Consumer Gets a Boost from Lower Rates, But Spending Growth Still Set to Slow

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Highlights

- The U.S. consumer remains the lynch pin of U.S. growth, supported by enviable fundamentals. Now, consumer spending has received an unexpected boost from lower interest rates.
- Consequently, spending on interest sensitive durable goods has picked up in 2019. Mortgage refinancing activity has also increased, with cash-out refinancings likely lending a hand to spending.
- The low level of borrowing rates will help support spending for a few quarters yet, however, various headwinds will contain the boost. These include: no further leg down in rates, lower homeownership rates, a lack of pent-up demand and a smaller share of durable goods spending in the consumer basket.

The U.S. consumer remains the lynch pin of U.S. growth. Hiring has slowed, but wage and income gains are solid and consumer confidence remains healthy. Yet, household spending has also been receiving a notable boost from one fundamental that was not anticipated at the start of this year: lower interest rates. A year ago, we had expected bond yields to rise in 2019. Instead yields fell dramatically from late 2018 to September of this year. Mortgage rates followed suit, falling a full percentage point from their year ago levels, while rates on new car loans have fallen roughly 25 basis points thus far. And, lo and behold, interest-sensitive spending has picked up in recent quarters.

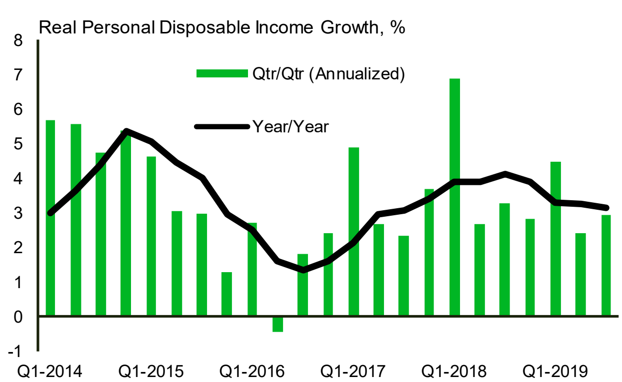
That said, we suspect the benefits to consumer spending (PCE) from lower borrowing rates are likely to wane in the coming quarters as overall gains in PCE slow closer to a 2% pace, from a hearty 3% over the past five years. While the rate environment will likely remain favorable for the next few quarters, mortgage rates have edged up from their lows, and the Federal Reserve appears to be finished lowering the policy rate (see Dollars & Sense), which suggests the impact from lower rates will start to wane later next year. Additional factors are also expected to dampen the impact of lower borrowing rates, including a lack of pent-up demand for autos, durable goods making up a smaller share of the consumer basket than in the past, and lower homeownership rates, which means less of a boost from mortgage refinancing.

The consumer backdrop is healthy

The consumer spending backdrop is healthy. Last Friday's better-than-expected employment gain in October provided reassurance that hiring remains resilient despite weakness in business investment and exports. Indeed, job gains have remained stronger, longer than most forecasters anticipated largely due to rising labor force participation, which has left more room for expansion. Employment growth and wage gains have driven solid increases in wages and salaries.

Real personal disposable income (PDI) growth has slowed a bit in line with a broader cooling in economic growth over the past year as the cycle has matured (Chart 1). Still, it advanced by 3.2%

Chart 1: Disposable Income Growth Still Solid



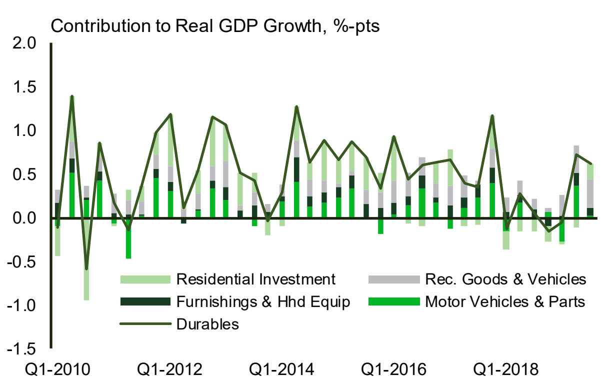
Source: Bureau of Economic Analysis, TD Economics over the past year, strong enough to support a robust pace of consumer spending. The personal savings rate has also ticked up in recent quarters, while household leverage, measured by the debt-to-income ratio, has remained relatively low. Given rising income and wealth inequality, these positive trends are unlikely to be spread evenly across the board and, hence, less instructive about the average consumer's capacity to spend. However, looking at trends in net worth across income quintiles, all but the bottom 20% have more than recovered the net worth lost in the housing bust. And net worth for the lowest income quintile has risen steadily since early 2017. So, notwithstanding some structural challenges, the recent drop in borrowing rates has come at a time when the consumer is in a good position to take advantage of them.

Interest-sensitive spending has picked up

There is solid evidence that consumers have responded to the large drop in mortgage and other borrowing rates through increased spending on interest-sensitive durable goods. The measure of consumer durables spending used by researchers at the Kansas City Fed includes: personal consumer expenditures on motor vehicles and parts, recreational goods and vehicles, furnishings and durable household equipment and residential investment. Residential investment encompasses both new home construction, renovation spending and activity generated by the resales housing market (like brokers' commissions).

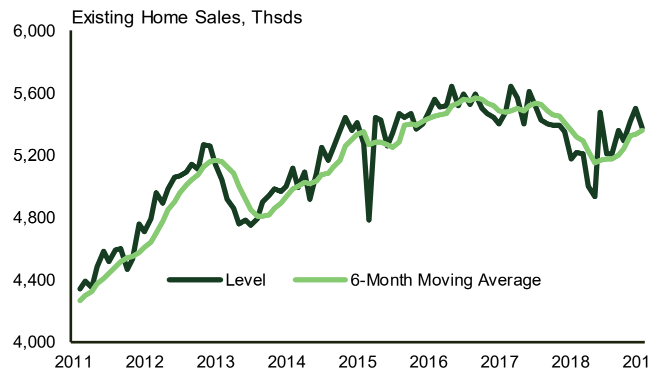
Despite being a relatively small share of GDP, durables expenditures contribute sizably to the business cycle because they are a volatile component of GDP. Looking at the various components of durable goods, residential investment is the most sensitive to rates, followed by motor vehicles, recreational goods & vehicles and then furniture.

Chart 2: Interest-Rate Sensitive Durable Goods Spending



Source: Bureau of Economic Analysis, TD Economics

Chart 3: Home Sales Trending Up in 2019



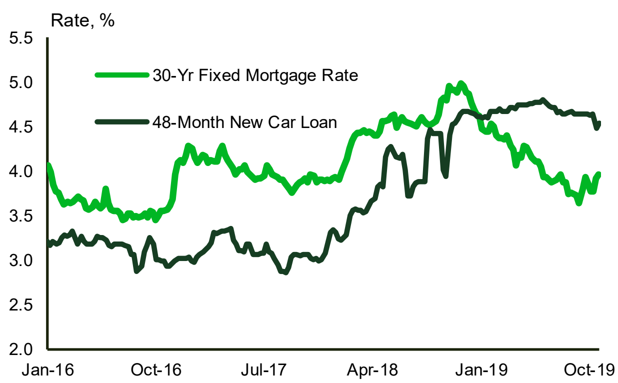
Source: National Association of Realtors, TD Economics

Purchases of these goods have picked up over the past two quarters (Chart 2), after a period of weakness. Most notably, residential investment grew for the first time in seven quarters in Q3, and monthly housing indicators are pointing to another solid outturn in Q4. Existing home sales are volatile on a month-to month basis, but zooming out, sales have been trending upwards through 2019, after a notable downturn in the latter half of last year (Chart 3). The sizeable drop in mortgage rates over the past year has helped boost demand for homes, although tight inventories are a constraint on sales and have pushed prices higher.

Spending at automotive and motor vehicle dealers have also picked up, even though unit sales have been a bit choppier and are flat overall. However, sales of light trucks (including popular SUVs) have been making up an increasing share of purchases, accounting for 73% of light vehicle sales, up from 50% six to seven years ago. Therefore, real spending growth is much stronger than unit sales, and has seen auto loans expand at a decent clip. This likely has a bit more to do with healthy income growth, as interest rates for new car loans have fallen relatively less than mortgage rates (Chart 4).

Spending on recreational goods and vehicles, which includes TVs, computers, sports equipment and recreational vehicles like motorcycles, boats and RVs, has grown at a consistently healthy clip in recent years. Spending on these items is less sensitive to interest rates than vehicles or housing, and more dependent on growth in income.

Chart 4: Mortgage Rates Have Dropped



Source: Bureau of Economic Analysis, TD Economics

Mortgage refinancing is likely providing a boost

Lower mortgage rates not only drive activity in the re-sale housing market, they also spur on refinancing activity in existing mortgages. Refinancing activity can spur increased spending in the near term if it leads either to a lower monthly payment or if homeowners opt to take out some of the equity in their home to spend on renovations or other major purchases. The latter is called a cash-out refinancing.

Whatever the end goal, refinancing activity has surged in the latter half of 2019. Looking at the weekly mortgage applications data, close to 60% of mortgage applications are for refinancing – the highest share in three years (Chart 5). But that doesn't tell us how much of this activity is intended to fund near-term spending.

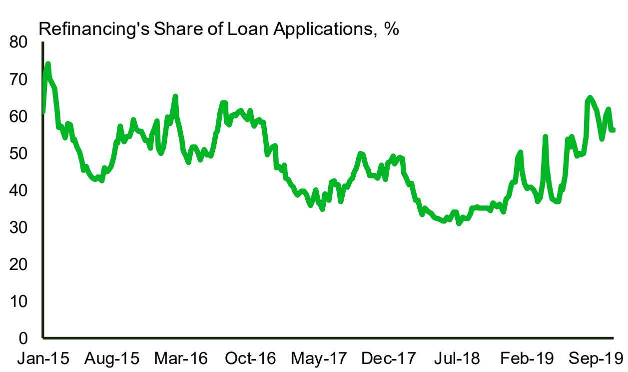
The data on cash-out refinancing is more lagged. In the first half of 2019, about two-thirds of refinancings resulted in a higher loan amount – i.e. were cash-out (Chart 6). That share had been as high as 80% in 2018, however the dollar amounts are much lower than the heydays of the housing boom (2005-2007). The weekly refinancing data suggest this activity picked up in the third quarter, and likely provided a boost to spending.

Headwinds will limit the boost from lower rates

There are various factors that are likely to limit the degree spending will benefit from lower rates in the coming quarters:

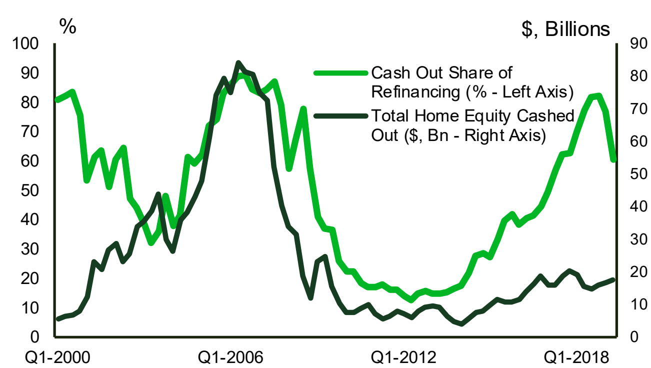
- *The move down in borrowing rates is likely finished* – Mortgage rates are up slightly from their lows, and the Fed also appears to be done cutting rates (see our latest rate outlook in Dollars & Sense). Borrowing rates are expected to remain below their medium-term average, which is still likely to lend support to interest sensitive durables, but the impact should peter out in later next year.
- *Lower homeownership rates* - This means fewer households can extract equity from their homes than in the past. The homeownership rate recently reached a post-crisis high of 64.7% in the third quarter. But, it is still down from the 69% at its peak in 2004. This is particularly the case for middle-aged households (Ages 35-64, Chart 7). Only the 65+ cohort has homeownership rates above where they were in the mid-1990s.
- *Pent-up demand largely sated* - Ten years into the expansion, there is little pent-up demand for many consumer durables (see detail on autos below).

Chart 5: Refinancing Activity Has Picked Up



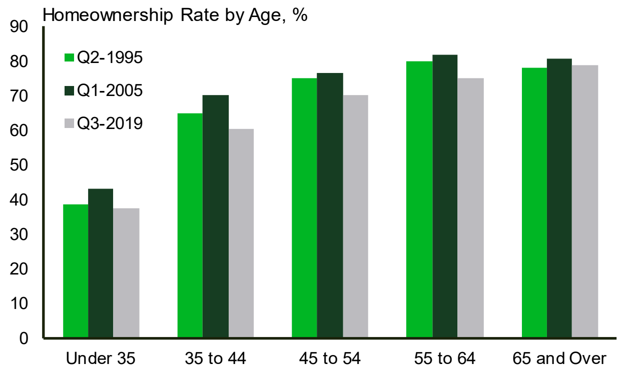
Source: Mortgage Bankers Association, TD Economics.
Last Data point October 25, 2019.

Chart 6: Cash-Out Refinancing Activity Has Picked Up, But Smaller Dollars



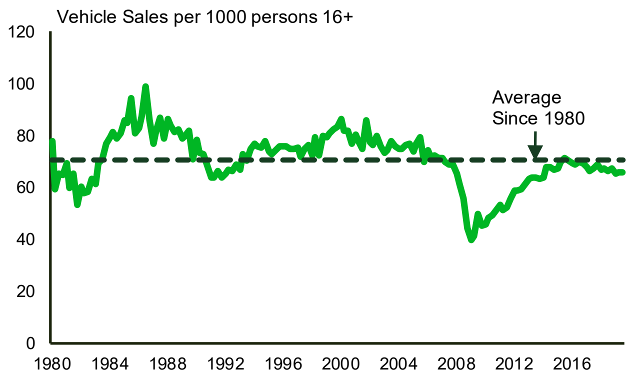
Source: Federal Home Loan Mortgage Corporation, TD Economics

Chart 7: Homeownership Rates Still Lower in Most Groups



Source: Census Bureau, TD Economics

Chart 8: Little Pent-Up Demand for Autos



Source: Bureau of Labor Statistics, TD Economics. Last data point 2019Q3

- *Interest-sensitive durable goods spending is less important* – These purchases make up less of the consumption basket than they used to. In 2018 they accounted for 14.6% of total consumer spending, down from a high of 21% in the last expansion. So even as these components respond to lower rates, the impact is smaller in the larger consumer spending basket.

The reality of durable goods spending is that it's lumpy. Once a household buys a new car or dishwasher, they are unlikely to buy a new one for a few years. That is why it is often a key driver of the business cycle. Typically, in recessions, purchases of these big-ticket items slow dramatically, and then once the economy is growing again, spending catches up. Consumers replace that old clunker in the driveway, once they feel confident enough about income and job prospects to take on debt. You can see this in auto sales. Looking at unit sales relative to the size of the adult population, they have been flat, to trending modestly downward since 2015 (Chart 8). We don't expect lower borrowing rates to unleash new demand for cars with pent-up demand seemingly sated, and as other structural factors like increased urbanization and an aging population leaning against more widespread car ownership. Our forecast for unit sales is a slight decline from 17.2 million pace in September, to average 16.6 million units in 2020.

Consumer spending to slow, but remain solid

Even though the boost from lower rates is likely to be more limited at this point in the economic cycle, it should still be supportive over the next few quarters. Recent monthly indicators from the housing market suggest that residential investment is likely to post another solid quarter of growth in Q4. And, purchases of housing-related durables are typically lagged by several months, suggesting further room to run on that segment of durable goods.

Still, after advancing at a healthy 3% pace in 2018, consumer spending is on track to follow through with a 2.6% pace this year, before slowing further in 2020 to a still solid 2.3%, supported by spending on durable goods closer to 4%. Residential investment is expected to swing form contraction in 2018 and 2019 to a positive in 2020, helped by lower borrowing rates. These will be key supports for the domestic economy as the manufacturing struggles with slower global growth and trade uncertainty.

The Bottom Line

As business investment and exports struggle in the face of slower global growth and uncertainty on the trade front, the U.S. consumer is increasingly being relied upon to support economic growth. Fortunately, consumers have responded to the drop in borrowing costs over the past year. The continued boost from low rates should help keep spending on consumer durables – including residential investment – growing at a healthier pace than expected this far into the business cycle. That said, we still expect consumer spending growth to slow from its heady pace in recent years over the next few quarters as various forces dampen the boost from lower rates.