Economics

IN FOCUS

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The rise and (upcoming) fall of US "resilience"

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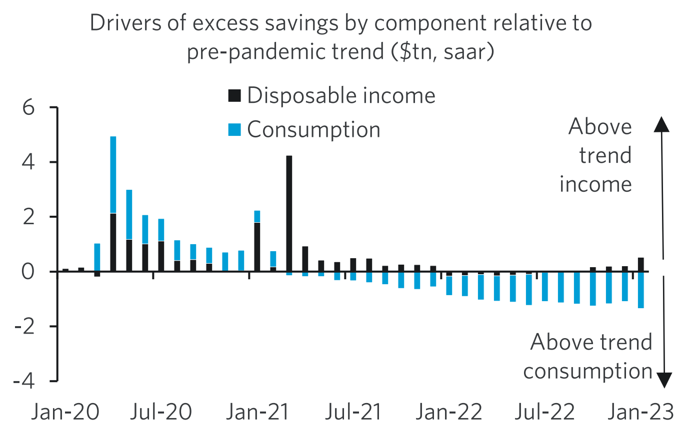
The word of the day for the US economy is "resilience." That's an apt description for an economy that has shown some surprising momentum in the first months of 2023. We and others were looking to see signs that last year's run of rate hikes was starting to bite, but instead, helped by solid job gains and what looks like a bump in consumer activity, Q1 growth looks to be tracking close to 2%. With some benefit from 20-20 hindsight, we can identify the factors behind that staying power, but also some signposts that suggest it's unlikely to persist as we move further into 2023, a reason why the Fed needs to be wary of overdoing its tightening on the basis of a firmer start to the year.

Show me the money

Consumption is almost always a key underpinning for growth, so understanding where the money has come from to support all that shopping is critical. Certainly, there's been jobs-a-plenty in recent quarters to support spending power and confidence, but payroll gains in the last couple of months seemed to defy signals of slowing demand and news of mass layoffs in the once-high-flying tech sector. The sectoral distribution of January's payrolls climb suggests that it was more of a lagged response to last year's brisk labor demand, and the resulting accumulation of unfilled positions that employers seem to be finding success in filling at the start of this year. Should future JOLTS data confirm the reduction in vacancies being already signaled by reduced activity at major recruiting firms, it would hint at less aggressive hiring ahead.

Chart 1: Divergences from spending and income trends drove build up and subsequent drop in savings

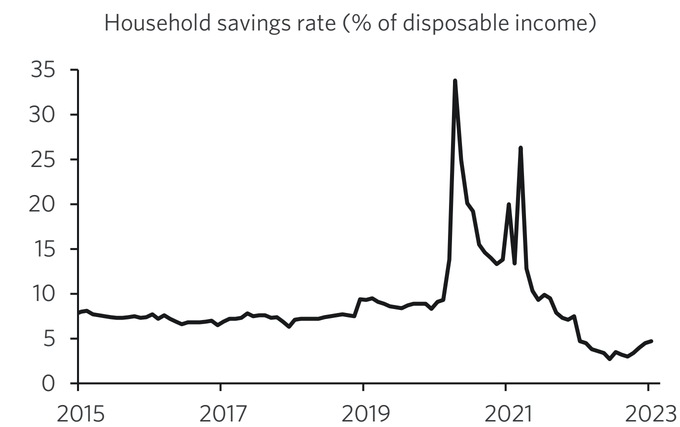


Source: BEA, CIBC

Brisk consumption, coupled with inflation outstripping wage rates during most of the pandemic, has meant that we've now had a long run in which Americans have outspent their paychecks. The ability to do so came from a big run-up in savings in 2020, fueled by the combination of disposable income gains supported by government stimulus, and below-trend consumption of services that year (Chart 1). But by 2022, disposable income gains had reverted to trend, while, driven by inflation, consumption was now above trend, with that combination draining savings. The most recent bounce in spending was helped by a one-off level shift in after-tax income coming from state tax cuts and a social security payment increase.

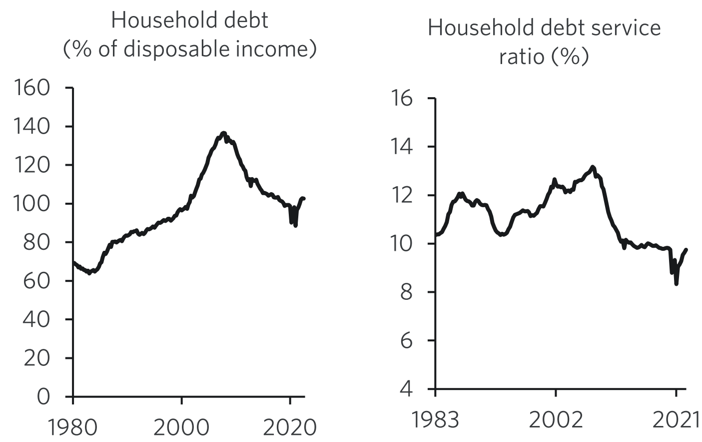
Higher interest rates are designed to make households wary of borrowing and reward them for saving, thereby encouraging a rise in the savings rate. But that hasn't yet happened to any great extent (Chart 2). The willingness to keep on spending and eschew a tilt back to savings up to now in part rests on the fact that Americans as a group were likely feeling comfortable with their balance sheets.

Chart 2: Savings rate still low despite higher interest rates



Source: BEA, CIBC

Chart 4: Household debt and servicing costs are contained



Source: FRB, BEA, CIBC

The uptrend in house values and equities that prevailed prior to 2022 saw Americans reaching a peak in household net worth as a share of income in Q1 2022 (Chart 3). That bounty isn't, of course, evenly distributed across income groups, and as we argue below, we might soon feel the impacts of the current, less impressive trend in asset values.

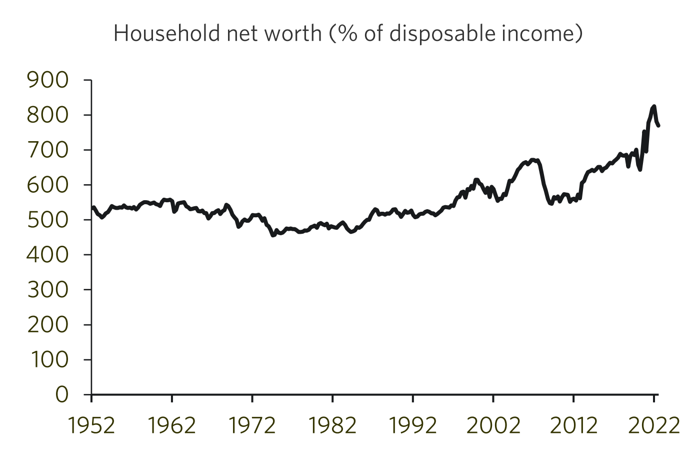
But debt levels also factor into net worth for a broader group of households. Americans have been more cautious in recent years, which is serving them in good stead as we start to feel the impact of higher rates. Total household debt and the debt service ratio are moderate by the standards of past cycles even after last year's climb (Chart 4). Mortgage debt was wiped off the books in the defaults associated with the 2008 crisis, but tame originations thereafter continued to see it decline as a share of income until recently (Chart 5, left).

Recent media reports spotlighted "record" levels of credit card debt, but just about every nominal measure of activity sets records in an economy that is growing, particularly when inflation is added to the mix. Relative to incomes, credit card debt has been climbing in this expansion, but is not out of line with where it stood in the prior cycle, and well below pre-financial-crisis levels (Chart 5, right). Delinquencies have started to tick up, but remain very low by historical standards, as they likely will until unemployment sees a material climb.

Less resilience ahead as lagged impacts kick in

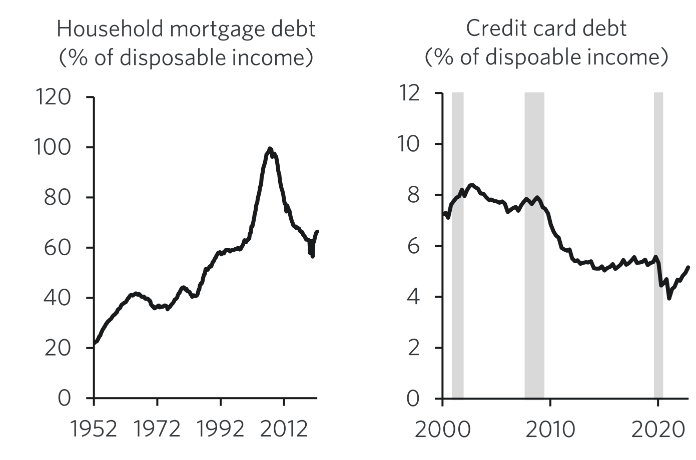
While perhaps the "resilience" to higher rates has been a bit more persistent than we had expected, history suggests that a delayed response to Fed tightening isn't really out of the ordinary. The lags built into the Fed's own forecasting model would indicate that, as of Q1, we will have only felt the equivalent of the full impact of a 200 basis point tightening. The Fed has already done more than twice that, and there's a

Chart 3: Household net worth near record high relative to incomes



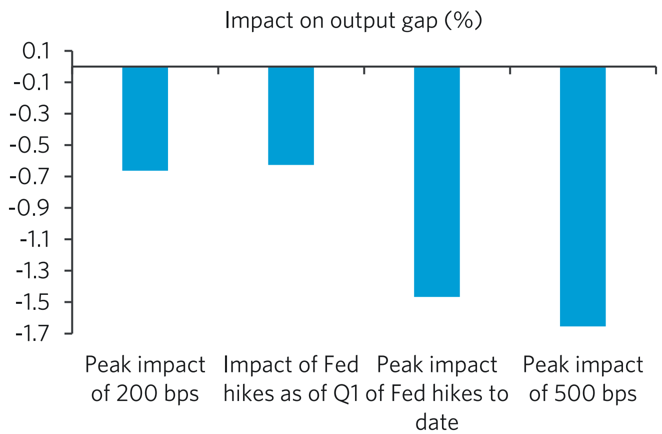
Source: FRED, CIBC

Chart 5: Mortgage debt relatively tame (l); credit card debt low (r)



Source: FRB, BEA, CIBC

Chart 6: Most of rate hike impact has yet to materialize



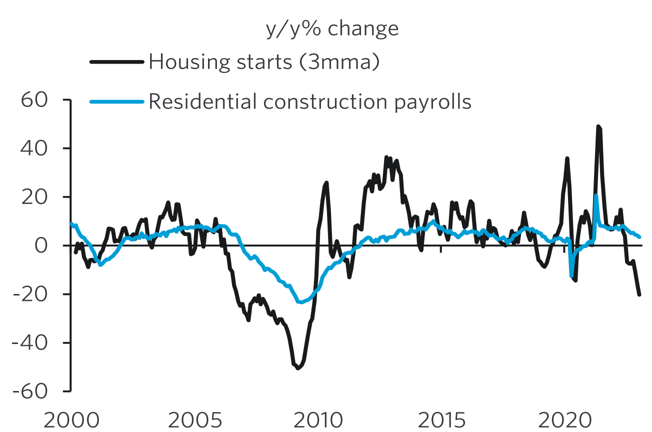
Source: Fed, CIBC

much larger drag ahead if we end up 500 basis points tighter than where we began (Chart 6).

Where do these lagged impacts come from? In part, by hitting interest sensitive elements of the economy in a first wave, slowing employment in those sectors, and then showing up in a negative multiplier effect on other sectors as corporates and those working in the first-hit industries pare back their spending.

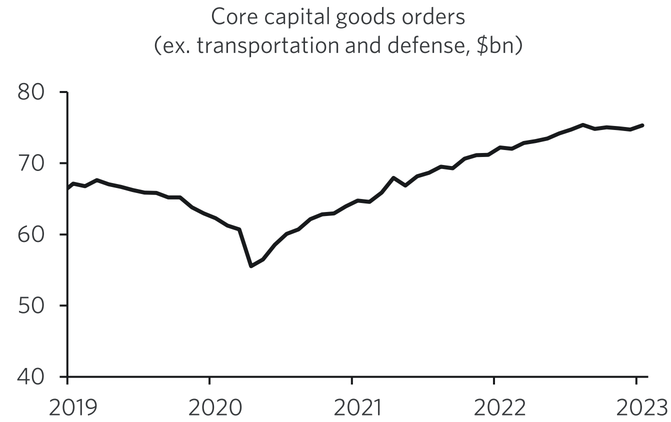
Some of that may have been delayed in this cycle by supply chain issues, which have lengthened the completion time for new housing units, but it's coming. New home sales have been in a trend decline and starts have fallen in the past year, and is typically the case, work completing those units is delaying the inevitable move to declining residential construction employment (Chart 7).

Chart 7: Rate-sensitive housing market activity weakening



Source: Census Bureau, BLS, CIBC

Chart 8: Cyclical factory sector has seen orders flatline



Source: Census Bureau, CIBC

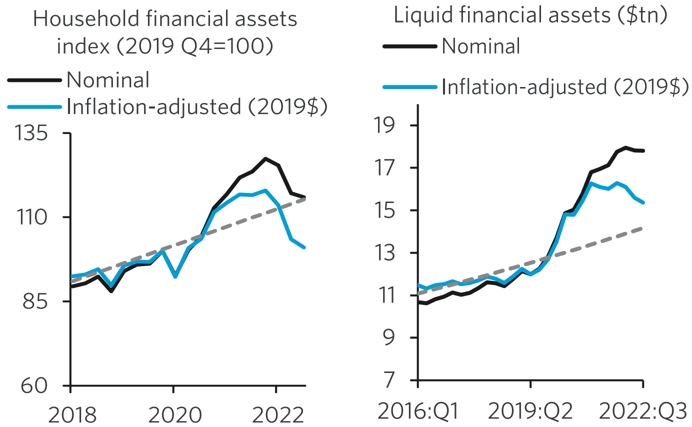
Auto sales could hold up better since many who looked to purchase in the past two years were stymied by the lack of inventory. But purchases of other durables are often tied to housing turnover, which is slowing. The ISM manufacturing index has slipped into sub-50 territory, a sign that the cyclically-sensitive factory sector is starting to feel the pinch.

Not so wealthy these days

Fed tightening also works through a financial channel, by depressing asset values. Weaker equity prices and higher bond yields raise the cost of capital for new projects, and thereby impact business investment. There's a potential offset in this cycle from climate-related spending spurred by tax credits in the Inflation Reduction Act, as well as the projects supported by the Bilateral Infrastructure Law and directed aid for chip production. But core capital goods orders did appear to be levelling off in the second half of 2022, and we can't read too much into the one-month bump seen in January (Chart 8).

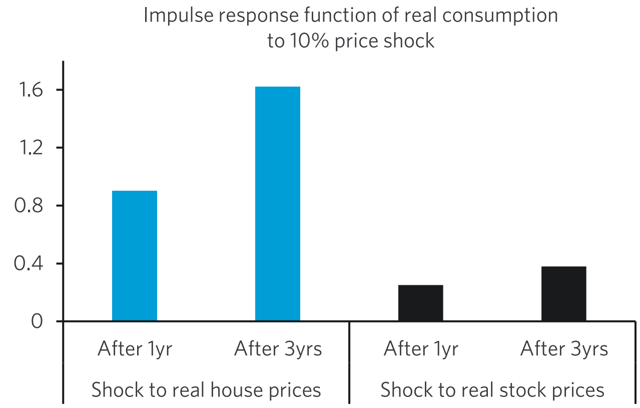
Weaker asset values could also cut into consumer confidence and spending decisions. Hit by falling equity prices, household financial assets are no longer sitting above their trend in inflation-adjusted terms (Chart 9, left). Some might argue that isn't the case for liquid financial assets like deposits (Chart 9, right), and that equities are narrowly held by upper income Americans and less relevant for spending. But these days, given more generous yields, much of what is in liquid deposits could also be intended as investments rather than a parking place for money to be spent. That appears more likely given that only the upper-20% of income earnings are holding above-trend levels of liquid financial assets.

Chart 9: Real financial assets below pre-pandemic trend (l); liquid asset build reflects higher rates on deposits (r)



Source: FRB, CIBC

Chart 10: Home values impact consumption more than stock market changes



Source: IMF, CIBC

It's true that equities, responsible for much of the drop in financial asset holdings, tend to have a weak causal link to spending. Their correlation overstates causation, because both spending and equity prices drop in recessions. But another source of household wealth, housing, is both more broadly distributed, and according to an IMF analysis, has a stronger causal link to consumption (Chart 10).

The median sale price for existing homes has dropped by more than 13% from last June to January 2023, and we still have some renewed downward pressure from the subsequent climb we've seen in mortgage rates in the wake of February's bond sell-off. Perhaps these wealth impacts, and the warnings of higher interest rates ahead, are behind the easing we've seen in the future conditions component of the Conference Board's confidence measure.

Add it all up, and the economy's ability to press higher in the first quarter may be more of a delay in its sentencing than a get out of jail free card. It does add to the risk that the Fed will press on with as many as three quarter point hikes, but the central bankers need to be wary about putting too much emphasis on economic resilience driven by factors that will lose steam as we move deeper into 2023. For now, that's why we're opting to wait to see the next payrolls data before definitely adding to our call that the ceiling for the fed funds rate will peak at 5.25%. Stay tuned.

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