

US WEEKLY ECONOMIC UPDATE



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US Economic and Investment Perspectives

Consumer Spending Increasingly Linked To Asset Growth

Retail sales rose 1.2% in December, pushing total sales up an annualized 10.1% in the fourth quarter—the strongest quarterly gain since the first three months of 2004 and the third-strongest of the current economic expansion. In 2004, retail sales rose 8.7%, the largest annual increase since 1999, and outpaced wage and salary income by 4%—one of the largest gaps in 30 years.

In fact, retail sales growth has been outpacing wage and salary income growth for four consecutive years now—a pattern not seen in more than 30 or 40 years. What accounts for this gap? While the federal individual tax cuts of 2001 and 2003 helped lift retail sales growth, they do not account for all of it. If this were the case, growth would have normalized by now because the largest benefits of the last tax cut flowed to households more than 18 months ago. In our opinion, this spending trend is more profound, reflecting the rising importance of wealth creation and asset prices to consumer behavior.

Last week, we noted that the contribution of wealth creation to the growth of household spending has roughly doubled in the past decade. Put another way, most of the “alpha” in consumer spending in recent years has come from wealth creation and not income growth.

Consumer spending has become, at the margin, more asset-driven than income-driven for several reasons. First, household net worth has roughly doubled over the past decade because of strong increases in both asset-price inflation and wealth creation. Second, changes in the tax law and financial innovations such as home-equity loans have made it easier for

households to “tap the till” and use proceeds to spend as they wish.

In the past, such choices were far more limited. Capital gains from the sale of a primary residence were tax-free only if they were re-invested in real estate within two years. And there was a one-time exception of up to \$125,000 in the sale of a home. Today, capital gains realized in the sale of a primary residence are tax-free up to \$500,000 every two years and there are no spending or investing restrictions.

The huge increase in asset prices and wealth creation suggests that real consumer spending will continue to grow relatively fast, rising 3.0 to 3.5% in 2005. Indeed, our calculations suggest that household net worth increased another \$3.5 trillion in 2004, bringing the cumulative gain for the past two years to \$8.5 trillion. While we don’t expect it to eclipse job creation and wage growth as the most significant factor in spending, there is no denying that asset prices and wealth creation have become more important.

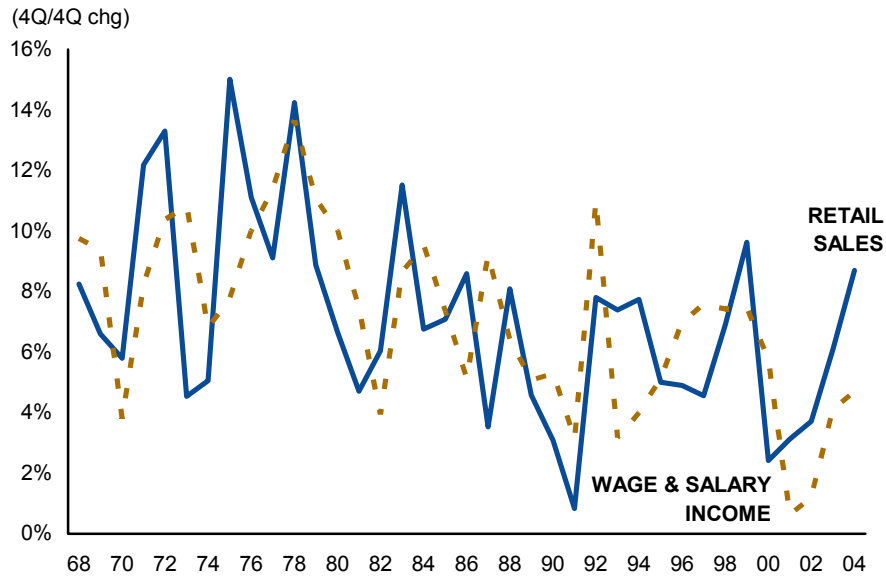
This growing relationship among asset prices, wealth creation and spending also has its risks, however. It is hard to say that consumers are more vulnerable to fluctuations in the interest-rate cycle, but the channels in which changes in interest rates impact consumer spending behavior have widened. No longer is it just on the debt-service side, but increasingly on the impact on asset prices and wealth creation. This is something we plan to monitor closely in 2005, particularly as the Fed has indicated it will continue to raise official rates and reduce its accommodative monetary-policy stance.

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Display 1: Unprecedented Gap Between Spending and Income Growth in Retail Sales, Wages and Salary Income



Source: Bureau of Economic Analysis and Haver Analytics, January 14, 2005

For four consecutive years retail sales growth has outpaced wages and salaries, a pattern not seen since the series was first published in 1968. In 2004, retail sales rose 8.7%, outpacing growth in wage and salary income by 4%—one of the largest gaps in 30 years. We have found that most of the extra spending "alpha" in recent years has reflected a growing tendency to spend out of wealth creation.