Can the US consumer stay strong?

Goldman Sachs Exchanges

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Allison Nathan: Despite high inflation and rising interest rates, the US consumer has continued to power the global economy. But are cracks now forming in that picture? And what does that mean for investors?

I'm Allison Nathan and this is Goldman Sachs Exchanges.

There's no one I'd rather talk to about this than the three colleagues sitting with me at the table today. David Mericle is our chief US economist. And Kate McShane and Bonnie Herzog co-lead coverage of the retail sector.

David, Kate, and Bonnie, it's great to have you on the program.

David Mericle: Thanks Allison.

Bonnie Herzog: Thank you.

Kate McShane: Thank you.

Allison Nathan: So, David, given how high inflation and interest rates have been over the last couple of years, I think a lot of people have been somewhat surprised by the strength and resilience of the US consumer. What's your outlook for the consumer at this point? Is it going to give out at some point?

David Mericle: Yeah. There certainly has been a lot of pessimism over the course of the last couple of years. There have been concerns about running out of pandemic savings. There have been concerns about the sustainability of the very low saving rate. And there have been concerns about the impact of higher prices on consumer spending power, especially for lower income households.

My take would be most of these concerns are overblown and that the basic outlook is a lot simpler than that. That many of these concerns over complicate things.

We are seeing real income grow at a solid pace, led by a strong labor market that is generating good job gains and a healthy pace of wage growth. And we have historically strong household balance sheets, at least in aggregate. And we're seeing further increases in household wealth that should drive a positive wealth effect to consumer spending.

That simple formula, strong real income gains plus a positive wealth effect gave us a robust pace of consumption growth last year. And I think it will this year too, just in moderation. Because last year was somewhat exceptional. We had a big immigration surge. We created about a quarter million jobs a month. That's not going to be sustainable going forward. But same basic formula, just in watered down form, I think will give us pretty good consumption growth this year as well.

Allison Nathan: Well, let me drill down into a couple of those points though. Because as you said, labor market has given a lot of support to the consumer. But we have seen signs that unemployment is rising, and the labor market has begun to weaken a bit. So, does that concern you at all?

David Mericle: Yeah, I think the signals in the labor market have been somewhat mixed. It definitely bears watching. But, you know, the basic concern here, which has come up a lot recently in markets, is that in US history, when the unemployment rate has risen a little, it has tended to go onto rise a lot and been accompanied by a full-blown recession. I think it's important though to understand the economic mechanics behind that historical pattern. Usually, what's going on or maybe always what's been going on is I lose my job. Suddenly I don't have any income to spend at your business. Now, you need to lay someone off. That person doesn't have any income to spend at another person's business. And you get this vicious circle of job and income loss leading to declines in consumption leading to further layoffs. That is not what has happened over the course of the last year as the unemployment rate has come up.

Actually, the layoff rate has been about as low as it's ever been in the history of the US. Labor demand still looks pretty healthy. Job gains have actually been strong. It's just that they haven't been quite strong enough to keep up with this big burst of labor supply, which has been led by the immigration surge.

So, what all of this means is that consumer spending, income growth, job growth, and consumer spending growth haven't been as high as they could have been based on that additional population coming into the country. But it's not as though people are losing their jobs, losing their spending power, and cutting back. It's just that things could have been even further above trend than they have been.

Allison Nathan: Interesting. Well, the other point I wanted to ask you about though is you mentioned balance sheets, consumer balance sheets have been pretty healthy. But we have seen consumer delinquency rates rising a bit. So, we have seen some concerning signs. Does that concern you at all?

David Mericle: Yeah. We actually did a little bit of research on this late last year motivated by the rise in the delinquency rate for both credit cards and for subprime autos, which I agree was intriguing and certainly, you know, was worth looking into.

The takeaway from that research is that it's a combination of two things. One of which I think is not concerning, one of which is, I would say, a legitimate negative, but probably not that worrisome for aggregate consumption.

The first key point here is most of the increase in the delinquency rate just reflects normalization or a compositional effect. And what I mean by that is in 2020 and 2021, people's spending needs were lower than usual because you weren't going to the movie theatre or going on vacation. And at the same time, people were receiving all of this extra income from the fiscal stimulus. So, unsurprisingly, people were able to pay their bills at a record rate. Or, if you like, the government essentially paid their bills for them.

So, most of the increase that we've seen over the last couple of years in the delinquency rate is just normalization. And to the extent that we have now, in a couple of metrics, especially for lower income households, overshot 2019 delinquency rates, a lot of that we found turned out to be a compositional effect. It's tempting to look at the delinquency rate, and this is sort of an economist's first instinct, as a proxy for household financial strength. And to some degree, of course, it is. It's just that that's not the only thing going on. And you have to learn to look at these measures the way a credit investor might. And realize that there also are changes over time in the riskiness of lending.

In particular, a funny thing happened back in 2020 and 2021. When the fiscal stimulus was flowing and everyone was paying their bills, people's credit scores started to go up. And banks made, we can say with the benefit of hindsight, some, perhaps, unwise decisions to lend to people who were riskier than they appreciated at the time.

So, some of the increase in the delinquency rate simply reflects this. That there was some inadvertently risky lending done, and now those 2020/2021 vintages of loans are defaulting at a higher pace. Some of this is also probably genuine in that I'm sure it's true that when lower income households total income, including the fiscal stimulus payments, was well above trend, some people probably got a little bit too accustomed to spending at a rate that would prove to be unsustainable once the fiscal transfers were gone.

For the most part, that adjustment, bringing spending back down in line with income, happened in 2022. By that point, excess savings or liquid assets for lower income households seemed to be more or less back to pre pandemic levels.

2022 was a weak year for consumer spending for overall GDP growth. And I think that the loss of that stimulus and the need to bring down consumption levels for people who were spending at an unsustainable rate was a big part of that. But the point is it happened a long time ago. And at this point, yes, there is still some weakness. As you would expect with interest rates so much higher, it's more difficult for some people, especially those who were spending at unsustainable rates to make those payments. But, you know, I think if what you're ultimately interested in is aggregate consumption, then I would fall back on that simple formula that we have strong aggregate real income growth supplemented by a positive wealth effect, mainly from further increases in the stock market.

Allison Nathan: So, you're pretty sanguine, it sounds like.

David Mericle: That's right.

Allison Nathan: Is there anything you are worried about when it comes to the consumer? What are you watching that would concern you more?

David Mericle: Yeah. I think the most obvious thing to keep an eye on is the labor market has been rebalancing over the last couple of years. For the most part that has gone very, very well. We've gone from probably the tightest labor market in the history of the United States two years ago to a labor market that looks comparable to the one that we had before the pandemic began. We've done all of that with only a trivial increase in the unemployment rate. And so, you know, I think the main takeaway is everything worked out very well.

The one caveat to all of this is now that we are back in balance, we would ideally like measures of labor market strength to start going sideways. They've certainly stopped softening at a quick pace. The pace of deterioration has slowed. But job growth is still trending lower. The labor market hasn't completely stopped softening and completely stabilized just yet. So, until that happens, you know, I think you can say you wouldn't want the, say, rate of decline in job growth over the last year to continue for the coming year. And until we kind of start moving sideways, that's certainly something to keep an eye on.

I'm not that worried about it though because if final demand for goods and services is strong, there's not an obvious reason that companies should continue pulling back aggressively on their demand for workers. And also, because even if I'm wrong about all of this and labor market conditions deteriorate a bit more rapidly than we expect in an unhelpful way, the Fed of course now has 525 basis points of room to cut and no reason to hesitate if things worsen.

And I think we've heard from Chair Powell over the last few weeks and from other Fed officials that they're on the same page on that point.

Allison Nathan: Interesting. Thanks, David.

David Mericle: Thank you.

Allison Nathan: So, David's pretty bullish on the consumer. Kate, you are our retail analyst. So, you are looking at things from a very different vantage point. What are you observing? And does it match up with what David just commented on?

Kate McShane: Yes. I think we are still seeing a robust consumer. And we are seeing it across retail. It's just where you're seeing it in retail. That's the difference. And it's a combination, I think, of how consumers are spending and how they're prioritizing to spend. So, for example, we have seen strength in consumables, household products, food. And part of that has to do with the fact that there's been inflation. And so, more dollars are going to that. But also, you are seeing a prioritization away from discretionary goods because people are still prioritizing services. So, eating out, hotels, travel.

And so, while all of retail hasn't looked the same depending on how much discretionary goods you sell, overall retail has held in okay over the last couple of years. It's just that prioritization in that share of wallet that's looked a little bit different.

Allison Nathan: Right. People have had to make different choices. You can't do it all because there is a lot of inflation.

Kate McShane: Yes. That's right.

Allison Nathan: And Bonnie, you cover a different side of the retail space, more on the beverage, tobacco, convenience stores space. Is what Kate said, and of course also what David said, in line with what you're seeing?

Bonnie Herzog: Yeah, broadly. And I primarily cover a lot of the staples companies. So, I think what we're noticing and seeing is that a lot of these consumers are being more choiceful and thoughtful about their purchases and seeking out value.

So, we are starting to see signs of that across different categories. I would say in general, some signs of down trading pressure, but still a little limited. There's definitely down trading within cigarettes from the more expensive cigarettes down to the cheaper, more affordable cigarettes. You know, we're seeing that because the price gaps are widening, and that's something that we spend a fair amount of time monitoring, measuring. And right now, certain categories, there are wider price gaps. So, there is risk for down trading. And so, we are seeing that in cigarettes and/or leaving the category entirely.

But again, I think these consumers are broadly resilient, still purchasing. You have to remember that a lot of these products are affordable luxuries when you think about whether it's a beverage or a household product, things that these consumers absolutely need to buy. But again, in terms of pack sizes, channels where they're purchasing some of these items, that's where we're starting to see some signs of changed behavior.

So, consumers are potentially trading down to a smaller pack size because it is more affordable, although they're paying more per ounce. So, the margin profile is a lot more attractive for--

Allison Nathan: Snack packs. People are consuming more snack packs.

Bonnie Herzog: Snack packs. Small, mini, you know, can of cola might be an example as well because you might not be able to afford the 12 pack. But you still want to enjoy that product. So, we're definitely seeing that.

Kate McShane: I think in our retailers' case, we have not seen an inflection in demand for categories like apparel, home décor, small appliances. That's been actually improving a little bit. But again, the consumables piece, the food piece has been very strong. So, that's the trade-off that we're seeing within those broader big box that offers everything. It's still depressed growth in more of those discretionary categories.

Allison Nathan: Right. But essentially, the price of that food, essentially, and those consumables, it's just higher. So, you're spending more.

Kate McShane: Yes.

Allison Nathan: And so, that's your basic, everyday needs, more or less.

Kate McShane: That's right.

Allison Nathan: I feel like I'm hearing that from both of you, that around the edges, at least--

Bonnie Herzog: Around the edges.

Allison Nathan: -- There are some signs of increasing pressure. What sectors would be most vulnerable if we were to continue to see some of that pressure building?

Kate McShane: Yes, I think really anything that is non-needs based. So, that's pretty obvious, I guess. But big ticket is probably some place that we are still seeing stress. I mean, you can talk about big ticket projects in home improvement, for instance. That's probably more a function of the interest rate environment we are in. But I think it's also a function of just how many dollars people have to spend, for instance. So, big ticket discretionary is still where we're seeing a lot of pressure.

But that also goes back to what we just experienced during the pandemic too in that there was a lot of big ticket purchasing. And the replacement cycle for big ticket items, home furnishings, mattresses, the like, it's a very long replacement cycle. So, something you bought three or four years ago might not need to be replaced for seven, eight, nine years. And so, there is the dynamic of choiceful spending, like Bonnie mentioned, and what we're seeing.

But there's also just there's been a lot of spending already, pull forward, if you will, that also is going into the equation.

Allison Nathan: And how about in your space, Bonnie, what's vulnerable?

Bonnie Herzog: Yeah, I would say it's more limited just thinking about the broader staple sector. But we are starting to see some of these categories step up in terms of promos to compete. And consumers, potentially, trading down from national brands to these private label or store brands because the price points are typically a lot more affordable.

We analyzed several of the household product categories. And about 60 percent of those categories, you are starting to see private label take more share. Categories such as cleaning products, trash bags. So, again, on the margin where consumers can maybe make different choices, as Kate mentioned earlier, to save money and spend it on experiences, etcetera, they pull back on other areas. That's where we're starting to see signs. And those companies that are exposed to some of those categories, I think, are at great risk.

And, you know, maybe the other categories within our broader universe, things to consider are prestige beauty, for instance, where there might be broadly some down trading into mass in terms of the beauty category. But otherwise, it's kind of on the margin again.

Allison Nathan: David and team were also pretty positive on inflation. We've already seen it coming off fairly dramatically, even if it's taken longer than we expected. And we expect to see more declines in inflation ahead. Are the consumers feeling that reprieve at all? Or are we just still in a very high inflation environment from the perspective of consumers?

Kate McShane: I think we have heard from our retailers the beginning of some elasticity response. So, as inflation has dissipated and as you've seen some more promotion that Bonnie talked about before, which is being supported by the vendors, you are seeing more units going into the basket. You also are hearing a little bit more, again, trade-off about discretionary. And if you're paying a little bit less for your groceries, you might have a few more dollars to buy something more discretionary than you would have last year. So, we're just starting to hear that from our companies as a result of inflation dissipating.

Allison Nathan: Right. Of course, and when we say inflation is dissipating, prices are rising by less than they were.

Kate McShane: Yeah.

Allison Nathan: So, the price level is still very high. Is that what you're seeing too?

Bonnie Herzog: Exactly. Yes. Because I think the consumers are still facing, you know, these elevated prices, although they're not continuing to increase. So, I think that's, again, where we're hearing from some of our management teams understanding this and this, you know, broad strains on consumers because of this and making sure, again, they are innovating and making enough of the different pack sizes, more affordable options, bundles, trying to encourage, again, the continued demand. And to, quite frankly, drive organic sales. Because that's what we're all going to need to continue to see.

Allison Nathan: And we're in the middle of earnings season right now. So, are managements telegraphing or forecasting more pressure? Or are they forecasting a more positive message? What are you hearing?

Kate McShane: I think in retail specifically, and we're going to hear more, our calendar is pushed out a little bit more into August before we hear in earnest from a lot of our companies. But up until now, the message has been, again, not a lot of panic around the health of the consumer. Steady. Choiceful. Those are words that you've heard from us. And that's what our companies are saying.

But the back half of the year is a little bit less clear to our companies. Obviously, the election.

Allison Nathan: I can't imagine why, exactly.

Kate McShane: Obviously, the election. But there are also five less shopping days between Thanksgiving and Christmas this year. And that's just a function of when Thanksgiving falls. And just the number of days you have. And for those companies that maybe aren't as robust with an e-commerce offering, or any kind of online offering, the brick-and-mortar piece of that business is much more dependent on the days than an e-commerce offering is. So, that five days, it sounds a little silly, but they do matter with the holiday season. So, that's being incorporated too with some of these outlooks at our companies as well.

Allison Nathan: Anything to add on?

Bonnie Herzog: I would say similar. You know, hearing that from some of the larger staples companies, you know, still broadly resilient consumer. But what you're hearing more of from our companies is these companies trying to manage through this period where there's some pressure, especially maybe on the low-income consumer in terms of purchasing. So, really starting to pull more aggressively on their revenue growth management capabilities, making sure they have the right products, the right place at the right time. And importantly, in the right size.

Allison Nathan: It's interesting because Bonnie and David both talked about low income versus high income. Are you seeing any evolution in purchasing trends between high income and low income on your end, Kate?

Kate McShane: We are somewhat. Again, we've had a couple of negative preannouncements in the retail space, and it has skewed towards a lower income consumer. It's hard necessarily to totally parse out how much is that a function of the customer versus the function of the execution of certain companies. But again, if you're not offering consumables, and you're offering more discretionary, and your core consumer is a lower income consumer, that seems to be where some of the weakness is coming. We are seeing it on the discretionary side, some increasing weakness from that lower income consumer.

There are also a couple of needs-based companies that we cover that we're hearing a little bit more about deferral from that lower income consumer as well. Think auto parts or eyeglasses, that's where we're hearing about a little bit more deferral for those lower income consumers who are not necessarily being able to make that purchase right now.

Allison Nathan: So, right, by deferral you mean they're just putting off the purchase because they can't afford it or don't want to spend that money at this time?

Kate McShane: That's right.

Allison Nathan: Interesting. But when I take a step back, I do feel like the bottom's up. There's potentially a bit more concern than what we heard from David on the top down. Does that some fair?

Bonnie Herzog: On the margin, I think, right? I mean, yes.

Kate McShane: To some extent.

Bonnie Herzog: It's the catch phrase. I mean, yes. We are seeing it in certain companies' results. You're seeing it in certain channels. I'm seeing it in, I cover the convenience store channel, which is impulse purchase. And you're starting to see some softness there as these consumers are maybe pulling back a little bit and shifting their purchases into some of the discounters or the club channel.

Allison Nathan: Kate, Bonnie, thanks so much.

Kate McShane: Thank you.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Monday, July 22nd, 2024. I'm your host, Allison Nathan.

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