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# CIO Strategy Bulletin

## Spotlight: The Consumer Versus the Fed

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### SUMMARY

- Consumer demand is at a critical juncture. US consumer fundamentals have been described alternatively as both strong and weak by analysts whose views are, obviously, contradictory. We expect a downshift in consumer spending growth this year, but not a contraction. What's most relevant for forward-looking financial markets in 2022 is the pace of moderation. This will significantly determine the Fed's actions.
- A soft landing will require the Fed to raise rates and implement QT in the right amounts and proportions to fight inflation without destroying consumer demand. Otherwise, a recession may ensue. It is this difficult task that causes us to weight our RESILIENT and RECESSION scenarios 45% and 35% at this time.
- Recessions begin when unemployment is at its lowest. US employment is now just 822,000 short of the pre-COVID record level. Labor force participation is also recovering at a solid rate even as the population grows. However, it is the rate of demand growth that determines the future need for labor, not the other way around. This means we are at a point of vulnerability – we are nearing full employment just as the Fed is implementing its substantial tightening policies.
- We believe consumer demand is slowing of its own accord, while the supply of consumer goods is now expanding. The impact of rate hikes and expected rate hikes will add further restraint ahead. The current trajectory of imports, production, and spending argues for a period of excess inventories to come and certain consumer goods prices to be marked down.
- With demand abating, inflation running hot (but cooling), and the Fed saying it will take the fight to inflation, we have an economy "at risk." The risk is the Fed slamming the brakes too hard and fast for the economy to bear.
- This is why we remain defensive in our investment strategy, waiting to shift tactically once we can see how hard and fast the Fed moves. While valuations are improving, for the time being, we would favor defensive staples rather than discretionary consumer goods producers within equity selection.
- With a sharp Fed tightening cycle priced into markets, we believe certain fixed income assets now offer compelling benefits to portfolios given their higher yields and diversification benefits.

## CONSUMER V. FED

Consumer demand is at a critical juncture. US consumer fundamentals have been described alternatively as both strong and weak by analysts whose views are, obviously, contradictory. On the one hand, some measures of consumer sentiment have fallen to recessionary levels in early 2022 ([figure 1](#)). On the other hand, US consumers opened their wallets to spend \$272 billion more on goods and services (non-annualized) in the first four months of the year since the end of 2021 ([figure 2](#)).

We expect a downshift in consumer spending growth this year, but not a contraction. Whether consumer spending is slowing quickly or remaining resilient will determine whether or not the Fed can engineer a soft landing for the economy as it seeks to fight inflation.

US fiscal policymakers “defaulted” to a more restrictive policy in 2021 by not repeating the massive income subsidies of 2020 and 2021. But the Federal Reserve also kept its “foot on the gas” through the first quarter 2022 by keeping rates low (even while talking them up) and adding to its bond holdings (QE).

This is all ending right now. As of June 1, the Fed began reducing its lending to the bond market while also hiking interest rates, potentially by the most in history for a one-year period.

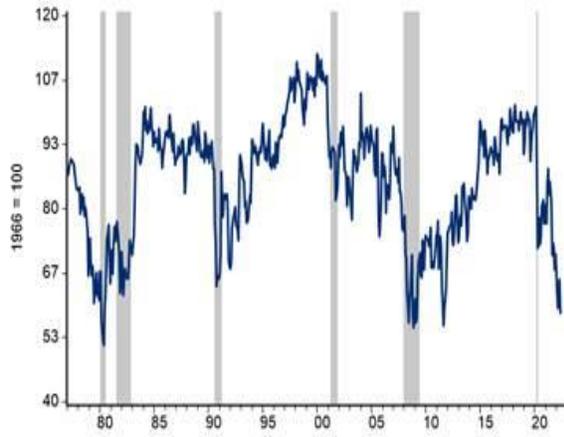
The Fed is tightening strongly even as consumer demand is softening. A soft landing will require the Fed to raise rates and implement QT in the right amounts and proportions to fight inflation without destroying consumer demand. Otherwise, a recession may ensue. It is this difficult task that causes us to weight our RESILIENT and RECESSION scenarios 45% and 35% at this time (See [“Why We Believe Bonds Are Back”](#) and [“Three Scenarios for the Economy and Markets”](#)).

## KEEPING A WATCHFUL EYE ON EMPLOYMENT

Recessions begin when unemployment is at its lowest. US employment is now just 822,000 short of the pre-COVID record level. Labor force participation is also recovering at a solid rate even as the population grows (see [figure 3](#)).

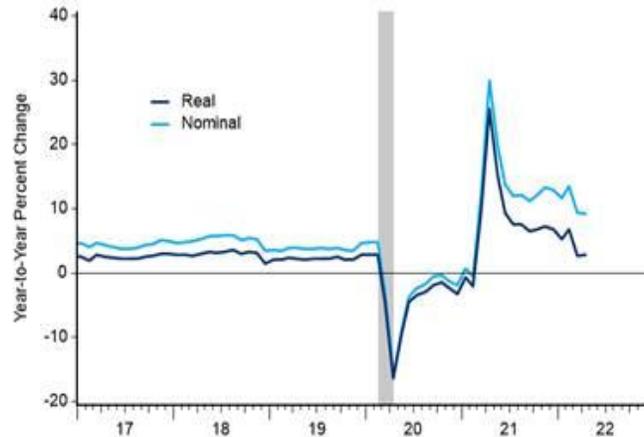
However, it is the rate of demand growth that determines the future need for labor, not the other way around (see [figure 4](#)). This means we are at a point of vulnerability – we are nearing full employment just as the Fed is implementing its substantial tightening policies. (In contrast, recoveries begin when labor markets are at their weakest ([figures 5-6](#))).

**Figure 1: US Consumer Sentiment and Recession Periods, (1996 = 100)**



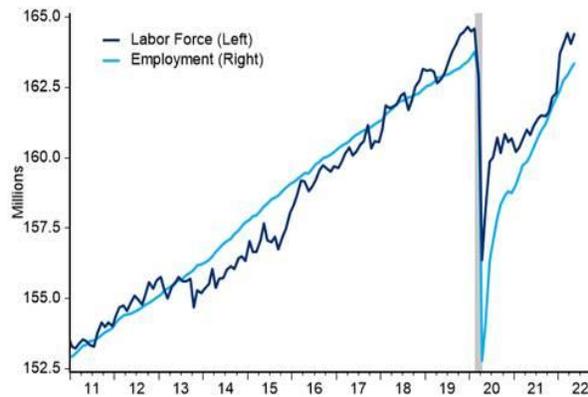
Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

**Figure 2: Nominal and Real Total Consumer Spending Y/Y %**



Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

**Figure 3: Total US Employment and Labor Force**



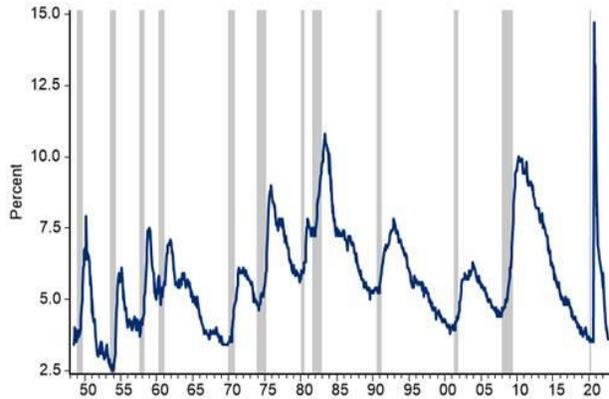
Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

**Figure 4: Real Consumer Spending Leads Employment Growth by 6 About Months and is Moderating**



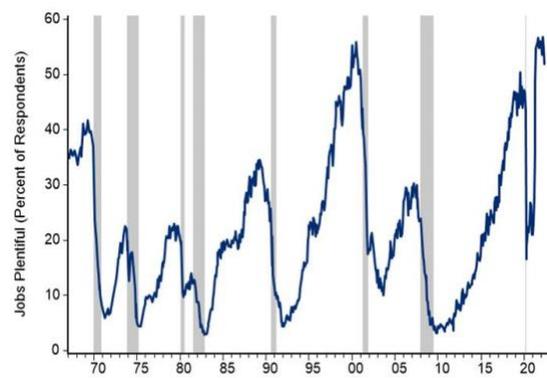
Source: Haver Analytics as of June 2, 2022. Arrow points to falling real consumer spending, ahead of US employment.

**Figure 5: US Unemployment Rate and Timing of Recession**



Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

**Figure 6: Consumer Appraisal of Job Market “Jobs Plentiful” And Timing of Recessions**



Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

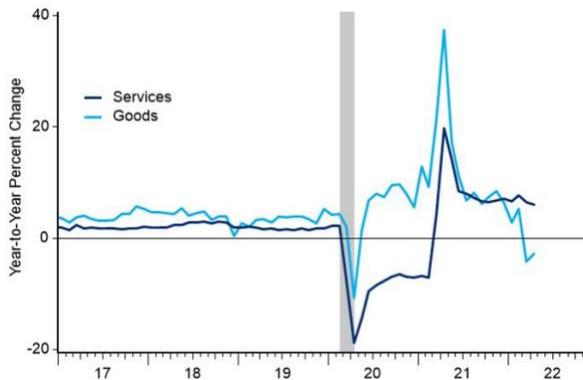
## THE “FIGHT” AGAINST INFLATION

Having supply and demand in equilibria is the best antidote for inflation and the risk of recession. Scarcity causes prices to rise disproportionately and, for the consumer, the view that prices are likely to rise will cause them to alter their buying behaviors in two ways. First, they will begin to buy essential goods sooner to forestall the future impact of inflation. Then, they will begin making trade-offs as their incomes are unable to keep up with inflation itself. This reduces aggregate demand (fewer units of goods), even as nominal purchase (the total value of goods) rises. US consumers are already buying fewer products this year even as their total dollars spent has [increased \(see figure 7\)](#).

Inflation is one problem, but it has two causes. The first cause is macro policy easing during the past two years. A bolus of “free money” dropped on households stuck in their homes distorted goods purchases wildly. The second cause is supply weakness owing to COVID-related upheaval and the Ukraine/Russia conflict.

We think a reduction in the fuel for inflation is forthcoming, but we wonder if the Fed has the patience to allow more conventional forces to rebalance supply and demand.

**Figure 7: Real Consumer Goods vs Services Expenditures Y/Y%**



Source: Haver Analytics as of June 2, 2022. Shaded areas note recession.

## REASONS FOR SLOWER FUTURE CONSUMER DEMAND

There are several reasons why consumer demand is falling and will continue to do so.

First, consumers have spent more rapidly than their incomes can sustain this past year. This has sent the personal savings rate down to a level that is abnormally low when looking at the pre-COVID period. As US consumers face inflation without government income support, more have begun to borrow to continue spending. This recent borrowing wave started from a reasonably low level, still well-supported by present income. Nonetheless, when consumers “borrow to buy” excessively, their ability to sustain purchases diminishes over time.

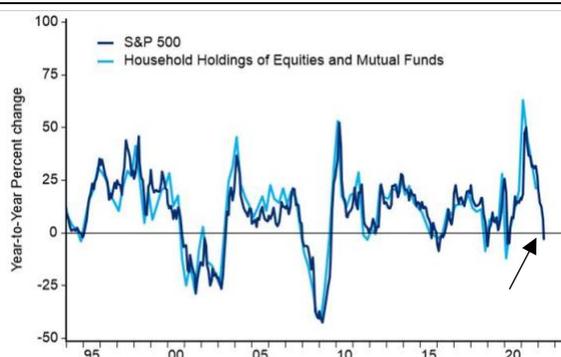
Second, as consumers spend on essentials, their rate of spending on other goods diminishes. One critical consumer tradeoff is in housing -- buying versus renting. Given the high cost of housing, more households will have to rent dwellings instead. Rising mortgage rates have contributed to a 13% drop in new home sales in the year-to-date. Weaker demand for housing will eventually cool housing-related price measures, but not quickly.

Third, consumer spending is dependent on the consumer’s actual and perceived wealth. When consumer wealth increases sharply, history shows it takes time for the perception of wealth to translate into more borrowing and spending. Individuals need to believe their wealth will be *lasting* to change their lifestyle and savings proclivity.

The large rise in housing and financial asset wealth over the past two years clearly signaled a strong period of spending. However, the recent drop in equities and bonds means that household wealth has peaked. The rise in mortgage rates that is cooling the housing market will add further concerns (see [figures 8-9](#)). Thus, we see a reversal of the recent “wealth boom” on the horizon, but with the biggest impact set for 2023.

While these three reasons point to slower consumer demand, real wage increases would provide an offset. Strong employment growth and moderate wages point to a *rebound* in real disposable income growth in the second quarter of 2022, but at a very low 1.5% pace. Nominal income growth is much stronger and would be more valuable for the economy if inflation was low, but as inflation is remaining stubbornly high, consumer spending must slow.

**Figure 8: US Households: Value of Equity and Mutual Fund Holdings vs S&P 500 Y/Y%**



Source: Haver Analytics as of June 2, 2022. Arrow points to drop in equities in the year-to-date.

**Figure 9: US Households: Value of Real Estate Holdings vs Home Price Index and 30-Year Mortgage Rate**



Source: Haver Analytics as of June 2, 2022. Arrow points to jump in mortgage rates this year, which will begin to impact the consumer “wealth effect” more significantly in 2023.

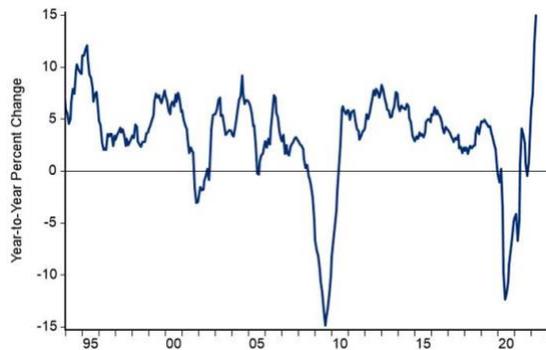
## SUPPLIES ON THE RISE

Among the strongest reasons why we think *a recession is not needed to stem inflation* is that the supply of consumer goods is finally expanding robustly, even as consumer demand is moderating. US production of consumer goods has risen 4.4% over the past year, while unit consumer spending on goods has fallen 2.9% over the same period. And imports of both intermediate inputs and finished goods have risen an even more robust 13.8% in the year through March.

With supplies on the rise, retailer inventories in April posted their largest year/year leap on record (see [figure 10](#)). Of course, this early data includes the value of inventories inflated by higher prices. However, the path of the data suggests that physical inventories are now rising, too.

This is consistent with retailer reports in 2Q, where the imbalances in sales and inventories caused some retailer shares to plunge. Quite simply, the drag on consumer budgets from higher essential costs like food and energy is leaving less room for discretionary merchandise purchases.

**Figure 10: Nominal US Retail Goods Inventories Y/Y%**



Source: Haver Analytics as of June 2, 2022.

### It's a Sale!! A What?? A Sale!!

“Pent-up demand” for consumer goods is a thing of the past. Higher inventories are a thing of the future.

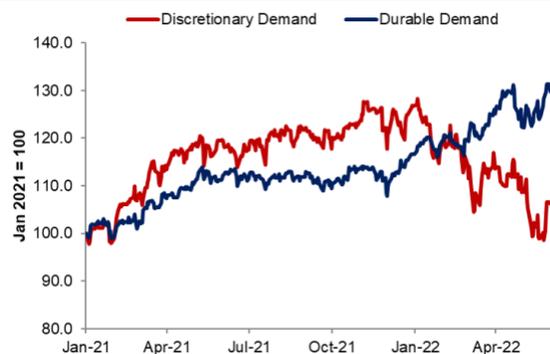
The current trajectory of imports, production, and spending argues for a period of excess inventories to come and *certain* prices to be marked down. While consumer essentials like food and fuel will remain costly, housing-related merchandise, like toys and apparel, will become plentiful and then cheaper.

This is anti-inflationary.

### Equity Markets “Get This”

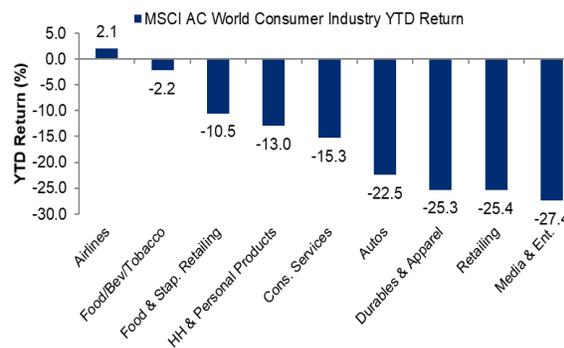
The equity market has sorted this out substantially in its performance this year already. Shares of firms providing essentials like consumer foods and energy have seen valuations rise or just fall modestly while discretionary groups and sectors have seen double-digit negative returns. In the year-to-date, the S&P Consumer Discretionary Sector has posted a -25% total return. The Consumer Staples sector has posted a -4.9% return (see [figures 11-12](#)).

**Figure 11: Discretionary Demand vs Durable Demand Equity Groups**



Source: Bloomberg as of June 2, 2022. Note: Discretionary demand industries are household durables, specialty retail, textiles, apparel & luxury goods, residential REITs, Hotels, Restaurants & Leisure, Financials and Airlines. Durable demand industries are Food, Beverage & Tobacco, Energy, Utilities, Health Care, Telecommunication services.

**Figure 12: Global Consumer Group Year-to-Date Performance**



Source: Haver Analytics as of June 2, 2022. Haver Analytics as of June 2, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

## REMAIN DEFENSIVE, WATCH THE FED, BUY QUALITY BONDS

The critical nature of this moment in the economy is clear. With demand abating, inflation running hot (but cooling), and the Fed saying it is going to take the fight to inflation, **we have an economy “at risk.”**

Higher inflation, higher rates and tighter fiscal policy are already at work to slow inflation – but these processes take time and patience. The economy’s growth in both demand and resources gives it upward momentum to manage the adjustment to a lower growth rate, assuming no recession.

Therefore, the “risk” is the Fed slamming the brakes too hard and fast for the economy to bear during a period of weakening demand. That risk is real because higher rates and QT have long tails. Damage will occur 6-12 months after the Fed overreaches, although there will be recessionary warning signs that can change the Fed’s course.

This is why we remain relatively cautious and defensive in our investment strategy waiting to shift tactically once we can see how hard and fast the Fed moves with an eye to how the economy will respond. If the Fed errs, it will cause a further repricing of certain equity groups as well as portend lower future interest rates.

While we do not expect recession as our base case, recession risks are unusually high at this moment. We think corporate earnings will remain pressured from mid-2022 and into 2023, making cyclical equities vulnerable. That’s why we have a strong preference for defensive and high-quality shares. We seek consistent dividend growers that have high quality balance sheets. We are overweight essentials such as pharmaceuticals and cyber-security providers. We also believe that growth equities in essential, durable demand areas will eventually feel relief from valuation pressures as government bond yields peak.

Ultimately, we see future opportunities for investors, as a large drop in some industry leading discretionary firms will establish an attractive entry point as markets recover from the 2022 inflation shock.

But, in our view, it is too soon to shift tactically into highly cyclical consumer equities. Present shortages and the required rise in food and energy output are still more compelling investment themes. The Fed, if it reinforces an existing consumer slowdown, will impact discretionary spending far more than essential goods. Thus, when excessive bearishness on the discretionary outlook is priced in, we will reconsider.

## **It is A Better Time to Own Bonds**

In 2022, bonds have suffered a brutal run, selling off hard on monetary tightening fears. As their prices have gotten crushed, yields have risen substantially. For investors, these higher yields may represent an attractive level at which to buy. We believe certain fixed income assets now offer an “antidote” to the “cash thief,” given their higher yields. What’s more, such assets may also help mitigate equity risk within a diversified portfolio. Historically, long-term US Treasuries are one of the few assets with a negative correlation to equities during large equity corrections (see [“Why We Believe Bonds Are Back”](#)).

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