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MACROCOSM

Immaculate Consumption

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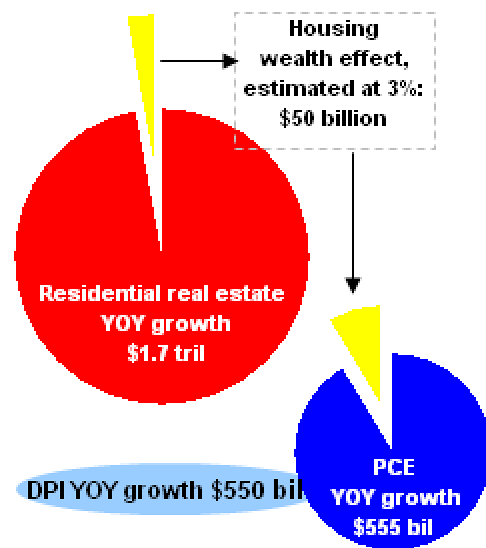
Consumers will stay strong -- bad news for the Fed, good news for the GOP.

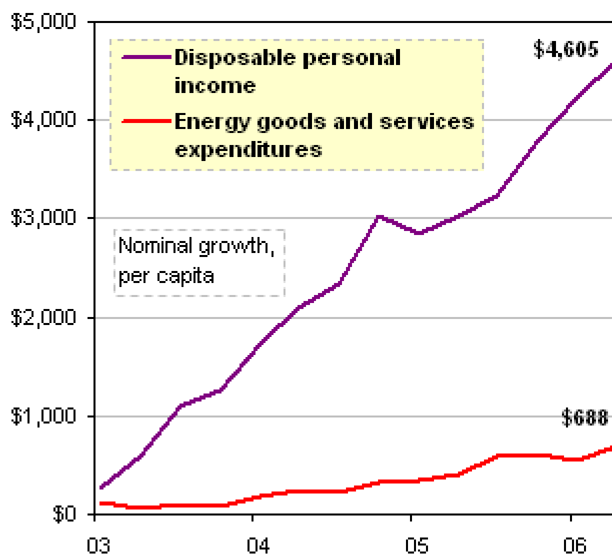
Update to strategic view
US MACRO: Consumption will remain strong. The housing slowdown is having minimal impact, and the drop in energy prices adds new support.
[see Investment Strategy Dashboard]

The Fed's Flow of Funds report released yesterday reported that household net worth in the second quarter topped the first quarter's upwardly revised all-time high, despite a falling stock market and a slowing housing market. Real estate gains by households were reported at $275 billion in the second quarter. That's down from an average gain of $503 billion over the previous four quarters, but given the well-publicized collapse of the "housing bubble," we might have expected to see no gain at all. And that $503 billion average prior gain was a downward revision from $591 billion, suggesting that the housing boom hasn't been quite so bubble-icious.



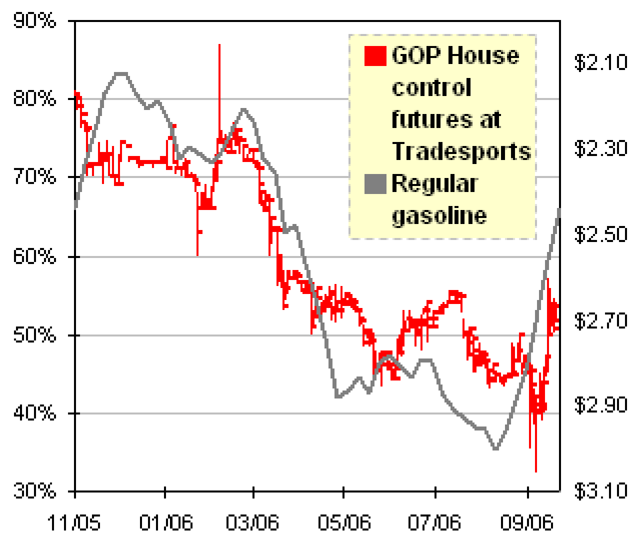
These data only strengthen our earlier analysis that the "housing wealth effect" has been a trivial contributor to the growth of personal consumption, and that its diminution does not represent the dire threat to the consumer economy that the conventional wisdom fears (see "The Housing Cool-off In Perspective" June 22, 2006). Over the four quarters ended June 30, real estate gains were $1.7 trillion, which is only 43% of the overall increase in household net worth. Personal consumption expenditures grew by $550 billion, a growth rate of 6.4%. Typical models assume that about three cents on the dollar of higher net worth feeds through to higher consumption through the "wealth effect." If that's the case, the increase in housing wealth drove only about $50 billion of the $555 billion increased consumption. Entirely excluding the housing wealth effect would have reduced the gain in consumption only from 6.4% to 5.8%. That difference is not entirely negligible, but it's clear that housing wealth has not been the sole determinant of increased consumer spending. What has? Income growth. Over the same period, disposable personal income grew by $550 billion, which alone accounts for all but $5 billion of the $555 billion growth in consumption. Other data from the Flow of Funds report suggests that the income gains driving personal consumption are likely to be sustained by an economy that continues to grow from the grass roots. Proprietor's equity in nonfarm noncorporate businesses

-- an indicator of the vitality of the entrepreneurial sector of the economy -- topped the first quarter's upwardly revised all-time high.



LOW ENERGY PRICES A GIFT, NOT A BAIL-OUT

The recent sharp drop in energy prices is another support for personal consumption going forward. And while we're on the subject, we note that, against all odds, our call last year to buy Wal-Mart and short Exxon-Mobil -- the last time the markets were gripped by exaggerated fears of a consumer collapse -- is now in-the-money (see "Played Out" October 5, 2005). The drop in energy prices will be especially helpful in the beleaguered transportation sector, where falling demand and falling prices have been playing hob with the Producer Price Index. But as far as overall consumption growth is concerned, investors shouldn't exaggerate the effect of *lower* energy prices the way the effect of *higher* prices has been exaggerated. While high prices have constrained consumption at the margin, the reality is that the increase in energy expenditures over the last several years has been modest in relation to the increase in disposable personal income. Since 2002, nominal per capita disposable income has grown $4,605, while energy expenditures have grown only $688. Nevertheless, today's lower prices will be welcomed by consumers, and may have sentiment effects out of all proportion to the actual dollars involved.



A GIFT FOR THE GOP, TOO

The most important sentiment effect may be political. According to the political futures contracts that trade online at Tradesports.com, the Republican party has recovered to a better than 50% chance of retaining its majority in the House of Representatives in the November elections. Just two weeks ago the futures pegged the GOP's chances at below 40%. What's changed is retail gasoline prices. Since late last year the GOP's chances have risen and fallen in lockstep with the retail price of gasoline (as the chart at left demonstrates, with the gasoline price shown on an inverted scale).

Will it be enough on election day? While today's broad sentiment seems to be that energy and other commodities are in free-fall, it's hardly a given that prices will be lower on election day, seven weeks from now, than they are today -- or, for that matter, that the linkage of prices and voter sentiment will continue even if prices *are* lower. And at this point, with the Tradesports futures at about 53%, the GOP shouldn't draw much comfort from the betting markets. Based on the historical record, political betting markets have strong predictive value only one month before a given election, and only when they imply chances of greater than 60% or less than 40%. For the GOP, it's still a coin-flip.

We continue to believe that whichever way House control goes, it will not be a big event for markets -- provided that the GOP retains Senate control, which seems highly likely.

BOTTOM LINE: We see personal consumption as not especially threatened by the slowdown in the housing market, and indeed being supported somewhat by lower energy prices. This will confound the Fed, which is counting on a sharply slowing economy to moderate inflation pressures. As consumption stays surprisingly strong throughout the rest of the year, the conventional wisdom now embodied by the Fed will have to shift to expectations of more rate-hikes, not the rate cuts that are currently expected. TM