Exchanges at Goldman Sachs

Amid Rising Inflation and Slowing Growth,

How is the U.S. Consumer Faring?

David Mericle, chief U.S. economist,

Goldman Sachs Research

Kate McShane, U.S. retail analyst,

Goldman Sachs Research

Eric Sheridan, U.S. internet sector analyst,

Goldman Sachs Research

Allison Nathan, Host, Goldman Sachs Research

Recorded: October 31, 2022

Allison Nathan: Consumer spending has been a bright spot in the US economy. But as the holiday shopping season kicks off against a backdrop of record-high inflation and slowing economic growth, will they remain so?

Kate McShane: It's been a very mixed bag on the consumer side. You're still seeing a lot of strength in certain categories. Where we've seen more of a pull back are bigger ticket items and more one-time purchase items that you only buy maybe once every couple of years or maybe, in some cases, seven or eight years like consumer electronics and home furnishings.

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

To help us understand the state of the consumer, I'm sitting down with my colleagues in Goldman Sachs research, David Mericle, our chief US economist; Kate McShane, who covers the US retail sector; and Eric Sheridan, who follows the US Internet sector. We'll dive into the health of the consumer and look at how and where they're spending. David, Kate, and Eric, welcome back to the program.

Multiple Speakers: Thank you.

Allison Nathan: David, you're looking at the consumer very closely but from a top-down perspective. How are consumers faring right now?

David Mericle: I think consumers are doing fine. In 2021, we had blowout consumption growth around 7%. This year in the first three quarters it has slowed to about 1.5% on an annualized basis. But in this context, where the Fed is trying to keep demand growth below potential so

that we can solve this inflation problem, that's exactly what you want. We've seen a big slowdown. We have not seen a contraction in consumer spending. And a slowdown is what policymakers are looking for.

Allison Nathan: And are consumers slowing down because they want to or because they have to?

David Mericle: So there is a lot going on here, but I break it into two drivers of recent consumer spending trends. One is willingness to spend, and the other is ability to spend, or how much spending power you have. On willingness to spend, a big part of the initial decline in consumer spending during the pandemic was that people weren't willing to spend on certain services where they worried about getting COVID. In 2021, a big driver of that blowout consumption growth was that people became more willing. That's actually extended into 2022, especially in the spring of this year. We saw a big jump on spending in categories like recreation activities, restaurant activities, transportation, and so on.

Now, that's not going to provide a boost to consumption growth forever. We've probably come most of the way we're

going to come. There is a bit of a further increase to get back to pre-pandemic levels, but I wouldn't count on that too much. What about the other driver, ability to spend? So here, things have flipped for a year and a half, from the spring of 2021 to the summer of this year, we had a protracted decline in real disposable income because all of those pandemic-related fiscal transfers -- things like the unemployment benefits, the stimulus checks, the child tax credit -- they all went away. And on top of that, high headline inflation outran households' labor market income gains.

So the thing that offset that during that period, though, was that we had rising wealth gains. Home prices were rising. And until this year, equity prices were rising. In 2022, at the moment, we're seeing the reverse of that. Now, household real disposable income is growing again rather than contracting, but wealth effects have turned negative as the Fed's rate hikes have pushed down equity prices and are beginning to push down home prices.

Allison Nathan: So you are carefully tracking all of this. You and your team put out a consumer dashboard. So talk to us about what that looks like and what it's showing.

David Mericle: Sure. We introduced this consumer dashboard just because there are a lot of moving pieces here. There is this goods-to-services rotation going on, and there are a lot of things driving overall consumption growth, too, both on the income side, on the wealth side, and on the consumer confidence side.

On the income side, we monitor carefully things like job gains, wage gains, as well as business and interest income. On the wealth side, we look at total household wealth relative to disposable income, which hit a historic high during the pandemic but is now beginning to come down and will probably fall a little bit further if home prices fall further. There are also some more idiosyncratic things that we look at under that broad heading of household balance sheets such as the excess savings, which were accumulated during the pandemic. Those we think did play a big role in supporting consumption growth last winter, but the peak effect on consumer spending growth is probably behind us.

We look at both wealth and debt. From a debt perspective, I would say obviously higher interest rates make things

difficult for indebted households. But at this point, we think debt levels, debt service and costs are still pretty manageable.

Credit utilization fell a lot during the pandemic. That picked up a lot at the beginning of this year. That was actually the difference between household consumption falling and rising. If it hadn't been for that ability to draw on credit lines at more normal rates, we actually would have seen a sharp decline in consumption growth in the first part of this year. That, too, I think can continue at least a little bit. Lenders are probably going to be more cautious, but despite that sharp growth in credit utilization, it's still below pre-pandemic levels.

Allison Nathan: So you mentioned, though, the wealth effect has now turned negative. We are seeing higher interest expense, not a huge drag at this point in time but likely going to continue because we're going to see the Fed hiking interest rates more on our forecast. So what does that all mean for spending into the end of the year and 2023?

David Mericle: Our best guess is that we will stay

in roughly the 1% consumption growth neighborhood. And I would really think of that as the ideal in this environment. The Fed is aiming for a gentle solution to the inflation problem, if that's possible. That means you want to grow below the economy's longer term trend or potential growth rate, but you want to avoid being in recessionary territory. 1% consumption growth and, more broadly, roughly 1% GDP growth that we're looking for more or less splits the difference. That's about the ideal.

Now, again, the big change going forward is, rather than falling income and rising wealth, we now have rising income and falling wealth because, going forward, there just aren't many transfer payments from the pandemic left to take away. They're all gone at this point. And we think that the combination of employment gains and wage gains should outrun inflation going forward.

My best guess would be that those things more than offset the negative wealth effect, and we're left with modestly positive consumption growth. But it is admittedly a bit uncertain when so many moving pieces are changing.

Allison Nathan: But I do think a key takeaway here is

that we want the consumer to slow a little bit to avoid a scenario where the Fed has to continue to hike even more aggressively to slay inflation and have a more recessionary outcome.

Kate, let me bring you into the conversation. David just gave us really solid top-down view of the consumer. But from your seat, covering retailers, what are you seeing bottoms up in terms of the behavior of consumers right now?

Kate McShane: Yeah, so it's been a very mixed bag on the consumer side as well, which I think reflects a lot of what David was saying. With regards to the fact that you're still seeing a lot of strength in certain categories, but you're also seeing a lot of price-led sales versus unit-led sales.

So as an example, categories where we continue to see quite a bit of strength is, like, home improvement, for instance. Grocery or food at home is another category that people continue to spend on. Other ticket items that people can still afford versus big ticket items. Sporting goods is still a good area where people are spending money.

These are all places where we did see growth during the pandemic when people were stuck at home but seems to still be a priority for people. Health and wellness, your home, being with your family with food.

Where we've seen more of a pull back are bigger ticket items and more one-time purchase items that you only buy maybe once every couple of years or maybe, in some cases, seven or eight years like consumer electronics and home furnishings.

Allison Nathan: And Eric, let me turn to you then. Kate is brick and mortar. You're Internet. And obviously during the pandemic, we saw a huge boost to consumption over the Internet, but what are we seeing now that a lot of these pandemic effects have run their course?

Eric Sheridan: Yeah. And I think the main theme that cuts through all the answers so far is the word “normalization.” We had an enormous pull forward effect from the pandemic. We believe ecommerce gained about two and a half years of penetration gains in the span of nine months, from March of 2020 through the holiday period in 2020.

2021 into the middle of 2022 was the normalization effect of that. Things slowed down. Amazon grew roughly 0-1% for most of the first half of '22, and now they're lapping those tough comps with easier comps and they're growing back in the mid-teens again. But on a 2-year stack or a 3-year stack, if you were to normalize what revenue looks like, ecommerce is still growing in the high single digits on a normalization benefit. They're going to take about 200 basis points of share, ecommerce versus offline retail. But Kate's companies -- and I'll throw it back to her -- are increasingly also getting ecommerce more right now than they ever did pre-pandemic.

There are companies I cover like Uber and Doordash and others that will tell you they're partnering with a whole host of Kate's companies on deliver from store, pickup from store. So this element of local commerce is getting more refined. Ecommerce as defined is getting more refined. But all we're really doing is finding a normalization balance in a post pandemic world.

Goods versus services. I cover a lot of travel companies. They all boomed in the summer of '21 and the summer of

'22. And now most investors I talk about are terrified of owning an online travel company because now you're going to have a weakening consumer into tougher comps in 2023. All we're finding is elements of normalization, true north, and growth rates are coming back to those elements from what I can tell.

Allison Nathan: Kate, talk to us a little bit more about those synergies because I think a lot of people think of brick and mortar or online. But the synergies between the two that really were developed and accelerated during the pandemic make sense.

Kate McShane: Yes. I actually love talking about this because there was a very short period of time where I didn't know if there would be brick and mortar for me to cover, and that it would just be Eric covering Amazon. But what we started to say maybe a year or two before the pandemic in earnest were the retailers starting to lean into their asset base, which is their stores. They figured out that most of their stores are within 90% of the US population within one or two days of delivery. And because of that, you're starting to see a lot more fulfillment from the stores.

So Eric mentioned the fulfillment by third parties like Uber and Doordash. That's been extremely successful. And the customer is willing to pay for it. That is a service fee. The retailer's not covering it. The retailer loves it because it's not 2-day free ship that they have to pay for. And the consumer's getting it in the time that they want to get it in.

The other thing that's been a game changer in my mind has been the “click and collect” concept, which is something that Walmart and Target introduced before the pandemic, where you order online but you drive up in your car and you stay in your car and someone brings it out to you. That “click and collect” was introduced by every specialty hard lines retailer during the pandemic and has been, again, another reason to go to the store.

Allison Nathan: And let me just ask a couple follow-ups. We are still seeing more people going back into stores, though, correct?

Kate McShane: Yes, we are. So we did hit that peak penetration at ecommerce or ordering online with the brick-and-mortar stores in '21. In '22, we've started to see

some erosion of that. We're not going to pre-pandemic levels, but you're seeing more people come back to the store.

Allison Nathan: And then on some of these pandemic-related developments, like the "click and collect," there still is a question mark, though, about how persistent those will be. So do you think that this now is a permanent aspect of shopping in the United States and beyond?

Kate McShane: I think it is. I think it could evolve over time, but I think what we've learned is the consumer loves optionality. If they want to buy something at the store and see it and feel it, they can go to the store. If they want it just delivered to their house because they buy it every single week and they know what to expect, then they'll get it delivered. And then, just whatever convenience I think that can be introduced to the consumer, they're going to try. And it does seem like the "click and collect" piece is really sticking. Target has highlighted, for the last several quarters, it's the fastest-growing piece of their digital business.

Eric Sheridan: And maybe if I could just jump in

for a second, I think you're also seeing elements of subscription come in here. Amazon Prime households are north of 90 million households in America. Amazon talked about on the earnings result last week that they added the most number of Prime households ever in the month of September just this past year, with the launch of Thursday Night Football.

So you think about that. A piece of media content led to probably 5 million-plus households becoming Prime membership households just through that content investment. So what you're seeing is the consumer wants what they want as fast as they can get it, as cheap as they can get it. Sometimes Kate's companies are the ones that are going to be the ones that do it. Sometimes it's going to be Amazon. It's also pushing Amazon up the investment curve, right? And we've seen two years of outsized fulfillment center investment, local delivery investment from Amazon. Some of that's now starting to moderate. But the throughput of the yield from that is going to be Amazon wants to do same-day delivery.

There are plenty of cities in the United States where Amazon has 2- and 4-hour window deliveries for same day.

Not in New York City but in plenty of places that we track. So this battle of same-day, next-day, convenience, price, last mile delivery, this is not going to abate anytime soon.

Allison Nathan: You mentioned earnings, Eric. It's been an interesting period for you and the Internet companies. Maybe you could talk a little bit about some of your key takeaways in terms of what you learned about the consumer base and beyond. And Kate, too, we'll turn to you to hear about some of your key takeaways from third quarter earnings so far.

Eric Sheridan: Yeah, I think just away from the consumer, I'll say the largest technology companies are slowing. They are big. They had enormous benefits from the pandemic. There are some overhangs from the economy, especially in Europe, that are now impacting these companies. They're slowing growth rates. We're now talking about low single-digit growth rates for many of these companies. I think there's better growth rates ahead against this theme of normalization, but we are adapting to a new lower growth algorithm.

When growth investors get thrown lower growth, they look

for profits and free cash flow. Unfortunately, most of my companies are throwing heavier levels of investment. So you saw the semiconductor industry rally because most of my companies are talking about building more data centers, building more infrastructure, and CapEx numbers were going up next week. So the lack of visibility into an output on cash flow in a low-visibility environment on growth really was an algorithm that gets sold by growth investors. It got sold last week, and a return to that visibility is very much needed to bring confidence. And with confidence comes multiple in the technology industry. And that's what'll bring some of our companies back.

Amazon was the one I thought that, in terms of the long-term secular bold thesis [?] -- cloud computing and where they stand with the consumer -- is probably the most intact by far. And that was the one that actually rallied off the worst of the reactions we saw last week.

Allison Nathan: And Kate, key takeaways from you on third quarter.

Kate McShane: Sure. Yeah, we haven't had too many prints yet. We've had a couple of auto part retailer

prints. We should probably concentrate on that a little bit because we did get quite a few investor questions. Auto part retail is one of the most defensive areas in which we cover because everybody needs their car to work. And we've all known what's been going on in the car industry with the supply chain. It's been hard to get a new car. It's been hard to buy a used car. And therefore, the average age of cars continue to go up, and consumers need to fix those aging cars.

And because of that, we've seen some of the strongest trends in auto part retail, and that's something that has persisted through the third quarter.

Allison Nathan: And let's grab onto that defensive aspect a little bit because one of the big themes, as we all know, over the last couple years has been the delays in supply chains. What are you all seeing at this point in terms of the delivery of goods and how much is that an ongoing impact now?

Kate McShane: I think from our point of view, if we back up just a little bit, going into holiday, one of the biggest concerns around holiday 2022 is being in stock

because holiday 2021, nobody was in stock. You went to the stores. There were empty shelves. Retailers left a lot of money on the table. So this year you had seen a big effort. And honestly, it kind of begets why the supply chain was in the state that it was. It was these retailers chasing all of this product that they wanted to be on the shelves.

And so as we enter into holiday '22, I think you'll walk into most of these retailers and see heavily stocked shelves. And we'll see if it's too much at the end of holiday, but they will be in stock. But in order to have done that, they brought in all of these goods very early. And I think looking into '23, the expectation is now that chase is done. Now that demand might be normalizing. You will start to see some alleviation in the supply chain.

One other thought is that the COVID-related shutdowns in Asia is another reason why you saw a lot of twisting of the supply chain. If that were to not happen, you'd have seen the reduction of ships from the ports. You've seen the ports become a little bit less clogged. You're not seeing the chase for inventory. So '23 is looking better from a supply chain standpoint.

Allison Nathan: Obviously inflation is the key concern right now, but you're telling me that there's plenty of inventory and that retailers understand that the consumer is slowing. Do we think that we could see some relief on the price side heading into this shopping season versus past seasons?

Kate McShane: Yes. So it's an interesting question. We know that prices are much higher than they were a year ago. We've seen it in the breakdown of ticket versus unit. In a lot of our retailers, we've seen high single-digit ticket growth. Now, that's not all absolute price where the price has gone up 10%, but it's there. Prices are higher.

But if the consumer is slowing, if goods are more in stock, it does beg the environment to be more promotional. And all of our companies have warned us that they are definitely going to be more promotional than last year, which I don't think is too hard of a conclusion to come to. It makes sense. The question is: Will they be as promotional as they were before the pandemic? And that's the debate by investors right now.

The companies are telling us that they're smarter about

inventory, they're smarter about conveying sales to their constituents, but at the same time there is a fear that, if that consumer starts to slow around holiday and there is all this inventory, that you will see a heavier level of promotions than expected.

Allison Nathan: What about on your side, Eric? Obviously Internet shopping is just a huge aspect of the holiday season shopping. What do you expect from the promotion season?

Eric Sheridan: Yeah, Amazon didn't really call out a need to be overly promotional as they said they would follow some of Kate's companies in North America if need be. They made very positive comments about where they sit in terms of inventory. Coming out of Prime Day was a couple hundred basis points of added growth in Q3, the 2-day event that Amazon had in July as a tailwind for growth.

They're a little more worried about Europe than they are the US. So it comes back to both tying some of David's comment about broad global consumer demand with some of Kate's comments that seemed a little bit more US

specific. But really Amazon's worry, while it got painted with a broad brush in its coverage last week by the media, was really more about Europe is slowing very dramatically. It's energy price driven. It's Ukraine conflict driven. So I think if there's a worry about having to be promotional and/or not having demand against the supply they built up, they're a little more worried about Europe than they are North America.

Allison Nathan: So maybe we just end with some final thoughts. We've touched on this. Ultimately, what really are you expecting to see from the consumer in 2023, from brick and mortar, Kate? And you online, Eric?

Kate McShane: With regards to the outlook for 2023, using David's outlook and the economists from GS, there is some thought that the consumer from an income standpoint will be in a good place. You're not lapping stimulus like you did in 2022 versus '21. And if there's a softer landing with the macro environment, you could see consumer cash flow up a little bit in '23.

I think what's going to be interesting is what I started saying today in our conversation is that a lot of the sales

were more price led than unit led. When we go into '23, the unit compare becomes much easier. So we do expect maybe a more balanced unit versus price driving environment for sales. And I do think it could look healthier than even 2022.

Allison Nathan: So just to clarify, by “unit,” you mean volume versus price? And that's what you look at when you're talking about an overall amount of revenue from retail sales?

Kate McShane: That's right. Where you won't see prices come all the way back, we don't think, depending on what category it is. And you might see a few more units sold because you're lapping a time when not as many units were sold.

Eric Sheridan: On the demand front, I'll back everything Kate just said. I think we would expect a relatively stable but lower growth demand environment. I think the more interesting thing from an ecommerce perspective, which really applies just to Amazon, Amazon has long not gotten right the big categories of wallet share by the US consumer -- food, CPG, big ticket items that

people tend to get in their car, go to a store, buy a lot of on the weekend, and then bring them back home. I think for them to sustain high single, low double digit growth in ecommerce, the days of consumer electronics or physical media being the driver of that are probably more behind us than ahead of us.

So I think what I'm watching for in 2023 is how well Amazon executes on the competitive dynamic with some of Kate's companies, vis-à-vis some of these big wallet share dollar categories going forward. I think that's probably going to be the more interesting dynamic to watch for in 2023.

Allison Nathan: David, Kate, Eric, thank you so much for joining us.

Multiple Speakers: Thank you.

Allison Nathan: Thanks for joining us for another episode of Exchanges at Goldman Sachs, which was recorded on Monday, October 31st. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share

and leave a comment on Apple Podcasts, Spotify, Stitcher, Google, or wherever you listen to your podcasts. And if you'd like to learn more, visit GS.com and sign up for Briefings, a weekly newsletter from Goldman Sachs about trends shaping markets, industries, and the global economy.

This transcript should not be copied, distributed, published, or reproduced, in whole or in part, or disclosed by any recipient to any other person. The information contained in this transcript does not constitute a recommendation from any Goldman Sachs entity to the recipient. Neither Goldman Sachs nor any of its affiliates makes any representation or warranty, express or implied, as to the accuracy or completeness of the statements or any information contained in this transcript and any liability therefor (including in respect of direct, indirect, or consequential loss or damage) are expressly disclaimed. The views expressed in this transcript are not necessarily those of Goldman Sachs, and Goldman Sachs is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this transcript. In addition, the receipt of this transcript by any recipient is not to be taken as constituting the giving of investment advice by Goldman Sachs to that recipient, nor to constitute such person a client of any Goldman Sachs entity. This transcript is provided in conjunction with the associated video/audio content for convenience. The content of this transcript may differ from the associated video/audio, please consult the original content as the definitive source. Goldman Sachs is not responsible for any errors in the transcript.