ECONOMIC VIEWPOINT

Are US Consumers Ready for the Challenges Ahead?

By Francis Généreux, Senior Economist

US households have benefited from a number of government support measures and, financially speaking, have come out of the pandemic relatively unscathed. However, soaring inflation, higher interest rates and uncertainty surrounding the war in Ukraine present additional challenges that could erode confidence and spending. This *Economic Viewpoint* details the current situation for US households and addresses whether they will be able to weather the storms to come. As long as the labour market remains strong, Americans should be able to navigate any economic pitfalls that arise. However, declining confidence is a major risk.

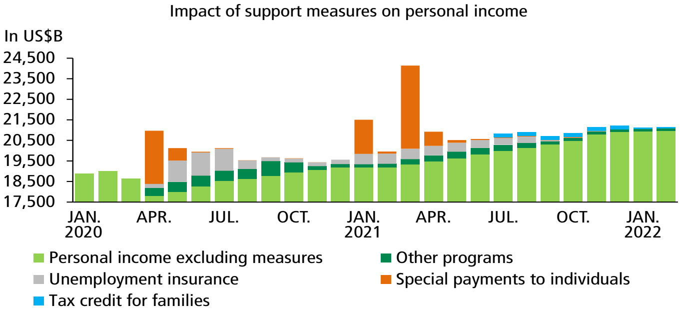
Real Household Disposable Income Is Declining

The pandemic has been highly detrimental economically for individuals and industries alike. However, in the case of the US economy, the recession caused by the public health measures implemented in March and April 2020 was severe but short. But, more than two years later, not everything is back to normal. Employment remains below its February 2020 cyclical peak. Overall though, it appears that US households have not suffered too badly thanks to the various support measures put in place by the federal government, which more than offset the drop in personal income caused by the pandemic (graph 1).

However, these government support programs have now mostly ended. The last round of payments to individuals was issued a year ago, extended unemployment insurance ended last fall, and additional tax credits for families were withdrawn at the end of 2021. The only measures that remain are less extensive and cover assistance for the health care system to fight COVID-19, income support for those who have to take time off work, and a pause on some student loan repayments.

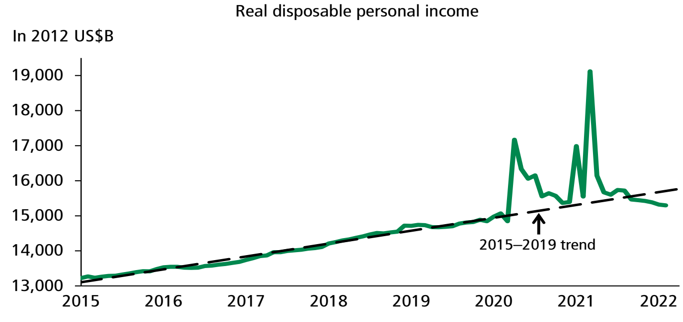
Household disposable income (total income minus taxes) declined when the main federal assistance schemes ended, especially from the peaks that occurred when payments to individuals were issued in April 2020, January 2021 and March 2021. This expected decrease was exacerbated by the increase in consumer prices. Real household disposable income has been declining constantly since July 2021 (graph 2). Despite this downward trend, it remains 1.5% above its February 2020 level. However, it has now clearly dropped below the prevailing trend during the second half of the previous economic cycle, when it was increasing.

GRAPH 1
Support measures from the federal government have underpinned household income, but have now mostly ended



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

GRAPH 2
The end of government support and rising prices are eroding Americans' real disposable income



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

Accumulated Savings Remain High

The sharp growth in personal income during the pandemic and the payments to individuals in particular changed households' saving habits. This shift in saving habits was also a result of forced changes to consumer spending, particularly on services, due to public health measures.

U.S. Census Bureau surveys give us an idea of what American households did with the extra income they received through their coronavirus stimulus cheques. Households generally spent the payment issued at the beginning of the pandemic, whereas the payments issued in 2021 were more often saved or used to pay off debt (table 1).

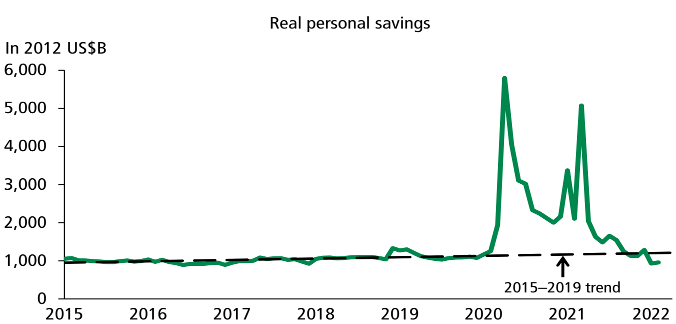
TABLE 1
The 2021 federal support payments mostly went to savings and debt repayment

	AMOUNTS PAID OUT	PERCENTAGE SPENT	PERCENTAGE SAVED	PERCENTAGE USED TO REPAY DEBT
First payment (April 2020)	US$1,200 per person	73.0%	12.5%	14.6%
Second payment (January 2021)	US$600 per person	25.8%	22.4%	51.8%
Third payment (March 2021)	US$1,400 per person	22.5%	25.3%	52.3%

Sources: U.S. Census Bureau, Federal Reserve Bank of Dallas and Desjardins, Economic Studies

If we compare savings activity during the pandemic to the pre-pandemic trend, we see that savings increased by a total of nearly US$2.2 trillion (in constant 2012 US$) (graph 3). This is equivalent to 16.6% of annual consumer spending before the pandemic, which is a considerable amount and puts US households in a particularly solid financial position. It also partly explains why real consumer spending remains fairly strong despite several consecutive months of declining real disposable income.

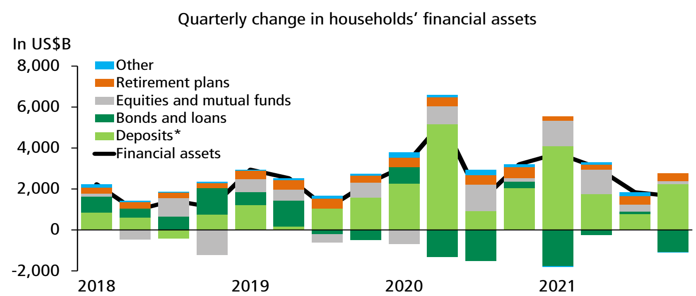
GRAPH 3
Savings are up considerably since the pandemic began



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

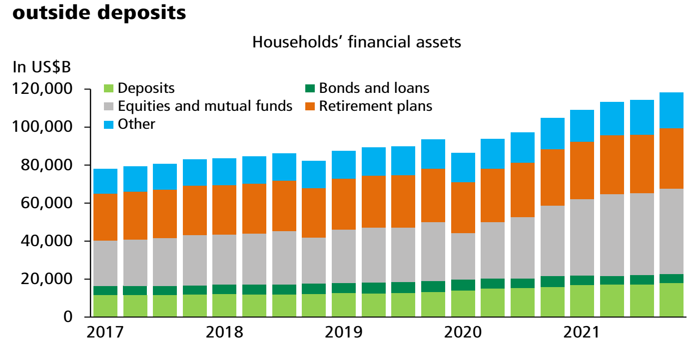
So, where have these savings gone? Are they really available for US households to quickly finance their spending or various projects? The Financial Accounts of the United States published quarterly by the Federal Reserve provide further insight here. The data shows that the excess savings households accumulated during the pandemic were generally held as bank deposits (graph 4), with notable peaks in the second quarter of 2020 (first payment) and the first quarter of 2021 (second and third payments). However, despite increasing over the last two years, deposits still only make up a relatively small proportion of households' total financial assets, the majority of which are held in securities and retirement funds (graph 5). Stellar market returns since the collapse during the first wave of COVID-19 have boosted the value of households' holdings in equities and mutual funds.

GRAPH 4
Most additional savings were placed in deposits



* Deposits include cash, demand deposits, term deposits, short-term investments and investments in money-market funds.
Sources: Federal Reserve Board and Desjardins, Economic Studies

GRAPH 5
However, households' financial assets are still concentrated outside deposits



Sources: Federal Reserve Board and Desjardins, Economic Studies

Obviously there are several factors that could cause households' financial assets to drop in value. First, weak disposable income and the end of special payments from the federal government are already leading to lower savings rates than before, which will considerably slow deposit growth. In February 2022, the savings rate was 6.3%, well below the 2019 average of 7.6%. The savings rate was as high as 33.8% in April 2020 and 26.6% in March 2021. But these peaks were clearly outliers resulting from government payments and fewer spending opportunities.

Second, the current backdrop is less conducive to strong bull markets. The war in Ukraine is increasing uncertainty, business costs are under pressure, some industries are having difficulty fulfilling orders, stock market valuation levels are high and interest rates are rising. All these factors are tempering the growth outlook for the major stock indexes.

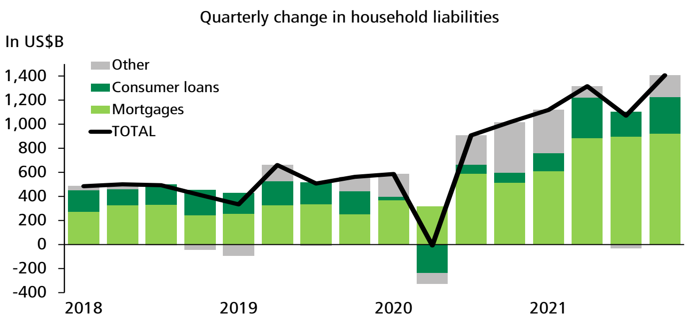
Debt Is Relatively Stable

Surveys indicate that US households took advantage of the government payments and public health measures, which reduced opportunities for discretionary spending, to shore up their personal finances. That said, in contrast to the information in table 1 on page 2, this "clean up" primarily took place early in the pandemic. We can see that household mortgage debt did not decline (graph 6). Demand for refinancing was high as households wanted to take advantage of plummeting interest rates (graph 7). The recovery of the housing market in turn stimulated the mortgage market, including for home purchases.

Households tended to shore up their consumer debt first. The drop in consumer spending at the very beginning of the pandemic and the increase in disposable income thanks to the US$1,200 stimulus cheques issued in April 2020 caused outstanding loans to fall considerably, especially for revolving credit such as credit cards and lines of credit (graph 8). Use of consumer loans has picked up again since but remains below pre-pandemic levels (graph 9).

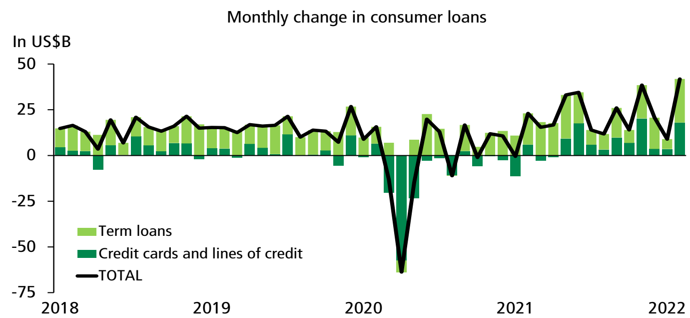
Overall, the debt situation for US households remains quite enviable and in a much better position than before the Great Recession in 2008–2009 (graph 10 on page 4). Despite the recent increase in housing prices, outstanding mortgage levels are still relatively modest compared to household income. This positive situation is also apparent when comparing the United States to other advanced countries (graph 11 on page 4).

GRAPH 6
Debt has been dominated by mortgages



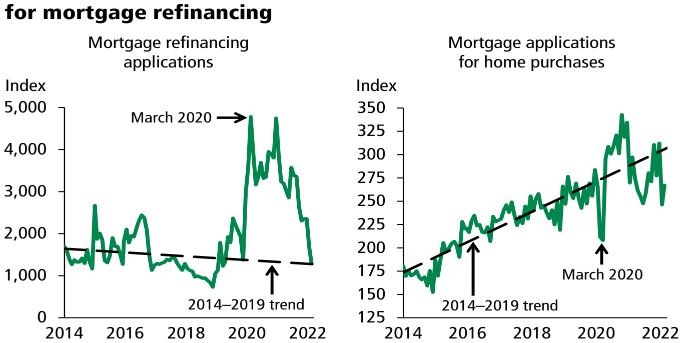
Sources: Federal Reserve Board and Desjardins, Economic Studies

GRAPH 8
Households took advantage of the first wave of the pandemic to eliminate part of their debt



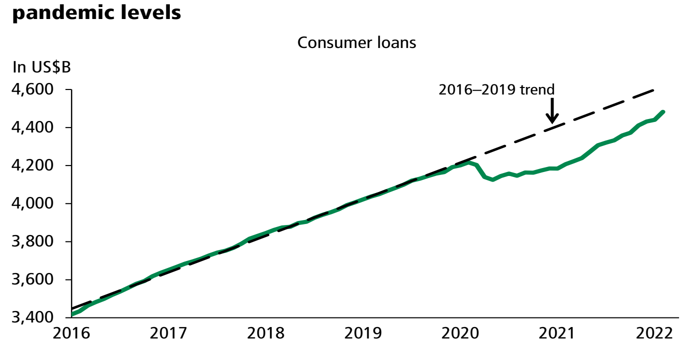
Sources: Federal Reserve Board and Desjardins, Economic Studies

GRAPH 7
Plunging interest rates early in the pandemic led to high demand for mortgage refinancing



Sources: Mortgage Bankers Association and Desjardins, Economic Studies

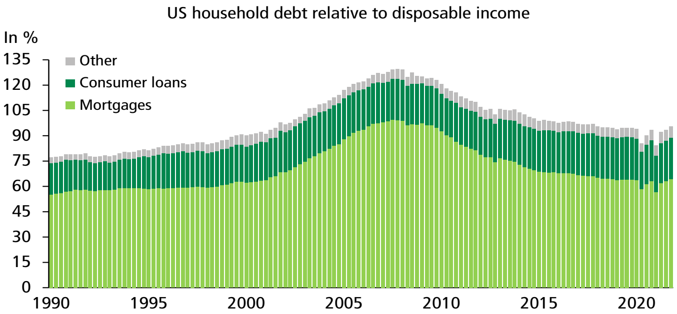
GRAPH 9
Use of consumer loans has picked up, but remains below pre-pandemic levels



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

GRAPH 10

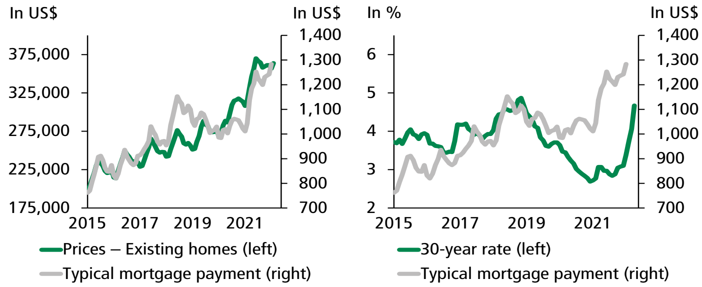
Total household debt is relatively stable



Sources: Federal Reserve Board and Desjardins, Economic Studies

GRAPH 12

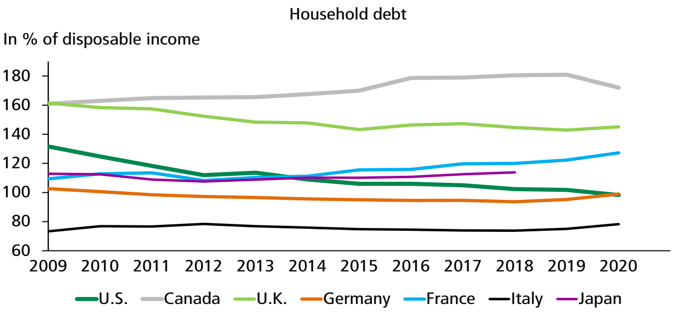
Low rates have helped to limit the impact of rising home prices, but the situation is expected to reverse



Sources: Mortgage Bankers Association, National Association of Realtors and Desjardins, Economic Studies

GRAPH 11

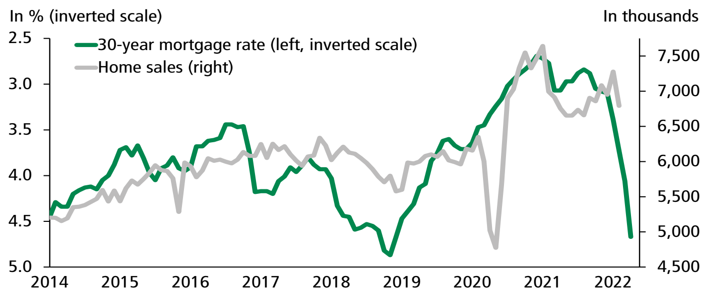
Of the G7 countries, household debt has declined the most in the United States over the last decade



Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

GRAPH 13

Rising interest rates could considerably slow the US residential real estate market



Sources: Mortgage Bankers Association, National Association of Realtors and Desjardins, Economic Studies

The Challenge of Rising Interest Rates

Although the US economy may be less vulnerable than others to any interest rate hikes, it is by no means immune. The housing market could react quite sharply to increases in mortgage interest rates. Graph 7 on page 3 shows that recent rate increases are eroding demand for mortgages.

Low interest rates during the first waves of the pandemic offset the impact of higher home prices on mortgage payments. By refinancing, households were able to keep their payments low or even reduce them (graph 12). However, we are now seeing a major shift. Mortgage interest rates have been rising rather sharply for a few months now. Thirty-year fixed rates rose from a low of 2.65% to 3.11% in early 2021 and then jumped to 4.67% in early April 2022. These higher interest rates may trigger a decline in home sales (graph 13). For those who choose to buy anyway, their discretionary income after their mortgage payment will certainly take a hit.

Trends in mortgage rates also influence consumer spending. For example, falling rates at the beginning of the pandemic led to a wave of refinancing that allowed borrowers to negotiate lower mortgage payments. This freed up additional discretionary income to use on consumer spending or saving. Clearly, higher interest rates will curb this trend. Moreover, by slowing down the real estate market, rising interest rates are also reducing purchases associated with buying a home, including renovations, furniture, appliances and other household accessories.

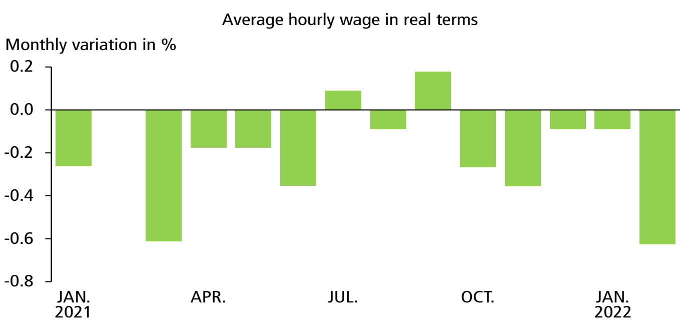
Higher interest rates on consumer loans will have a direct impact by tempering spending on durable goods, including vehicles. These sectors are already struggling with global supply chain issues. Some pent-up demand caused by these supply chain woes could return at some point once these issues are behind us. However, demand is unlikely to escape the impact of increased rates and could be affected. This is what the Federal Reserve seeks to accomplish in order to cool inflationary pressures.

Inflation Is Eroding Wages

The supply chain issues mentioned above have been a pivotal factor in the soaring inflation the US economy has been experiencing for nearly a year now. Consumer prices have not seen such a rise for 40 years. The consumer price index hit 7.9% in February and is expected to climb further over the coming months.

High inflation is an additional challenge for households. As we have seen previously, real household disposable income has been declining constantly for several months. This is especially remarkable given that wages have been rising sharply, but not enough to completely offset the continually soaring cost of living (graph 14).

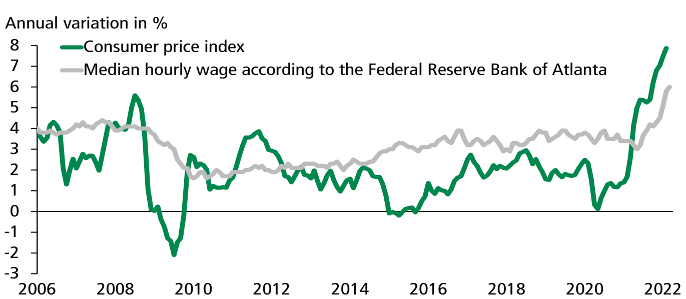
GRAPH 14
Real hourly wage increases have been rare over the past year



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

This situation is in sharp contrast to the last economic cycle. Apart from during temporary periods of soaring oil prices, since the recession in 2008–2009 wages have increased more quickly than consumer prices. Despite a relatively slow economic recovery in the 2010s, real wages made solid strides (graph 15). The situation is different now. Employees and households are understandably not accustomed to such a decline in their relative standard of living.

GRAPH 15
Prices are now increasing much more quickly than median wages



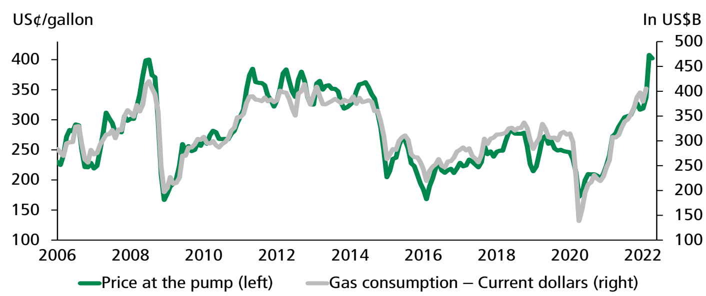
Sources: Bureau of Labor Statistics, Federal Reserve Bank of Atlanta and Desjardins, Economic Studies

Confidence Has Been Damaged

Even before the war in Ukraine, rising inflation was a major challenge for households and one of the main reasons that certain consumer confidence indexes had been declining since mid-2021.

Russia's invasion on February 24 exacerbated the situation. One economic impact of the war is the sharp rise in oil prices and, as a result, gasoline prices. The cost of filling up reached an all-time high in March in current dollars. This will force households to allocate a greater portion of their income to transportation costs (graph 16). This loss of discretionary income will have a negative impact on other types of spending and savings trends.

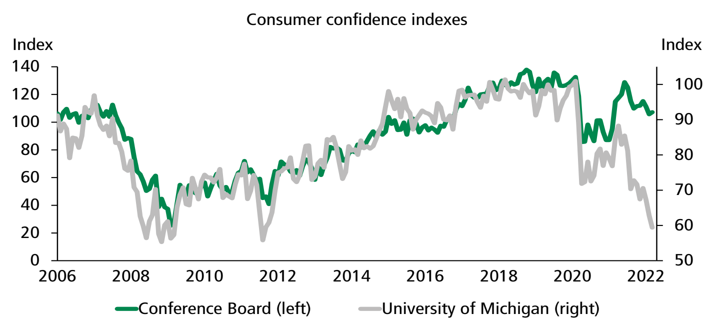
GRAPH 16
Gas will erode a significant portion of household income



Sources: Energy Information Administration, Bureau of Economic Analysis and Desjardins, Economic Studies

Higher gas and food prices (the latter have risen 7.6% year-on-year) are impacting household confidence indexes. These are the prices that consumers watch most closely, and their recent jumps are one of the main factors behind the deterioration of certain confidence indexes, in particular the University of Michigan consumer sentiment index (graph 17).

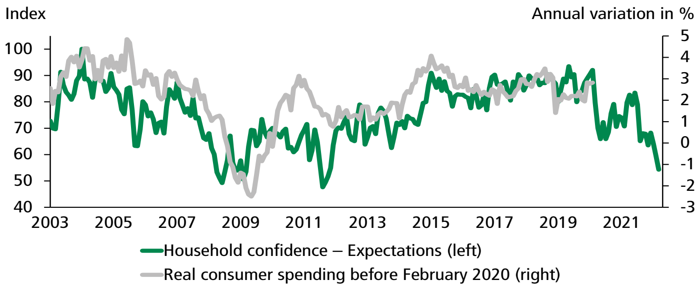
GRAPH 17
US consumer confidence has declined sharply according to some indexes



Sources: Conference Board, University of Michigan and Desjardins, Economic Studies

The uncertainty triggered by the war in Ukraine, and the resulting gas price hike and sliding stock markets, could continue to dampen household sentiment over the coming months. A decline in household confidence usually shows up in weaker real consumer spending growth (notwithstanding the major fluctuations caused by successive waves of the pandemic) (graph 18).

GRAPH 18
A drop in confidence may negatively impact consumer spending



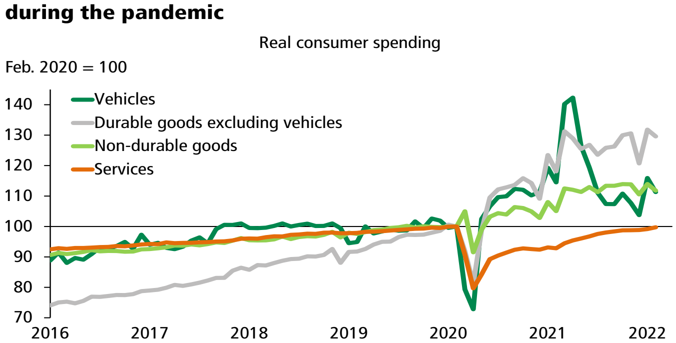
Sources: University of Michigan, Bureau of Labor Statistics and Desjardins, Economic Studies

The Post-Pandemic Recovery Is Not Yet Complete

Although US consumers are facing a number of headwinds, there are more positive factors at play too.

First, the service sector recovery is still incomplete. Amid the multiple changes imposed by the pandemic and the measures to contain it, consumer spending habits shifted completely. When COVID-19 arrived in March 2020, sales contracted virtually across the board, with the exception of grocery stores. The recovery, driven by the first round of government assistance, was more uneven (graph 19). Real consumer spending on goods recovered quickly and reached extraordinary levels. Meanwhile, services—especially contact-intensive services—had to endure the impact of public health measures for longer, as well as a degree of caution from households. In February 2022, real consumer spending on services was still lower than it was two years earlier.

GRAPH 19
The real consumer spending picture has changed dramatically during the pandemic



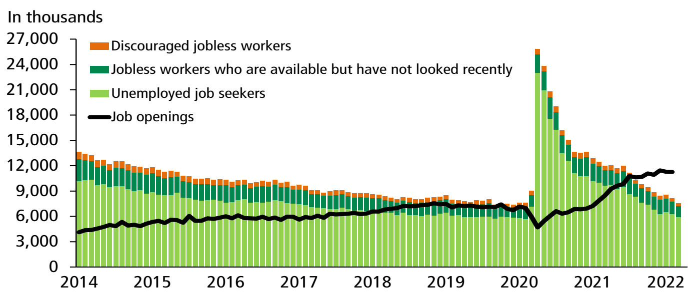
Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

We expect that the pent-up demand for services will enable this sector to continue to grow and attract consumers despite current and future difficulties. The situation is very different when it comes to goods. Some spending could well continue, but the trend is likely to be much slower and move back toward pre-pandemic levels that have been far exceeded over the last two years. Restrictions caused by lower disposable income, higher interest rates and relatively low confidence are expected to have a greater impact on goods than services.

The labour market is also continuing to recover. Job creation has been strong for some time in the United States, with nearly 600,000 monthly net new hires on average for the last six months. The unemployment rate has almost reached its pre-pandemic low and the 1,579,000 employment gap that remains could be closed by the summer. The solid labour market has helped certain confidence indicators to avoid falling too far into the doldrums. As we have seen, the increase in wages driven by high demand for workers is not completely offsetting the rise in the cost of living but is nonetheless mitigating a large part of it. It is also interesting to note that workers in the industries with the lowest wages and poorest job security are the ones who are currently benefiting from the largest pay raises. For example, the median hourly wage for workers ages 16–24 increased 11.4% in the 12 months ending in February, which is well above inflation.

The labour market still seems to have the wind in its sails. The number of job openings remains much higher than the number of job seekers (graph 20). Households' lack of concern over the labour market is a major supporting factor in the current economy.

GRAPH 20
The number of job openings is still high while the number of job seekers is falling



Sources: Bureau of Labor Statistics and Desjardins, Economic Studies

Numerous but Manageable Challenges

Two years into the pandemic, US households remain in a relatively strong position. Real disposable income is roughly the same as it was before the pandemic, the savings accumulated thanks to the government's support programs are yet to be used, households are not over-indebted, the labour market is back on track and the services industry continues to recover from COVID-19.

However, the outlook is less positive. Eroded by inflation, real wages are declining, and the level of certain consumer confidence indexes is worrying. The war in Ukraine is weakening the US and global economies. Furthermore, interest rates have begun an abrupt—albeit necessary—rise. In particular, it will affect residential investment and related expenses.

US households will have to remain resilient to sustain growth and avoid a downturn. As such, we must hope that they can overcome the challenges they're facing and that the current shocks don't last too long. Continued labour market strength is vital. An easing of inflation, starting with energy prices, would also be welcome. US consumers are extremely important for the global economy, so ensuring their resilience is key.