Paranoid? An Update on Consumer Sentiment

Consumer and business confidence metrics are not yet out of the woods, and the recent spike in rates, oil, and the dollar might chip away at relatively resilient sentiment.

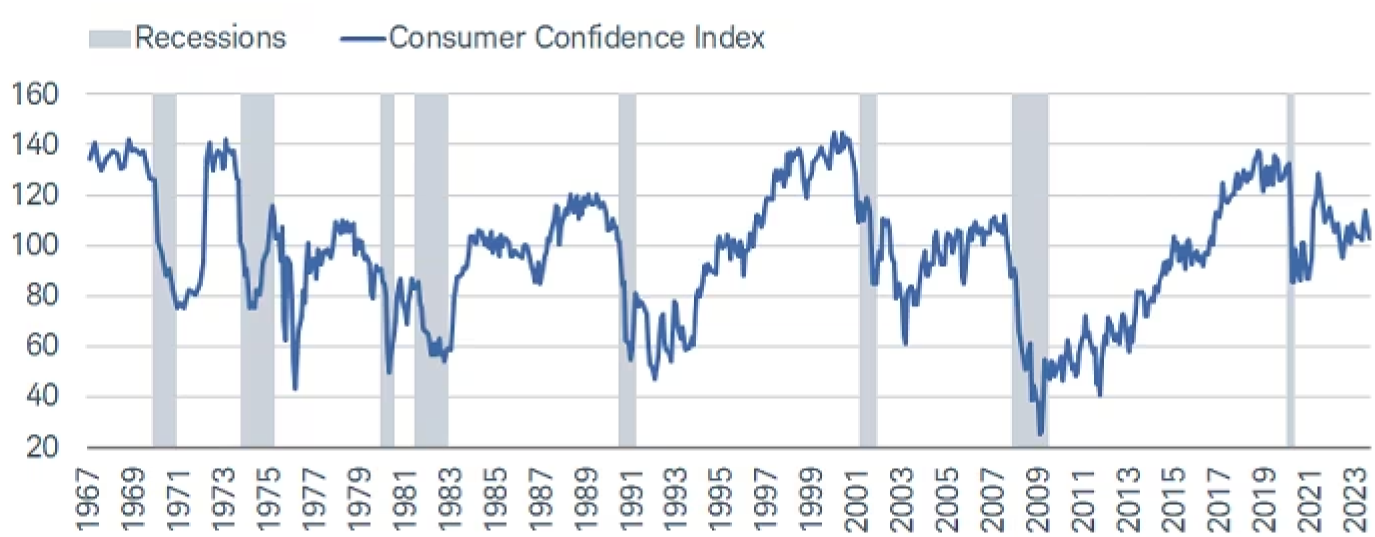
October 02, 2023

Throughout the summer, there was a litany of developments keeping the U.S. consumer on edge: oil prices surged nearly 40% between mid-June and late September; Treasury yields have pushed to new cycle highs as the Federal Reserve has maintained a restrictive policy stance, which in turn has boosted the U.S. dollar; and the stock market turned lower in a broad-based selloff at the end of July. Among other things, these issues have elevated the question of whether cracks are starting to form in a key pillar of economic support.

Since the Fed began its aggressive rate-hiking cycle last year, the consumer has been hailed as a source of both strength and resilience in keeping the economy afloat, as major pockets of weakness have emerged in areas like manufacturing and housing. Underscoring the "upside-down" nature of this economic cycle, consumers have been relentless in their willingness and ability to spend even as their confidence and sentiment have waned considerably.

As shown in the chart below, The Conference Board's Consumer Confidence Index (CCI) hasn't recovered from its drop during the pandemic; in fact, the magnitude of its decline from the 2021 peak has been consistent with prior recessions. There has been some relative stabilization over the past year, thanks to the resilient labor market (key to keep in mind is that the CCI is more influenced by labor; not as much by inflation). As we have been pointing out, this metric was one of the first to enter its own recession—helping precipitate our "rolling recession" thesis. In keeping with the adage "listen to what they say, but watch what they do," the weakness in consumer confidence having been offset by strength in actual spending.

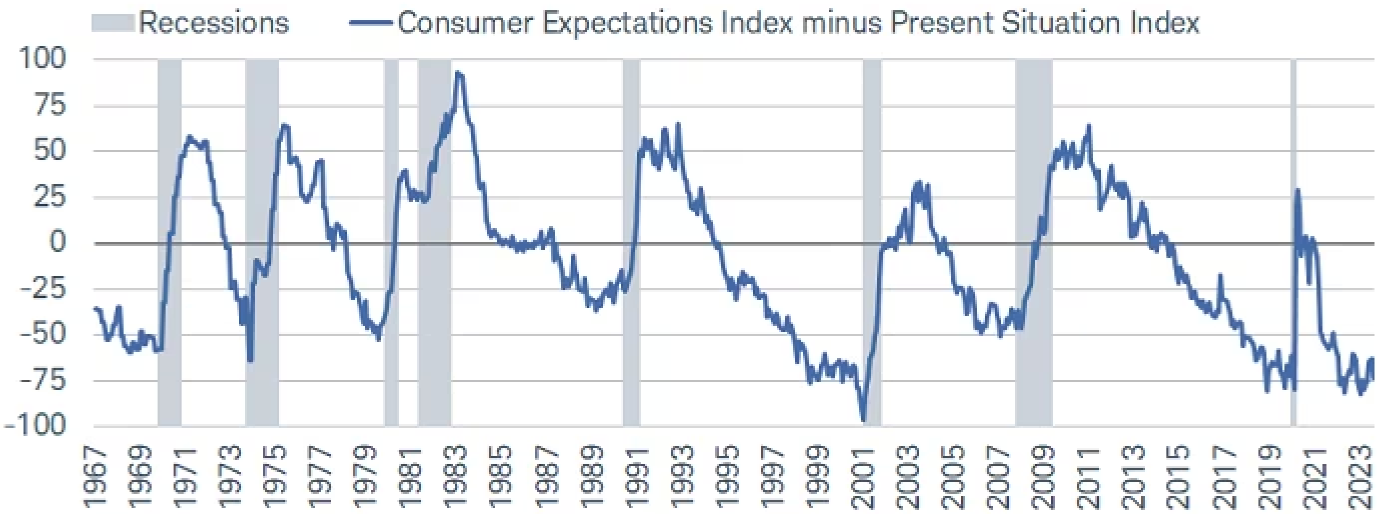
Confidence: Neither hot nor cold



Source: Charles Schwab, Bloomberg, The Conference Board, as of 9/30/2023.

Investors might scratch their heads at the drop in confidence and think that the CCI is "broken" as a forward-looking economic indicator, given a broad-based recession has not yet occurred. Not so fast. The chart below plots the difference between the CCI's "expectations" and "present situation" components. The former measures consumers' feelings about the future whereas the latter measures their current sentiment. When the spread reaches a low—as is the case now—it tends to precede recessions. Yet, it doesn't mean the economy is *currently* in one. If you look closely, a rapidly rising spread is what has signaled recessions being underway.

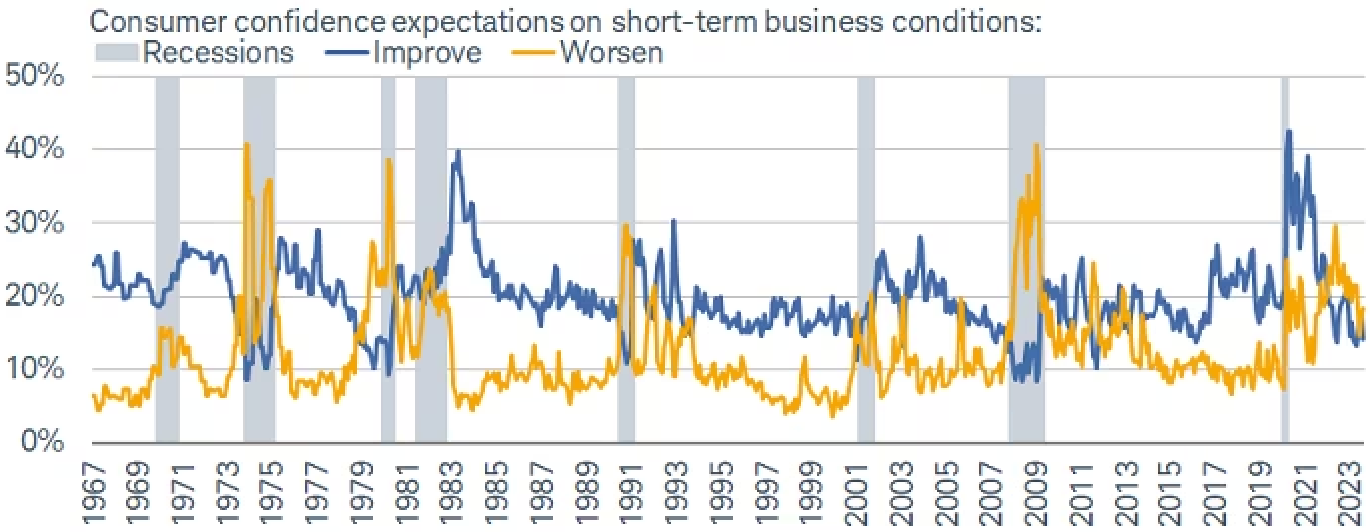
Not-so-great expectations



Source: Charles Schwab, Bloomberg, The Conference Board, as of 9/30/2023.

We should also be increasingly focused on consumers' deteriorating expectations for business conditions. As shown below, the percentage of respondents in the CCI who are expecting conditions to worsen over the next six months has again climbed above the percentage expecting conditions to improve. While the spread is not consistent with prior recessions, it's also not consistent with durable expansions. Historically, when the economy was growing and recession prospects were low, expectations for worse conditions were consistently subdued relative to expectations for better conditions. We don't see this getting cleared up in earnest any time soon, not least because of the uncertainty around monetary policy, the path of inflation, and cracks in the labor market.

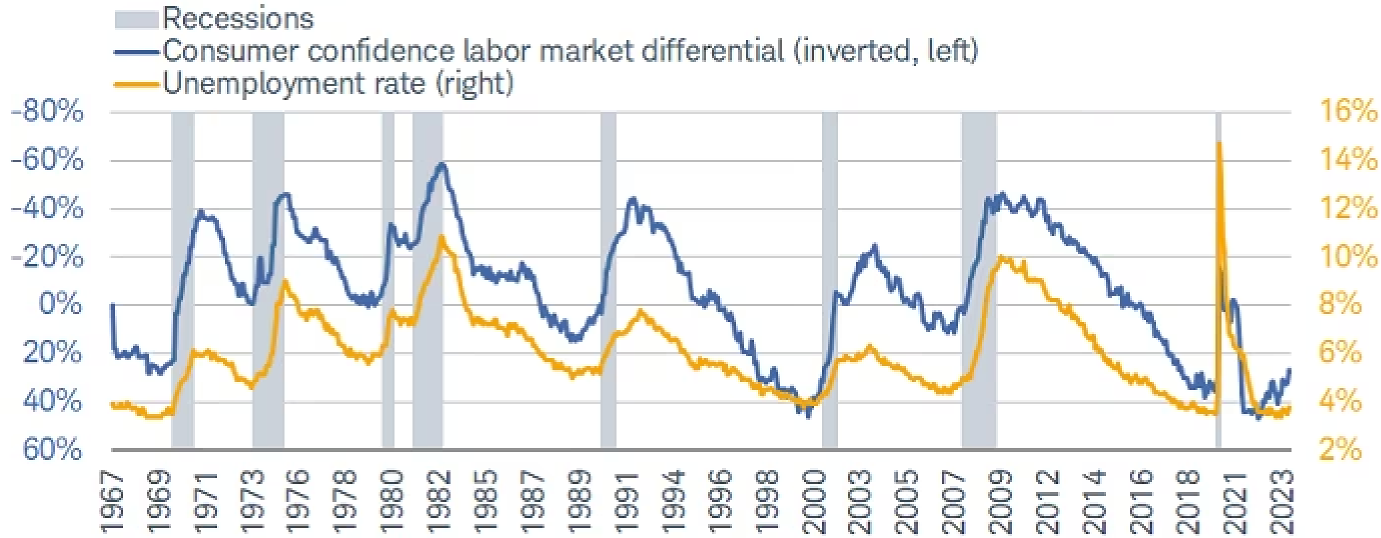
No clear signal from business expectations



Source: Charles Schwab, Bloomberg, The Conference Board, as of 9/30/2023.

Labor cracks are still in sight and, per the CCI, widening. As shown below, when looking at the index's labor differential—the percentage of consumers saying jobs are plentiful minus the percentage saying jobs are hard to get—it points to conditions starting to worsen. Historically, this kind of weakness was consistent with a commensurate increase in the unemployment rate. At present, there is a disconnect in this relationship; but given the unique nature of this cycle (and the labor market), don't dismiss that it might take longer for the unemployment rate to move higher this time (assuming the CCI's labor differential continues to weaken).

Labor confidence has deteriorated



Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics, The Conference Board.

Consumer confidence labor market differential (as of 9/30/2023) represents percentage of respondents who say jobs "are plentiful" minus percentage of respondents who say jobs "are hard to get." Unemployment rate as of 8/31/2023.

There was additional important data released last week that corroborates the elevated consumer stress narrative. On Thursday, the Bureau of Economic Analysis (BEA) released its GDP (gross domestic product)/GDI (gross domestic income) revisions coving 2013-2023. In general, the revisions portray a weaker consumer, with both the savings rate and spending revised lower (although incomes were revised higher). The large historical downward revisions to the savings rate mean the rate has been rising more sharply this year than previously thought. In particular, one can infer that the lower income groups which are now running negative savings rates are under increasing pressure.

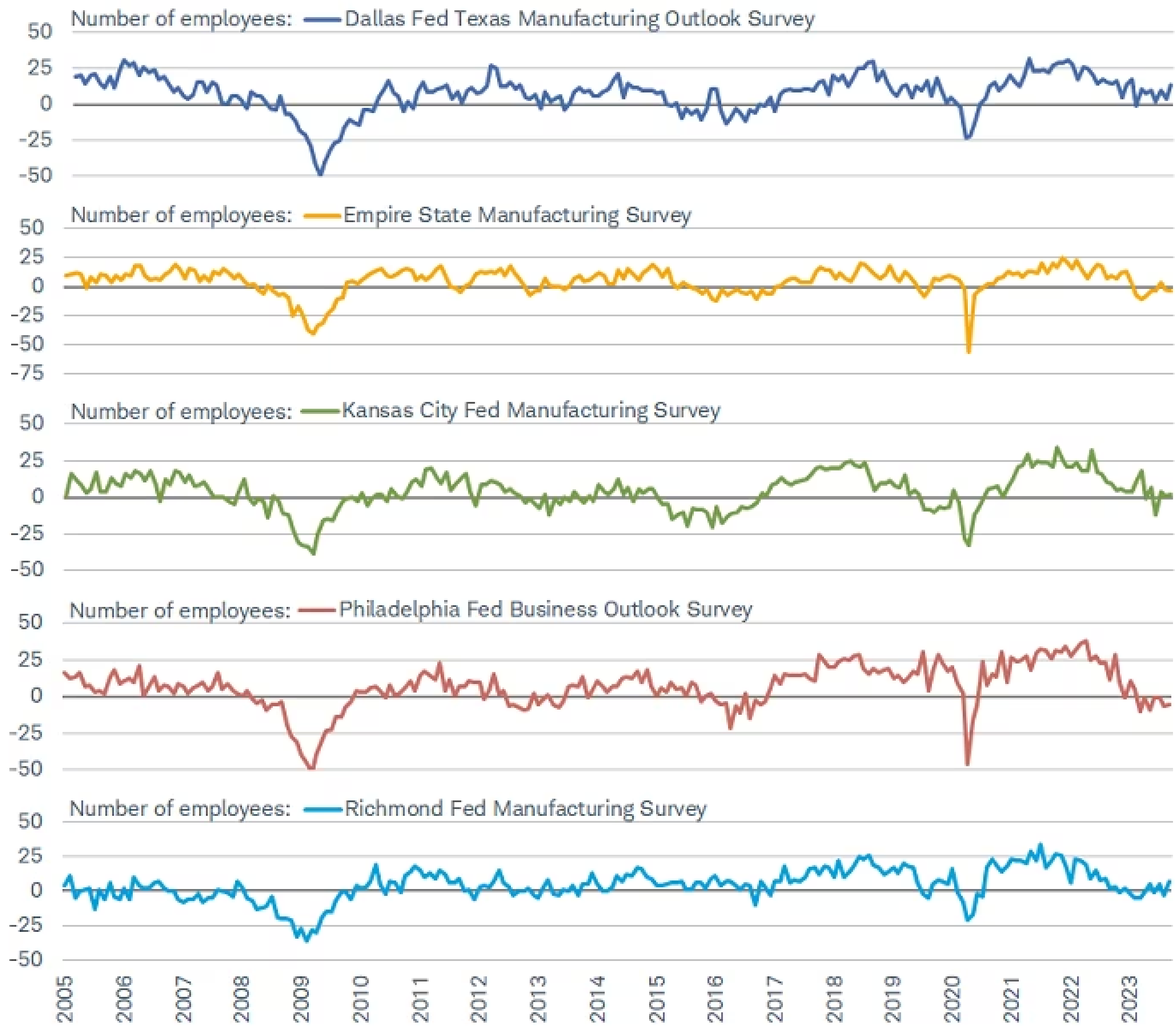
One important component of the revisions was a sharp downward adjustment to consumer spending within GDP for the second quarter of this year. Instead of the initially-reported 1.7%, spending is now seen as having grown less than half of that, at 0.8%. It was, however, offset by an upward revision to business spending (capex), in keeping with our longer-term thesis that capital spending may take away some "share" of GDP relative to consumer spending.

Going regional

Consumers have been dented, but not broken, in large part due to the resilience of the labor market. The unemployment rate will eventually start moving up, but the path could be choppy, highlighted by some mixed messages coming out of several key regional Federal Reserve Bank data. The series of charts below covers some components within the manufacturing indexes from the five major regional Fed banks.

Like the Institute for Supply Management (ISM) Purchasing Managers' Index for manufacturing (PMI-M), these are diffusion indexes; so, a reading below zero denotes contracting activity relative to the prior month (and vice-versa). As shown, hiring activity over the past year has been much weaker in New York ("Empire"), Kansas City, and Philadelphia, while Dallas and Richmond have generally fared better.

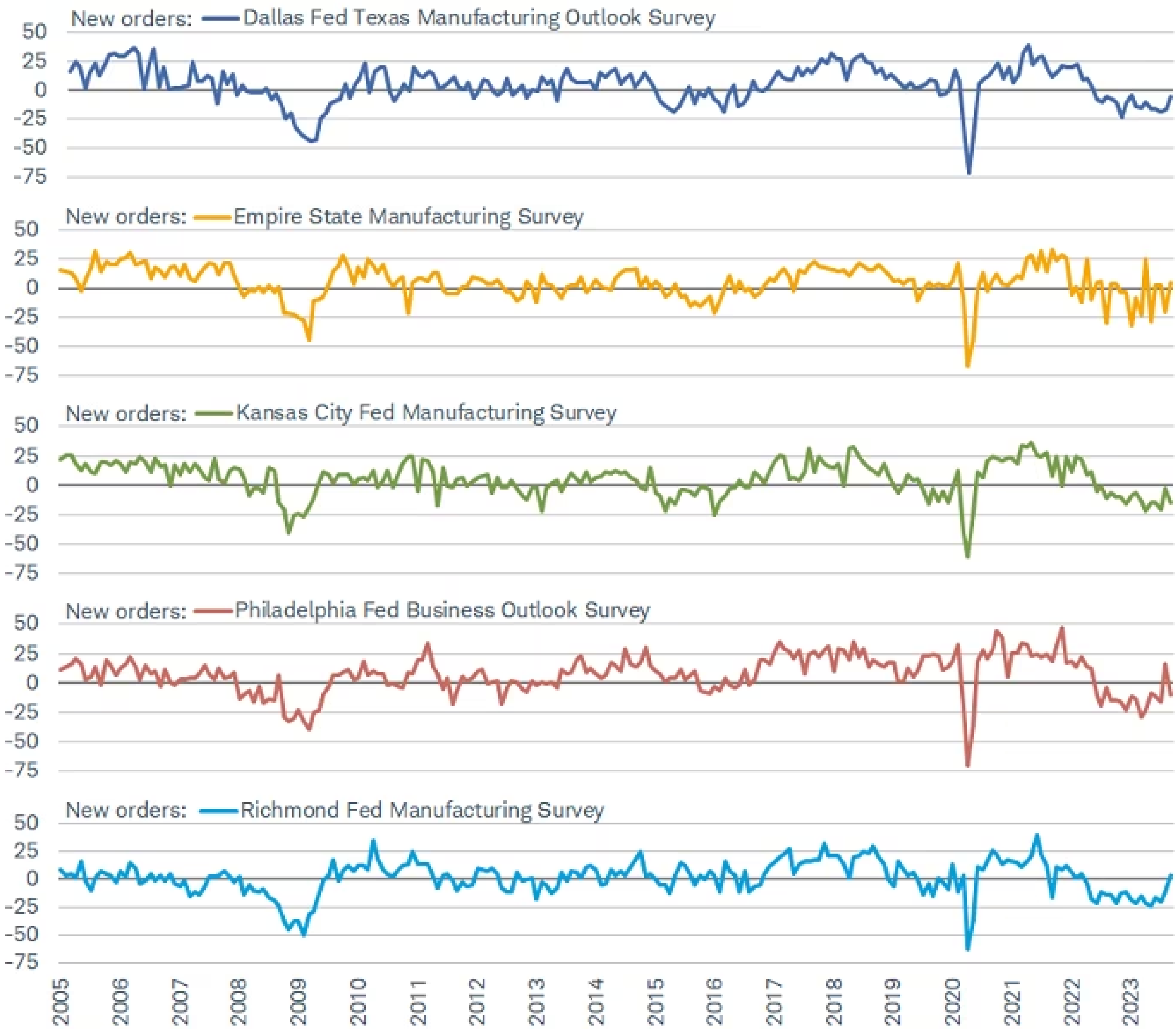
No consistency in employment metrics



Source: Charles Schwab, Bloomberg, Federal Reserve Banks of Dallas, New York, Kansas City, Philadelphia and Richmond, as of 9/30/2023.

The rub is that demand has not held up well. As shown below, new orders are contracting in Dallas, Kansas City, and Philadelphia; and while they're expanding in New York and Richmond, the jumps have been modest. All else equal, the mix of strong employment and weak demand ostensibly bodes ill for productivity, which is in keeping with currently elevated unit labor costs. At some point, companies either need to see a resurgence in demand or a slowdown in labor costs (likely via job cuts) to alleviate profit margin pressures.

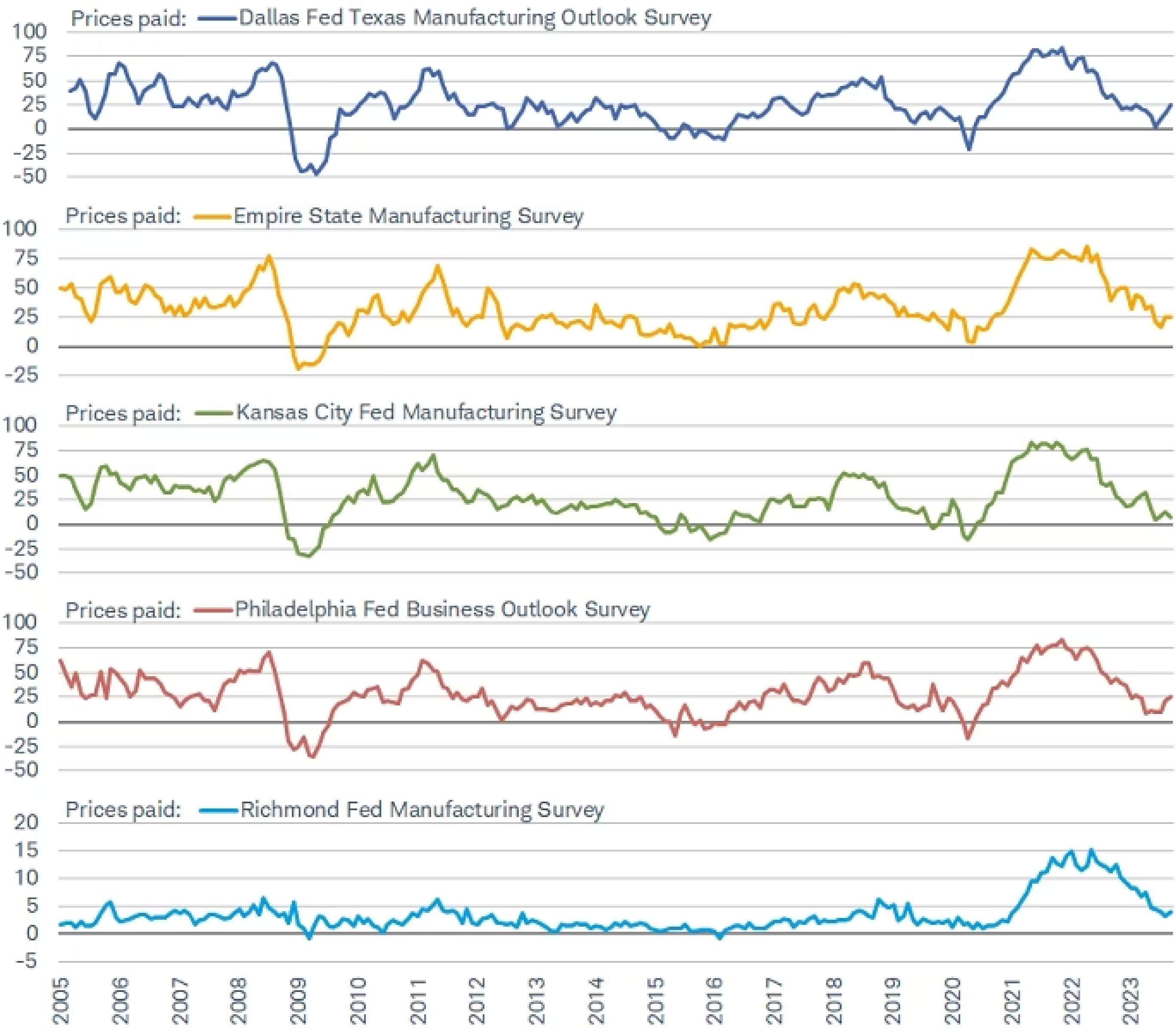
New orders, but only for some



Source: Charles Schwab, Bloomberg, Federal Reserve Banks of Dallas, New York, Kansas City, Philadelphia and Richmond, as of 9/30/2023.

If a demand comeback is the way margins regain strength, the tricky aspect is whether it happens without a commensurate snapback in inflation. Shown below are the prices-paid components within the regional Fed indexes, which act as proxies for price pressures. All have come down markedly from their peaks (good) but some have started to see relatively sharp increases (not so good). Not all rebounds are inherently bad, given supply stress today is not like it was in 2021 into 2022; so, the hope is that some stabilization can kick in around current levels.

Is the price right?



Source: Charles Schwab, Bloomberg, Federal Reserve Banks of Dallas, New York, Kansas City, Philadelphia and Richmond, as of 9/30/2023.

In sum

The deterioration in consumer confidence and regional Fed manufacturing indexes were central to our initial thesis around rolling recessions. There have been some signs of stabilization (and potential recovery) for these metrics, but more cracks in the labor market, tighter monetary policy, and slowing economic growth have the potential to stunt these recoveries. We continue to think the debate between recession and soft landing is too simplistic and doesn't capture the distinct nuances of this extraordinarily unique cycle.

Since hard landings have already occurred in some key pockets of the economy—including manufacturing, housing, housing-related, and various consumer goods areas—a traditional soft landing is not an apt descriptor. We continue to think a roll-through of recoveries, offsetting coming weakness in areas not yet hit, is the best-case scenario for the economy. Yet, the recent jumps in the "triple threat" of bond yields, oil, and the dollar—along with a still-murky inflation path—act as hurdles in avoiding more hard landings and/or an officially declared recession, not least because the increasing likelihood they dent consumer confidence. Of course, any easing in the triple threat could dial back some pressure, but for now, we remain on watch for that.

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The Dallas Fed Texas Manufacturing Outlook Survey, conducted on a monthly basis by the Federal Reserve Bank of Dallas, tracks sentiment among manufacturers in Texas.

The Empire State Manufacturing Survey, conducted on a monthly basis by the Federal Reserve Bank of New York, tracks sentiment among manufacturers in the state of New York.

The Kansas City Fed Manufacturing Survey, conducted on a monthly basis by the Federal Reserve Bank of Kansas City, tracks sentiment among manufacturers in the Kansas City Fed's district which includes Kansas, Colorado, Nebraska, Oklahoma, Wyoming, the northern half of New Mexico and the western third of Missouri.

The Philadelphia Fed Business Outlook Survey, conducted on a monthly basis by the Federal Reserve Bank of Philadelphia, tracks sentiment among manufacturers in the Philadelphia Fed's district which includes Eastern Pennsylvania, Southern New Jersey and Delaware.

The Richmond Fed Manufacturing Survey, conducted on a monthly basis by the Federal Reserve Bank of Richmond, tracks sentiment among manufacturers in the Richmond Fed's district which includes Virginia, Maryland, North and South Carolina, the District of Columbia and most of West Virginia.

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