the future, several challenges emerge:

- Rising interest rates on various loans could suppress consumer spending **(Figure 8)**.

FIGURE 8

Consumer Loan Rates Have Soared Since the Fed Started Tightening in 2022



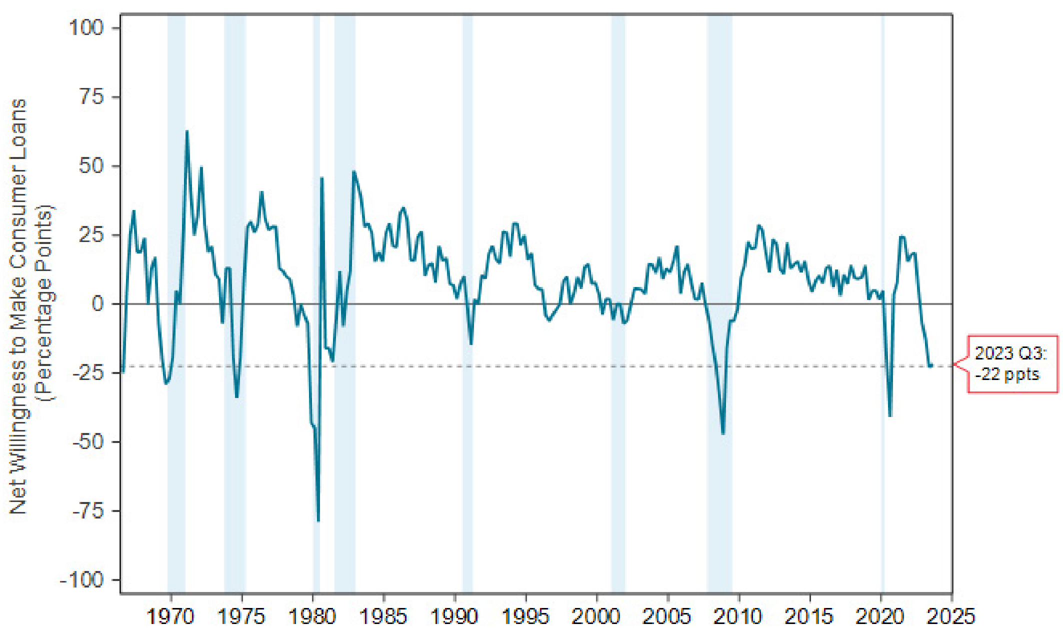
Sources: GW&K Investment Management, Federal Reserve, and Macrobond

Higher consumer loan rates represent a clear headwind for consumer spending. Since the Fed started to tighten in early 2022 consumers have faced surging credit card and auto loan rates.

- Despite overall healthy balance sheets, there are pockets of distress among lower income households, with consumers falling behind on car payments at the highest rate in decades.
- Bank surveys suggest a decreased willingness to lend to consumers — although recent bank earnings offer a more positive assessment of consumer health **(Figure 9)**.

FIGURE 9

Senior Loan Officer Survey: Banks' Willingness to Lend to Consumers Is at Recession Levels



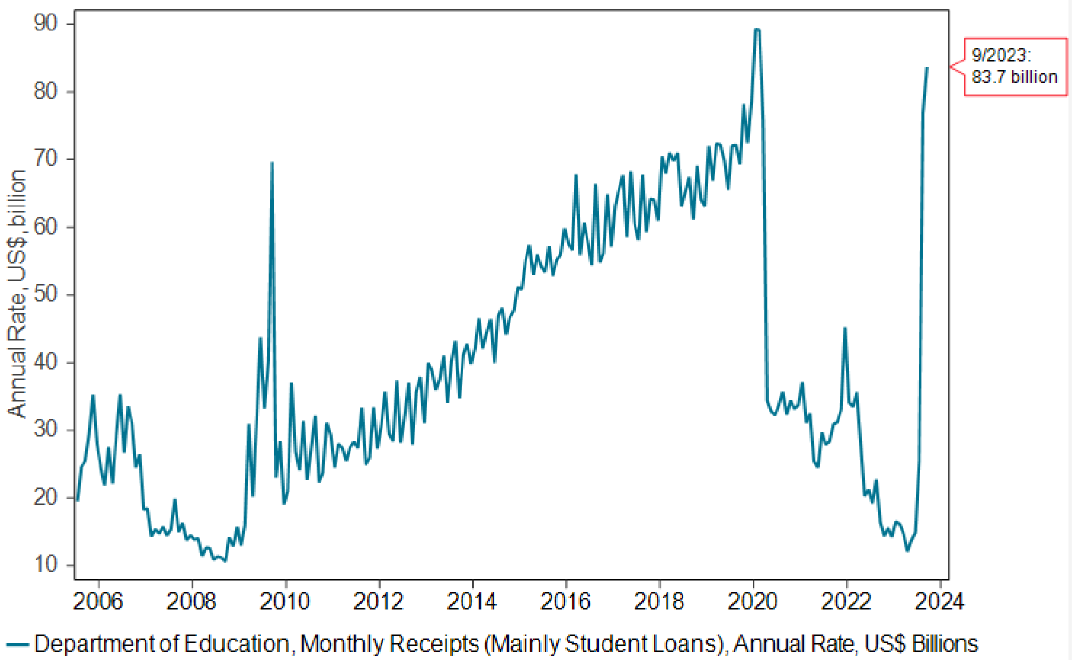
Note: Shaded areas denote NBER recession periods
Sources: GW&K Investment Management, Federal Reserve, and Macrobond

In response to aggressive Fed tightening and associated strains in the banking system, banks' reported willingness to lend to consumers is at a low level associated with recession periods.

- The resumption of student loan repayments may impact consumer spending, given the $84 billion annual rate seen recently **(Figure 10)**.

FIGURE 10

Student Loan Payback Has Begun: Monthly Payments to US Treasury



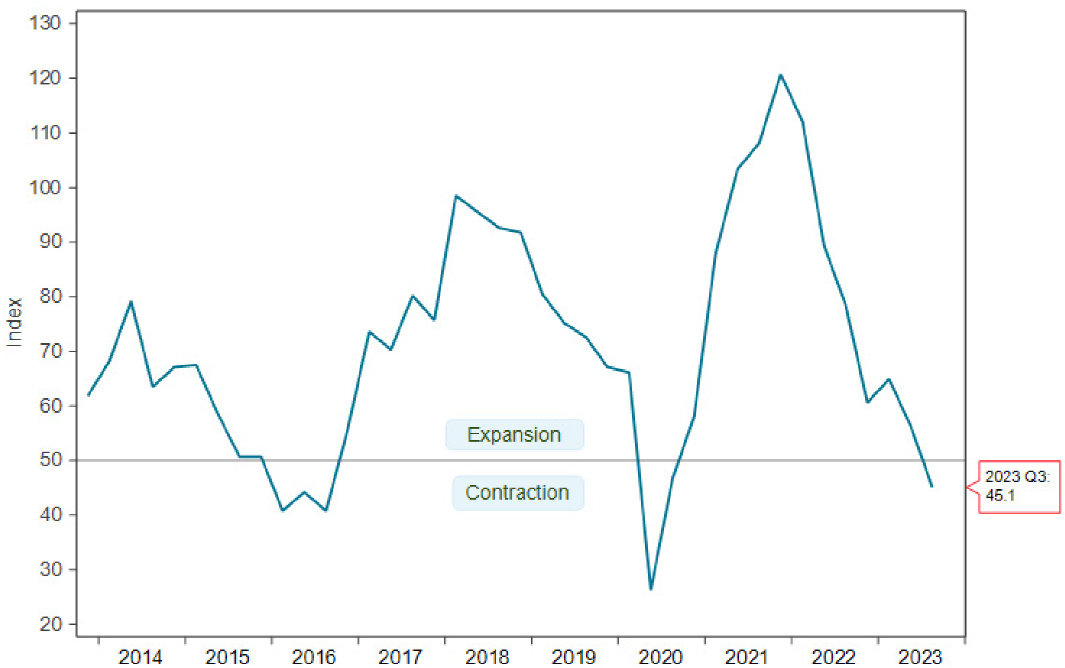
Sources: GW&K Investment Management, US Treasury, and Macrobond

Student loan repayment has begun again, surging in recent months to an $84 billion annual rate in September. But recent NY Fed research points to a very limited impact on a $27 trillion economy.

- Signs of a cooling labor market include reduced hiring plans by CEOs and a more pessimistic outlook from small business owners **(Figure 11)**.

FIGURE 11

Employment Outlook Dims: CEO Employment Outlook, Next Six Months



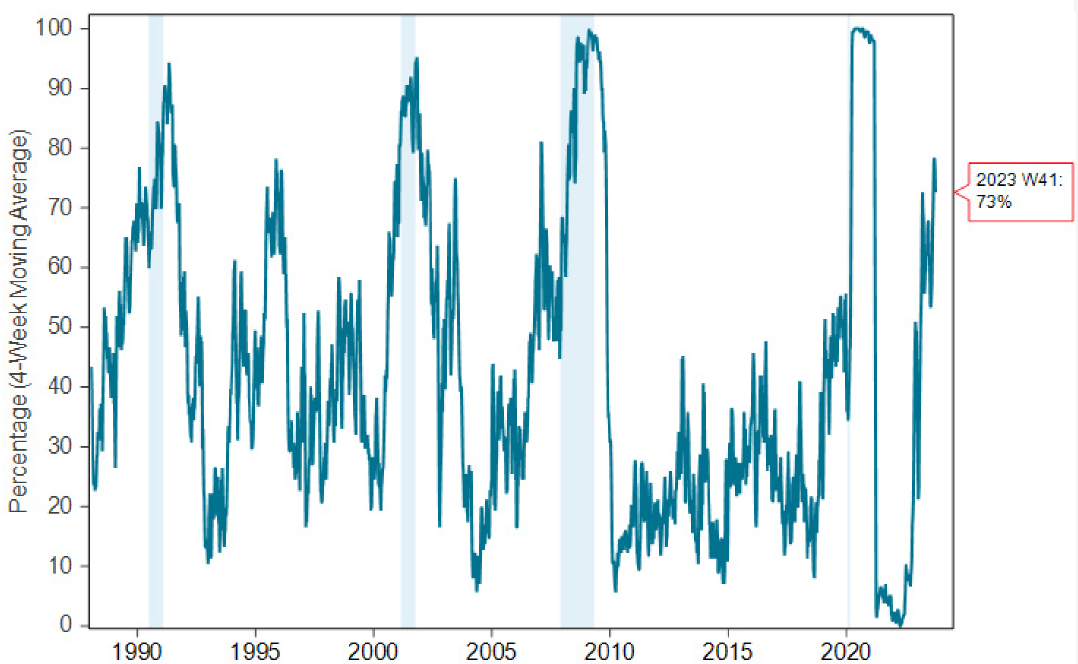
Sources: GW&K Investment Management, Business Roundtable, and Macrobond

Although the labor market has remained strong, corporate CEOs expect employment to contract over the next six months. That could represent a strong headwind to consumer spending.

- Significantly increasing jobless claims across most US states suggest potential economic weakness ahead **(Figure 12)**.

FIGURE 12

Percentage of US States With Unemployment Claims Rising More Than 20% From a Year Ago



Sources: GW&K Investment Management, US Department of Labor, and Macrobond

Another sign of a cooling labor market is that nearly three-quarters of US states have seen significant rises in jobless claims over the past year, a rate typically seen in recessions.

Moreover, the specter of geopolitical risks, such as the recent Israel-Hamas conflict, might have repercussions for global oil prices and, subsequently, US consumer spending.

In conclusion, while US consumers have demonstrated resilience, the road ahead is uncertain and challenging. The Federal Reserve aims to rein in consumer spending and combat inflation. Whether the US experiences a recession or a softer economic slowdown remains to be seen. Yet, the broader trajectory is evident: Consumer spending is poised to decelerate. How rapidly this occurs will dictate the Fed's future actions, including potential rate cuts projected for the latter half of the upcoming year.

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