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No Place Like Home
Prospects for U.S. Consumer

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"Someday I'll wish upon a star
And wake up where the clouds are far behind me
Where troubles melt like lemon drops,
Away above the chimney tops
That's where you'll find me"

Judy Garland's classic delivery of the song "Over the Rainbow" in the 1939 movie *The Wizard of Oz* offers a metaphor for where we are in the economic cycle. The expansion has finally reached a milestone by exceeding the length of the one in the 1960s. We are now experiencing the second longest economic expansion since World War II. Unemployment has plummeted, confidence has rebounded and, by most accounts, the economy appears to have regained much of the ground lost to the housing and financial crises. It seems we've made it out of the flat, colorless existence not unlike Depression-era Kansas and into the magical land of Oz.

What we have found, however, is not as perfect as it appeared in the distance. Economic gains remain extremely uneven. Employment growth is concentrated in low-wage jobs. Fewer prime-age workers (25-54) are participating in the labor force. Home ownership rates are historically low. The American Dream of home ownership and continually rising living standards is still out of reach for many.

The result has generated nostalgia and a desire to turn back the wheels of time in an attempt to return "home" as Dorothy did in the movie. Unlike Dorothy, we are not living in a fairytale. We cannot go back, only forward, even if the improvements are slower than we would like.

This edition of *Economic Currents* takes a closer look at how comfortable consumers are since they have gained ground after years of subpar growth. Persistently low interest rates helped to slowly repair consumer balance sheets in the aggregate. It is not the buoyant spending we saw during much of the post-World War II era but many hope this will be a breakout year for consumers.

Headwinds are emerging but the biggest risks remain to the upside as wages are poised to accelerate. At the same time, equity held in individual homes hit a new record in the fourth quarter of 2017. In response, banks are demonstrating renewed interest in providing home equity loans and credit lines; the goal is to generate fees to replace their refinancing business, which faded when rates turned higher. The extent to which consumers decide to abandon caution and accept new offers of credit could make

Growth Picks Up.

The economy decelerated to a 2.3% pace in the first quarter of 2018 compared to 2.9% in the fourth quarter of 2017. Consumer spending slowed dramatically as unusually harsh winter weather took a toll on spending. The trade deficit improved on fewer imports due to the pullback by consumers. After draining inventories in the fourth quarter, businesses started to rebuild in anticipation of stronger demand. Government spending remained weak.

Prospects for the second quarter look significantly better as overall economic growth nears 3%. We expect to see consumer spending rebound on pent-up demand following the winter. Government spending should rise with a surge in federal spending approved for fiscal year 2018; that ends September 30. The only fly in the ointment is the trade deficit, which we expect to widen when imports pick up with consumer spending. That could further complicate trade negotiations with U.S. allies. So far, however, the administration's bark on protectionism has been worse than its bite.

Fed Poised to Raise Rates

The Federal Reserve will raise short-term interest rates again in June. Our forecast holds for a total of four rate hikes this year, but the final decision on the pace of increases will depend on whether wages finally accelerate. The Fed has made it clear that unemployment could be allowed to fall further and even cause inflation to overshoot if that helped wages.

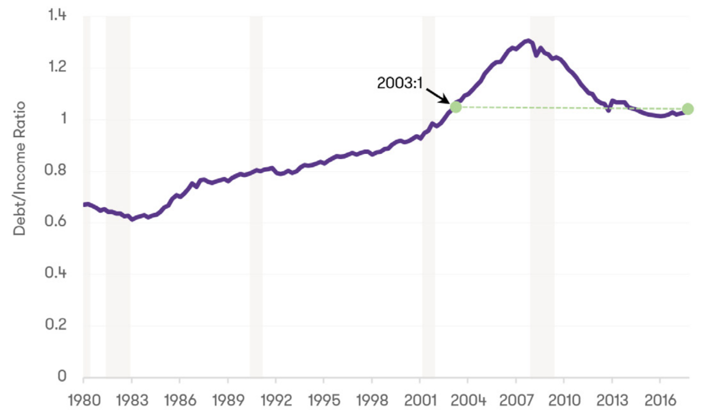
the difference between a good or a great year for the economy. Blockbuster gains would come at a steep price if inflation results in a much faster pace of rate hikes by the Federal Reserve; the Wizard behind the curtain could be busy this year.

Underlying Fundamentals

Chart 1 shows the forecast for consumer spending in 2018. Adjusted for inflation, consumer spending is expected to bounce back following a lackluster first quarter and then slow from the 2017 pace.

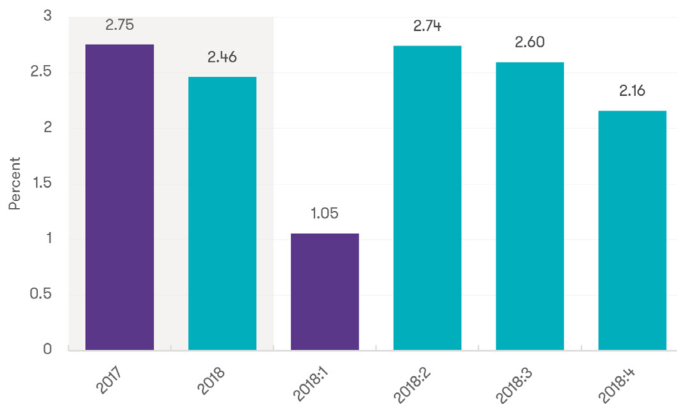
On the plus side, unemployment has plummeted, job gains remain solid, and wage gains appear poised to accelerate. Job openings hit a record high in April as anecdotal reports of wage gains intensified. The Federal Reserve's Beige Book, which tracks real-time shifts across the Fed's twelve districts, reported further tightening in labor markets, increased spending for job training and "persistent" wage gains in April.

Chart 2: Household Debt/Income Ratio Bottomed
1980:1-2017:4



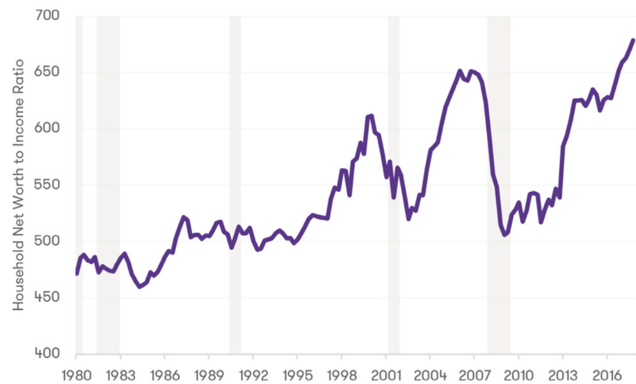
Source: Federal Reserve Board of Governors, Z.1. Income Series: "Households and Nonprofit Organizations; Disposable Personal Income"; Debt Series: "Households and Nonprofit Organizations; Disposable Personal Income"

Chart 1: Consumer Spending: Solid not Spectacular
Inflation-adjusted Changes in Personal Consumption Expenditures



Annual figures are year-over-year growth. Quarterly are annualized growth rates.
Source: Haver Analytics.

Chart 3: Household Net Worth to Income Hits New High
1951:1-2017:4



Source: Federal Reserve Board of Governors, Z.1. Income Series: "Households and Nonprofit Organizations; Disposable Personal Income"; Debt Series: "Households and Nonprofit Organizations; Disposable Personal Income"

Tax cuts have boosted disposable incomes. The Tax Policy Center estimates tax cuts will average $1260 per household in 2018 although the overwhelming majority of those cuts will accrue to the top 5% of earners. [Households in the middle of the income distribution, those earning between $49,000 and $86,000, will get $800. Households in the bottom quintile, those earning less than $25,000 per year, will get $40.]

Consumers have finally rid themselves of an overhang of debt and regained wealth lost to the financial crisis. The overall debt-to-income ratio has fallen to precrisis levels in recent years, while net worth as a share of income has risen to a new high. (See Charts 2 and 3.) High-income households have benefitted more than low-income households, especially when it comes to financial assets, but the rebound in real estate values has been more evenly distributed now with lower priced homes appreciating in value.

The return of first-time buyers to the market, combined with an acute shortage of entry-level homes for sale, has pushed up the prices of less expensive properties much more rapidly than home prices at the high end. New limits on mortgage deductions, especially in states with high taxes, could further skew the appreciation of home values toward lower priced homes.

This is particularly important given recent shifts in credit conditions. The Fed's recent Senior Loan Officer Opinion Survey showed tightening credit conditions for most forms of consumer debt, with one major exception: home equity lines of credit.

That easing is beginning to show up in the data on home equity lines of credit, which grew by more than $200 billion in 2017, the fastest pace of growth in nine years. That is still a fraction of what we saw during the peak of the housing market bubble, but the pump is primed.

One bank in downtown Chicago has plastered its windows with colorful ads for home equity loans. The signs urge consumers to inquire about home equity lines of credit that they can use “For Whatever.” Suggested purchases go well beyond needs to wants, from home renovations to ”a trip to Rome, a third honeymoon, four more rooms of furniture, an MBA, bandcamp, summer camp, braces or just the best birthday ever.” (See PHOTO)

When I saw that I felt like I was in a time warp, vaulted back to 2005 when many consumers used their homes as ATMs to finance anything their hearts desired. My contacts in housing finance confirm that banks are moving back into this market. They also caution that the liquidation of housing market equity has historically led to financial duress down the road. Whatever we borrow today must be repaid at what will likely be higher interest rates. This is in addition to self-selection; those most likely to liquidate the equity in their homes tend to be the ones who can least afford it.

On the downside, higher prices at the gas pump are eating into consumer budgets and offsetting the benefits associated with tax cuts for low- and middle-income households. Regular gas prices went up more than $0.50 per gallon, or 21%, in the week ending May 14; we expect prices to continue higher. The increases could cost consumers between $420 and $570 more per year, wiping out more than half of the benefits of tax cuts for middle-income households and all of the benefits for low-income households.

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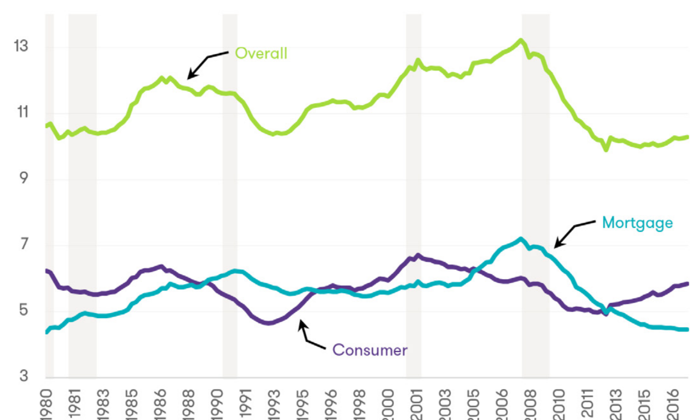
Health care inflation has begun to accelerate again. Hospital and prescription drug prices are forecast to rise at a faster pace this year. Retirees and those living on fixed incomes will be affected the most. This is in addition to the broader acceleration in inflation that the Fed has been waiting for, most notably in the service sector.

Another rate hike by the Federal Reserve in June is a foregone conclusion. The extent to which the costs of servicing our debt will continue to rise is highly contingent upon how fast the Fed raises short-term interest rates this year. Our forecast holds for a total of four rate hikes; that is a 1% increase in rates and represents a doubling since the Fed started to raise rates in December 2015.

Higher interest rates have already boosted the cost of some forms of credit. The cost of servicing debt including credit cards, student and vehicle loans has moved up even as the cost of holding a mortgage has fallen. (See Chart 4.)

Chart 4: Mortgage Debt Service Costs Could Accelerate
1980-2018



Source: Federal Reserve Board of Governors. Household Debt Service and Financial Obligations Ratios.

Those increases are in addition to the upward pressure on rates associated with mounting federal deficits and debt. The yield on the ten-year Treasury bond hit the highest level since 2011 on May 15, partly in response to a shortfall in tax revenues in early May and the realization that the government will need to issue much more debt. The Congressional Budget Office (CBO) is forecasting the federal deficit will exceed $1 trillion in fiscal year 2019. CBO forecasts on growth and tax revenues tend to be optimistic. We could see deficits rise even more rapidly.

There are already some signs of duress in the system. Defaults on student loans have leveled out in recent years but remain in the double digits. A recent report suggests a default rate on subprime vehicle loans that is higher now than it was at the height of the financial crisis.

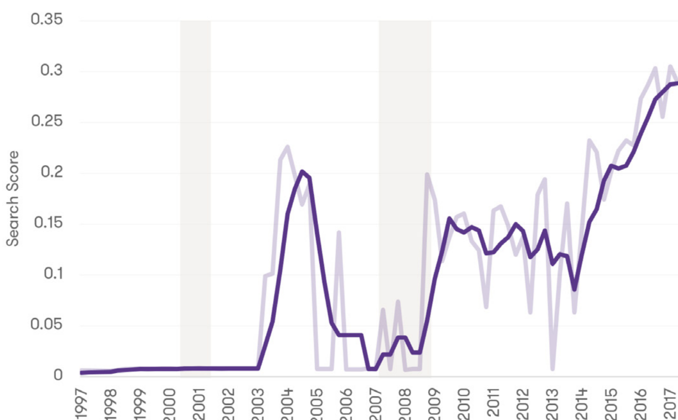
The saving rate remains extremely low despite some improvement in the first quarter when spending faltered. This should, in theory, constrain spending and limit debt accumulation.

> “Old habits die hard. Consumers have repeatedly proven their willingness to take on more debt than they can afford.”

Last, but by no means least, employers say that worker shortages are constraining hiring. Workers left on the sidelines during the crisis are losing skills at the same time that immigration curbs are stemming the inflow of new workers. The opioid crisis is also taking a toll as it shifts from prescription to more potent, illegal versions of the drugs. The Center for Disease Control has reported that fentanyl is particularly lethal.

Upside Risks: Old habits die hard. Consumers have repeatedly proven their willingness to take on more debt than they can afford. Our research found a sudden jump in online searches for home equity lines of credit. In 2017 and early 2018, queries exceeded the surge during the height of the housing market bubble. (See Chart 5.) Some of the recent increase in online searches may be attributed to the proliferation in smartphones, which make it easy for consumers to compare deals offered by lenders. That said, there is clearly an upswing in demand for home equity lines of credit.

Chart 5: Online Searches for Home Equity Loans Surge



Source: Webpages scraped from Wayback Machine/Archive.org; Search results are authors’ calculations.

Changes in the tax law that limit deductions for mortgage and home equity lines of credit may cap some of the spending fueled by credit. Severe understaffing at the IRS, however, begs the question, Who will enforce the restrictions?

In response, consumer spending could be significantly stronger than forecast, with growth coming in closer to 2.8% instead of 2.5%. That would push overall economic growth to well above the 3% threshold in 2018 but not without a cost. Rate hikes by the Fed could increase from four to six over the course of this year. While that is still small relative to history, it would up the ante on a recession in 2019.

Implications for the Composition of Spending

Recent surveys of buying conditions for big-ticket items indicate that older homeowners are opting to repair and remodel instead of trading up; renovations could be further supported by an expansion in home equity loans. Consumer attitudes toward buying furniture and appliances picked up significantly in recent months.

Vehicle sales could rise more than expected. Buying attitudes regarding vehicles improved significantly in April; purchases were financed by home equity borrowing during the housing market bubble.

Some parents could decide to roll student debt into home equity loans to ease their children’s debt burdens. That would free up funds for college graduates, which would most likely show up in rents and housing. The percent of adult children living at home surged during the crisis and the years that followed; less debt would enable them to move out.

Bottom Line

We have traveled a long way to get here, a place much better than where we were during much of this expansion. Too many are still feeling left behind but this year could be a tipping point for those households. An acceleration in wages across income strata and continued housing appreciation should help distribute economic gains more evenly across households.

The worry is that consumers will decide to take on more debt to finance a more rapid increase in living standards, which would only borrow from future growth. Dorothy realized that the sparkle of the Emerald City was little more than an illusion; what felt like a “place where dreams come true” turned into a nightmare; those winged monkeys in Oz still give me the creeps. Note: Debt-financed spending can also cause sleepless nights.

Economic forecast — May 2018

	2017(A)	2018	2019	2017:4(A)	2018:1(A)	2018:2	2018:3	2018:4	2019:1	2019:2	2019:3	2019:4
National outlook												
Chain-weight GDP[1]	2.3	2.8	2.7	2.9	2.3	2.9	3.2	2.9	2.7	2.5	2.29	1.74
Personal consumption	2.8	2.5	2.3	4.0	1.1	2.8	2.5	2.3	2.0	2.3	2.23	2.16
Business fixed investment	4.7	5.6	5.6	6.8	6.1	3.5	5.8	6.1	6.1	5.6	5.1	4.07
Residential investment	1.8	2.5	3.1	12.8	0.0	3.3	4.4	1.5	3.3	2.8	3.89	3.89
Inventory investment	15.2	47.5	72.9	15.6	33.1	44.1	54.4	58.3	69.9	75.9	78.7	67.1
Net exports	-621.8	-663.8	-722.9	-653.9	-645.9	-658.0	-668.5	-683.0	-698.5	-714.0	-731.16	-747.74
Exports	3.4	5.1	5.7	7.0	4.8	5.4	5.6	5.8	5.1	5.8	6.43	6.48
Imports	4.0	5.5	6.4	14.1	2.6	5.9	5.8	6.5	6.1	6.6	7.22	7.14
Government expenditures	0.1	1.9	2.3	3.0	1.2	2.1	3.0	3.7	2.7	1.6	1.11	0.69
Federal	0.2	3.6	4.1	3.2	1.7	5.0	6.9	7.3	4.4	2.2	1.13	-0.09
State and local	0.1	0.9	1.2	2.9	0.8	0.4	0.6	1.5	1.6	1.3	1.09	1.17
Final sales	2.4	2.6	2.5	3.4	1.9	2.6	3.0	2.8	2.5	2.4	2.23	2.01
Inflation												
GDP deflator	1.8	2.0	2.4	2.3	2.0	1.7	2.0	2.2	2.5	2.5	2.55	2.54
CPI	2.1	2.5	1.7	3.3	3.5	1.8	2.8	1.1	0.9	2.2	2.43	2.33
Core CPI	1.8	2.3	2.3	2.2	3.0	2.2	2.3	2.3	2.3	2.4	2.38	2.41
Special indicators												
Corporate profits[2]	2.7	4.3	4.5	2.7	3.4	4.1	2.9	4.3	7.5	7.5	5.47	4.5
Disposable personal income	1.2	2.1	3.1	1.1	3.4	2.2	1.0	3.5	4.4	2.9	2.77	2.63
Housing starts (mil.)	1.2	1.3	1.4	1.3	1.3	1.3	1.3	1.4	1.4	1.4	1.41	1.41
Civilian unemployment rate	4.4	3.9	3.7	4.1	4.1	4.0	3.9	3.8	3.7	3.6	3.7	3.76
Total nonfarm payrolls (thous.)[3]	2176.7	2493.2	1601.3	556.3	616.3	606.7	652.1	618.0	568.9	453.0	305.13	274.26
Vehicle sales												
Automobile sales (mil.)	6.3	5.6	5.4	6.3	5.7	5.6	5.6	5.5	5.5	5.4	5.4	5.3
Domestic	4.5	4.0	3.9	4.6	4.1	4.0	4.0	4.0	4.0	3.9	3.9	3.8
Imports	1.7	1.6	1.5	1.7	1.6	1.6	1.6	1.5	1.5	1.5	1.5	1.5
Lt. trucks (mil.)	10.9	11.3	10.5	11.5	11.5	11.3	11.2	11.0	10.7	10.6	10.5	10.2
Domestic	9.0	9.1	8.6	9.4	9.3	9.2	9.1	8.9	8.7	8.6	8.6	8.3
Imports	1.9	2.1	2.0	2.1	2.2	2.1	2.1	2.1	2.0	2.0	1.9	1.9
Combined auto/Lt.truck	17.1	16.9	16.6	17.8	17.2	16.9	16.8	16.5	16.2	16.0	15.9	15.5
Heavy truck sales	0.4	0.5	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4	0.4
Total vehicles (mil.)	17.5	17.3	16.3	18.2	17.7	17.4	17.3	17.0	16.7	16.5	16.3	15.9
Interest rate/yields												
Federal funds	1.0	1.8	2.5	1.2	1.5	1.7	1.9	2.1	2.3	2.4	2.61	2.75
10-year treasury note	2.3	3.1	3.5	2.4	2.8	3.0	3.2	3.4	3.4	3.5	3.57	3.65
Corporate bond BAA	4.4	4.8	5.4	4.3	4.5	4.8	4.9	5.1	5.2	5.3	5.42	5.53
Exchange rates												
Euro/Dollar	1.1	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.21	1.22
Dollar/Yen	112.1	105.4	100.3	112.9	108.3	105.9	104.1	103.3	102.1	100.7	99.7	98.72

1. In 2016, GDP was $16716.164 billion in chain-weighted 2009 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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