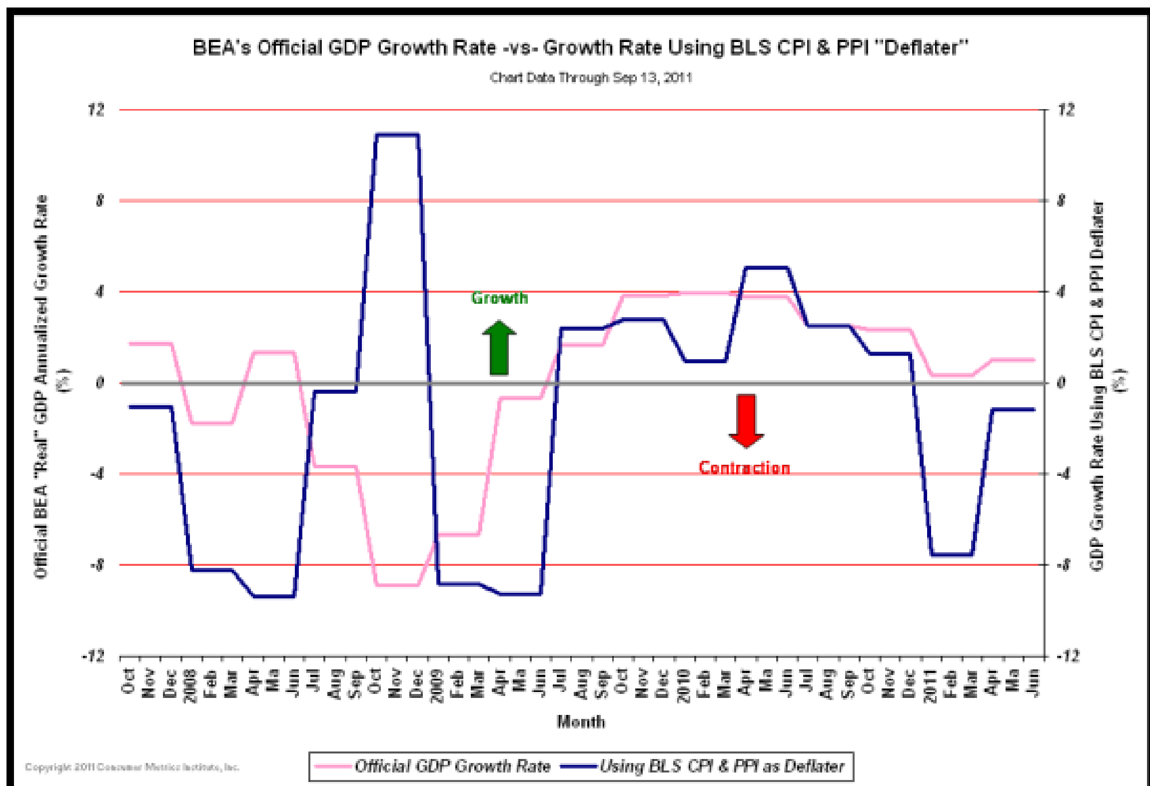
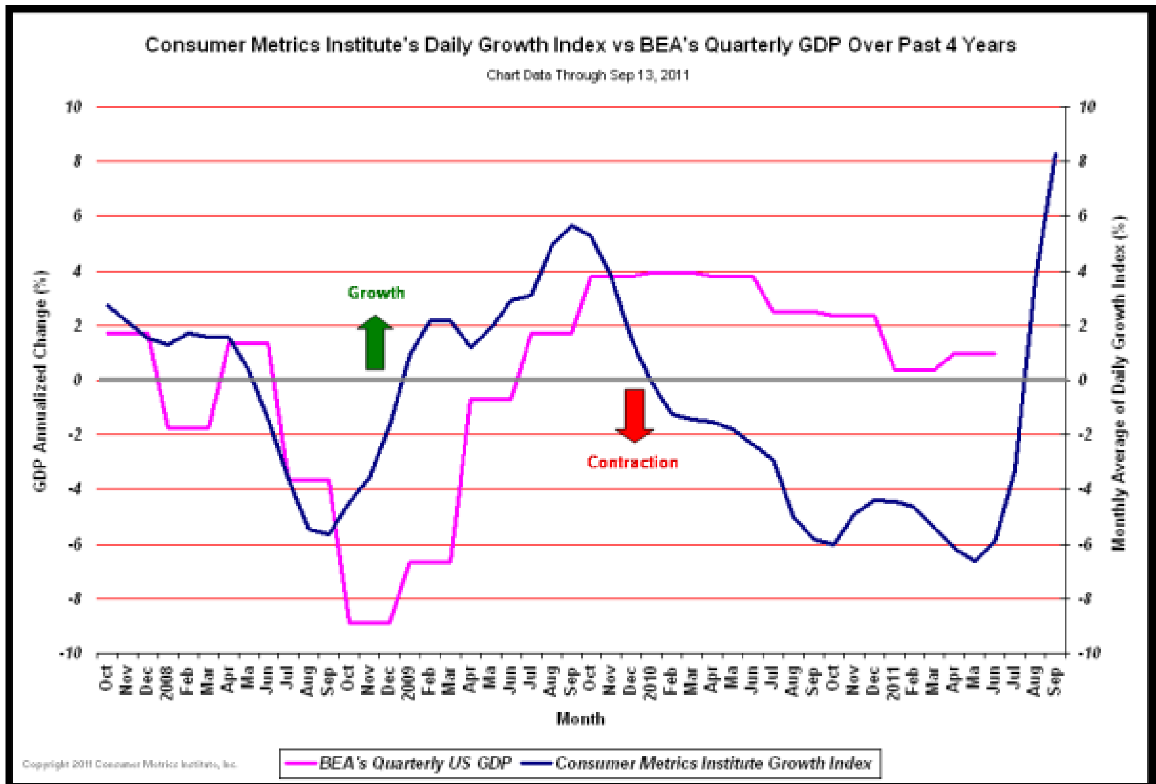
Consumer Metrics Institute Members News

September 9, 2011: Persistent Questions

We continue to receive questions about how an economy that has already slid into a "real" second dip recession can be generating the kinds of year-over-year numbers we are seeing in our indexes. When any plausible inflation rates (e.g., the Bureau of Labor Statistics' (BLS) consumer and producer price indexes) are used to convert the Bureau of Economic Analysis's (BEA) "nominal" GDP annualized growth into a "real" inflation-adjusted GDP growth rate, the U.S. economy has clearly been in contraction over the past two quarters -- constituting the clinical definition of a new recession:



Yet the "curse" of truly leading data has our indexes literally soaring since they bottomed at the end of May:



The most glaring reason for the surge in our indexes is how dismal things were last summer, particularly in the housing market. Our primary data is year-over-year, essentially measuring the rate of change (or slope) of consumer demand. As a consequence even a flat spell at the bottom of an economic canyon may look good year-over-year, since a flat 0% absolute slope is a huge improvement relative to the numbers seen during the steepest parts of the descent.

But we think that the current situation is more complex than merely favorable comparisons against horrific year-earlier data, with some really interesting things going on:

-- First of all, our data is highly sensitive to the upticks in discretionary spending that occur when critical commodity prices deflate. People who still have jobs are currently feeling real relief at the gas pump. That may not be anywhere near enough to stimulate the economy or generate job growth, but even minor budgetary improvements (and the psychological relief of the "doomsday" gas price forecasts proving unwarranted) will cause discretionary trinkets to move in a bout of "feel good" therapeutic spending. Our view is that such increased activity is literally coming from growing residual pocket change -- and decidedly not from increased income or substantive new debt.

We saw the same thing happen in late 2008, also as the result of short term commodity deflation. Unfortunately the surge was misread (a quarter and a half later) by the markets and most economists as signs of a structural "recovery" instead of what it actually was -- a reversion to "normal" spending habits when historically disproportionate commodity (e.g., energy) costs moderated.

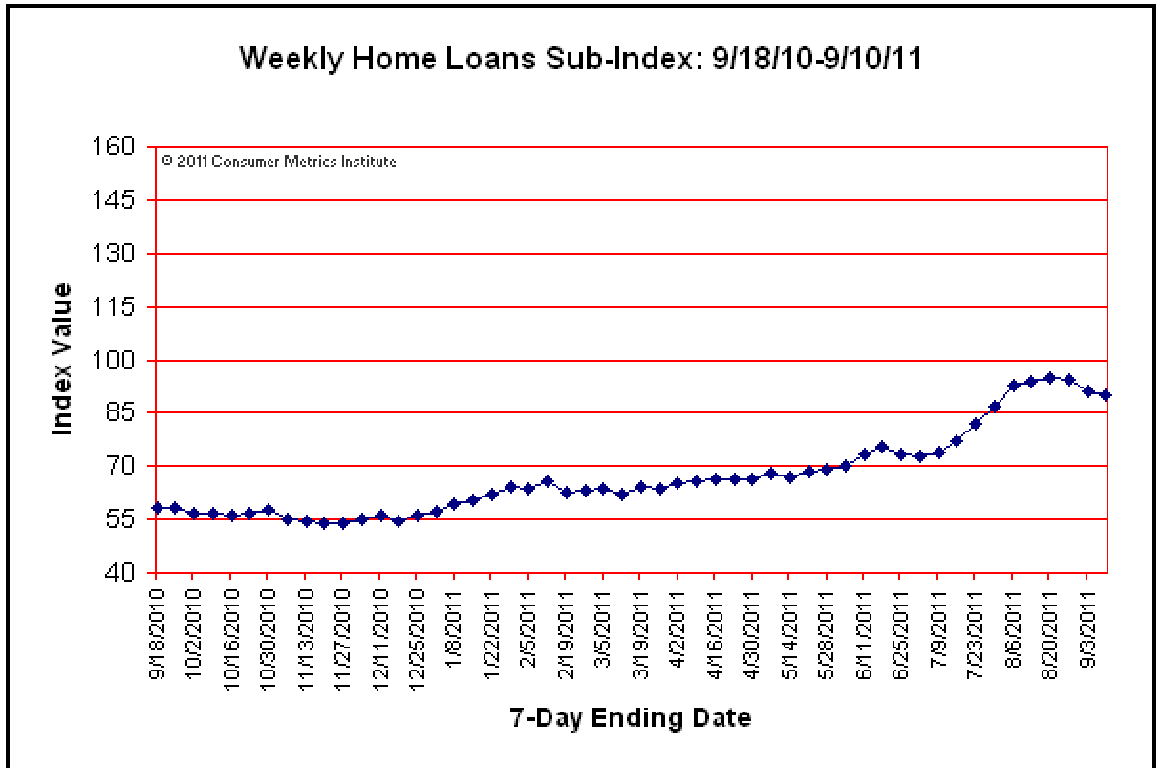
-- There continue to be some bizarre things happening with consumer credit. The vast bulk of the new credit is in the student loans portion of the "Federal Government" line in the Federal

Reserve's G.19 report (excerpt shown below). At least some of the increase is an artifact of loans moving "on book" (from a Fed perspective) to the "Direct Loans Program" as a consequence of the "Higher Education Opportunity Act of 2008" (i.e., they are now being issued from accounts that the Fed is obligated to capture) and the implementation of FAS 166/167 encouraging the reclassification of securitized funds:

Credit Type	**June 2010**	**June 2011**
Total	2387.5	2427.4
Commercial banks	1133.7	1074.8
Finance companies	527.2	501.3
Credit unions	225.8	220.6
Federal government	222.6	370.1
Savings institutions	80.6	86.8
Nonfinancial business	52.8	53.1
Pools of securitized assets	144.8	120.7

But we wonder if there isn't more to the story. Is it possible that student loans are to some extent simply replacing unemployment insurance as a source of subsistence income? If so, we may be creating another asset bubble of sorts, with consequences much more dire to the debtors than anything we have seen before. Thanks to the "bankruptcy reforms" of 2005, those student loans cannot be "cleared" by bankruptcy, no matter how hopeless the situation. We may have simply created a new version of a Dickensian "debtors' prison" that may ultimately imprison an entire generation of young borrowers.

-- During the early part of the summer we recorded a brief spurt of precursor activity for new home loans and refinancing, likely as a result of even lower mortgage rates and dire media warnings about the Federal debt woes triggering higher rates in the near future. Then we saw that activity subside after the Fed announced that it would sustain low rates into 2013. It now seems that there is no urgency to lock in the low rates by pulling new purchases forward. The Fed may have just shot a potential bump in the housing market directly in the foot:



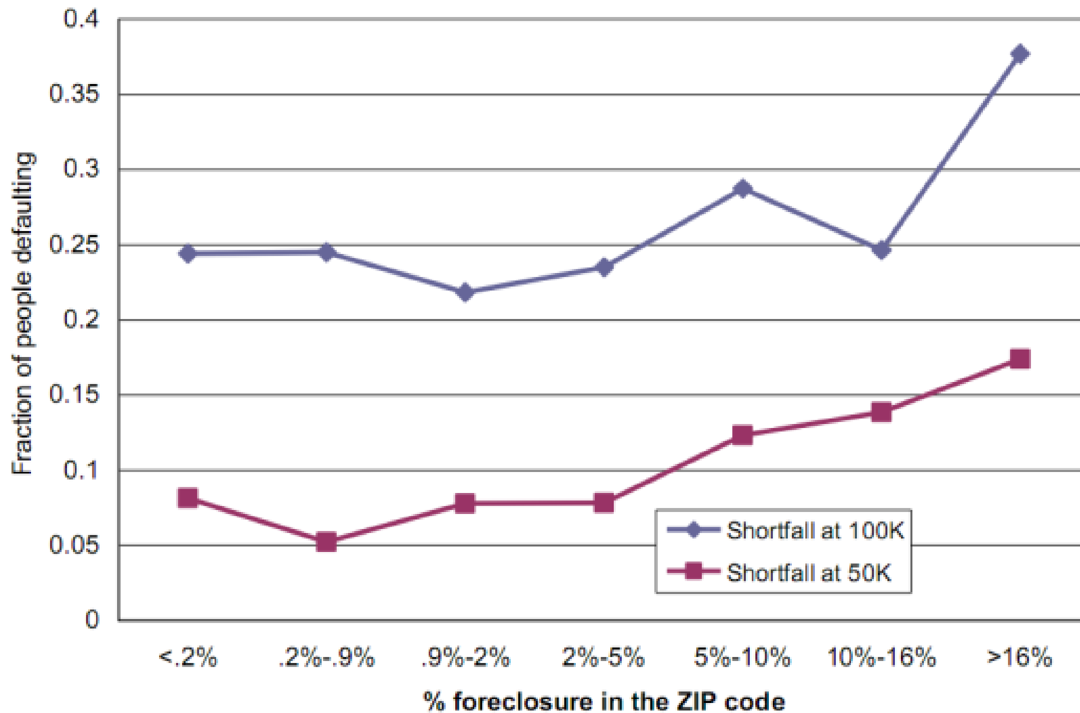
-- We have also seen a number of signs of the next half-generation of young people moving into the market place. These are new households too young to have been materially harmed by the housing market excesses. They have good credit ratings (provided that they have kept their student loans current) and they have ample sums available to make 20% down payments on "bargain priced" new homes (at least some of which is coming from highly liquid Mom & Dad -- who can find no better risk-adjusted returns for the funds at the moment).

This new blood will not remotely begin to clear the housing inventory (either official or "shadow"), nor begin to offset an imminent demographic wave of Baby-Boomer "downsizing" that has now been postponed for at least 4 years -- but is, nonetheless, inevitable. But it will move our indexes up relative to abysmal 2010 housing data -- especially given that our Weighted Composite still carries a significant "weighting" for the housing sector.

-- Additionally we think that it may take years to fully recognize the economic impact of the "rent free" living made possible by the mortgage mess. We have previously estimated that delinquent mortgage payments are generating between $90 - $100 billion per annum in free disposable cash flows. Given that in some states the judicial backlog in processing foreclosures is now a decade deep, a lot of people have strong disincentives to sink even more hard cash into hopelessly upside-down mortgages. In fact, for some it would be highly irrational to continue with the payments -- however morally obligated they may be.

And a study by Guiso, Sapienza and Zingales found that "strategic defaults" are culturally contagious:

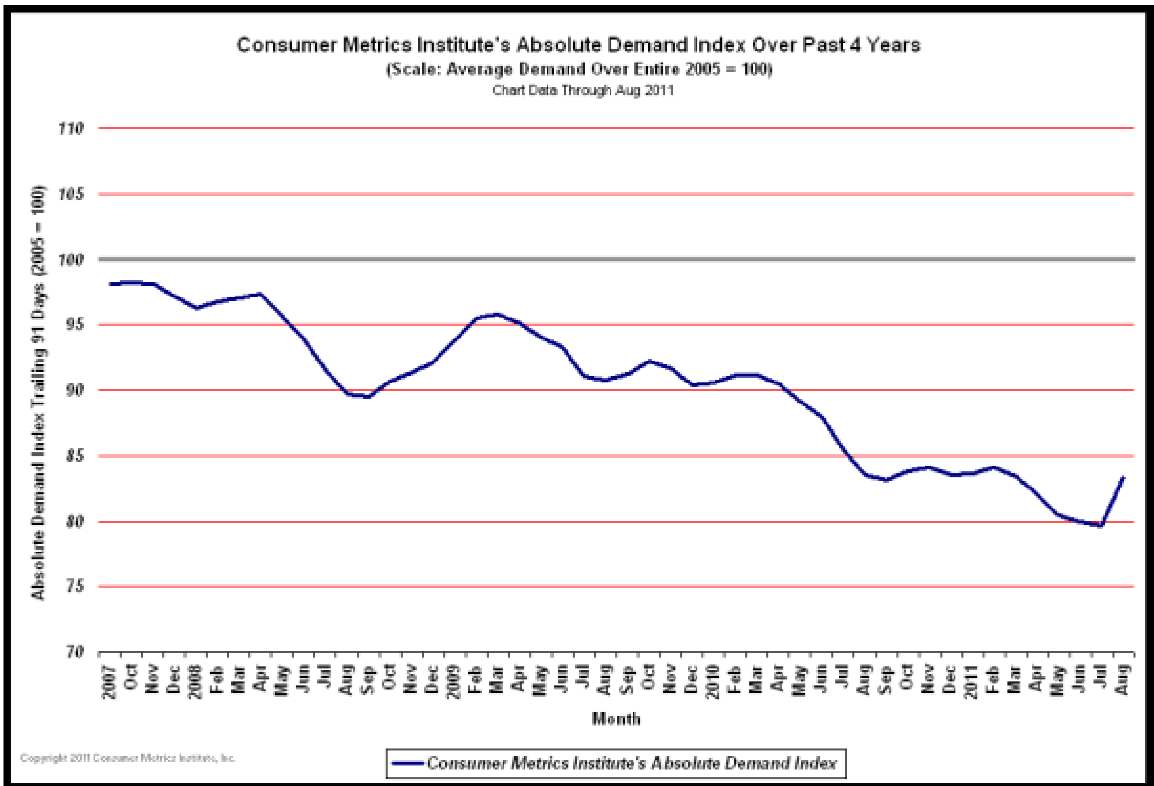
"... people who know someone who defaulted are 82% more likely to declare their intention to do so. The willingness to default increases nonlinearly with the proportion of foreclosures in the same ZIP code."



We may be just now reaching the "tipping point" for the contagion.

-- And lastly, we may also be seeing a market shift to internet sales that is faster than our anti-biasing methodologies can handle. The premise behind this suggestion is that things have gotten so bad that people are turning more and more to internet bargains to make ends meet. Our methodologies to compensate for long term growth of internet market shares are based on year-over-year same-shopper metrics. But perhaps the real economic situation is deteriorating much faster than year-over-year corrections can handle. If so, the surge we are seeing may be in part the result of consumer desperation.

Again, we cannot emphasize enough the fact that our indexes are highly sensitive measurements of year-over-year changes in consumer demand for discretionary durable goods. For that reason we feel it is important to keep the "absolute" levels of consumer demand in mind:



An uptick is certainly happening, but let's not get carried away just yet.

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