ECONOMIC OUTLOOK
REGIONS
June 2022

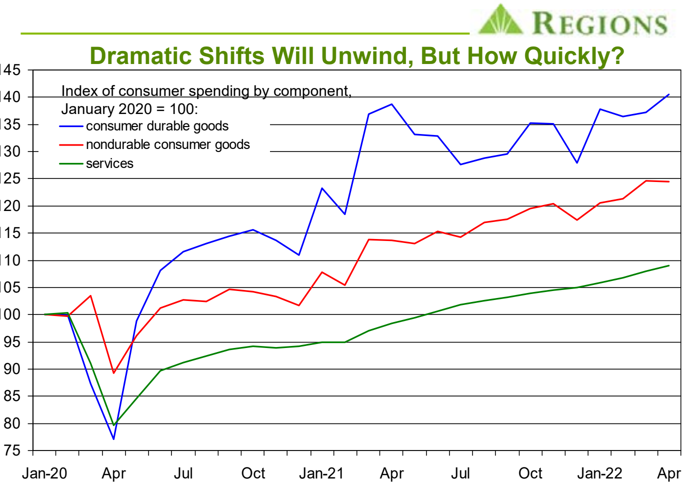
Losing The Consumer?

The most recent round of retail earnings releases triggered a wave of pessimism over the state of U.S. consumers, which led to stock prices of many retailers being beaten down, severely so in several cases. One question we thought worth asking was whether the picture painted by the retail earnings releases was a spending story or a cost story. Sure, for those holding stocks of retailers, it may not have mattered one way or the other, but from our perspective it did. Our sense was, and is, that the outlook for U.S. consumers isn't as bleak as may have been inferred from the latest round of retail earnings releases. There was, after all, a common theme across those earnings releases that seemed to support our contention, that theme being "revenue beat, earnings miss." In other words, what were in many if not most cases beats on the top line ended up being misses, often significant, on the bottom line due to larger than expected increases in costs. At the same time, guidance on the path of earnings offered little hope that cost pressures were set to ease any time soon.

Even if the latest round of retail earnings releases was more of a cost story than a spending story, one element of those releases that did not escape notice was many retailers reporting inventories unexpectedly rising. Rising inventories were, for the most part, concentrated amongst discretionary goods, with necessity goods capturing a greater share of consumer spending on goods. This shift reflected higher prices for necessities such as food, energy, and shelter that were weighing on discretionary spending for many households. More broadly, higher prices for consumer goods helped account for beats on the revenue side of the ledger. So, in short, even if significantly higher costs were the primary culprit behind a disappointing batch of retail earnings releases, there were causes for concern over the state of U.S. consumers.

To be sure, higher prices for necessities are straining the budgets of lower-income households, and higher financing costs will weigh on spending on consumer durable goods that are typically paid for over time. At the same time, however, overall household financial conditions remain sound. A preponderance of fixed rate debt on household balance sheets will mitigate the effects of higher interest rates. As such, while monthly debt service obligations will rise, the magnitude of those increases will be less than would have been the case in past cycles, and those increases will start with debt service obligations hovering near recorded lows. Moreover, coming into this year, households across all income levels were sitting on sizable financial buffers, giving them capacity to absorb the effects of higher prices, though clearly not indefinitely.

While those buffers have no doubt thinned down, particularly for lower income households, we continue to think the most likely outcome is a deceleration in the pace of growth of consumer spending rather than significant and sustained declines in the level of consumer spending, even after accounting for higher prices. Still, all of this may come as little consolation to retailers, as we think there is much further to go in the rotation in patterns of consumer spending – away from goods, toward services – that we and many others have been pointing to for some time now.



Source: Bureau of Economic Analysis; Regions Economics Division

The above chart illustrates our point. As we've discussed on many occasions, the combination of generous financial support that bolstered disposable (after-tax) household incomes and much of the services sector being effectively shut down led to a dramatic increase in consumer spending on goods that began in the early stages of the pandemic. Successive rounds of transfer payments, such as the second and third rounds of Economic Impact Payments that were delivered in Q1 2021, helped sustain the binge of consumer spending on durable goods, which was reinforced by notably low interest rates. While services spending has rebounded, that rebound has been far less exuberant than was the case with spending on goods. To that point, as of April (the latest available data), consumer spending on durable goods was 40.5 percent above its pre-pandemic peak, with spending on nondurable consumer goods 24.5 percent higher but consumer spending on services just 8.8 percent above its pre-pandemic peak.

We have for some time expected that there would at some point be a rotation in consumer spending patterns. After all, the nature of consumer durable goods – items such as motor vehicles, home furnishings, appliances, and electronics – means that these are not repetitive purchases and, at some point, demand would be largely sated. To be sure, the increased incidence of remote work added to the spike in spending on consumer durable goods, as many reconfigured their homes to facilitate working remotely, leading to increased sales of office-related furnishings and electronics, but that wave would also have been expected to ultimately subside. At the same time, as the services sector of the economy reopened,

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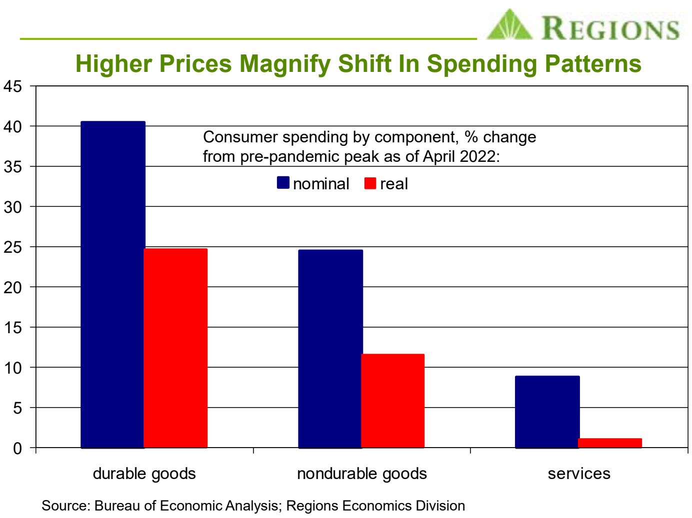
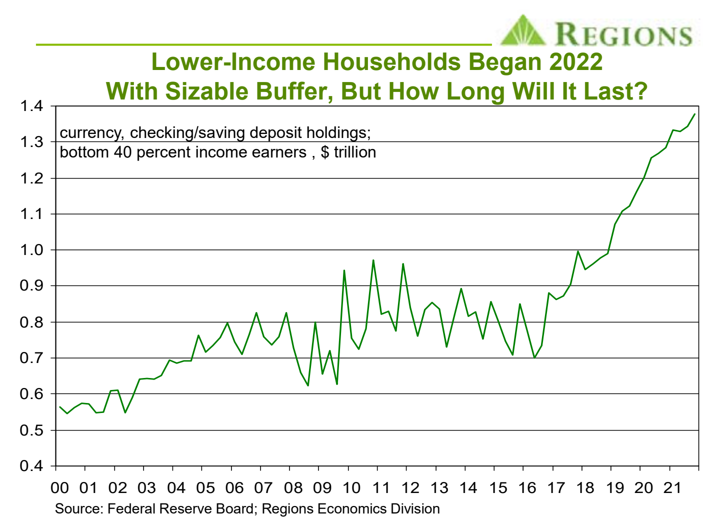
what came to be a high degree of pent-up demand for services such as travel, tourism, dining out, recreation, and entertainment would be unleashed, leading to significantly faster growth in spending on services. That the reopening of the services sector has to some degree come in fits and starts, due to recurrent waves of the pandemic, has weighed on the pace at which services spending has rebounded. That rebound, however, has clearly shifted into a higher gear over the past several weeks, which could be sustained through the summer months barring another wave of the virus leading to renewed restrictions on activity.



To some extent, price changes have distorted the magnitude of the shift in consumer spending patterns, particularly over the past year or so. It was the spring of 2021 when inflation began its sharp acceleration, primarily driven by rapidly rising goods prices. After accounting for changes in prices, consumer spending on durable goods was 24.7 percent above its pre-pandemic peak as of April, with spending on nondurable consumer goods 11.5 percent higher and spending on services a mere 1.1 percent higher. So, while higher prices may distort the magnitude of the shift in consumer spending seen since the onset of the pandemic, that shift is very real but, we'd argue, likely to reverse.

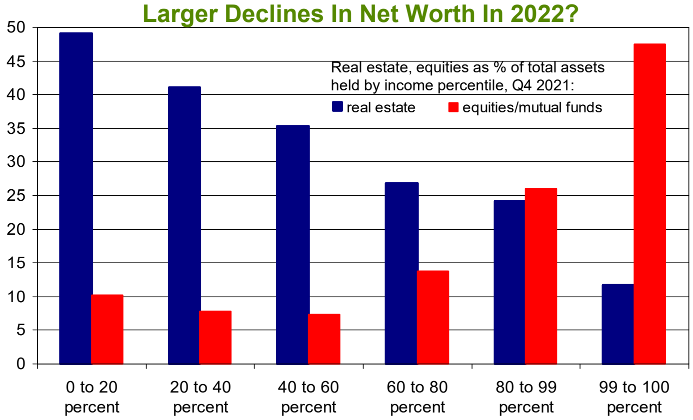
As noted above, growth in spending on services has picked up sharply over recent weeks, though the present pace is not likely to be sustained. But, to the extent we are correct in thinking the rotation in spending away from goods and toward services has further to run, that raises the following points. First, those retailers who did not anticipate such a shift or underestimated the extent of the shift in spending patterns will be caught out with too much inventory on their hands, which could lead to discounting in order to move this inventory. That would, of course, impact both their top lines and their bottom lines when it comes to earnings. Second, even as goods capture a smaller share of total consumer spending in the months ahead, there are likely to be further shifts within good spending, with necessity goods accounting for a larger share and discretionary goods accounting for a smaller share of overall goods spending. Third, if at some point there is relief from supply chain and logistics bottlenecks which results in more consumer goods being produced and shipped, that will weigh on goods prices, to the extent that no one should be surprised to see outright declines in goods prices. To be sure, we and most others had expected to see some such relief by this point, which has not been the case. When it does come, however, either more moderate increases or outright declines in goods prices will exaggerate the extent of the shift away from goods spending, particularly to the extent that services price inflation accelerates further, just as rapidly rising goods prices exaggerated the extent of the shift on the way up. Fourth, to the extent we do see a more pronounced rotation away from spending on goods and toward services, the monthly retail sales report will not be a meaningful gauge of the health of U.S. consumers, even if many will insist on interpreting it as such. Keep in mind that the retail sales data are not adjusted for price changes and, more significantly, do not capture consumer spending on services. The monthly reports on personal income and spending produced by the BEA capture spending on goods and on services and show both nominal and real spending. As such, the BEA's monthly reports will be more informative indicators of the state of U.S. consumers.

We do think consumers have the wherewithal to sustain spending to a greater degree than might be inferred from elevated inflation and rising interest rates. As counterintuitive, if not downright odd, as it may sound, household balance sheets emerged from the pandemic-induced recession stronger, not weaker, than they were prior to that recession. That of course is a reflection of the fiscal transfers from the public sector and interest rates being pushed down to extraordinarily low levels (which are different discussions for different days). Still, consumers were quite judicious in taking advantage of these circumstances to a degree that many found surprising. Many used good portions of fiscal transfers to pay down debt and bolster saving in addition to increasing spending, while taking advantage of ultra-low interest rates to refinance debt, thus emerging with notably lower debt service burdens.



There is ample evidence that improvements in household financial conditions were broad based across all levels of income and net worth, rather than being largely confined to those on the upper ends of those distributions. For instance, the Federal Reserve's *Distributional Financial Accounts*, which integrate data from the "Flow of Funds" reports and the *Survey of Consumer Finances* to provide quarterly measures of the distribution of household wealth across the income and net worth cohorts, show those in the lowest forty percent of the income distribution holding considerably higher currency/deposit balances at year-end 2021 than was the norm in the years prior to the pandemic. Unfortunately, the latest observation in this series is Q4 2021, with the lag understandable given the scope of the data, and these balances have surely diminished over the first half of 2022 in the face of elevated inflation. At the same time, though, other data show deposit balances remain above pre-pandemic norms, meaning that lower-income households still have a buffer to fall back on. In the face of elevated inflation, they are likely being more circumspect as to how they deploy this buffer.

Upper Income Households Seeing Larger Declines In Net Worth In 2022?

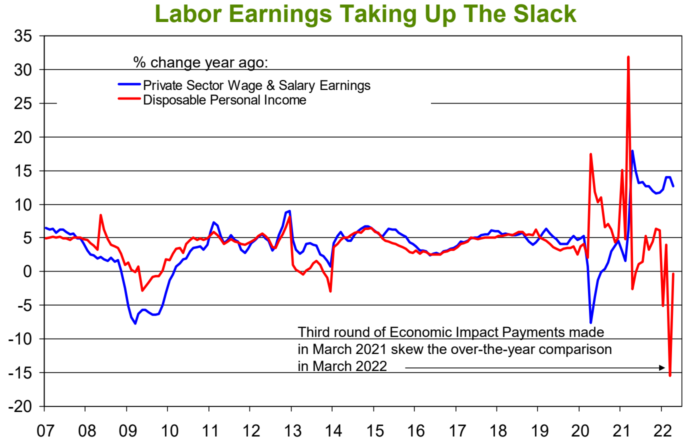


Source: Federal Reserve Board; Regions Economics Division

It is interesting to note that while households across all levels of income and net worth saw meaningful increases in net worth by year-end 2021, it is those households in the upper ranges of the income and net worth distributions that have likely experienced the most pronounced declines in net worth thus far in 2022. As the above chart shows, real estate comprises a much larger share of net worth (mainly in the form of primary residences) for those in the lower ranges of the income and net worth distributions than is the case for those in the upper ranges. For the latter group, equity holdings account for a substantially greater share of net worth than does real estate. With house price appreciation having yet to slow while equity prices have taken a beating, declines in net worth thus far in 2022 have likely been highly concentrated amongst upper-income, upper-net worth households. Obviously, elevated inflation is eroding the purchasing power of checking and saving deposits, but lower-income households were nonetheless more liquid, with a greater pool of funds at their disposal coming into this year than has been the case historically.

While a rapidly declining personal saving rate, as measured by the BEA in their monthly reports on personal income and spending, may make it seem as though any financial buffers households were sitting on coming into this year have largely evaporated, we'd caution against putting too much stock in this metric. The BEA's measure of the personal saving rate is simply based on the gap between disposable personal income and personal outlays in any given month, giving rise to measurement issues. For instance, the entire amount of large-scale purchases, such as motor vehicle purchases, is booked as spending in the month the purchase is made, whereas the actual monthly outlay on those purchases made via financing is the amount of the loan payment. In those months, such as April, when there is a sizable increase in motor vehicle sales, that naturally biases the saving rate lower. While the trend in the saving rate over time is a useful guidepost, the reported saving rate in any given month is of far less use. To be sure, the saving rate has been trending lower, which was to have been expected as pandemic-related transfers ran their course and, in so doing, held down growth in disposable personal income.

Labor Earnings Taking Up The Slack



Source: Bureau of Economic Analysis; Regions Economics Division

Finally, we think it important to note that, while pandemic-related transfer payments having run their course is holding down growth in disposable personal income, as of April aggregate private sector wage and salary earnings had posted double-digit year-on-year increases in each of the past thirteen months. This is far and away the largest single component of personal income, and while many focus on average hourly earnings, it is aggregate wage and salary earnings – the product of the number of people working, the number of hours they work, and what they earn for each hour worked – that are the driving force in growth in personal income and spending. Faster wage growth has taken hold across all industry groups, encompassing workers of all skill levels – of all the main industry groups, aggregate wage and salary earnings are growing the fastest in leisure and hospitality services. Robust growth in labor earnings is putting a floor under personal income and spending, and we expect this to remain the case.

So, while this isn't to say that U.S. consumers are not facing challenges from elevated inflation – particularly for food, energy, and shelter – and rising interest rates, neither are they without financial resources to help mitigate the effects. This, and shifting spending patterns are worth keeping in mind when processing the retail sales data and retail earnings releases over coming months. We do expect growth in consumer spending to slow over coming quarters, but do not expect a substantial and sustained decline.

Buiilders Left Holding The Bag?

With a jump in mortgage interest rates compounding the effects of a prolonged period of rapidly rising house prices to further diminish affordability, it came as no surprise that new home sales declined in April. The extent to which they did so, however, was more than a little surprising. New home sales declined to an annualized rate of 591,000 units in April, down from March's sales rate of 709,000 units and easily the lowest monthly sales rate since

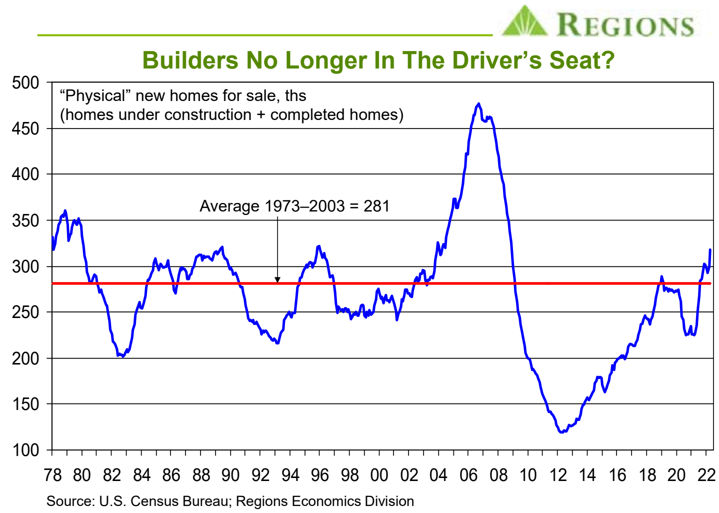
April 2020, when sales plummeted as the economy shut down in the early weeks of the pandemic. The not seasonally adjusted data, the basis for all of our analysis of the data on residential construction and sales, show new home sales fell from 68,000 units in March to 53,000 units in April, a 22.1 percent decline.

While we anticipated new home sales to have declined in April – it is typical for not seasonally adjusted sales to fall in April – we also think the magnitude of that decline to be somewhat suspect. The 22.1 percent decline is the largest April decline in the life of the Census Bureau's data on new home sales dating back to 1963 and is the eighth largest decline in any month over that span. Even allowing for the increase in mortgage interest rates, the decline reported by Census looks overdone, particularly given that builders had literally been turning away prospective buyers over the prior several months. Our suspicions were also aroused by the ratio of new home sales to single family permit issuance (using the not seasonally adjusted data), a metric we've long used to guide our forecasts of new home sales, coming in at just 53.9 percent in April, the lowest of any April on record and the third lowest of any month in the life of the data. While not every single family unit permitted and constructed is made available for sale, allowing for the usual "leakages" generally leaves the sales-to-permits ratio in the mid-70s, which is why April's reading caught our eye.

To be sure, new home sales are perhaps the most inherently volatile of the top-tier economic data series, prone to sharp month-to-month swings and sizable revisions to the initial estimate of sales in any given month. So, it could be that either the initial estimate of April sales will be revised higher with the release of the May data, or it could be that the May data will show a sharp increase in sales (and a correspondingly high sales-to-permits ratio). We'll know that soon enough, but regardless of what the April sales number ultimately turns out to be, it seems clear that new home sales have further to go on the downside given the extent to which higher mortgage rates are making affordability constraints more binding. That in turn raises the possibility that builders may find themselves stuck holding higher inventories than they had planned on given how they changed sales tactics in 2021 in the face of supply chain constraints and blistering demand.

As we've discussed on several occasions, including the February 2022 *Outlook*, the combination of sizable, and growing, backlogs of unfilled orders and increasingly binding supply chain constraints led many builders to change tactics in 2021. One change was that many builders imposed caps on sales as a means of curbing the growth in order backlogs. Another change was starting work on new units but not releasing those units for sale until construction was well underway. With rapidly rising materials costs and growing uncertainty on delivery times, this change afforded builders more control over completion dates and shifted price risk to buyers. With still-low mortgage interest rates helping fuel strong demand, these changes in tactics posed little risk to builders, though that was obviously contingent upon the continued strength of demand. That the rapid increase in mortgage interest rates this spring shifted the balance of risk is clear, but what is less clear is the degree to which that balance has shifted to builders.

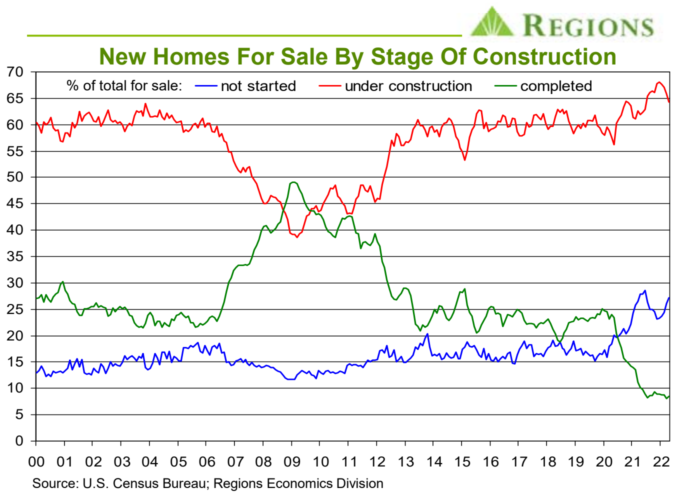
Recall that new home sales can be booked in any phase of the construction process – before the start of construction, while construction is underway, or after completion. The data show a pronounced shift in shares of sales by phase of construction over the course of 2021, with units under construction accounting for an increasing share of total new home sales. For 2021, units under construction accounted for 45.8 percent of all new home sales, the highest share since 1972, and over the first four months of 2022 that share increased to 48.3 percent.



At the same time the share of new home sales accounted for by units under construction has been increasing, so too have spec inventories of new homes for sale, or, the combined number of completed units and under-construction units for sale (we often refer to these as "physical" new homes for sale), as shown in the above chart. Our suspicion has been all along that there was at least some degree of double counting embedded in the Census Bureau's data, i.e., under construction units turning up as both sales and inventory in the same month. While we are unable to back that out of the data, our broader point was that rising spec inventories posed little risk to builders. Again, they were starting units well before they were making them available for sale, and as long as demand remained intact, there was little chance that these spec units would go unsold.

With new home sales having slowed, even if not to the extent implied by the initial estimate of April sales, builders are facing increased risk in the form of rising spec inventories. As of April, there were 318,000 physical new homes for sale, up 40.1 percent year-on-year and the most in any month since November 2008. While there is, apparently, a natural tendency to do so, making comparisons between now and then it isn't all that instructive, as should be clear from the above chart. While late-2008 was not even the mid-point in a long and painful inventory correction after a collapse in demand left builders with record-high inventories, the recent increase in spec inventories comes after a period of chronic undersupply, and while demand has cooled due as mortgage rates have risen, it's hard to argue that demand has collapsed.

To be sure, we're still early in the process, and it is unclear how much higher mortgage interest rates will rise and how much further demand for new homes will tail off. That said, we'd argue that the increase in spec inventories poses considerably less risk to builders than was the case in the prior cycle. One reason we think this is that the composition of spec inventories, i.e., the split between completed units and under-construction units, is more favorable for builders than was the case in the prior cycle, as we illustrate in the following chart.



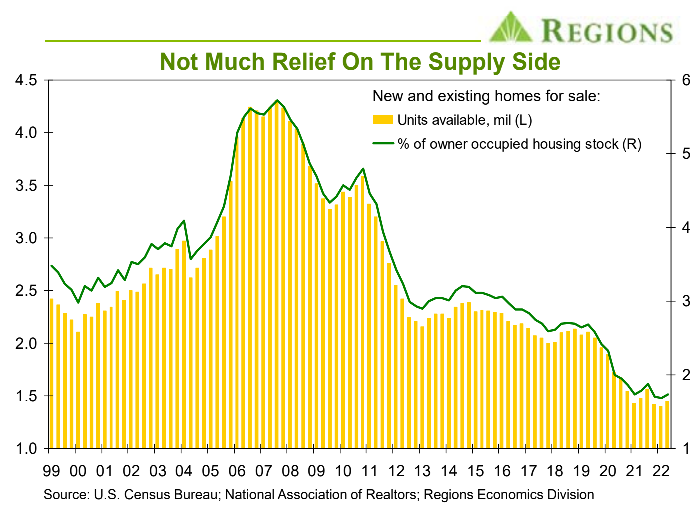
Source: U.S. Census Bureau; Regions Economics Division

The above chart shows the composition of inventories of new homes for sale by stage of construction. One thing that stands out is the significantly diminished share of inventories accounted for by completed units. In March, this share fell to 8.1 percent, the lowest in the life of the data (data by stage of construction go back to 1973), and while this share rose slightly in April, it nonetheless remains far below historical norms and even further below the elevated share seen during the last cycle. To some extent, this low share reflects longer completion times due to supply chain and labor constraints. But, when builders are sitting on completed units for sale, there are few options other than cutting (price) and/or waiting (for market conditions to improve), neither of which is all that appealing and neither of which is all that profitable.

One could argue that the options for builders with rising numbers of under-construction units are neither any different nor any more appealing. We'd argue that builders at least have more latitude in trying to sell units under construction. For instance, there is still time to change design/finishing options, which may mitigate the degree to which prices would have to be cut in order to sell these units, as opposed to completed units where what you see is what you buy, thus giving potential buyers more bargaining power when it comes to price. Also, builders have at least some control over completion times of under-construction units, which can make waiting out better market conditions less costly. While far from ideal, sitting on inventories of units under construction is preferable to sitting on inventories of completed units. As for units for sale on which construction has not yet been started, which at present account for a higher than normal share of units for sale, riding out lower demand is less burdensome to builders than is the case with completed or under-construction units.

While the composition of inventories of new homes for sale is more favorable for builders now than was the case in the prior cycle, it is still a bit premature to draw any firm conclusions as to the risks to builders from growing spec inventories. As we noted earlier, we are not convinced that demand has dropped off to the extent implied by the initial estimate of April new home sales. And, with the market having for years been chronically under-supplied, there remains a considerable degree of pent-up demand. With it yet being unclear how much further mortgage interest rates will rise, it could be that demand is more resilient than some now fear will be the case. But, even if demand has much further to fall, it is still the case that the level of spec inventories is nowhere near as high as it was in the last cycle, and single family starts will quickly adjust to further erosion in demand.

Slowing demand poses another risk to builders that cannot be tracked in the regular monthly data on new home sales. Recall that new home sales are booked at the signing of the sales contract, regardless of the ultimate disposition of that contract. The jump in mortgage interest rates has led some buyers to walk away, in the form of cancelling sales contracts. Since cancellations are not tracked in the data, this is leading to new home sales being at least a bit overstated. It is important to note that, at least based on builder commentary, cancellations are rising from abnormally low levels and could just be returning to more normal ranges. It is likely buyers who signed sales contracts prior to having locked in their financing rate and are either unwilling or unable to bear the extra monthly costs resulting from higher mortgage interest rates who are walking away. Again, though, the units in question are most likely either units that had not been yet started or units under construction, not finished units, which leads us back to the prior discussion of how the composition of inventories is different now than was the case in the prior cycle.



Source: U.S. Census Bureau; National Association of Realtors; Regions Economics Division

In thinking about the risks posed to builders from rising inventories of new homes for sale, it also helps to consider the totality of inventories of homes for sale, both new and existing. Though also rising of late, inventories of existing homes for sale are rising from record-low levels. As can be seen in the above chart, which we often use to illustrate how chronically undersupplied the market has been over recent years, inventories are so lean that, even with some erosion of demand due to higher mortgage interest rates, the market remains undersupplied. While builders are seeing increasing inventories of new homes for sale, the composition of those inventories and the overall low level of inventories matter. So, while they may have to make some concessions on price in order to move these units, there is a difference between a slimmer profit margin and an outright loss. It is far from clear we're at the point of the latter, and while that isn't to say we can't reach that point, we still contend builders are better positioned to withstand a slump in demand now than was the case in the prior cycle.

ECONOMIC OUTLOOK

REGIONS

June 2022

Q4 '21 (a)	Q1 '22 (p)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)	Q1 '23 (f)	Q2 '23 (f)	Q3 '23 (f)		2019 (a)	2020 (a)	2021 (a)	2022 (f)	2023 (f)
6.9	-1.5	3.2	2.1	2.2	1.8	1.9	1.9	Real GDP[1]	2.3	-3.4	5.7	2.6	2.0
2.5	3.1	3.0	1.2	2.0	2.0	1.7	1.5	Real Personal Consumption[1]	2.2	-3.8	7.9	3.1	1.8
2.9	9.2	6.2	6.9	5.8	5.3	5.0	4.2	Real Business Fixed Investment[1]	4.3	-5.3	7.4	6.0	5.3
2.8	13.2	7.3	6.1	5.1	4.6	4.5	3.3	Equipment[1]	3.3	-8.3	13.1	6.6	4.7
8.9	11.6	8.1	7.3	5.9	5.2	5.0	4.8	Intellectual Property and Software[1]	7.2	2.8	10.0	9.2	5.6
-8.3	-3.6	-2.4	7.8	6.9	7.0	6.5	5.0	Structures[1]	2.0	-12.5	-8.0	-2.3	6.0
2.2	0.4	-11.0	-1.9	2.0	1.0	1.0	1.4	Real Residential Fixed Investment[1]	-0.9	6.8	9.2	-3.5	0.1
-2.6	-2.7	1.4	0.4	1.7	1.5	1.6	1.7	Real Government Expenditures[1]	2.2	2.5	0.5	-0.8	1.4
-1,350.1	-1,543.5	-1,477.9	-1,472.5	-1,479.7	-1,503.8	-1,506.1	-1,516.9	Real Net Exports[2]	-905.3	-942.7	-1,284.3	-1,493.4	-1,510.0
1,170	1,186	1,099	1,114	1,133	1,148	1,154	1,158	Single Family Housing Starts, ths. of units[3]	889	1,002	1,131	1,133	1,156
509	538	580	533	526	514	507	499	Multi-Family Housing Starts, ths. of units[3]	402	393	474	544	504
17.6	19.4	19.3	15.6	11.7	7.1	3.0	2.4	CoreLogic House Price Index[5]	3.9	6.1	14.9	16.4	3.7
12.9	14.1	13.8	14.8	15.3	15.5	15.7	15.9	Vehicle Sales, millions of units[3]	17.0	14.5	15.0	14.5	15.8
4.2	3.8	3.6	3.5	3.5	3.4	3.4	3.4	Unemployment Rate, %[4]	3.7	8.1	5.4	3.6	3.4
4.3	4.6	4.5	3.8	3.0	2.1	1.5	1.2	Non-Farm Employment[5]	1.3	-5.8	2.8	4.0	1.5
-4.5	-6.7	-2.5	-1.0	2.0	6.8	3.3	3.3	Real Disposable Personal Income[1]	2.3	6.2	2.3	-5.7	3.0
5.9	6.9	7.0	7.0	6.1	4.9	3.9	3.0	GDP Price Deflator[5]	1.8	1.2	4.1	6.7	3.6
5.5	6.3	6.5	6.6	6.0	5.1	4.1	3.2	PCE Deflator[5]	1.5	1.2	3.9	6.3	3.8
6.7	8.0	8.3	8.7	7.8	6.4	4.8	3.3	Consumer Price Index[5]	1.8	1.2	4.7	8.2	4.3
4.6	5.2	4.8	4.6	4.1	3.7	3.4	3.1	Core PCE Deflator[5]	1.7	1.4	3.3	4.7	3.3
5.0	6.3	5.8	5.5	4.9	4.2	3.5	3.3	Core Consumer Price Index[5]	2.2	1.7	3.6	5.6	3.6
0.13	0.17	0.78	1.76	2.34	2.79	2.88	2.88	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	1.26	2.85
1.54	1.94	2.87	2.94	3.11	3.11	3.11	3.14	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.44	2.71	3.13
3.08	3.82	5.16	5.23	5.40	5.38	5.33	5.32	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.96	4.90	5.34
-3.6	-3.9	-3.6	-3.4	-3.5	-3.5	-3.4	-3.3	Current Account, % of GDP	-2.2	-2.9	-3.6	-3.6	-3.4

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2021 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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