

## **Consumer Outlook: Goldilocks and the Bears**

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### **Introduction**

I will begin my discussion of the current state of consumer confidence with the familiar fable of Goldilocks. During the past few years, Goldilocks believed that the economy had moved in her favor. Record lows in inflation and interest rates had persisted longer than anyone expected, unemployment returned to record lows, wages began to increase, and rising home and stock prices improved the balance sheets of households. These positive developments kept consumer spending advancing, and by avoiding the excesses of booms and busts, kept the economy on its long expansionary path. This was Goldilocks' economy. An economy that was neither too hot nor too cold, but one that she judged to be just right for her purposes. Rather than the usual ending, however, this turned out to be a new age version of the traditional children's story. In a surprise twist, the outcome that counted was the reaction of the three bears. When they returned to their rural home, they found their porridge had been eaten and their once secure livelihood in tatters. Enraged at their desperate predicament, the bears chased Goldilocks and her party far into the woods, yelling "it's the economy!, it's the economy!"

Like most everyone else, I expected (and hoped) that Hillary Clinton would easily defeat Donald Trump. In the past eleven presidential elections, I have included questions about which candidate consumers expected to win the election. I have never asked which candidate they favored or for whom they intended to vote, but who they expected to actually win. Candidates have typically distinguished themselves by the economic policies they favored, and I have always been interested in how the policies of the eventual winner might influence expectations immediately following the election. Consumers have correctly anticipated in the month prior to the election the eventual winner in every election except one: in this October's survey, 70% expected Clinton to win and just 24% expected a Trump victory (see Chart 1). Note that the proportion who expected a Clinton victory grew as the election neared. That erroneous assessment was essentially similar to the predictions of nearly all presidential polls. Interestingly, this disaster was a repeat of the first polling fiasco captured by the famous 1948 photo of a jubilant Truman holding a copy of the Chicago Tribune with its headline declaring "Dewey Defeats Truman." Rather than embark on a review of survey methodology, although I will note that the surveys are based on equal probability selections from an all cell phone sample. Instead, I will begin this presentation by discussing the economic causes that favored the disruptive influence of Trump over the reassuring experience of Clinton.

First, I need to dispense with the most common question that I have been asked since Trump's election. Will consumer confidence plunge or will it improve? The simple answer is that I have no data as yet that could answer that question. The preliminary data for November excludes any interviews conducted after it became known that Trump would win on election eve. Unfortunately, the data collected prior to the election provides mixed signals. To be sure, those who expected Clinton to win were much more optimistic about future economic conditions (see

Chart 1). The difference of nearly 24 Index-points on the Expectations Index in October was extremely large as it represented nearly half of its entire peak-to-trough range. Moreover, optimism among those that expected Clinton to win grew substantially over the past several months. Nonetheless, when specifically asked which candidate would be better at improving their own finances or better at improving the overall economy, there was no difference between Clinton and Trump in the October survey; the most common response was that it would make little difference for either their personal finances or economic growth regardless of which candidate was elected. Overall, these data provide no clear indication of how consumers will react, and more importantly, provide no basis for anticipating an emerging preference for disruption rather than consistency.

Eight years ago at this conference as the 2008 financial crisis was unfolding, I detailed five stages of economic discontent. The first three stages involved consumers' reactions to rising inflation, high unemployment, and losses in household wealth. The fourth stage occurs when economic discontent is translated into political discontent. This stage has been commonly observed in the past, with consumers repeatedly advocating for changes in economic policies and entire administrations. Only if the desired economic improvements were not forthcoming do consumers enter the final stage of discontent, when people relinquish any hope for improvement and simply focus on economic survival. At last year's conference, I advanced the notion that persistent secular stagnation meant that people's economic aspirations were receding, and their dreams for a better life for themselves and their children were fading. I did not fully appreciate the anger and resentment that accompany these losses, nor the impact of the resulting blind rage that would be expressed by favoring a disruptive candidate, even if he was a very unpleasant choice. Trump provided a conduit to express their outrage while the other candidate advocated acceptance of the status-quo. Luckily, I am not a political scientist nor a psychologist so I do not need to explain Trump's victory beyond the economic factors.

I need to make one more detour before beginning my usual presentation, which is to assert that consumers hold more rational views than the candidates professed on the major economic issues.

### **Economic Policy Preferences**

In the July to October 2016 surveys, consumers were asked about their preferences for policies involving international trade, immigration, income inequality, and entitlement programs. Two aspects of the preference questions should be kept in mind. First, the questions asked whether changes in these policies would have a positive or negative influence on the overall economy. No other aspects of the various policies were considered. Second, the questions asked consumers about their basic views about each policy, avoiding any reference to how the policy would be implemented. For example, the question on international trade read: "Which would be better for the economy as a whole — more trade with other countries, less trade with other countries, or wouldn't it make much difference to the national economy?"

Compared with the campaign rhetoric, 60% favored more international trade and just 21% of all consumers thought less trade would be better for the U.S. economy (see Chart 2). Another 15% thought more or less trade would not make much difference to the economy. If inequality were reduced by higher taxes on the wealthy, nearly half of all consumers (48%) thought it would

help the overall economy, while just one-quarter expected it to hurt the economy and another one-in-four thought it would not make much difference. On immigration, the mix of opinion was quite different. Only 21% thought increased immigration from other countries would benefit the economy, while 37% thought it would be better to decrease immigration. Notably, another 37% thought neither an increase nor a decrease would make much difference to the national economy. Finally, consumers thought the better solution to covering the increasing costs of Social Security and Medicare was to raise taxes, favored by two-thirds of all consumers, while about one-in-four favored cutting benefits. Overall, the data suggest ample room for compromise. This conclusion is supported by an examination of demographic differences in these preferences, although sharp differences do exist across political party affiliations.

Preferences for greater international trade rose from 50% among those with incomes in the bottom third to 69% among those with incomes in the top third, and to 77% among households with incomes in the top 10% (see Chart 3). Higher educational attainment went along with more positive views of trade, and consumers of all ages were favorably disposed toward more international trade. Note that Democrats were slightly more in favor of trade than Republicans. On immigration, the differences were more subtle, with generally more favorable assessments of immigration on the economy as income, education, and age rose (see Chart 4). A policy that increased taxes on the wealthy to reduce inequalities found, as might be expected, lower income groups were more in favor, but there were few differences across education and age groups (see Chart 5). That same pattern was also evident on assessments of Social Security and Medicare, with tax increases favored more frequently by lower incomes, and support for cutting benefits fell as people aged (see Chart 6).

## **Consumer Sentiment**

The Index of Consumer Sentiment has drifted slightly lower during the past two years, although it has remained at a level comparable to prior cyclical peaks (see Chart 7). The recent peak was 95.5 in the 1<sup>st</sup> quarter of 2015, and the early November reading was 91.6, which was just below the two year average of 92.0. The slight downward drift reflects the fact that few consumers anticipated additional declines in inflation, unemployment, or interest rates, and only modest gains in incomes and household wealth. The relatively high level of overall consumer confidence is surprising given that the GDP has posted an average annual growth rate of just 2.1% during the seven year expansion and only 1.5% over the past four quarters. During the past year, it has been the continued strength of consumer spending that has offset the declines in business investments and enabled the economy to avoid a recessionary downturn.

I have shown the correspondence between the Sentiment Index and changes in GDP many times at this conference (see Chart 8). As usual, no attempt has been made to apply a statistical technique to smooth the rough edges of the correspondence. Note that in the past few years, consumer sentiment would have been more consistent with a faster pace of GDP growth, dropping back with each new disappointing performance, with most of the shortfalls, but not all, centered on business investments. Many people do not believe that the consumer sector could acquire and interpret the necessary information to accurately forecast economic outcomes, despite the evidence to the contrary. When compared with annual GDP growth rates, the Sentiment Index suggests a growth rate of about 2% during 2017.

## **Divergent Underlying Trends**

The Sentiment Index has two main components: the Index of Current Conditions and the Index of Expected Economic Conditions. Those two indices have diverged to a significant extent during the past year (see Chart 9). Note that such a divergence has been a longstanding component of the cycles in these indices, and that the extent of the divergence has generally increased over the past half century. Importantly, the widest divergences have occurred just before an economic downturn. This divergence exemplifies the forward looking nature of the Expectations Index, as consumers change their economic forecasts while conditions in the economy are still quite favorable. In today's economy, the weaker Expectations Index is due to a growing consensus that interest rates and inflation will be higher in the year ahead. Needless to say, few anticipate that interest rates will rise very much, and its impact on spending depends on associated developments in wages.

## **Personal Finances**

The gap between current and expected economic conditions is well demonstrated by consumers' views about their own financial situation. When asked to judge their current finances, consumers have given virtually identical responses in recent surveys as one year ago (see Chart 10). The data show a rapid rise from the recession lows, reaching a peak that was fully comparable to all other recoveries, except for the two longest expansions in the mid 1960's and late 1990's. To be sure, consumers' financial assessments have varied slightly in the past few years, recording slight declines at year end 2015 and 2016. When asked to explain how their finances had changed, income gains were reported by 33% of all households, compared with 24% who reported income declines (see Chart 11). Note that these references to income gains recorded the same pattern of small declines at year's end.

Another factor that has contributed to a greater sense of financial wellbeing has been the decline in household debt. Perhaps the best quantification of this is the ratio of required monthly debt payments to disposable income, a series calculated by the Federal Reserve (see Chart 12). The latest reading puts this repayment ratio near its lowest level since 1980, which was the first year that this series is available. As might be expected, most of the decline from recent peaks involved mortgage debt, falling to 4.5% from 7.2% of personal disposable income.

I have noted in the past few conferences that people's evaluations of current finances outperformed their judgements about future prospects. The same is true this year. Moreover, people's expected financial prospects are still viewed less favorably than at the peaks in most prior expansions (see Chart 13). The reason consumers' financial prospects have remained largely unchanged during the past few years has been the failure of income growth to move beyond very modest levels. Across all households, the preliminary 4<sup>th</sup> quarter estimate is that households anticipate a nominal income increase of just 1.3% (see Chart 14). This was just below the average expected income growth rate of 1.4% recorded since the start of 2015. To be sure, some of the slowdown in nominal incomes can be attributed to the prevailing low inflation rate. When asked about their inflation-adjusted income expectations, consumers in the latest survey gave the most favorable assessment since 2007 (see Chart 15). Nonetheless, it was still at a less favorable level than in the two prior expansions.

## **Unemployment Threatened By Weaker Economic Growth**

Prospects for the national economy weakened in the recent surveys. When asked about the economic outlook for the year ahead, nearly equal proportions expected good as bad times financially in the economy as a whole (see Chart 16). The same was true about the longer term outlook as consumers were nearly evenly divided between expecting a continuing expansion and a downturn sometime in the next five years. Of course, if the expansion did last another five years, it would establish a new record for the longest expansion in the past century and a half. While that prospect is not impossible, it is unlikely. The prime concern of consumers with the overall rate of economic growth is job creation. The Trump presidency may have a significant impact on prospects for the economy, as he has emphasized more expansive fiscal policies, with the intention of creating more jobs. Nonetheless, even if he undertakes these plans, these policies will have little impact on jobs and economic growth in 2017.

The national unemployment rate was just 4.9% in October, a bit above the low of 4.7% recorded earlier in 2016 (see Chart 17). The last time it was as low was in 2007 when it fell to just 4.4%. There were nonetheless sharp differences across education levels, with the unemployment rate among college graduates just 2.6%, about half the 5.5% among high school graduates. Note that those in the prime working age range of 25 to 54 had an unemployment rate of just 4.2% in October; in comparison, it reached a cyclical low of 3.4% during the last expansion ten years ago.

Consumers are asked about how they expect unemployment to change during the year ahead. In the most recent surveys, consumers anticipated a very marginal increase in the unemployment rate by the end of 2017. Consumers' unemployment expectations have continued to accurately forecast actual changes in the national unemployment rate (see Chart 18). These data suggest that the unemployment rate will change by a few tenths of a percentage point during the year ahead.

Unlike past years, when the unemployment rate fell due to declines in labor force participation rates, during the past year the declines have been due to rising employment rates (see Chart 19). Despite the employment gains, total employment as a percent of the population is still at levels last recorded in the early 1980's, with the labor force participation rate at levels last recorded in the late 1970's. As many of you might have anticipated from the reduced levels of unemployment among prime age workers, the gains in employment have been more substantial among those aged 25 to 54 (see Chart 20). Nonetheless, the employment ratio among prime aged workers is still at its lowest level in more than 20 years. Just as important, the participation rate has also begun to edge upward among those aged 25 to 54. Although the employment of those under 25 has significantly declined over the past decade, the employment of those aged 55 or older has continued to increase (see Chart 21). And among my age peers, one-third of those in their late 60's work, one-in-four of those in their early 70's are employed, and one-in-ten of those 75 or older still work.

Increasing employment was a major issue for the Trump campaign. Like every president before him, how employment changes during his administration will be a major factor in how his policies will be judged by consumers.

## **Inflation Edges Upward**

Expected inflation rates rose significantly in the past few months. In the October survey, consumers expected the lowest combination of a year-ahead and five-year inflation rates. While the year-ahead expected inflation rate has been well below 2.4% in prior surveys, it was the first time in a half century that both the near and longer term expected inflation rates were that low. In early November, however, both near and long term expected inflation rates rose to 2.7%. While the year-ahead expected inflation rate has frequently moved more than three-tenths of a percentage point due to changes in gas prices, for example, there have only been a dozen surveys in the past quarter century that recorded a simultaneous increase in both near and long term inflation expectations of three-tenths of a percentage point or more. It will be very interesting to see how consumers' inflation expectations respond to Trump's election. Economists, mostly those on Wall Street, expect somewhat higher inflation as well as higher interest rates during the year ahead. The impact of such changes on consumer spending is the next topic I will discuss.

## **Spending Prospects Depend On Low Interest Rates**

As many of you know, the surveys have a series of questions about buying conditions for homes, vehicles, and large household durables. Following each question, consumers are asked to state, in their own words, the reasons underlying their evaluations. I will not report the overall evaluations—they are all slightly lower than a year ago, although still quite favorable. The pre-Trump data indicate that light vehicle sales are expected to be 17¼ million in 2017 and housing starts to advance by 1¼ million. Instead, I will concentrate on the reasons given by consumers for the evaluations of buying conditions. In particular, the role of prices and interest rates in their purchasing decisions. The quick summary is that consumers have judged prices less favorably, and interest rates more favorably over the past year.

Low and attractive pricing reached all-time peaks across all markets at the end of Great Recession (see Chart 22). The declines in attractive home prices plunged from a peak of 74% in 2009 to just 24% in the latest survey. For vehicle purchases, references to low prices fell from a peak of 64% in 2009 to a low of just 20% in 2016. For household durables, the decline from the 2009 peak of 52% has been much less, falling to a 2016 low of 32%, but rebounding to 40% in the latest survey.

The attractive power of low prices played a significant role earlier in the expansion as consumers were very cautious, and lenders were very hesitant, about adding to their debt burden. Those concerns have eased in the past year, but have hardly disappeared. Nonetheless, consumers have shifted from the appeal of low prices to the appeal of low interest rates. For all three markets, consumers have gradually increased their references to low interest rates since the end of the Great Recession (see Chart 23). You might have imagined that consumers' references to low interest rates would be at all-time peaks given how low interest rates fell, in nominal as well as real terms. In fact, much higher peaks were recorded in the prior twenty years. In part, this reflects both credit qualification standards as well as credit cost, with the availability much greater before the financial crisis. The difference in consumer assessments pre and post 1980 corresponds to a basic shift in policy, which I discussed at this conferences a few decades ago.

Although interest rates are widely anticipated to increase, the proportion of consumers that mentioned it was better to borrow-in-advance of the expected increases has remained very low. Even for home purchases, where mortgage interest rates can be anticipated to play a more important role, borrowing-in-advance of expected interest rate hikes were only mentioned by 7%. The appeal of currently low mortgage rates, in contrast, was mentioned by 38%, on balance. Moreover, it could be expected that even with a few quarter-point increases in the Fed rate, consumers would still be motivated more by their current low level rather than the expectation of future increases. In addition, a significant rise in buying-in-advance of home *price* increases is even less likely as most consumers still anticipate a long-term rate of appreciation to remain comparable to the expected inflation rate.

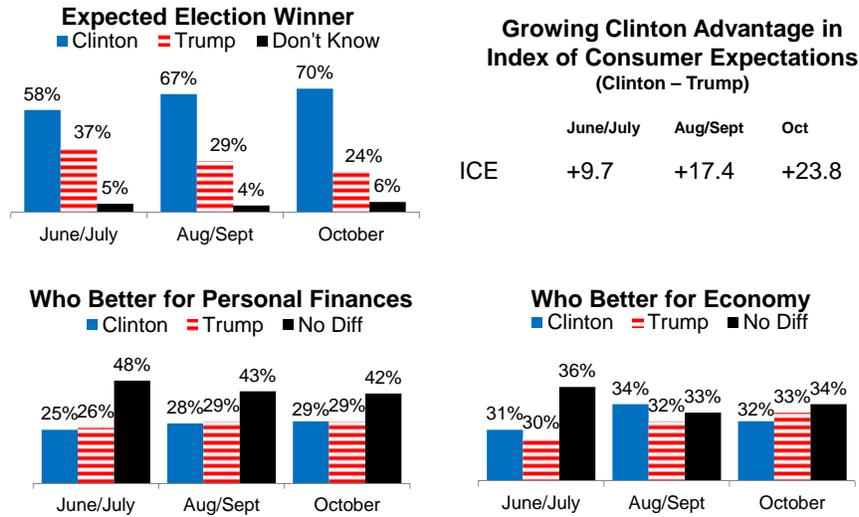
## **Summary Outlook**

In closing, let me return to the fable of Goldilocks and the bears. The bears did not want to give up their cherished dreams of economic prosperity and security. When the achievement of those aspirations was no longer possible, the bears accepted, however begrudgingly, an unusual, and at times bazaar, method of redress. No one wants to give up their children's economic birthright without a fight. To be sure, the bears do not anticipate a solution would emerge anytime soon, but they want to feel that economic policies have their best interests in mind. Everyone loves an underdog, especially if they can relate to their economic predicament. Increasing numbers of the disaffected, at the last minute, decided to vote their primordial economic interests, even if they found all of the candidate's other views atrocious and frightful. Indeed, the more outrageous the candidate, the more forceful the message that the bears sent to the established interests.

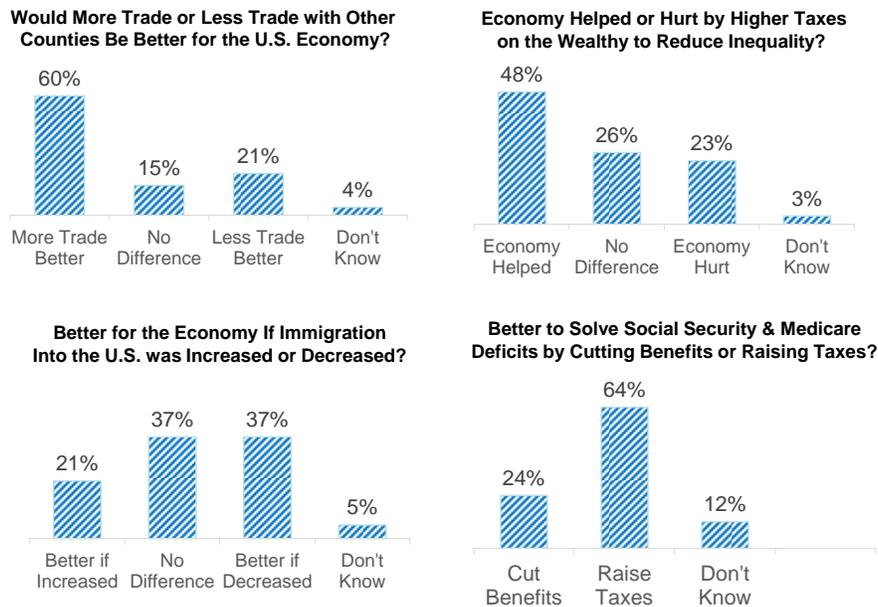
The central issue is what new policies will the Trump administration propose, and how will those proposals be translated into official economic policies by Congress. Needless to say, like most other observers who are much more knowledgeable about these matter, I have no estimate of the final results. I suspect that the policies that eventually emerge will not be direct translations of Trump's campaign pledges. The dizzying array of Trump's economic policy statements makes that outcome impossible.

From the Goldilocks point of view, nearly all of the economic gains due to low inflation, unemployment, and interest rates have already been experienced. While no large up-tick is anticipated during the year ahead in any of these key economic factors, the best forecast is that they will inch higher but remain reasonably low. Wage gains will be the key; they are crucial to maintaining confidence at high levels as well as allowing higher inflation and interest rates to be accepted and not disrupt spending decisions. This implies that the current expansion comes one year closer to topping the current 10 year record. The outlook significantly worsens if the Trump presidency causes a sharp drop in consumer confidence, and that would also mean there would be a chance of a downturn starting in late 2017. Quite apart from the impact on the economy, the overall tenor of social discourse may be contentious and hardly civil. So even when we are enjoying an extended period of good economic times, public discourse may accentuate the negative. Nasty election campaigns may now extend from merely two years to cover the entire four year presidential term. Happy Thanksgiving!

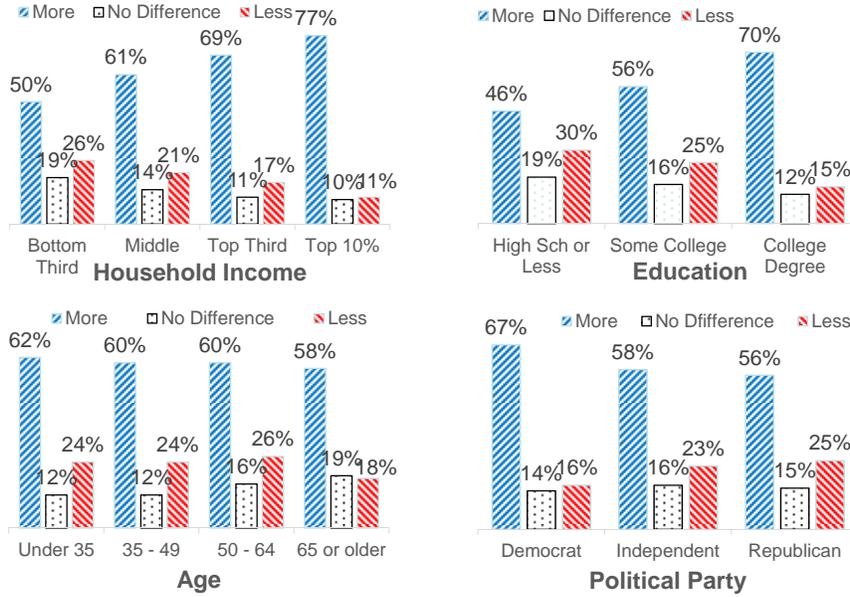
## Chart 1: Clinton Victory Widely Anticipated but Neither Candidate Expected to Resolve Economic Challenges



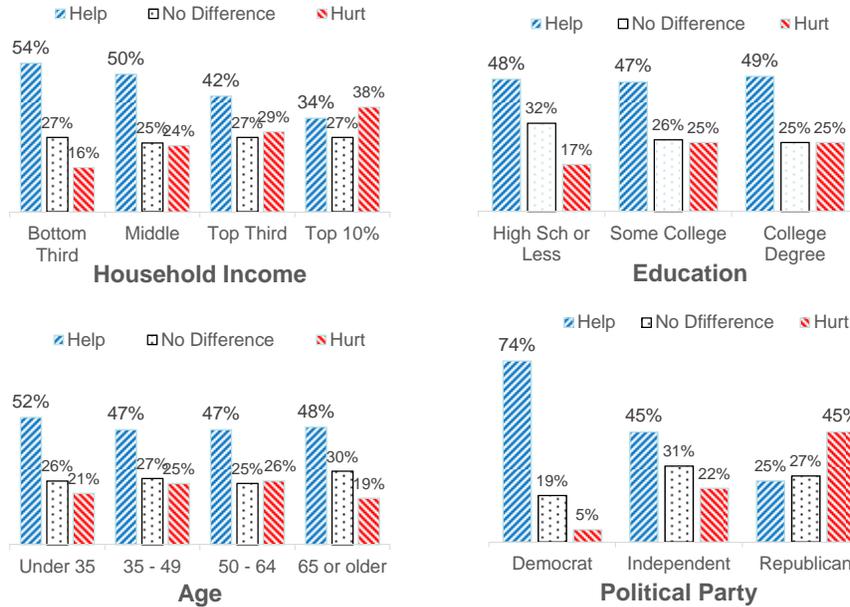
## Chart 2: Economic Policy Preferences



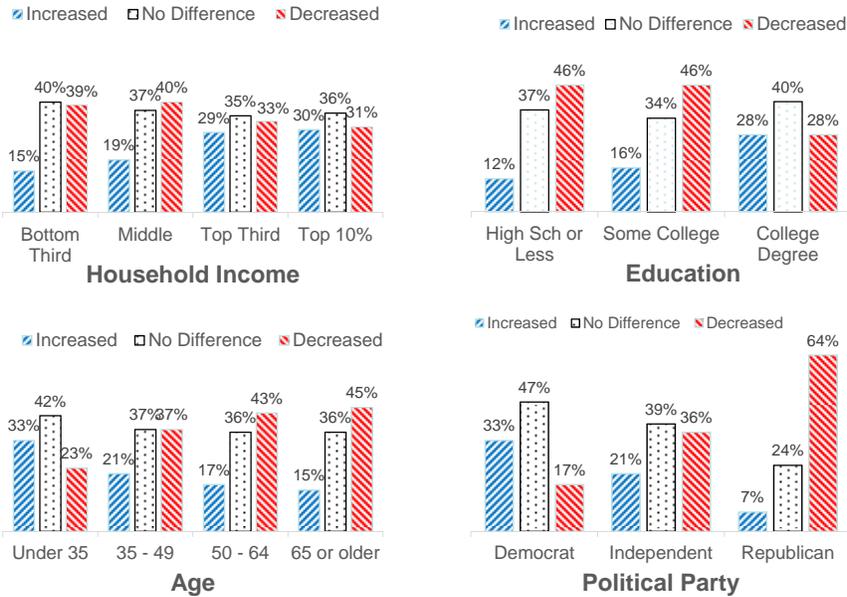
**Chart 3: Would More Trade or Less Trade with Other Countries be Better for the U.S. Economy?**



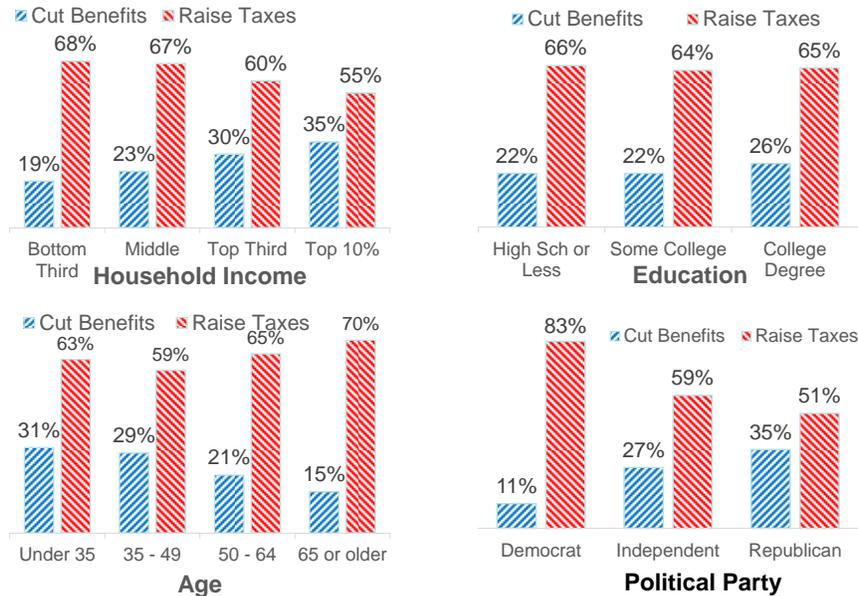
**Chart 4: Would the Economy be Helped or Hurt by Higher Taxes on the Wealthy to Reduce Inequality?**



**Chart 5: Would it be Better for the Economy If Immigration Into to U.S. was Increased or Decreased?**

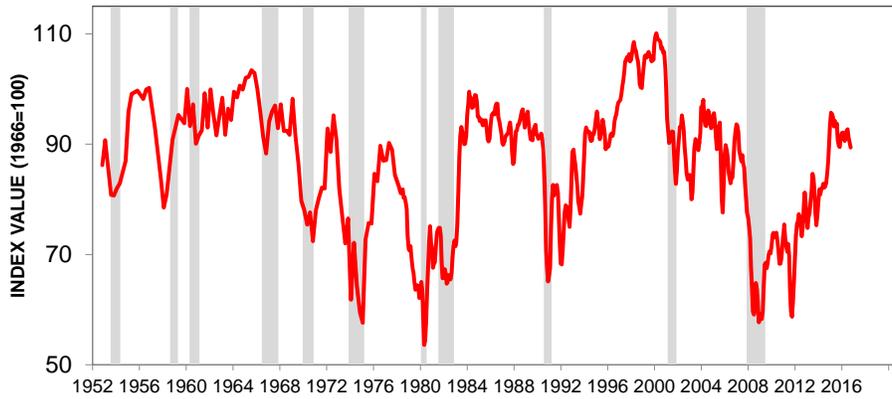


**Chart 6: Better to Solve the Increasing Costs for Social Security and Medicare by Cutting Benefits or Raising Taxes?**

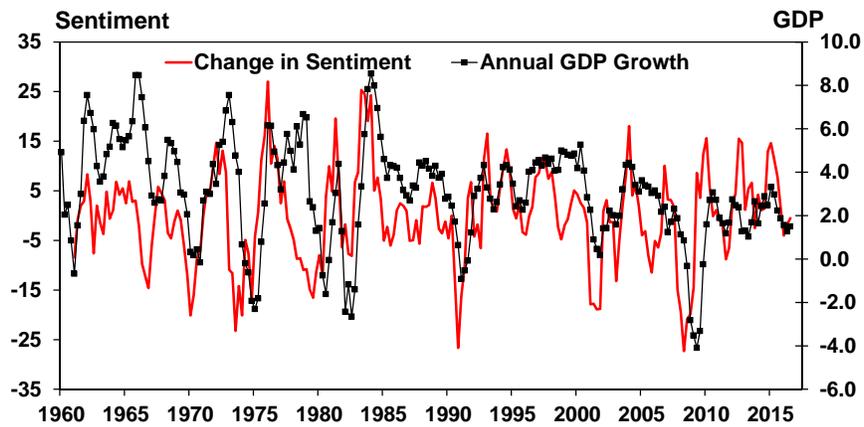


**Chart 7: The Index of Consumer Sentiment:  
Small Retreat from 2015 Peak**

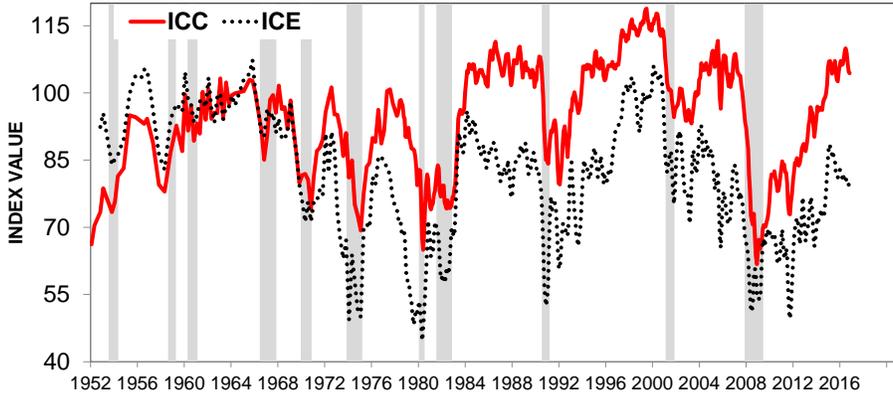
2015:1 = 95.5  
2015:4 = 91.3  
2016:4p = 89.4



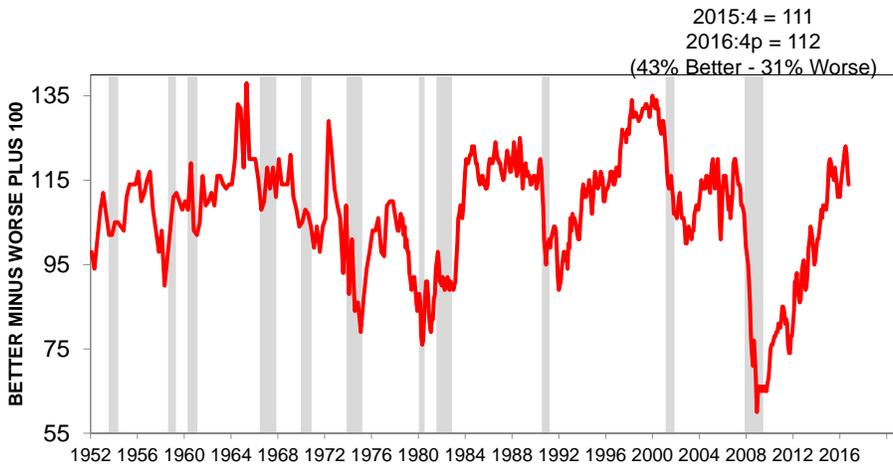
**Chart 8: Sentiment Indicates Continued  
Slow GDP Growth During Year Ahead**



**Chart 9: Current and Expected Components of the Index of Consumer Sentiment**



**Chart 10: Current Finances Judged Favorably, Although With Small Retreats at Year-end 2015 & 2016**



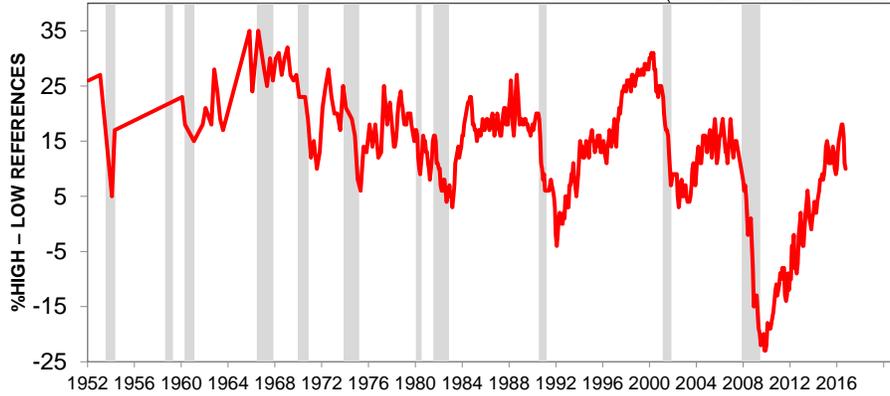
**Chart 11: Recent Net Income Gains Remain at Improved Levels but Retreat in Late 2015 & 2016**

(%Higher Income - %Lower Income)

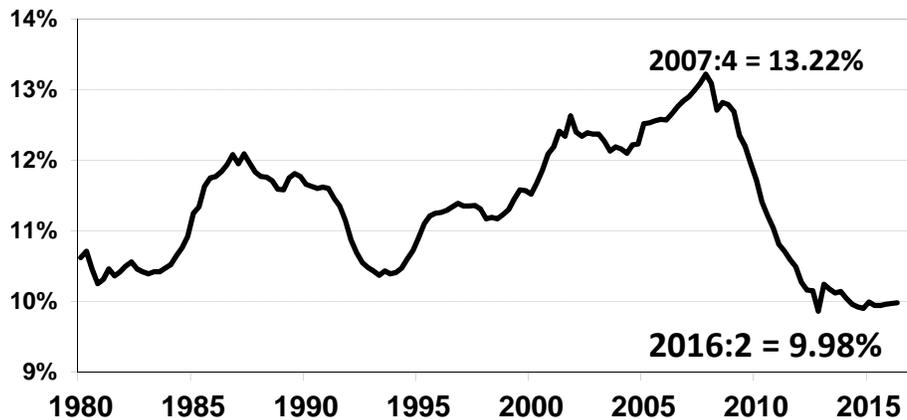
2015:4 = 9

2016:4p = 9

(33% Better - 24% Worse)

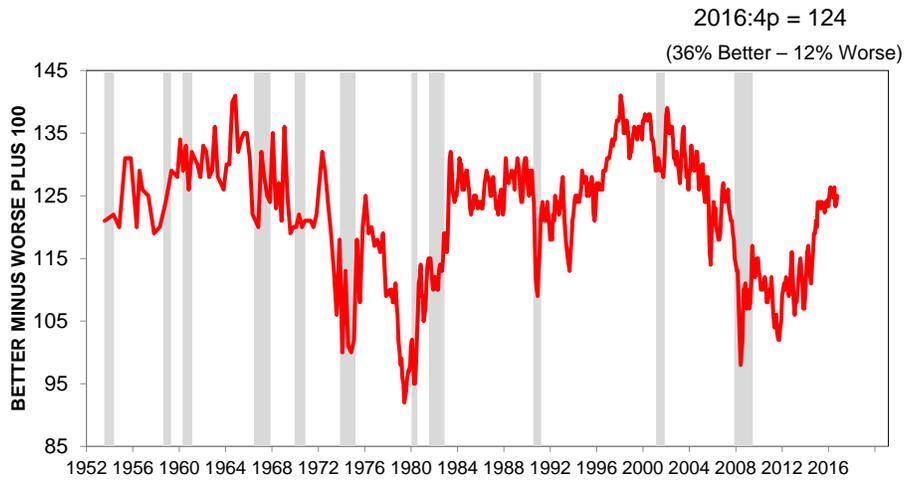


**Chart 12: Debt Repayments as a Percentage of Personal Disposable Income Lowest Since 1980**

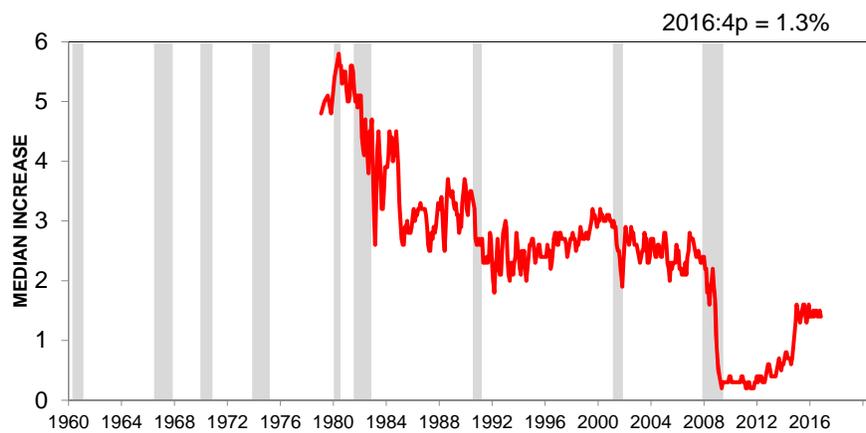


	Debt Service		
	Peak	Latest	Difference
Mortgage	7.2%	4.5%	-2.7pp
Consumer	6.0%	5.5%	-0.5pp
Total	13.2%	10.0%	-3.2pp

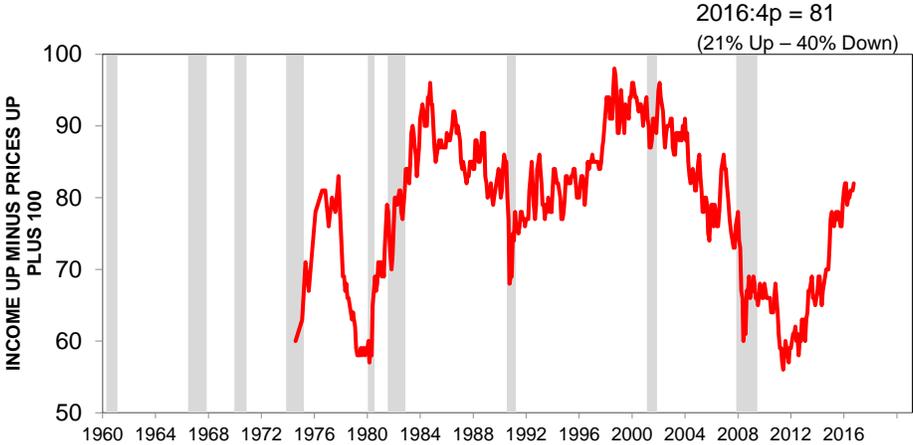
**Chart 13: Financial Prospects for Year Ahead  
Remain Largely Unchanged at Improved Levels**



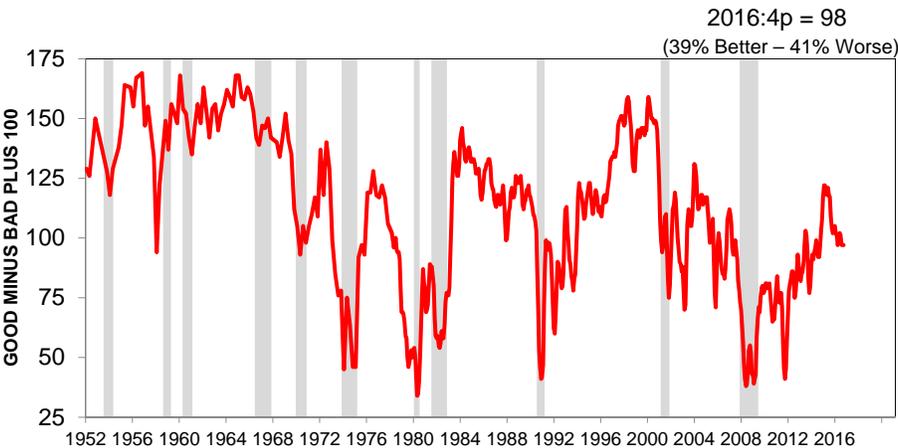
**Chart 14: Expected Change in Household Income  
During the Next Year Shows No Further Gains**



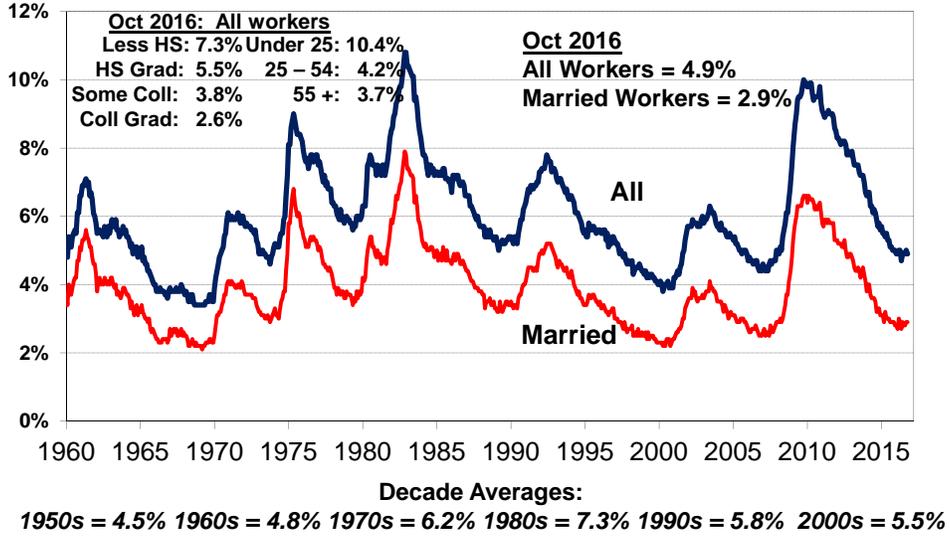
**Chart 15: Low Inflation Improves Expected Change in Real Income During the Next Year**



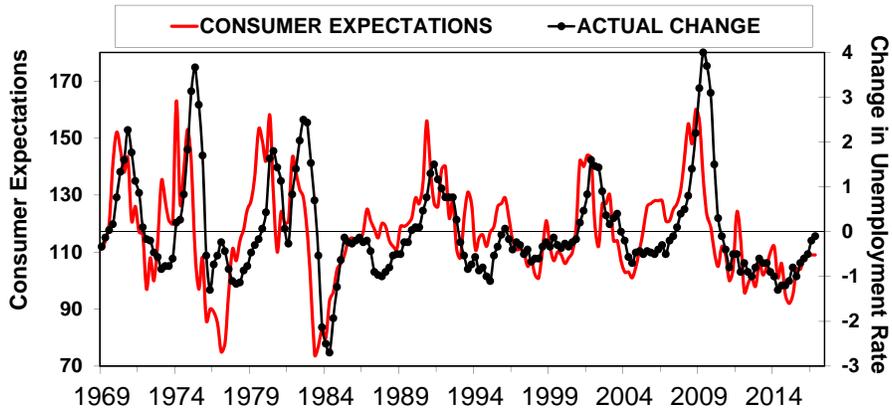
**Chart 16: Weaker Economic Outlook Expected During the Next Year**



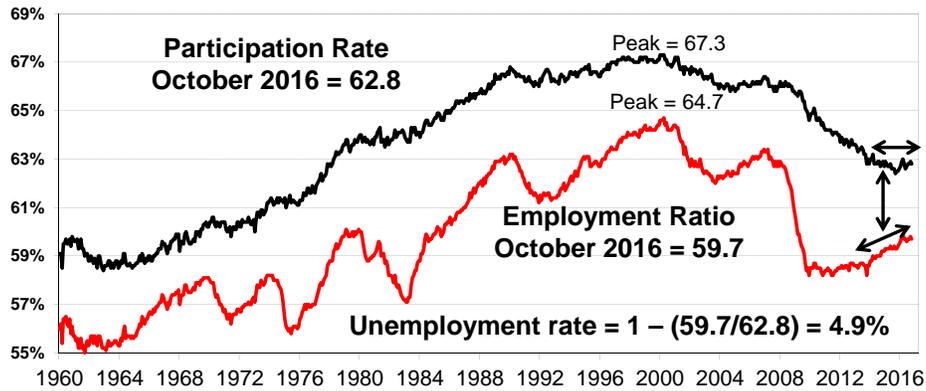
**Chart 17: Unemployment Rate Remains Unchanged At Lowest Levels Since 2007**



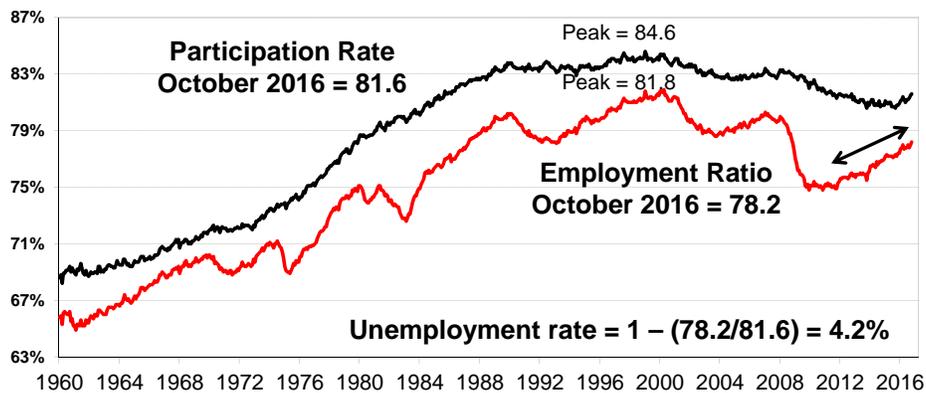
**Chart 18: Consumers Expect Unemployment Rate to Remain Largely Unchanged During Year Ahead**



**Chart 19: Unemployment Declines Due to Increasing Employment As Participation Rate is Largely Unchanged**



**Chart 20: Employment Gains Larger Than Rising Participation Rates Among Prime Labor Force Aged 25 to 54**



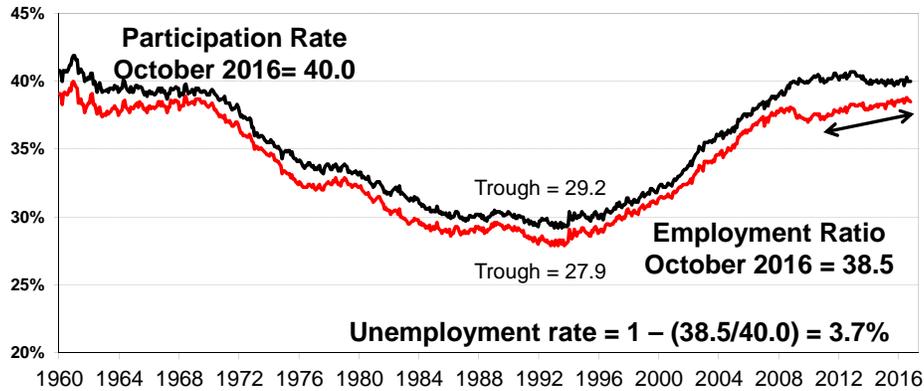
**Under age 25 Employment Ratios  
(October 2016)**

Men = 49.7%    Women = 48.6%

**Pct Pt Change from 2000 Peak**

Men = -12.3    Woman = -9.3

**Chart 21: Rising Employment and Flat Participation Rates Among Those Over Aged 55 or Older**

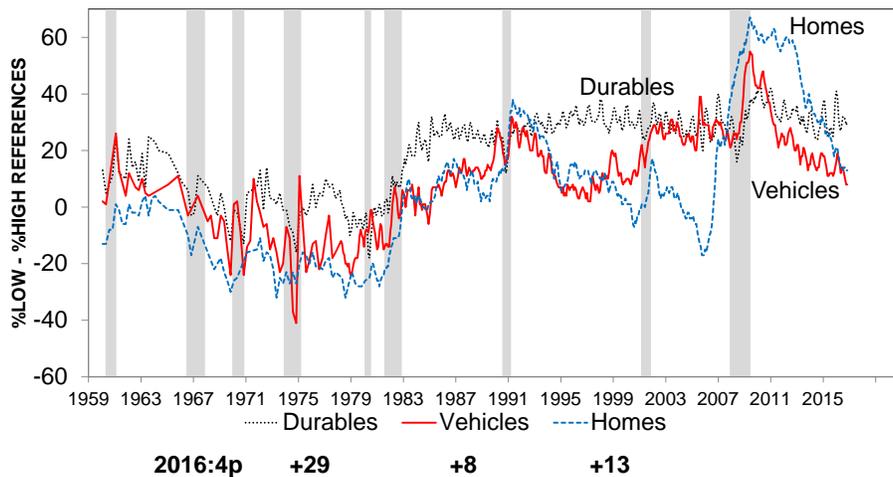


**Employment Ratios (10-year ppt. change)**

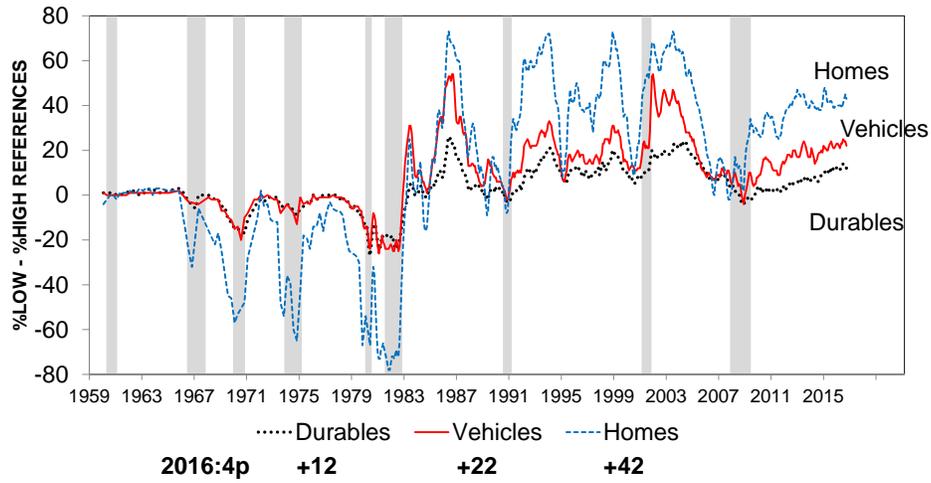
Age	Men	Women
65 – 69:	34.9 (-0.7)	26.1 (+1.2)
70 – 74:	24.9 (+2.7)	14.1 (+1.9)
75 +:	11.1 (+1.8)	6.5 (+2.1)

**Chart 22: Net References to Prices in Evaluations of Buying Conditions**

(%Low prices - %High prices)



**Chart 23: Net References to Interest Rates in Evaluations of Buying Conditions**  
 (%Low interest rates - %High interest rates)



**Chart 24: Consumer Expectations Indicate Continued Expansion in Total Personal Consumption Expenditures**

