A Consuming Desire -- what better way to describe both an important driver of economic expansion and the need to know whether such activity has returned to normal. In this webcast, we discuss consumers’ financial health, a subject covered in previous webcasts in this Quest for Normalcy series from the standpoint “Will Consumers Spend, or Won’t They?” Actually, I believe this question should be viewed from the “can they or can’t they” perspective, since the desire to spend seems virtually innate. Taken from such a perspective, the recovery in the domestic consumer group’s financial conditions is impressive indeed. As we look at several fundamental elements, you will see the progress underway.

Consider the Bureau of Labor Statistics Index of Weekly Payrolls, a proxy for the year-over-year change in consumer core spending ability, which is based upon wage earnings. The index measures the compound effect of average hourly earnings, average weekly hours, and employment within the private sector of our economy. Our graph shows the year-over-year change for two series: production and non-supervisory workers going back to the 1960’s and all employees (which only begins in 2006). We can see that the group’s core spending power re-entered growth territory in the spring of 2010, after a stunning outright decline in the recession, and it draws closer to the average growth level of the last 50 years.

Now, consider a change in use of debt. A key element of previous recoveries was the increase in debt as consumers felt more optimistic, and pre-spent future income. However, the opposite is occurring this time around as various measures show that debt use is conspicuous by its absence. Early in 2009, an absolute decline in the amount of consumer debt outstanding began, producing significant, positive effects in my favorite way to envision the amount of income pre-spent by consumers: the debt service and financial obligations ratios. The debt service ratio, which includes the minimum required mortgage and consumer credit payments, stands at about 11.5% of personal disposable income, while the financial obligations ratio, which adds in leases, rent, insurance and property taxes, has fallen to about 16.4%. Both ratios are at the lowest level since the mid-1990’s. Indeed, both are below the average level of the last 30 years.

These trends of core income growth and reduced debt use reveal a growing flexibility for consumers to decide what to do with more, and more of, income. I submit that regular activity is getting closer to normal, but another consideration – savings – also demands attention, and it has been climbing from historic lows for several years now. In the October 2010 webcast, “The Cache of Cash,” I pointed out that consumers increase their savings for various reasons: uncertainty, repairing excesses, squirreling away “just-in-case monies,” and when there is a reduced availability of credit. I will add that people also apparently choose to save when they do not want to rely on outside sources due to too much paperwork, too restrictive conditions, or perhaps, from lessons learned by being too strapped in days gone by. In any event, consumer savings does seem to be a perfectly rational response to any and all of these conditions. Further, while the savings’ percentage is not as high as the 1970’s or 1980’s, the nominal dollar amount is higher and the purchasing power may be higher since inflation is markedly lower than in those days.

These savings do not come without a palpable cost, however, as short-term interest rates are agonizingly low, and the Federal Reserve is apparently in no hurry to raise them. Considered from our quest for normalcy perspective, though, there was a time when a savings account was a place to store money for emergencies. It was not viewed as an income generator, per se, but a part of the balance sheet of a conservative, responsible
person. Perhaps that really is normal? If so, while we may soon leave these particularly stressful conditions, this view may continue to gain more adherers as we move forward.

Now, let’s turn to an intriguing facet of consuming demand – household formation. Seemingly hopeless discussion regarding the over-supply of houses on the market and its depressing effects highlights the nagging worries that the shadow inventory of homes (those without current For Sale signs, yet expected to enter that category soon) will depress our consumer economy for years to come. However, supply is not the only story; housing demand matters, too. Stressful economic times usually suppress such demand, as housing costs are a major part of consumer budgets, and the recent experience was extraordinary.

So ponder these statistics from the Census Bureau. Estimated household formation over the last few years was about one-third its multi-decade average of more than 1 million per year. Approximately 20 million adults still live with their parents, with the number of 25-to-34-year-olds at home at a four-decade high. The echo baby boom (the children of Baby Boomers) exceeds the population size represented by their parents.

And also think about this: about 1.6 million students are expected to graduate from college in 2011. We all know college graduates have one consuming desire – to get out of Mom and Dad’s house! The National Association of Colleges and Employers reports that the Class of 2011 has something the Classes of 2009 and 2010 could only wish for: expanding job fairs, more recruiting, and more job offers. On the heels of these employment opportunities comes the ticket to move and the demand for a new place to live. Not that they don’t love their parents, but let’s face it: having your own place is a natural step in the process of growing up. In my own family, two new households were formed in the last few months – besides the benefit to our economic life, these two new decision-makers need things they can’t get from home: let the furnishing begin!

So, what if the worries about the shadow inventory of homes are answered by this shadow inventory of home seekers? As household formations approach an estimated one million per year in 2011 and 2012 with more in future years, one could argue this progress toward normalcy will spread its healing effects throughout the consuming public, perhaps sooner than we think. Rental markets are tightening as we speak, so housing activity seems poised to move ahead.

As to the question, “Will Consumers Spend, Or Won’t They?” we answer with a decided yes. After determining that they can, it’s only a matter of time until they will. Indeed, measures of consumer spending already display the effects of improving financial metrics as spending climbs alongside income. Add in the pent-up demand from those potential household form-ers, and A Consuming Desire is being met.

We are already out of time, but we have not yet even considered the consumers of the developing and emerging world, who see the opportunity to pursue the Western standard of living as quite exciting. Previously, these budding consumers could hope to emigrate to the West in such a pursuit. Now the opportunity is coming within reach across the globe. Indeed, a fundamental element of our equity investing for clients builds from this consuming desire in a population—whether emigrants or not—whose potential exceeds that of our beloved USA. But, these are topics for another time.

Thanks for listening in, and have a great day!