



# E Themes on the Economy®

Mesirow Financial™

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## Breaking the Back of the U.S. Consumer

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### No Longer an Atlas

For years, the U.S. consumer has not only carried the U.S. economy but has also acted as “spender of last resort” for the rest of the world. We literally snapped up imports, which helped to keep foreign economies expanding, even as our own economy was slipping into a recession in 2001. China was among the largest beneficiaries, but Europe and Japan were not far behind.

Moreover, we helped to trigger the expansion with robust spending on homes and big ticket durable goods in 2002 and 2003. Conversely, businesses have been extremely slow to spend and invest this decade, after being burned by investing too aggressively in the 1990s.

Excessively easy credit provided the bulk of the support for consumer spending, especially in the housing and vehicle markets. The problem, of course, is that we went too far. We built more homes and bought more gas-guzzling sport utility vehicles (SUVs) than any reasonable estimates of demand could sustain. A subsequent tightening of credit conditions and surge in commodity prices were just the straw that broke the camel's back. Indeed, we are now expecting consumer spending to actually decline in the second half of 2008.

This report takes a closer look at the outlook for consumer spending, paying special attention to what has happened to consumer balance sheets over the last year, and any offset that the recent drop in

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commodity prices may provide for consumer spending. The end of tax rebates is only one in a series of challenges the consumer faces in the second half of the year.

Separately, the impact that persistently weak economic conditions is having on consumer confidence will be examined. Consumer confidence in the economy has deteriorated even more rapidly than overall economic conditions would suggest.

The report will conclude with a look at the implications of deteriorating consumer spending and confidence for the elections. Ever since Roosevelt won against the incumbent, President Hoover, at the height of the Great Depression in 1932, presidential candidates have attempted to capitalize on bad economic conditions to gain favor with voters.

It seems clear that Democrats will continue to gain more seats in Congress this fall, as most voters blame Republicans for the current economic malaise. The jury is still out on the presidential elections, however, now that McCain may finally be differentiating himself from the Bush

### A Weak Second Half

Real GDP grew at a revised 3.3% pace in the second quarter. The overwhelming majority of those gains, however, could be attributed to an improvement in trade, which is more reflective of strength abroad than strength at home. Consumer spending was also revised up, but remained relatively anemic, despite the boost from tax rebates, and inventories contracted at a slower rate than initially reported.

Prospects for the second half of the year are significantly worse. Consumer spending is expected to actually contract now that the tax rebates have been spent, and the contribution to growth from trade is expected to diminish. Much of the world's economies have shown signs of weakening, which will put a damper on exports. On the brighter side, the housing market is starting to show signs of bottoming and investment in new equipment appears to be picking up. The rush to take advantage of accelerated depreciation rates on smaller equipment purchases should provide an extra lift to computer sales, in particular, in the fourth quarter. On net, real GDP is expected to rise a meager 1.3% in the third quarter and actually contract by almost a percent in the fourth quarter.

**The Fed Stuck in a Holding Pattern.** A further weakening of economic conditions and tightening of credit market conditions is expected to keep the Fed on hold for the balance of 2008 and through the first quarter of 2009. Then, hawks concerned about inflation are expected to get an upper hand, and push the rest of the Fed to start raising rates. The fed funds rate is expected to rise from 2% to 3-1/4% in 2009.

## For all charts/graphs:

■ = Actual ■ = Estimate (e) □ = Forecast

CHART 1

## Real Disposable Income

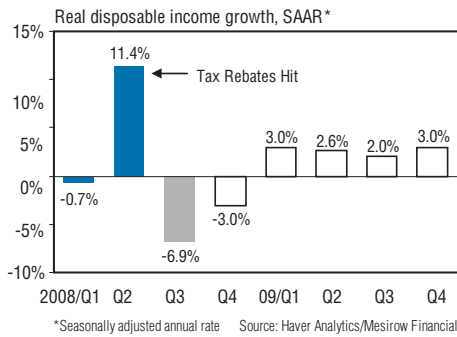


CHART 2

## Debt Levels Rise

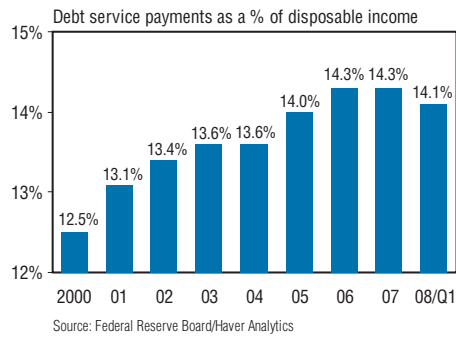
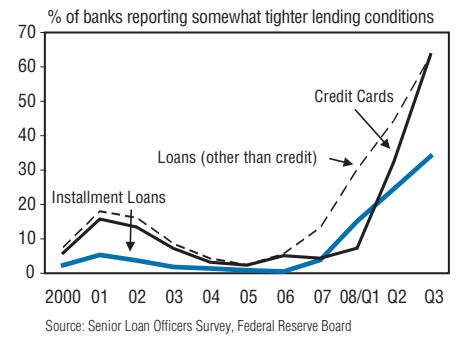


CHART 3

## Credit Conditions Tighten



administration. His new vice presidential candidate, in particular, could up his appeal to white, blue-collar workers.

## Deteriorating Fundamentals

An end to the tax rebates is expected to exacerbate the weakness associated with already deteriorating consumer balance sheets:

- Real disposable income is deteriorating now that the tax rebates have been spent. (See *Chart 1*.) A slow erosion in employment and rapidly escalating food and energy prices are the primary culprits. Stagnating wages and a cut in overtime pay are other reasons. Workers at some banks have actually been “promoted” (demoted in pay) to salaried status from hourly status to lower their overtime pay. In fact, unit labor costs actually dropped in the second quarter, as employers got workers to do more for little or no increase in their wages. Moreover, conditions are getting worse rather than better, with employment dropping by an unexpected 81,000 in August and the unemployment rate surging to 6.1%, up a whopping 0.4% from July, and its highest rate since September, 2003.

Separately, bonuses for high-wage workers have been curtailed, especially on Wall Street, where the profits of the large financial firms have plummeted. This is to say nothing of the affect falling stock prices have had on Wall Street compensation (just ask anyone who used to work for Bear Stearns).

- Debt levels have become debilitatingly high, forcing a surge in bankruptcies and home foreclosures. (See *Chart 2*.)
- Credit conditions have continued to tighten, despite aggressive easing by the

Federal Reserve to keep liquidity flowing. (See *Chart 3*.) Mortgages and home equity loans have become particularly hard to secure in the face of falling home values. This is to say nothing of the loss of credit provided by non-bank lenders, many of which were forced into bankruptcy by the subprime debacle. Even auto loans have become harder to get, with zero percent financing and low cost lease incentives becoming scarcer in recent months.

- Net worth has fallen in response to declining home values and recent losses in the stock market, which will eventually raise consumers’ saving relative to spending. (See *Chart 4*.) Baby boomers are the most likely to forego some consumption and up their savings for retirement as they are the closest to retiring.
- And, consumer sentiment has plummeted, which is dampening our *willingness* to take on additional debt and spending. It is worth noting, however, that consumer attitudes tend to tell us more about how we will vote (for or against perceived incumbents) than how we will spend.

## Offsetting Commodity Prices?

The only major offset to deteriorating consumer balance sheets is falling commodity prices. Oil prices, in particular, have plummeted almost 30% from their peak earlier this summer. However, prices remain more than 50% ahead of where they were a year ago and are still way too high to avert an actual contraction in consumer spending.

What would it take to get consumer spending to actually reverse course and rise in the fourth quarter? Work done at Mesirow Financial suggests that oil prices would have to plummet to the \$75 per

barrel range before the end of September, and stay there for the duration of the quarter in order to get consumers to post any kind of an increase in spending over the period. This seems highly unlikely in the near-term, given recent comments by some OPEC members that they would be willing to cut production to stop oil prices from slipping below \$100 per barrel.

Moreover, work done by the auto industry suggests that vehicle sales started to slow once prices at the pump crossed \$2.75 per gallon, well below the current rate at the pump of close to \$4 per gallon in Chicago.

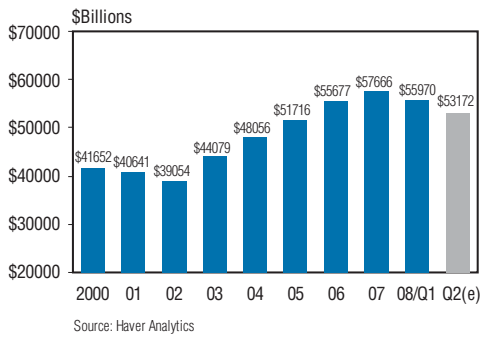
Then there is the ongoing threat of the hurricane season, which has only just begun. Gustav was just the first in what could be many threats to our refineries this fall. Ike was headed toward the Gulf Coast and the oil-producing facilities of the regions, as of the writing of this report.

Agricultural prices have also dropped from their peaks, but remain too high to free up much in terms of disposable income. Indeed, much of the rise in food costs associated with early increases in grain and oil prices have yet to work their way through to the consumer.

## The Outlook

On net, consumer spending is expected to get worse before it gets better. To some extent it already has, with disappointing back-to-school sales. Only Wal-Mart, which offers consumers a value proposition over other retailers, fared well during August. The outlook for the fourth quarter is particularly bad as consumers must now try to keep spending afloat without the additional support of the tax rebates. In fact, consumer spending is expected to drop for the first real back-to-back declines in

CHART 4  
Household and Nonfinancial Net Worth Falls



consumer spending in the third and fourth quarters since the early 1990s.

Prospects for 2009 are only slightly better, with the headwinds created by the housing market bust abating and some healing expected to occur in credit markets. A rebound in profits should also eventually make its way into jobs and wages over the course of the year. We are not likely to see consumers become a major driver of overall economic growth, however, until well into 2010. (See *Chart 5*.)

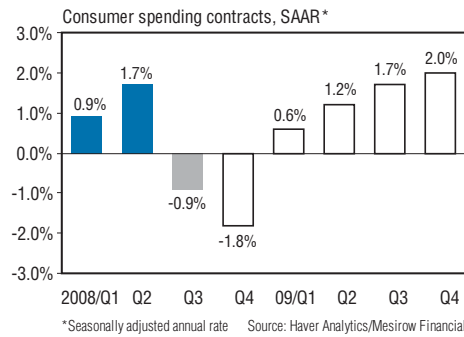
#### “It’s the Economy, Stupid!”

In 1992, we saw for the first time that economic growth in and of itself was not enough to re-elect an incumbent President George H.W. Bush. The economy had to be growing enough to both lower unemployment and give the majority of Americans a sense that they were participating in that recovery in order for voters to give him a second term.

Of course, the economy wasn’t growing fast enough, and the first President Bush lost the race for the White House to a relatively “inexperienced” politician named Bill Clinton. Indeed, the win was such a shock for Democrats that many more seasoned politicians in the party didn’t even bother to throw their hats into the ring in 1992 for fear that they would lose.

Work done at that time by my former mentor, Jim Annable, suggests that consumer confidence deteriorated even as overall economic conditions were improving. Why? Because the economy was not growing fast enough, and consumer spending was not expanding rapidly enough to make consumers feel as though they were making any headway in their living standards. Confidence in the economy, in

CHART 5  
Real Consumer Spending Lags



particular, is more of a relative than static concept. We are ultimately more concerned about the pace at which we can continue to accumulate stuff than about the volume of things we already own.

Specifically, Jim argued that confidence started to deteriorate more rapidly than one would expect, given overall economic conditions, when the pace at which we could spend dipped below an aggregate 3% inflation-adjusted threshold. Or, our discontent with the economy intensified when the pace at which we could spend dipped below the post-World War II average, the rate at which our parents could keep spending growing.

Now, fast forward to 2008. Consumer spending has been expanding at a negligible 1.2% pace in the last year, well below the 3% threshold, and confidence in the economy has been deteriorating disproportionately. In fact, consumers are as nervous about the economy today as they were in 1980. This is despite significantly better overall economic conditions than we saw in 1980. (That year we saw double-digit inflation and the start of the worst recession of the post-World War II era.)

#### Implications for the Elections

As a result, the economy now outranks the war in Iraq as the most important issue that the next president must tackle. If McCain were truly seen as an extension of Bush and an “incumbent,” he would likely lose. And, until recently, that is exactly what the polls were suggesting. McCain was trailing Obama largely because of his perceived similarities to Bush.

Then along came his vice presidential running mate, Sarah Palin, who is married to a card-carrying union member, and wants

to increase U.S. oil production by expanding drilling in her own back yard of Alaska.

Promises to increase the number of union jobs via the pipelines that would carry the oil to the “bottom 48” are likely to play particularly well among blue-collar voters. They already feel left behind by the shift from an industrial to a more knowledge-based economy, and are likely to welcome anyone who might be willing to turn the clocks back to a “kinder and gentler” age.

The idea that increased oil production could also lower energy prices makes the proposition even more attractive to middle- and low-income households, who are already living paycheck to paycheck. This is despite the fact that it would take at least seven years to actually realize an increase in oil production from untapped reserves in Alaska.

Those concerned about our overall dependence on fossil fuels and the damage additional drilling would do to the environment won’t welcome Sarah Palin. Most of them, however, were probably leaning more toward Obama than McCain in the first place, and their discontent with her views won’t mean much in terms of electoral votes in December.

On net, the race for the White House remains too close to call. Sarah Palin is clearly a wild card, which could ultimately tip the election in either candidate’s direction.

What about vice presidential hopeful, Joe Biden? He bulked up Obama’s reputation on experience and foreign policy, but now that the election is about the economy, it is unclear that he can do much more. The Democrats hoped that he could sway fence-sitting, blue-collar voters in their direction, but Sarah Palin just upped the ante on the fight for middle-class America.

If the mean-spirited tenor of Giuliani’s comments at the Republican convention is any indication of what is to come, the only thing we can be sure about is that both the economy and the campaign for the White House are likely to get uglier before the elections in November.

## Mesirow Financial Economic Forecast (Numbers as of September 9, 2008)

	2007(A)	2008	2009	2008:1(A)	2008:2(A)	2008:3	2008:4	2009:1	2009:2	2009:3
<b>National Outlook</b>										
Chain-Weighted GDP	2.0	1.8	1.5	0.9	3.3	1.3	-0.7	1.7	1.9	2.2
Personal Consumption	2.8	0.9	0.3	0.9	1.7	-0.9	-1.8	0.6	1.2	1.7
Business Fixed Investment	4.9	4.2	1.4	2.4	2.2	5.7	2.5	-1.1	0.6	1.7
Residential Investment	-17.9	-19.5	-5.3	-25.1	-15.7	-8.1	-7.0	-5.2	-3.9	-1.0
Inventory Investment (billions)	-2.5	-23.5	8.0	-10.2	-49.4	-11.6	-22.8	-2.5	5.9	10.6
Net Exports (billions)	-546.5	-395.4	-337.0	-462.0	-376.6	-379.5	-363.6	-352.0	-341.0	-332.2
Exports	7.5	8.8	4.2	4.5	16.6	2.7	4.9	2.4	3.6	3.5
Imports	1.7	-2.1	0.9	-2.0	-7.6	2.2	0.8	0.6	1.9	2.3
Government Expenditures	2.1	2.4	2.1	1.9	3.9	1.5	2.2	2.2	2.2	2.0
Federal	1.6	4.4	3.2	5.8	6.8	2.5	3.3	3.0	3.0	2.7
State and Local	2.3	1.2	1.6	-0.3	2.2	0.9	1.5	1.7	1.7	1.5
Final Sales	2.4	2.0	1.1	0.9	4.8	-0.2	-0.3	0.9	1.6	2.0
<b>Inflation</b>										
GDP Deflator	2.7	2.0	1.9	2.6	1.2	1.0	2.9	2.5	1.6	1.3
CPI	2.9	4.2	2.1	4.3	5.0	3.5	2.3	2.0	1.2	1.2
<b>Special Indicators</b>										
Corporate Profits*	-2.0	3.7	6.1	-1.5	-7.0	0.1	3.7	6.9	10.8	4.2
Disposable Personal Income	2.8	1.2	0.9	-0.7	11.4	-6.9	-3.0	3.0	2.6	2.0
Housing Starts (millions)	1.34	0.99	0.90	1.05	1.02	0.96	0.94	0.91	0.89	0.89
Civilian Unemployment Rate	4.6	5.5	6.4	4.9	5.3	5.9	6.0	6.2	6.3	6.4
Employment	0.8	-0.6	-0.1	-1.5	-0.5	-0.2	-0.3	-0.1	-0.3	0
<b>Vehicle Sales</b>										
Automobile Sales (millions)	8.0	7.2	7.7	7.5	7.7	6.8	6.6	6.8	7.0	7.8
Domestic	5.5	4.7	5.2	5.0	5.0	4.4	4.3	4.4	4.5	5.3
Imports	2.5	2.5	2.5	2.4	2.7	2.4	2.3	2.4	2.5	2.5
Lt. Trucks (millions)	8.6	6.3	5.3	7.9	6.6	5.5	5.4	5.2	5.2	5.2
Domestic	7.1	5.1	4.2	6.5	5.3	4.4	4.2	4.2	4.1	4.0
Imports	1.5	1.2	1.2	1.4	1.2	1.1	1.0	1.0	1.1	1.2
Combined Auto/Lt. Truck	16.6	13.5	13.0	15.4	14.3	12.3	12.0	12.0	12.2	13.0
Heavy Truck Sales	0.4	0.3	0.4	0.3	0.3	0.3	0.2	0.3	0.4	0.4
Total Vehicles (millions)	16.9	13.8	13.3	15.6	14.6	12.6	12.2	12.3	12.6	13.4
<b>Interest Rates/Yields</b>										
Federal Funds	5	2 <sup>1</sup> / <sub>4</sub>	2 <sup>3</sup> / <sub>4</sub>	3 <sup>1</sup> / <sub>8</sub>	2 <sup>1</sup> / <sub>8</sub>	2	2	2	2 <sup>3</sup> / <sub>8</sub>	3 <sup>1</sup> / <sub>8</sub>
10-Year Treasury Note	4 <sup>5</sup> / <sub>8</sub>	3 <sup>3</sup> / <sub>4</sub>	4 <sup>1</sup> / <sub>2</sub>	3 <sup>5</sup> / <sub>8</sub>	3 <sup>7</sup> / <sub>8</sub>	3 <sup>3</sup> / <sub>4</sub>	3 <sup>3</sup> / <sub>4</sub>	4	4 <sup>3</sup> / <sub>8</sub>	4 <sup>3</sup> / <sub>4</sub>
Prime Rate	8	5 <sup>1</sup> / <sub>4</sub>	5 <sup>3</sup> / <sub>4</sub>	6 <sup>1</sup> / <sub>8</sub>	5 <sup>1</sup> / <sub>8</sub>	5	5	5	5 <sup>3</sup> / <sub>8</sub>	6 <sup>1</sup> / <sub>8</sub>
Corporate Bond AAA	5 <sup>5</sup> / <sub>8</sub>	5 <sup>1</sup> / <sub>2</sub>	6 <sup>1</sup> / <sub>8</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>5</sup> / <sub>8</sub>	5 <sup>5</sup> / <sub>8</sub>	5 <sup>5</sup> / <sub>8</sub>	5 <sup>3</sup> / <sub>4</sub>	6	6 <sup>1</sup> / <sub>4</sub>
<b>Exchange Rates</b>										
Yen/Dollar	118	107	112	105	108	110	110	111	112	111
Dollar/Euro	1.37	1.49	1.33	1.56	1.48	1.42	1.38	1.37	1.34	1.30

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

\*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was \$11,049 billion in chain-weighted dollars.

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