TrendMacro

Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

MACROCOSM

The Consumer: QED

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Donald Luskin

The recession is so over, the consumer is still king, and the "new normal" is off the table.

This week's retail sales numbers were a foamy splash on the rising tide of optimism about the economy. It's been a three-month winning streak, lifting sales 2.6% above year-end levels. More remarkable, the *level* of "core" retail sales -- that is, the dollars spent on goods other than autos, gasoline and building materials -- is now at all-time highs. In fact, this is the second month for which that is true -- February was a record, and now March has topped it (please see the chart below). We are nonplussed by the NBER's decision earlier this week to pro-actively announce that it was not yet calling the official end of the recession. We called it in real-time 11 months ago when the first green shoots arose (see "Stress Test for T-Bonds" May 8, 2009), and we think that the NBER's more risk-averse criteria were fully met about six weeks ago (see "On the February Jobs Report" March 5, 2010).

We hope this will put an end once and for all to the "new normal" theme, which calls for a secular collapse of consumption in the US as the putatively over-indebted consumer enters a bleak "new era" of "scrimp and save." As we have commented repeatedly from the beginning of the

Update to strategic view

US MACRO: The US consumer has led the economy out of recession. Core retail sales has been at all-time highs for two months, and services consumption made new highs last October. The US economy faces challenges, but the "new normal" -- a "new era" of "scrimp and save" -- isn't one of them. As the economy recovers, the consumer will be there.

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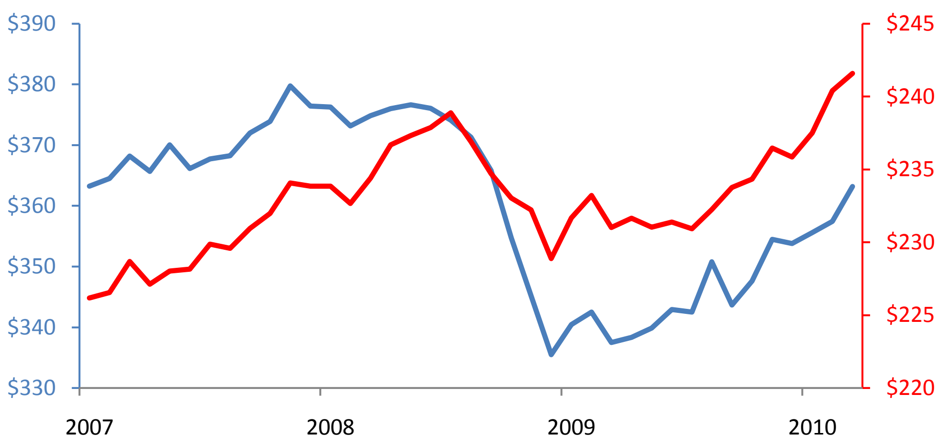
Retail sales "Core" retail sales
USD billions, seasonally adjusted



Source: Census Bureau

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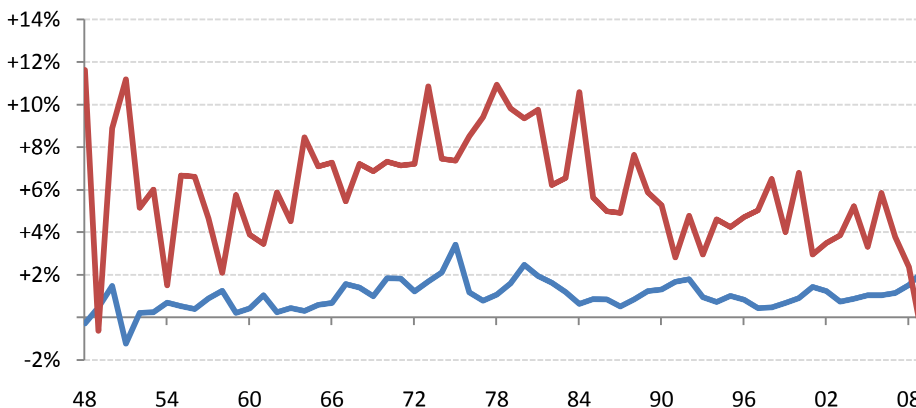
recession, consumption as a share of GDP has risen to all-time highs despite the worst economic environment since the Great Depression (see, earliest, "Is This a "New Era" Recession?" December 29, 2008), and most recently, "On Q4 2009 GDP" January 29, 2010). This is *precisely* the opposite of the core forecast of the "new normal" camp. It's self-defeating for them to claim it's only because everything else in the economy did worse during the bad times. If the consumer were the economy's Achilles' heel, that wouldn't have happened. Moreover, now that recovery is self-evidently upon us, consumption is leading the way to the upside. The "new normal" would predict that the consumer would retrench while the rest of the economy passed him by.

- Markets affirm our long-standing view on this: since the March 2009 bottom, the consumer discretionary sector has returned 120% (including dividends), ranking second only to the back-from-zero financial sector.

Could the "new normal" camp argue that retail sales are giving us a false picture, since services represent a larger part of the consumer economy? No, because consumption of services is even stronger. It already moved to new all time highs last year, in October. We don't mean just as a percentage of GDP, although that has been true, too, since March 2008 -- we mean an all-time high absolute level.

Could the strength in consumption be explained away by government "stimulus"? Certainly this is a factor to contend with. Without the transfer payments enabled by last year's "stimulus" bill, disposable personal income growth would have been negative in 2009 for the first time in 50 years (please see the chart below) -- and it would continue to be negative so far into 2010 (see "The Case for Ambivalence, Volume Three" March 4, 2010). We can't disagree that without this artificial income support consumption would have been less. But the fact that this support went into

Disposable personal income growth
Contribution by transfer payments **All other sources**
Nominal



Source: Bureau of Economic Analysis, TrendMacro calculations

Contact TrendMacro

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

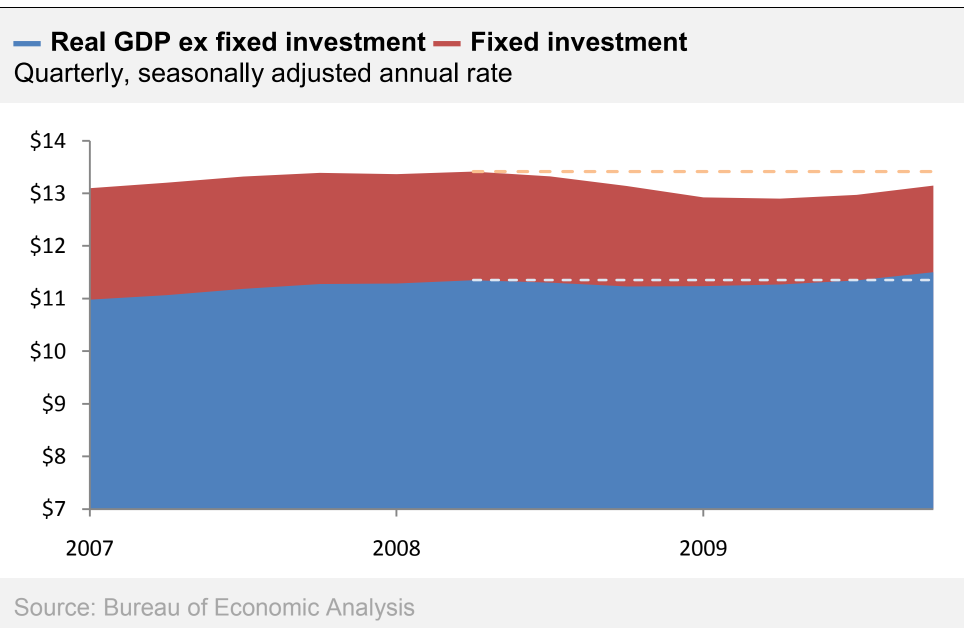
[About us]

consumption rather than *savings* -- and sufficiently so not just to support services consumption and core retail sales but indeed to drive them to all-time highs -- tells us that the US consumer's propensity to consume is intact. At this point the only straw that the "new normal" camp can cling to is that, when income supports are removed, then -- finally -- the consumer will retrench. But we don't see why such an outcome ought to be expected. Supports will only be removed when employment and income more than replace them -- so why should consumption fall *then*?

Granting that all this is so, where do we go from here? Now that the consumer has recovered from recession, there is no longer the low base that enables the most superior percentage growth, the sling-shot effect that drives the bounce-back from business cycle troughs. From here, recovery has to mature into growth, inherently a more difficult matter since there is no longer a low base from which to draw easy comparisons.

All else equal, there is still the opportunity for superior growth as consumption returns to trend levels. It is at this point in the analysis that we become a bit skeptical about consumption growth. But it's not because of any inherent skepticism about consumption and savings *preferences* in a post-bubble world, which is the backbone of the "new normal" case. Instead, we have doubts about the ability of the growth of the rest of the economy, outside of consumption, to *fund* consumption growth at trend rates.

The troubling reality is that while consumption, which dominates the economy, has already nicely recovered, the fixed investment component of the economy has not. Fixed investment -- which is made up of housing, commercial real estate, and equipment and software -- has fallen to an all-time low share of GDP, from a peak of 17.2% in 2006 to only 12% now. At the same time, thanks primarily to consumption, the other 88% of GDP has already recovered to new all time highs as of Q4 2009 (please see the chart below). For overall GDP to recover first to new highs, and then hopefully back to trend, it is virtually a necessity for there to be strong



recovery in fixed investment. It was the driver of the recession -- and it was such a dominant one, without it being the driver of recovery there probably can't be a true expansion back to trend.

But can it be that driver? We fear not. Of the 12% of the economy represented by fixed investment, a little more than half is equipment and software -- that is, capital goods. Surely there is a growth opportunity here. But with excess manufacturing capacity still high, and with much of new capacity probably fated to be built outside the US, it doesn't inspire confidence to hang hopes for extremely rapid overall growth on this sector. But it's what we've got. The other components of fixed investment are housing and commercial real estate. We're not saying those can't make positive contributions, but with huge overcapacity and the stench of the mortgage meltdown still fresh in our nostrils, these simply cannot be engines of large-scale superior growth in anything like the near term.

Without a full recovery in fixed investment, there won't be a full recovery in employment or incomes -- at least not right away, although it is theoretically possible that underutilized labor can ultimately migrate out of those sectors and into other ones with better prospects. Employment in other sectors is already beginning to improve -- so if we're right that there is no "new normal" at least in the consumption attitudes of the growing number who have jobs, then consumption growth can still be gratifying. But until we can shrink the growing number of people who *don't* have jobs -- and right now, we're seeing growth in both employment *and* unemployment (see "On the March Jobs Report" April 2, 2010) -- it is axiomatic that we won't see trend consumption *growth*, or trend *levels* of consumption. That's both a different chain of reasoning and a better outcome than one would get under the "new normal" doctrine. But we think it's a useful note of caution in the midst of the sudden improvement in sentiment about the economy that we’ve seen over the last several weeks.

Bottom line

The US consumer has led the economy out of recession. Core retail sales has been at all-time highs for two months, and services consumption made new highs last October. The US economy faces challenges, but the "new normal" -- a "new era" of "scrimp and save" -- isn't one of them. As the economy recovers, the consumer will be there.