CAPITAL CREEK PARTNERS REPORT – JUNE 2023

The U.S. Consumer: Running on Empty?

A Close Look into the State of the U.S. Consumer

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About Scott

Partner, Chief Strategist

Scott is a partner of the firm and the Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Management Committees. Scott has 35 years of investment experience as a strategist and portfolio manager. Scott spent most of his career in New York, working at Kidder, Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

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Running on empty

Running blind

Running into the sun

But I'm running behind

(Jackson Browne)

Austin, TX

As a child of the 1970s, I am a fan of Jackson Browne. Not only do I enjoy his music, but there is something special and haunting about his songwriting. He perfected his craft working with the great Joni Mitchell up in the hills of Laurel Canyon in the 1960s. He wrote and sang so poignantly about the joys and hardships of life on the road with his band. In the photos from his 1978 Running on Empty Tour, you can see the pathos in his eyes from the endless days on the road setting up, singing, playing, and breaking it all down again just to get back on the bus and head to the next show. His deep state of exhaustion was an inspiration for the album, Running on Empty. As investors, we must stive to understand whether the US consumer has anything left in the tank after running hard post the pandemic into five hundred basis points of Fed rate increases (in 15 months) combined with quantitative tightening (QT) and tightening consumer credit conditions.

Executive Summary

- A plentiful jobs market, declining energy prices, a stabilizing housing market, an equity bull market, and moderating interest rates are all supportive of continued consumption during the remainder of calendar 2023 and into 2024.
- US consumption is bifurcated into healthy spending levels by the wealthy and more challenged consumption patterns at the low end. Wealthy consumers are much more important to the overall consumption outlook, and they remain in solid shape.
- A balance sheet (assets vs. liabilities) approach to the US consumer reveals a symmetrical picture tilted to the positive (see Exhibit 1).
- The US consumer is highly resilient, and it is historically rare for real personal consumption expenditures (PCE) to decline in the US.
- PCE declines outright when consumers lose their jobs. The US labor market remains healthy and continues to create, not destroy jobs.

- PCE will likely need to decline to induce a US recession.

"Don't Bet Against the US Consumer"

Sometime in the early 2000s, I was fortunate enough to be in the offices of the legendary economist, Ed Hyman of EvercoreISI. I was a guest at the firm's morning research meeting, and someone was making the case that the US consumer was about to collapse due to heavy indebtedness and falling consumer confidence. As the speaker concluded, the great Hyman simply communicated that all of US economic history informs us not to bet against the consumer. The room fell silent and those of us with some experience knew he was correct. The entire US economy and our capitalist system is built upon voracious consumption, and nobody does it better than the unsinkable US consumer. Americans have an inherently positive psychology embedded deeply within their DNA. As a society, we strive to improve our standard of living. We want to acquire more services, houses, autos, clothing, and toys for the young and old. As we age, we spend more on services, leisure, and healthcare. My thirty plus years in markets has taught me that if Americans have jobs, they will continue to spend. Today, practically anyone who wants a job can attain one. The US economy continues to have a tight labor market with the unemployment rate still close to historical lows at 3.7%.

However, the outlook for future consumption is not without challenges, which is why we decided to dig into the health of the US consumer. The Conference Board Jobs Plentiful Index is beginning to soften from the record highs of 2022 (see Exhibit 2). Weekly Jobless Claims are starting to trend higher. A softening labor market is just what the Fed wants to create in line with the goal of a soft landing. We are aware that the labor market is a lagging indicator and can change quickly with the onset of an economic recession. Nevertheless, the US labor market still has momentum and is creating on average over 300,000 jobs per month through the first five months of 2023 (see Exhibit 3). Once again, our simple bottom line is that if consumers have access to jobs and income, they will continue to spend.

Exhibit 1: Major Tech Waves are Bullish and Disinflationary

Source: Capital Creek Partners Research

Assets
Strong Labor Market
Falling Inflation
Pent Up Demand
Fiscal Spending
Personal Savings
Strong Dollar
Rebouding Equity Prices
Stable Housing Market
AI (Disinflation)

Liabilities
Hawkish Fed Policy
Low Consumer Confidence
Currently High Inflation
Student Loans
Tightening Consumer Credit
Negative Leading Indicators
AI (Job Automation)

A balance sheet approach to analyzing the US consumer reveals a symmetrical picture modestly tilted to the positive. I give a slight edge to the asset side or the positives because a solid labor market combined with persistently falling inflation are the most crucial factors on either side of the balance sheet. Artificial Intelligence (AI) is likely to be both a positive and a negative. AI will contribute to disinflation in the near-term but may be a high-end job liquidator over the intermediate term. In the end, the assets outweigh the liabilities. This gives me confidence that the US consumer is not about to suddenly capitulate, throwing the US economy into a deep recession.

Exhibit 2: Jobs Plentiful Index--Trending Down but Still Well Above L-T Average

Source: Capital Creek Partners Research, Bloomberg

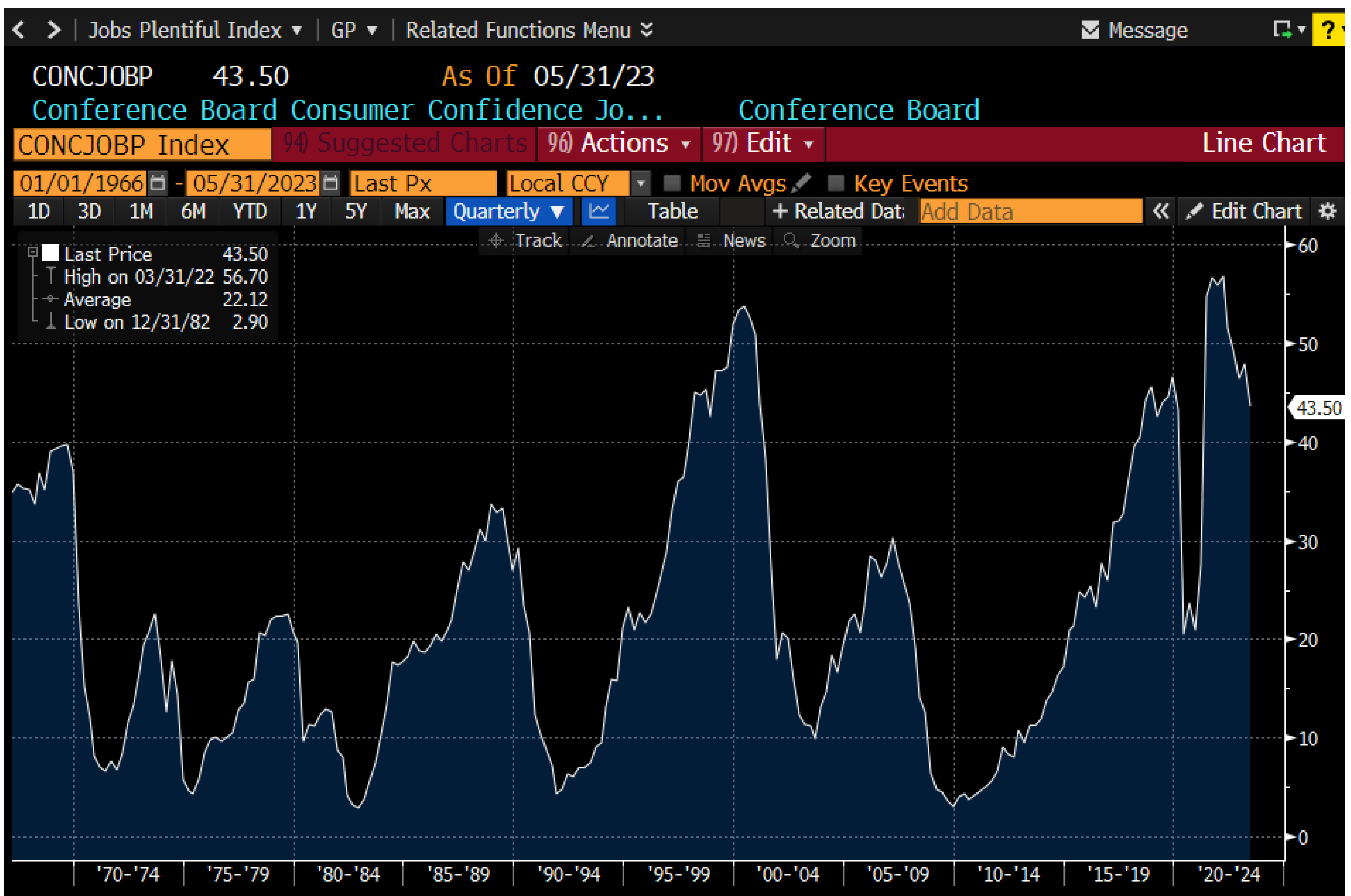
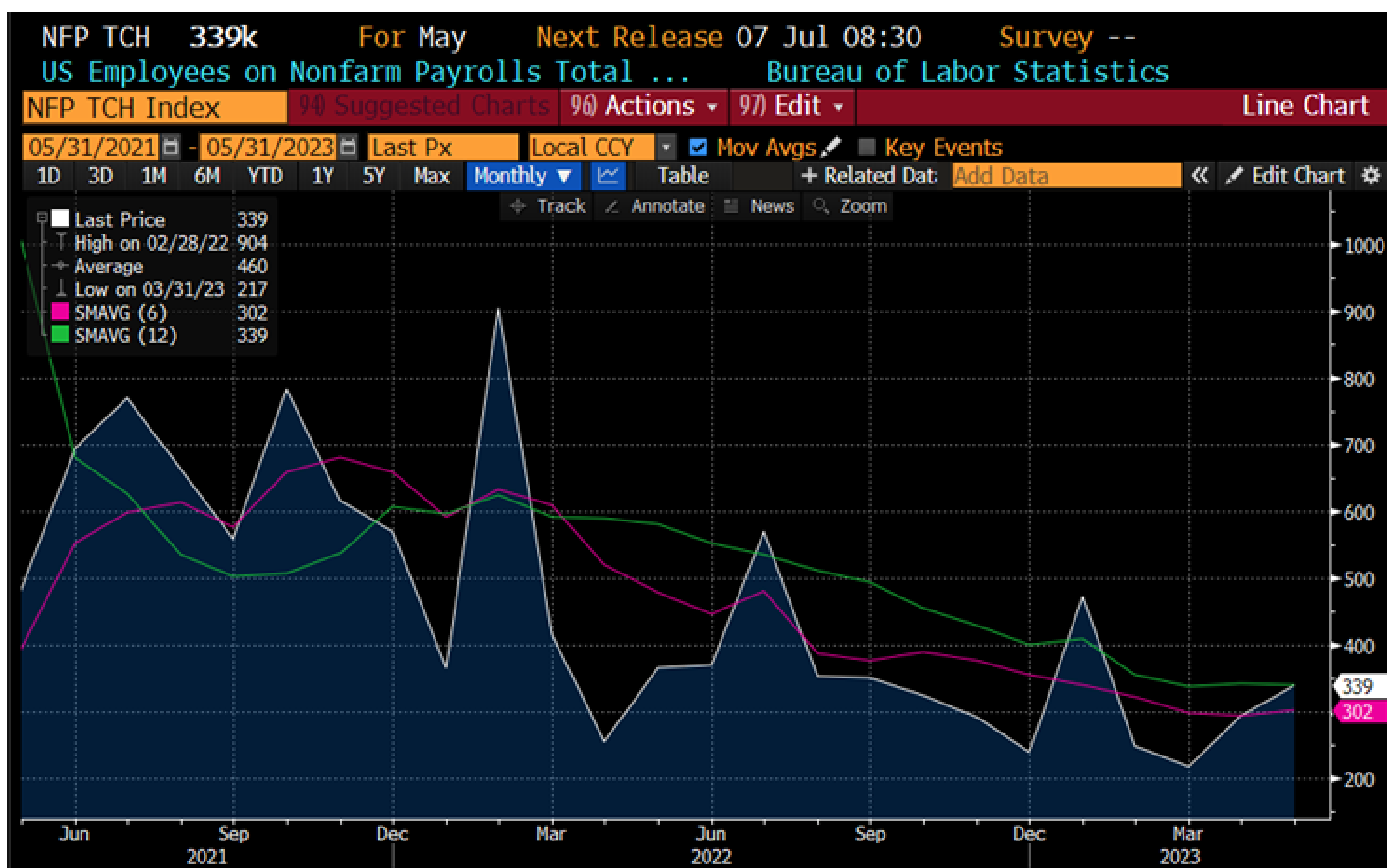


Exhibit 3: US Monthly NFP Additions – Cooling but Still Healthy

Source: Capital Creek Partners Research, Bloomberg



The Bifurcated US Consumer

Our research led us to discover that the US consumer is not a monolith but rather a bifurcated group of spenders spanning the wealthy to lower income groups. Lower end consumers have been gaining employment and income in recent years. The unemployment rate for citizens without a high school degree is now the lowest in the history of the data at only 4.3%. At the same time, these consumers are being squeezed hard by high inflation, more expensive auto loans, and higher credit card rates. In addition, weaker consumers have been caught off guard by reduced tax refunds and reduced SNAP benefits. The good news is that lower end consumers have jobs. According to JPMorgan, low end pay raises are now solidly outpacing inflation and consumer bank account balances are much higher than they were before the pandemic. The bottom 20% of American consumers make up only 6% of overall spending while the top 20% account for over 40% of total consumption. The high-end consumer is much more important to the future consumption outlook and those wealthy consumers are still prospering as we demonstrate later in the report.

To gauge the current health of low-end consumers, I built an equity basket consisting of retailers that mostly sell to these consumers (see Exhibit 4). The basket includes Big Lots (BIG), BJ's Wholesale Club

(BJ), Burlington (BURL), Dollar General (DG), Family Dollar Stores (FDO), Ross Stores (ROST), TJX (TJX), and Walmart (WMT). This basket is sending a warning signal about the strength of low-end consumption by falling over 21% since early January. This is dramatic underperformance compared to the S&P 500, which is up almost 15% on the year.

Exhibit 4: Our Low-End Consumer Basket Sounds a Warning

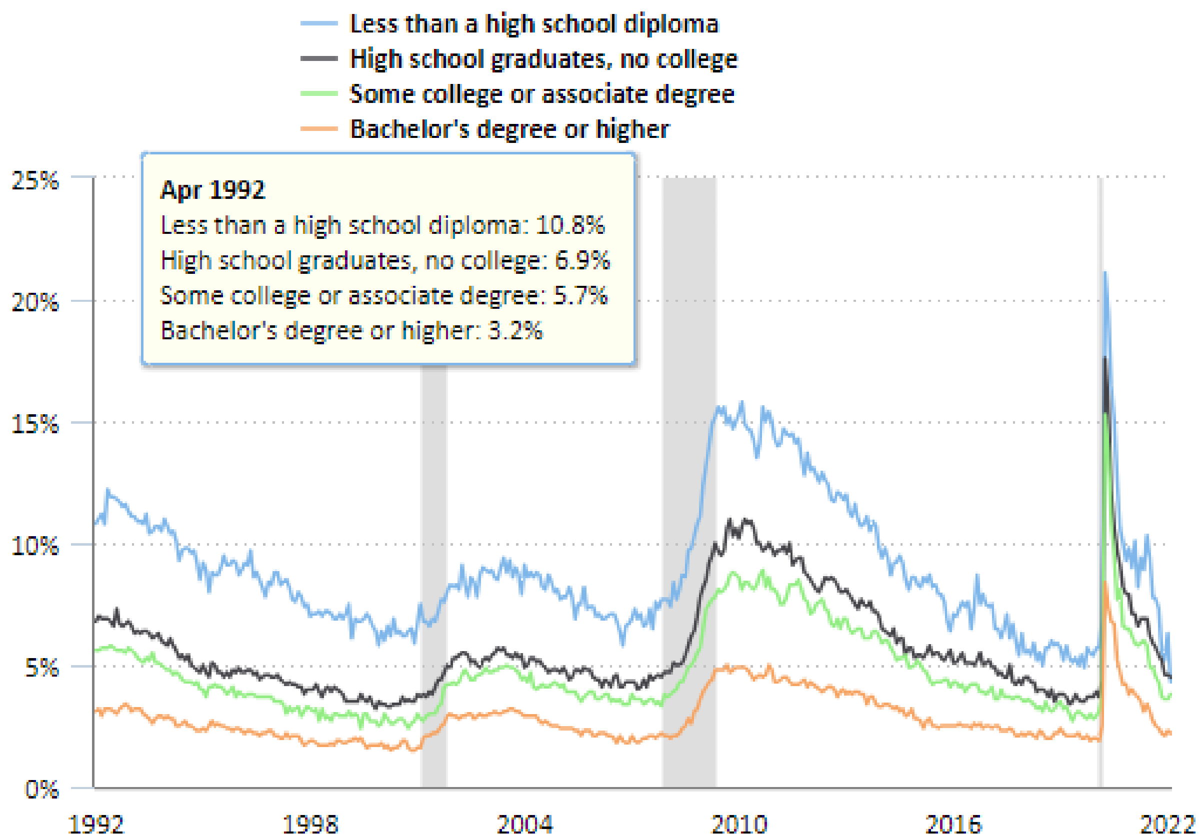
Source: Capital Creek Partners Research, Bloomberg

Exhibit 5: Lowest Unemployment Rate in History for Least Educated Workers

Source: BLS, Capital Creek Research

Unemployment rates for people age 25 and older by educational attainment, January 1992 to February 2022

Click/touch and drag to zoom in.

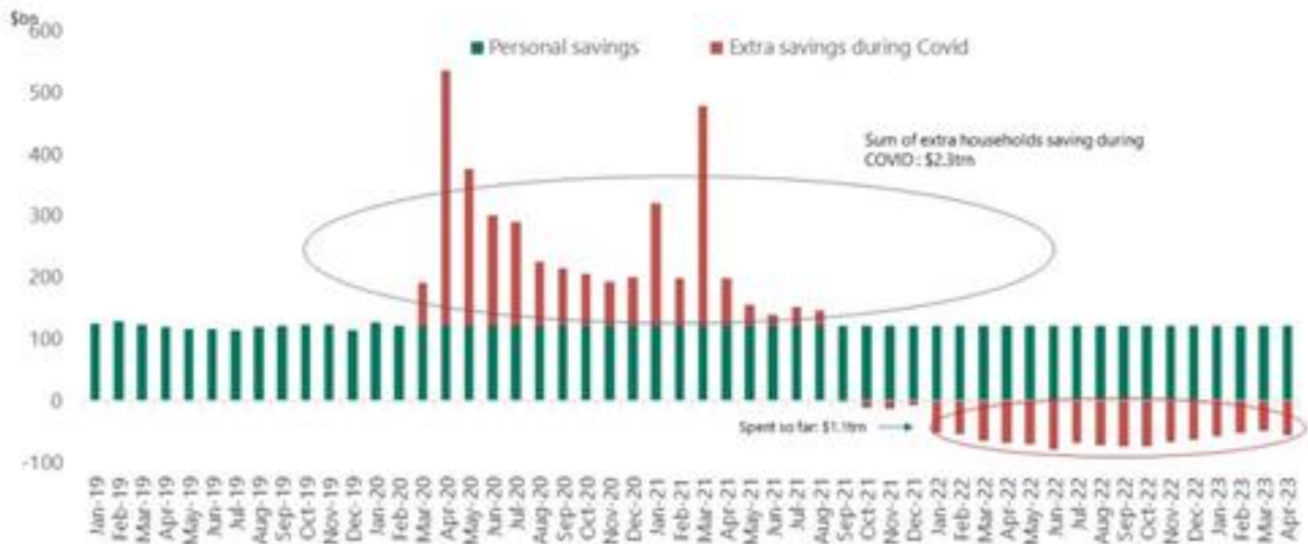


Five Trillion Dollar Mystery

Based upon the increased size of the Fed's balance sheet, it pumped close to five trillion dollars into the US economy during the pandemic. A good portion of the money was delivered directly to consumers in the form of checks and grants. Another chunk of fiscal largess went to businesses to keep them afloat in the hope that they would not reduce employment. An enormous amount of money was saved during Covid as consumers feared for the future. A portion of that money was spent during the pandemic and more has been spent as the economy reopened during the second half of 2021. According to Apollo, while households are running down their excess savings, there remains about $1.2 trillion of Covid savings left to spend. This may be part of the reason that spending on services remains so robust and the US economy has defied economists and their models forecasting a recession in 2023. This cycle really is different in the sense that the Fed has never printed this much money this fast and put much of it directly into the hands of middle to lower end consumers who are inclined to spend it.

Exhibit 6: Consumers Still have Pandemic Related Savings to Spend

Source: Apollo



High Consumer Savings Support Consumption

Consumers are still benefiting from extremely high savings rates during the pandemic. Massive fiscal stimulus and other forms of government largess helped lift consumer savings rates to the highest levels in history. For almost two solid years, it was easy to save and hard to spend. Consumers are spending down these savings in 2023, but they have not come close to exhausting their savings yet. The savings rate has collapsed in 2023 but that hardly indicates that consumers have burned through their savings. A better way to look at the savings rate is to take a 36-month rolling average which currently comes in at 8.5% or remarkably close to the very long-term average of 9%. In our estimation, consumer dissaving needs to go on for much longer to become problematic.

Exhibit 7: Consumers Retain Latent Spending Power

Source: Capital Creek Partners Research, Bloomberg

Burdensome Borrowing

As pictured in Exhibit 8 below, credit card interest rates have soared to the highest rates in the history of the data which goes all the way back to 1971. This is a clear challenge to consumers who want or need to take on debt to supplement consumption. Nevertheless, consumers have continued to add credit card debt with outstanding balances reaching record levels approaching $1 trillion as of the end of March (see Exhibit 9). As long as consumers have jobs and income, they appear willing to continue to spend. Higher credit card rates combined with the resumption of payments on student loans this August does make it harder to envision robust consumer spending during the balance of 2023.

Exhibit 8: Credit Card Rates Soar, Challenging Consumer Borrowers

Source: Capital Creek Partners Research, Bloomberg

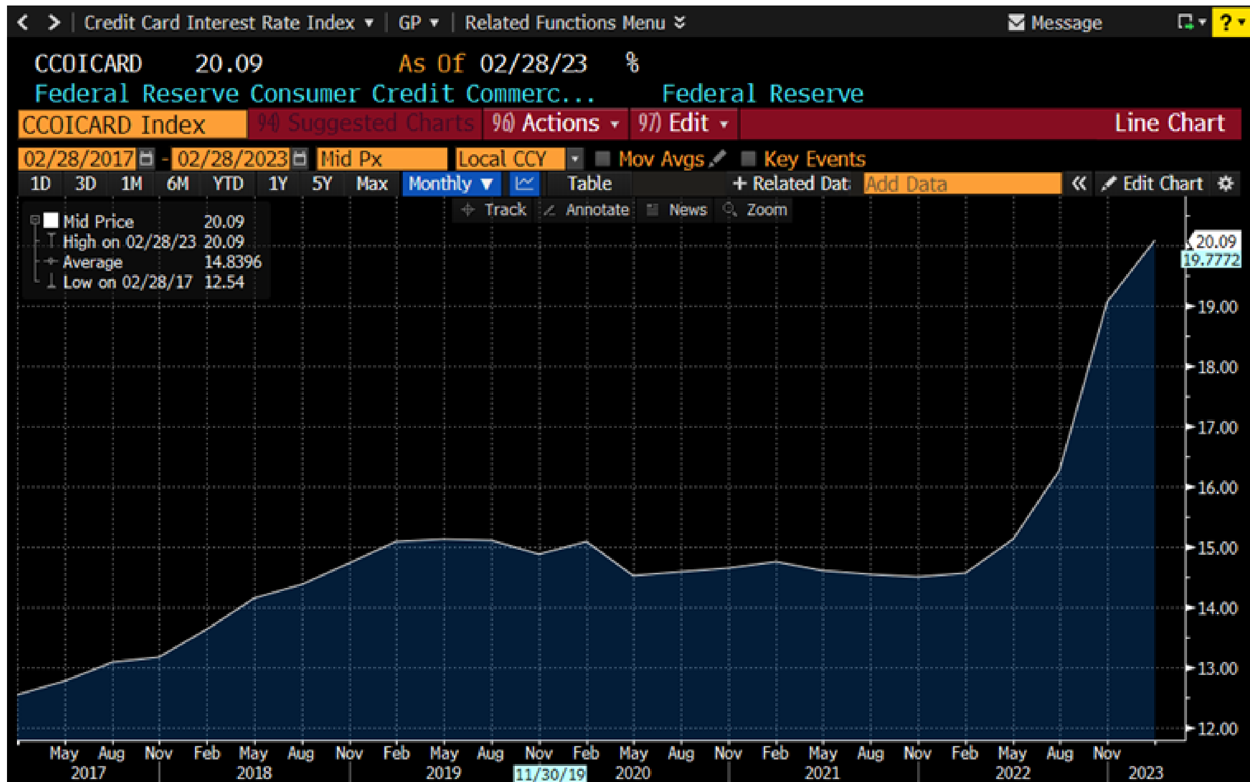
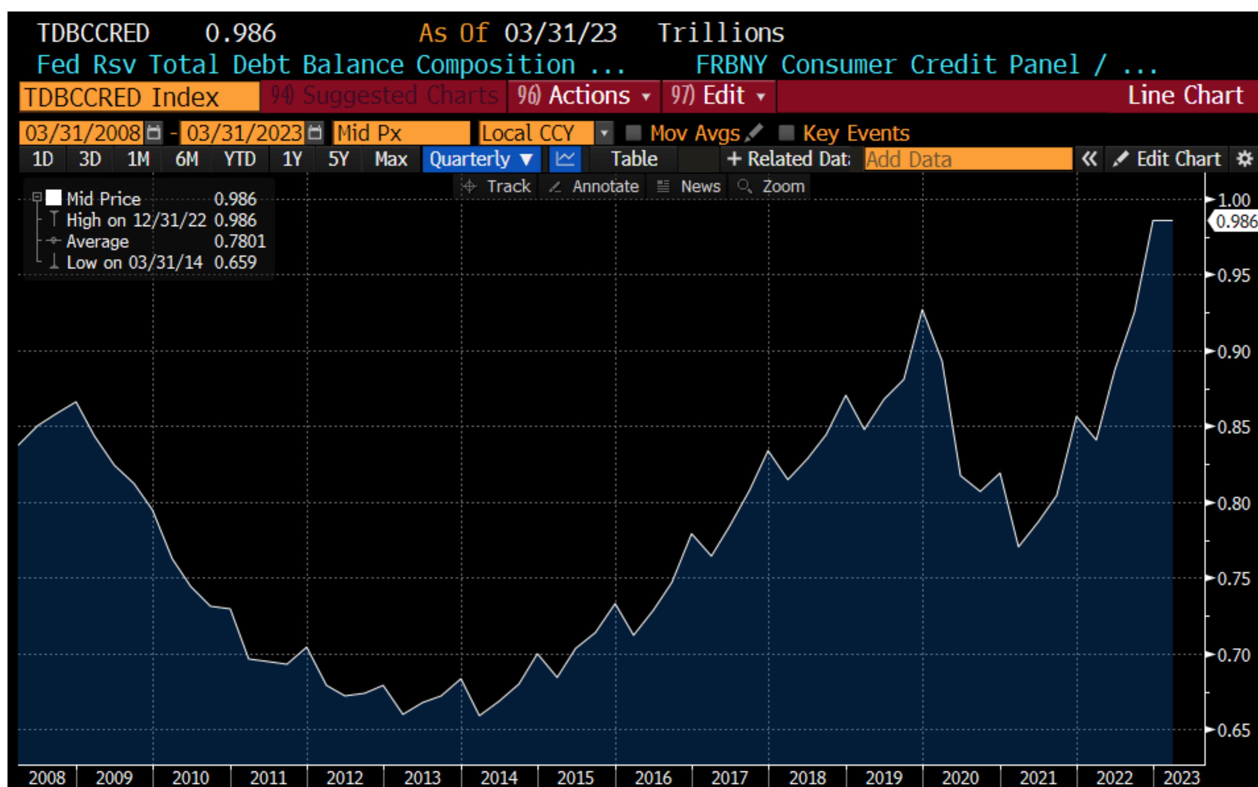


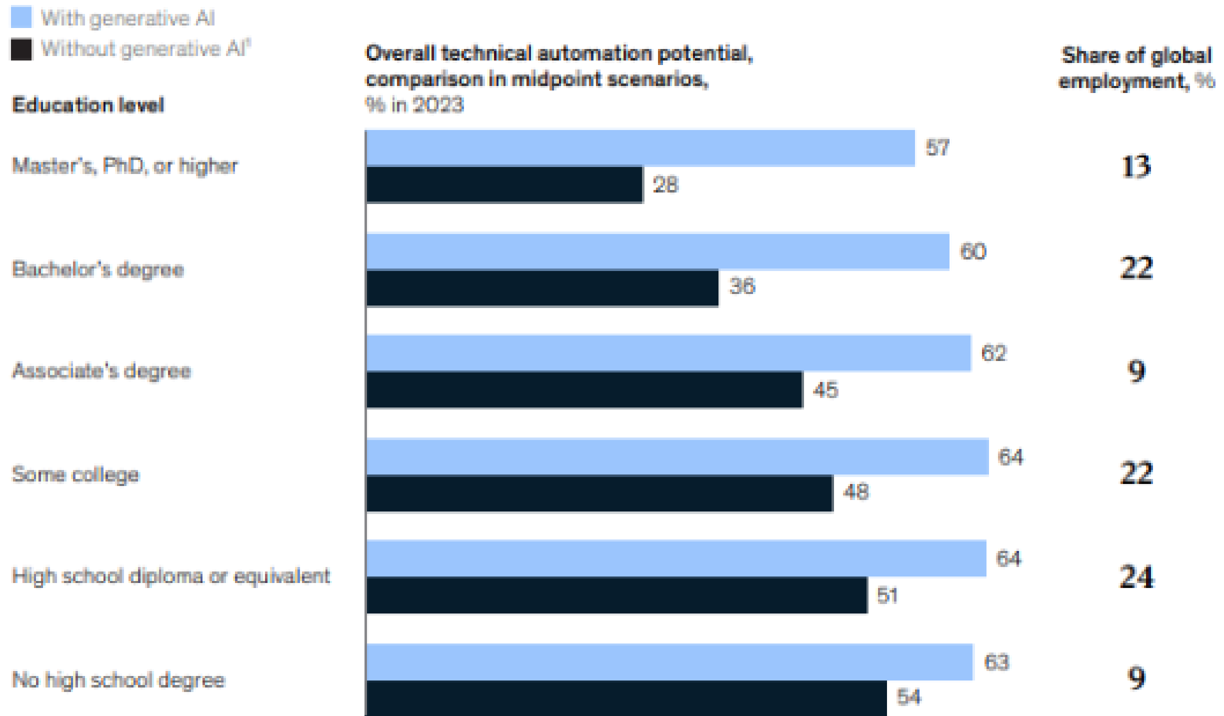
Exhibit 9: Credit Card Debt Hits Record Highs Despite Higher Rates

Source: Capital Creek Partners Research, Bloomberg



In my recent strategy piece entitled, *The Artificially Intelligent Investor*, I make the case that we are in the early innings of the next technology innovation wave. Artificial Intelligence (AI) is highly likely to usher in major socio-economic changes in a short amount of time. Consumers will also need to adjust accordingly. AI is likely to enhance knowledge worker productivity significantly. It is also likely to increase job insecurity significantly as many high-quality knowledge-based occupations become automated away. How will this impact consumer confidence? How will this impact the consumer's willingness to spend? AI adoption is advancing rapidly, and we could be surprised how fast it could change spending patterns. The AI revolution could be different than past tech innovation waves in that it may hit the high-end knowledge-based workers the hardest in terms of unemployment (see Exhibit 10). These are the wealthy consumers that drive so much of the discretionary spending in America. AI driven job destruction for high end service workers such as lawyers and computer programmers are a potential risk to my sanguine outlook on the US consumer. I currently estimate that this risk does not come into sharp focus until 2025 or beyond.

Exhibit 10: Knowledge Workers Could be Most at Risk to AI Driven Automation

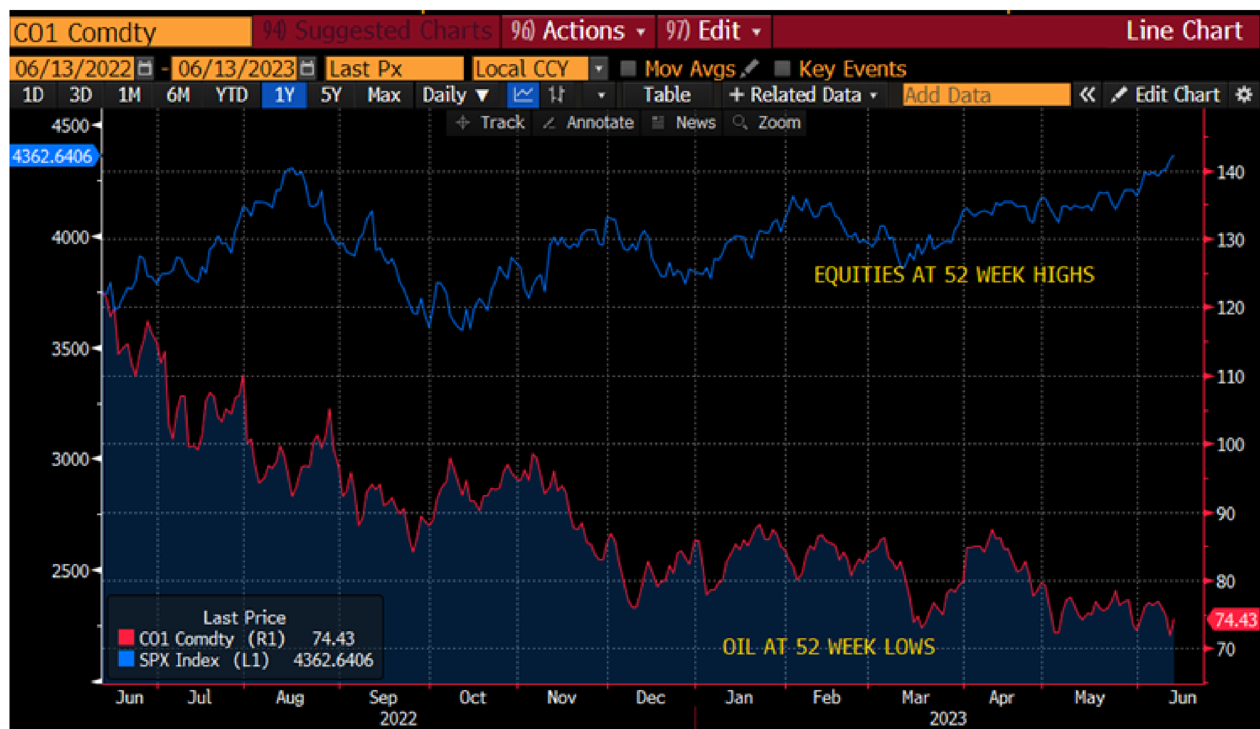


Rebounding Markets and Falling Energy Prices

The US consumer has caught a break in the first half of 2023 from a strong stock market, a stabilizing housing market, and sharply falling energy prices (see Exhibit 11). Rising equities are helping to power up the high-end consumer, which does the bulk of the spending in the US economy. Rising equities and stable housing values, due to tight supply, are making the wealthy feel more confident, thus underpinning strong levels of consumption from this key cohort. At the same time, lower end consumers who spend a significant portion their discretionary income on energy have seen these costs come down significantly in the last year. Average gasoline prices are down approximately 30% from the beginning of "driving season" last summer. This acts like a tax cut for middle and lower-end consumers.

Exhibit 11: A Consumer Tailwind--Falling Energy Prices and Recovering Equities

Source: Capital Creek Partners Research, Bloomberg

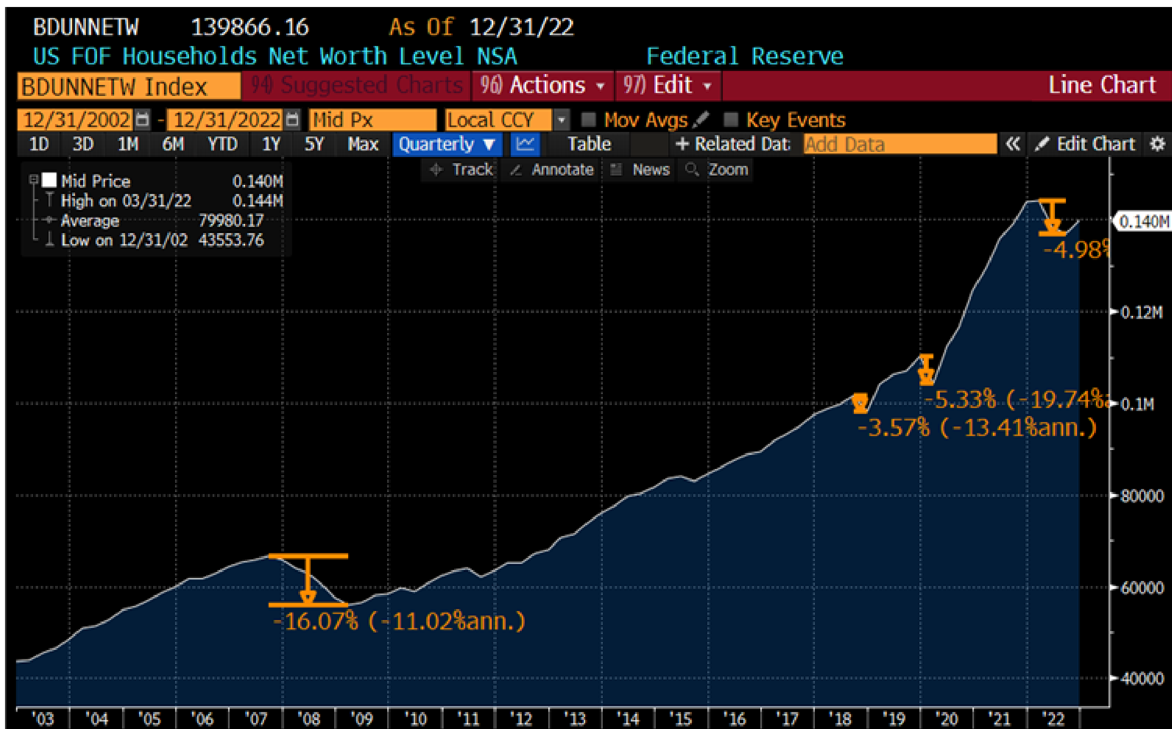


Household Wealth Remains Immense—Recent Decline is Manageable

While no doubt painful, the 2022 drawdown in Household Net Worth appears manageable for consumers. The recent period of wealth destruction looks more like the 2018 equity bear market and the 2020 pandemic bear market than anything resembling the Great Financial Crisis (GFC), which resulted in severe and sustained declines in consumer wealth. The wealthy asset holders in the US are doing fine. I have little doubt that they will continue to spend at robust rates. Wealthy Americans are getting older and just got a major wakeup call from the Covid-19 pandemic. These well-heeled consumers found out that life is tenuous, and they may not have as many years to spend as they previously thought. Assets prices are rebounding strongly in 2023 (see Exhibit 12), which will help to underwrite the spending of this key cohort.

Exhibit 12: Household Wealth has Rebounded in 2023

Source: Capital Creek Partners Research, Bloomberg



Conclusion

The US consumer, despite facing tightening monetary policies, high inflation, and post-pandemic exhaustion, still shows signs of resilience and continued spending. The infusion of trillions of dollars into the economy during the pandemic, along with high savings rates, and a robust labor market provides a solid foundation for ongoing consumption. However, it is important to acknowledge the divergent nature of the US consumer, with wealthier segments exhibiting stronger spending patterns compared to lower-income groups facing high inflation, higher interest rates, and reduced benefits. While the potential impact of AI on job security looms, the historical track record of the US consumer's drive to improve their standard of living suggests that the US consumer still has fuel left in the tank to sustain the economy.

"Don't bet against the U.S. consumer."

Ed Hyman