Don't Worry About the US Consumer — by Tan Kai Xian

There is a schizophrenic quality to commentary on the health of the US consumer. On the bright side, sentiment readings are cheery and the labor market is generally solid. The oil price has moderated and even yesterday's tanker attacks in the Persian Gulf barely generated a ripple. Yet on the other hand, Cassandras point to rising credit card delinquency rates, and weakness in sales of autos and homes as early signals of a recession. So what gives?

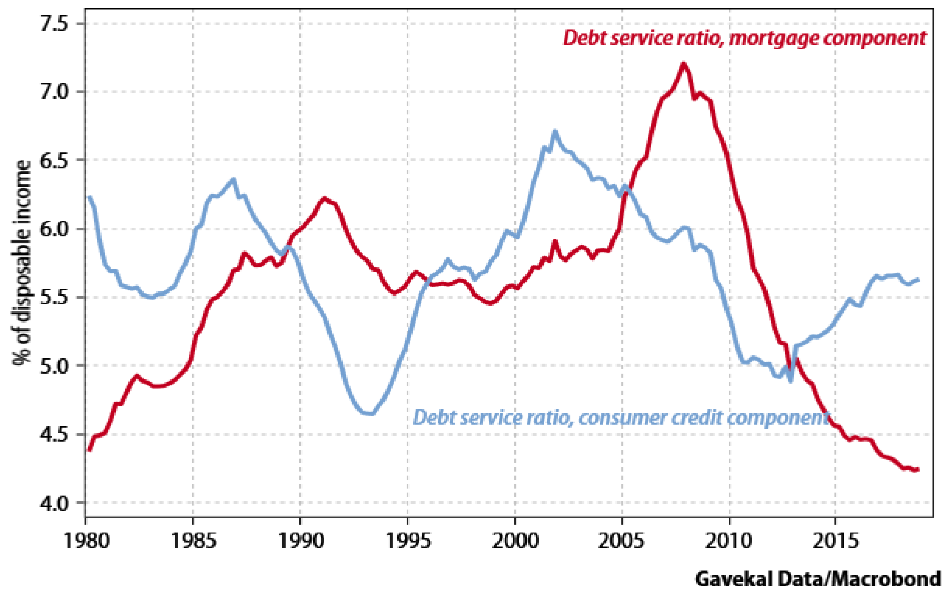
In fact, this mixed picture is typical of late-cycle environments. As the US labor market tightens, there are not enough workers to fill job openings, which gives workers more bargaining power, causing wage growth to accelerate. It is a happy brew for overall consumer confidence. The countervailing factor is that rising wage growth usually forces the Federal Reserve to tighten monetary policy. Faced with rising short rates, US consumers tend to cut spending that is tied to credit priced in this part of the curve—autos and credit card usage stand out.

So with the US-China trade war escalating, which of these two dynamics will prove the stronger? I tend to the former for the following three reasons:

1. **Consumer income**: While the trade war is negative for US firms in the short run as they face higher costs on imported goods and lost export markets in China itself, a layoff cycle is not likely to result. This is because benign financial conditions mean that US firms can still profitably borrow to invest (see **Recession Risk Mispriced**). Moreover, the trade war is not all bad for the workers. If "re-onshoring" is successful in bringing production back to the US, the increased investment could boost demand for labor, and so wages as well.

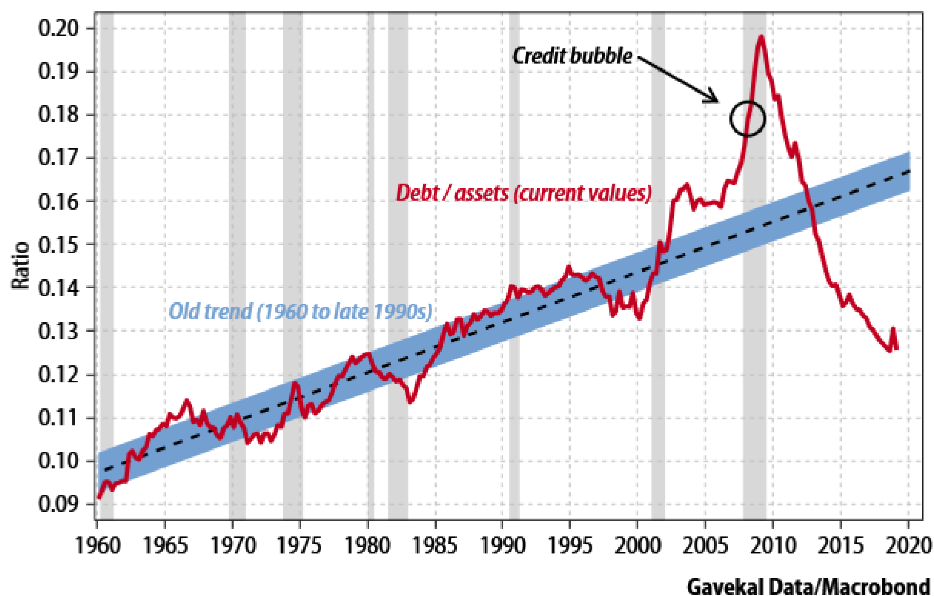
2. **Consumer spending**: The main worry is the direct increase in consumer prices to offset the tariff rise. To me, this concern is overblown. According to an analysis by the San Francisco **Fed**, the imposition of a 25% tariff on all Chinese exports to the US would only boost PCE price inflation by 0.4pp. This (somewhat unrealistically) assumed no adjustments in the value of the US dollar or supply chain adjustments, so the actual effect would probably be smaller than this estimate.

   US consumers may also get some indirect benefits from others' misfortune. As the trade war weighs on growth prospects in Europe, Japan and emerging economies, the oil price has declined by -20% since late April. This not only lowers consumer prices, but has allowed the Fed to turn more dovish. As shown in the left-hand chart below, the recent rise in household debt is concentrated in non-mortgage borrowings, which is mostly tied to short rates. Hence, if there is a rate cut in July, as expected by the market, then consumer sectors like autos should get a fillip.



3. **Consumer leverage**: Since the 2008 financial crisis, US households have steadily deleveraged such that their debt/asset ratio is back at levels last seen in the mid-1980s. This generally cautionary approach to debt means they are decently well placed to weather any hit from the trade war.

There is no good time for an economy to face big rises in tariffs, so there is likely to be some drag on US consumer demand. It is not, however, likely to be a big effect. US consumers have rarely been the source of US recessions and they approach this stand-off in decent shape.



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