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WEEKLY ECONOMIC COMMENTARY

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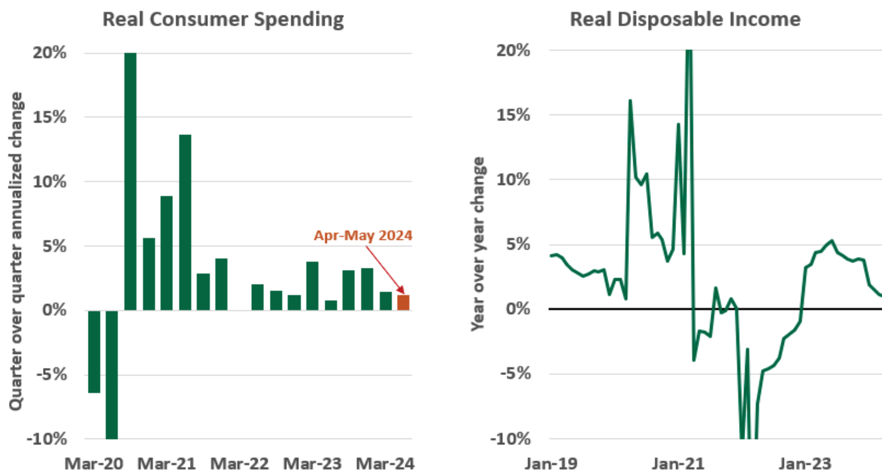
When my wife gets anxious about the cost of going out for an elaborate dinner, I remind her of what American political satirist P. J. O'Rourke wrote: "Better to spend money like there's no tomorrow than to spend tonight like there's no money."

Deep down, I know that's not sustainable advice. And more American consumers are waking up to that reality. Tomorrow has arrived, and some reckoning is in order. But reckoning is not retreat.

Flush with cash generated by pandemic-era support programs, American consumers splurged on goods during the lockdown and on services during the reopening phase. Resilient household spending has been one of the main reasons the U.S. economy has avoided a recession and outperformed its peers.

But the days of splurging have come to an end. Real consumption growth has slowed to an annualized rate of 1.4% in the first half of 2024, down from a pace of over 3% in the last two quarters of 2023. The overall path for goods spending this year has been weak; a slowdown in auto sales suggests some hesitation to make major purchases. According to research firm NielsenIQ, customers are still visiting stores regularly, but are buying fewer items at each trip..



Sources: Haver Analytics, BEA

Expenditures on services have also been relatively soft this year. Spending at restaurants fell to its lowest level in seven months in May, according to the National Restaurant Association.

Forward-looking indicators are pointing towards further softening in demand. The University of Michigan Consumer Sentiment Index dropped to an eight-month low in July,

remaining far below its pre-pandemic levels. Consumers in the bottom third of the income distribution are more downbeat than the rest, but higher earners are also growing cautious. More and more companies have been calling out spending weakness. Consumers are making "tough choices with their budgets," said the chief executive officer of a major U.S. retailer on a first-quarter earnings call. With shoppers becoming more price sensitive and sales declining, retailers are returning to offering discounts.

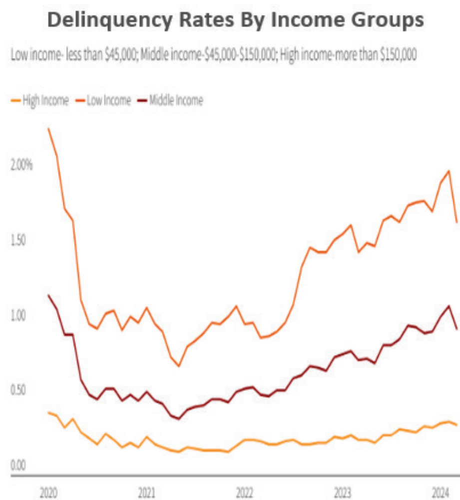
One root cause can be found in the data on earnings. Real disposable income growth has averaged just 1.3% year over year in the first five months of 2024, compared to an average annual increase of 4.1% in 2023 and 3.3% in the year before COVID. Those earning less than $45,000 a year have witnessed a notable deterioration in their finances, which contrasts with resilience among affluent consumers.

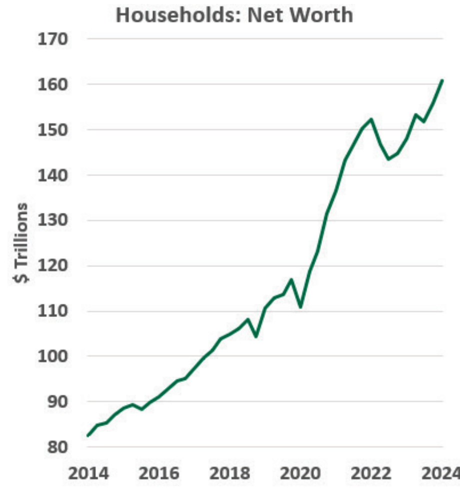
An increasing number of Americans have seen their savings dwindle as elevated inflation and interest rates continue to squeeze household finances. Excess savings, which ballooned to $2.1 trillion in August 2021, have been fully exhausted, according to San Francisco Fed estimates. Since early 2022, American households are saving less than 5% of disposable income.

Consumers are pulling back, but not collapsing.

As incomes decline and savings are exhausted, an increasing number of households have turned to debt to support outlays. Outstanding credit-card balances have risen to $1.33 trillion, up from a pandemic-era low of $970 billion in April 2021.

Younger and lower-income borrowers are falling behind on payments. Data from the New York Federal Reserve shows that about 9% of credit card balances transitioned into delinquency in the first quarter of 2024, the highest rate in a decade. Auto loans, the second-largest debt category behind mortgages, are experiencing their highest delinquency levels since 2010.





Sources: VantageScore, Reuters, Haver Analytics

While there are pockets of concern, the perception that consumers are exhausted is not accurate. Overall, household balance sheets remain healthy: though excess savings have been depleted, households have more financial resources to draw on during a rainy day. Household net worth has surged by a whopping $44 trillion in the last five years, boosted by rising home values and strong stock market returns.

Interest costs associated with consumer debt have increased, but households are still spending about the same percentage of their incomes to service debt as they did before the pandemic.

The labor market is loosening, but businesses are still hiring and incomes still growing. Jobless claims have not risen much, and layoffs remain low. No longer overheated, this is a labor market that is starting to resemble conditions before the pandemic.

That said, lower-income households are not enjoying wealth effects from high house prices and the equity rally, with fewer resources to contend with a higher cost of living. Combined with rising consumer credit delinquency, signs of a K-shaped recovery are accumulating: the divergence between households prospering and struggling is increasing.

U.S. consumers are sound overall, but there is some divergence of fortune.

In our view, broad trends are signaling a return to a normal pace of consumption, as opposed to foreshadowing recession. Nonetheless, Americans are spending less enthusiastically. Showing some discipline tonight will help households to be in better financial shape tomorrow.

Across the Rio Grande

Growing up near a river taught me how water will always find its own level. During floods, stacked sandbags were rarely impervious, and submersible pumps were no match for a river's flow. Houses on our street were at risk not from direct inundation, but from the river filling storm drains and backing into home sewer lines.

The global economy has been reckoning with a flood of exports out of China, and hastily erected barriers are struggling to contain the flow. The United States has led the push against China's export power, levying an array of tariffs and export controls meant to reduce the competitiveness of Chinese output. These polices are showing some evidence of progress, such as the share of U.S. imports from China now falling to second place behind a resurgent Mexico. But some of that shift is likely a redirected flow, not the end of the flood.

The world has become awash in exported metals from China. The U.S. has tried to reduce its use of these metals by levying tariffs of 25% on imported steel and 10% on imported aluminum since 2018. Only a handful of nations have negotiated exceptions, including America's neighbors through the U.S.-Mexico-Canada Agreement (USMCA) free trade deal.

As China's obstacles at the U.S. border accumulated, Chinese metals started flowing south to Mexico, and then finding their way north with the advantage of the USMCA. This allowed China to keep its foundries running, despite much lower domestic demand for new construction.

The backdoor is not as simple as shipping to an alternate port. Trans-shipments, or goods passing directly through Mexico to the U.S., are identified and tariffed. Instead, raw materials like metals are traveling from China to Mexico, to be processed and finished for export to the U.S.

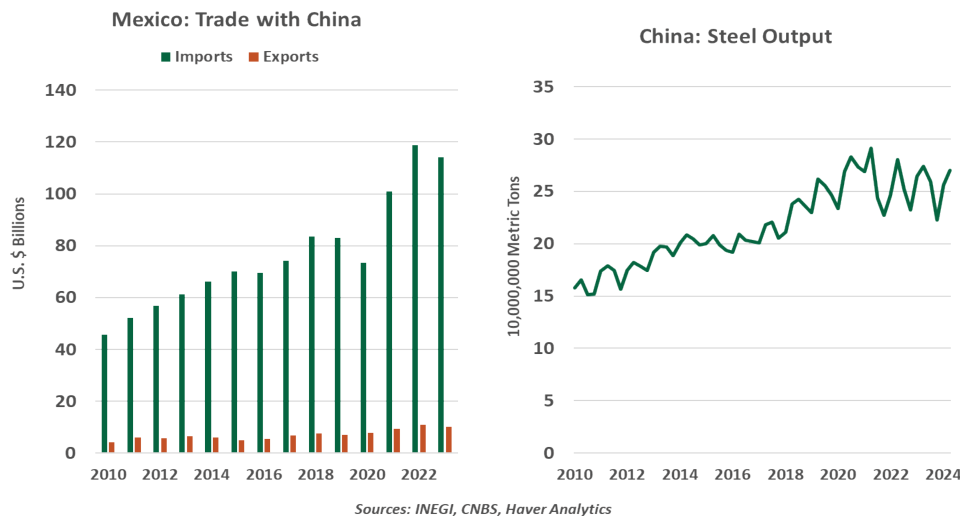
In many cases, the processing may be done by Chinese entities. Foreign direct investment from China into Mexico reached a record high in 2022 and has remained elevated. Whole industrial parks are being built and populated by Chinese investors. Chinese inputs are manipulated enough to place a *Made in Mexico* label on the finished product.

This process of *white-labeling* is drawing increased scrutiny. The scheme was not addressed in the terms of USMCA, nor its predecessor NAFTA. The white-labeled metal products are produced in Mexican factories using Mexican labor; the claim that they are made in Mexico is not fraudulent. The automotive industry has long had a similar tension between vehicles' material origins and their point of final assembly.

Last week, the Biden administration imposed a new set of national security tariffs to curb white labeling. Any steel entering the U.S. from Mexico must have been melted and poured in North

America, or it will face 25% tariffs. The statement was made jointly by the Mexican administration, which promised to require importers to provide more information about metal products' origins.

Like the recent round of tariffs on Chinese electric vehicles, the measure is intended to stop a foreseeable outcome before it gains momentum. U.S. officials estimate 13% of steel and 6% of aluminum imports from Mexico are processed outside the continent and will now face the tariffs.



Sources: INEGI, CNBS, Haver Analytics

Mexican metals are just one market. Chinese steel can flow to other nations, distorting domestic metal production elsewhere. And more broadly, the U.S. is the world's largest consumer, and China is the world's leading exporter. Container shipments from China to Mexico are on the rise, poised to distort many other product categories. Piecemeal barriers to trade will not overcome such sizable forces of demand and supply.

Flood-prone communities understand that lasting, effective remediation is a slow and expensive process. Civil engineering to reduce flooding is costly and time consuming; relocating to higher ground is disruptive. Faced with rising flood waters, simple but imperfect measures like sandbags are the only option.

A realignment of global supply chains will also be a cumbersome process, but thoughtful interventions today can help reduce the mess that will need to be cleaned up in the years to come.

Data Dependent

Members of my team are required to memorize what have become known as "Tannenbaum's Laws," which govern the use of statistical techniques. One entry in the list is: "The best of models is often undone by the worst of data." Analysts periodically construct elegant algorithms that produce interesting conclusions, only to learn that the underlying information is flawed.

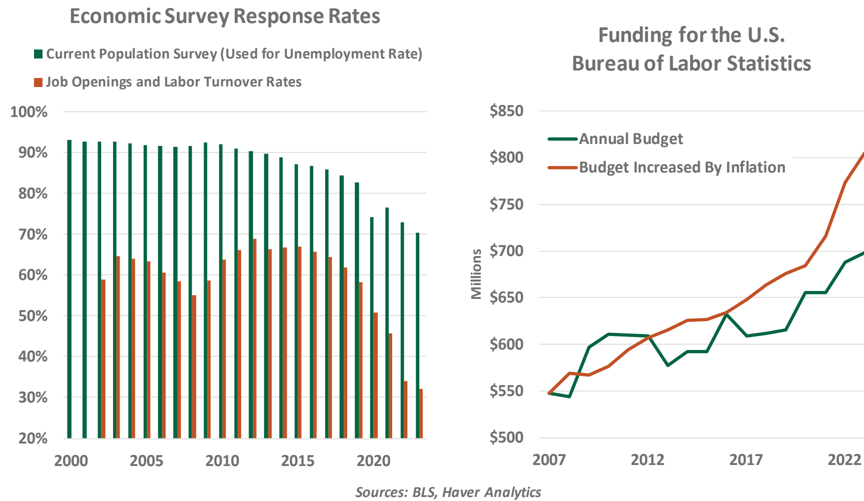
To avoid that outcome, a fulsome understanding of data is essential. I had the opportunity to address this topic recently at an Economic Measurement Seminar put on by the National Association for Business Economists (NABE). NABE is the premier organization for people who use economics in their work, and has long been dedicated to improving the quality of the data that we all rely on.

Measuring economic activity is not easy. Important quantities are sometimes not directly observable, and must be inferred through the use of surveys and assumptions. One leading

example is employment, which is gauged in many countries by a series of questions that are posed to households. Respondents are asked if they are working, and if not, why not.

Assembling adequate data for this exercise has become more difficult. Response rates to surveys used to explore the labor market have plunged since the pandemic. The process relies on telephone calls, and fewer people are answering. This reduces the quality of measures like job openings and the unemployment rate, which play a very important role in the conduct of economic policy. Any models that rely on these variables are subject to a heightened risk of error.

Sustaining the breadth and quality of economic data is an imperative.



Sources: BLS, Haver Analytics

Correcting for this requires an investment in people and processes. Unfortunately, economic statistical agencies have routinely struggled to sustain the funding needed to fulfill their missions. Some budgets have failed to keep pace with inflation, while others have been cut outright. In some cases, this has led to the curtailment of data collection efforts.

Objective and comprehensive evidence on economic activity is an essential foundation for sound decision-making. History is littered with examples where this process has been compromised, to ill effect.

Another one of Tannenbaum's Laws is that increments of money and time should be applied to areas that yield the best returns. Some additional investment of both in economic data would yield substantial benefits.

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