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US Economics | North America

Soft Q1 services consumption exaggerates weakness in the US consumer

Household spending on services in Q1 decelerated markedly. Historically, this is a negative signal for the outlook. However, we think a confluence of factors help explain the sharp slowdown in services consumption. Labor market income continues to outpace inflation and Q2 data point to a rebound.

Key Takeaways

- Our outlook calls for a slowdown in consumption later this year due to lagged effects from tariffs. Downward revisions to services spending challenge this view.
- The BEA estimates that personal consumption of services grew by a meagre 0.6% q/q saar, down from 1.7% in the second estimate and 2.4% in the advance estimate.
- Payback from strong spending in 2H 24, front-running of tariffs that boosted goods spending, and residual seasonality in inflation likely explain the slowdown.
- Growth in labor market income continues to outpace inflation and data in April and May indicate spending has not downshifted as much as Q1 data suggest.
- Based on the data to date and our forecast revisions, we are tracking real GDP growth of 2.1% in Q2, with final sales to domestic purchasers at 1.5%.

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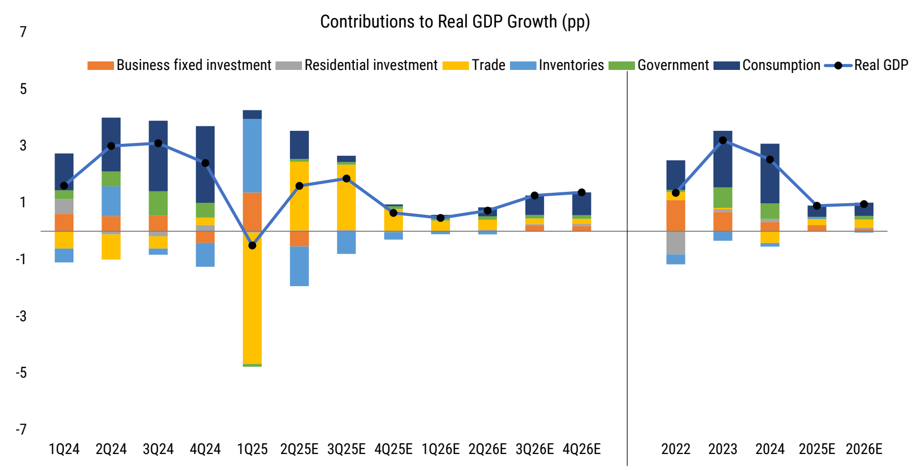
Soft discretionary services spending weighs on Q1 growth

We expect the economy to cool, but mainly later this year

Our outlook for the US economy this year and next includes slower growth and firmer inflation as a result of trade protectionism and immigration controls outweighing fiscal and deregulation policies when it comes to economic activity (see US Economics Mid-Year Outlook: Still slow growth, firm inflation, 20 May 2025).

That being said, our outlook includes differential timing effects on the economy, with tariffs boosting inflation first and consumer and business spending slowing with a lag. Our forecast for inflation, based in part on what we believe to be reasonable assumptions of tariff pass-through to the end consumer, has the 3-month annualized rate of inflation peaking at 4.5% in September-October and the year-on-year rate of headline and core PCE inflation rising to 3.0-3.5% in December. We think inflation should move higher, not just stay sticky at current run rates.

Exhibit 1: Morgan Stanley US Economics 2025-26 outlook



Source: BEA, Haver Analytics, Morgan Stanley Research

Our forecast for final sales to domestic purchasers (GDP less trade and inventories), which we think is a more accurate measure for underlying growth in an environment of volatile trade and inventory data, slows to 0.1-0.2% q/q saar in Q4 25 and Q1 26 as tariff-induced inflation eats into real purchasing power with a lag. We then expect the economy to gradually re-accelerate as tariff-induced inflation recedes and real purchasing power improves.

As a result, it would be a big surprise to us if the consumer and, in turn, the economy sharply weakened in advance of tariff pass through. This could happen, for example, if heightened uncertainty was sufficient to induce households to shift into precautionary saving mode or firms to shed labor.

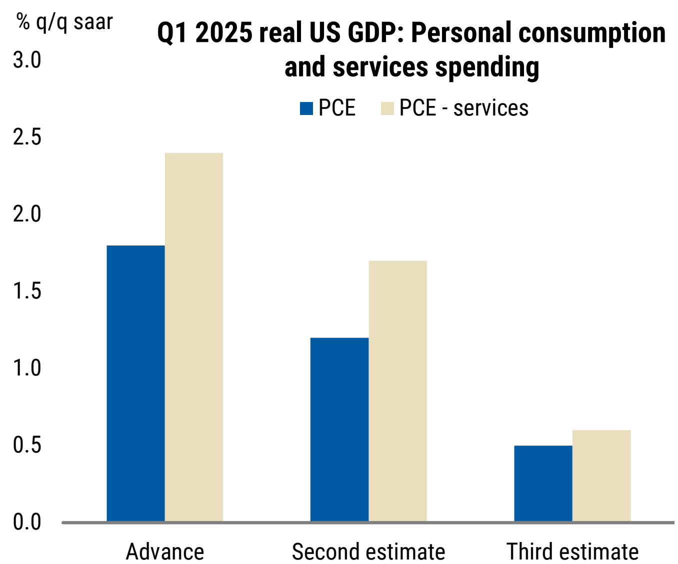
Revisions point to much weaker spending on services to start the year

With this as context, we note that the third estimate of Q1 US GDP contained another downward revision to services spending by households. The BEA now estimates that personal consumption of services grew by a meagre 0.6% q/q saar, down from 1.7% in the second estimate and 2.4% in the advance estimate. The downward revision to services spending between the advance and third estimates is substantial and, given its weight in total consumer spending, means growth in private consumption was only 0.5% q/q saar in the quarter.

What do we make of these revisions and do they challenge our view of a resilient US economy that slows gradually in response to policy implementation?

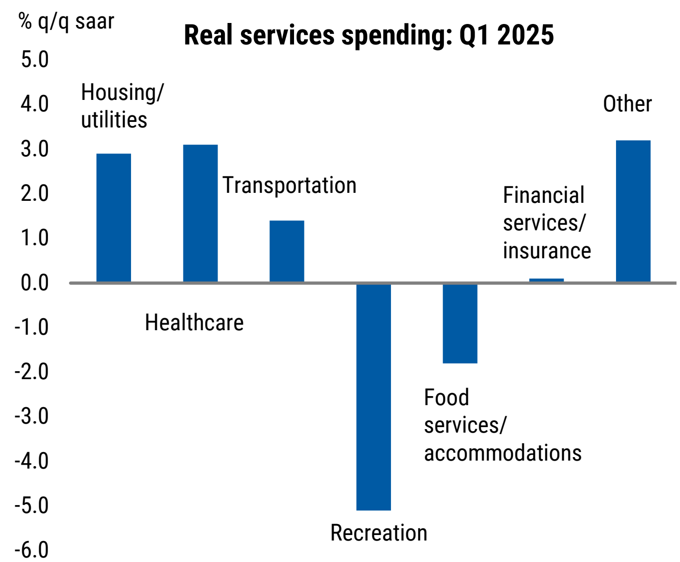
We think a confluence of factors exaggerated the weakness in Q1 services spending. While the pace of growth has moderated from last year, we do not believe we have yet seen a major downshift in consumer spending, and labor market income is still outpacing inflation by a healthy margin. Q2 consumption has been stronger so far, and we think the weakness is still ahead of us in the back half of the year.

Exhibit 2: Downward revisions to services spending pulled consumption lower



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 3: Services spending was softest in discretionary categories



Source: BEA, Haver Analytics, Morgan Stanley Research

Do Q1 GDP revisions say a more abrupt slowdown is at hand?

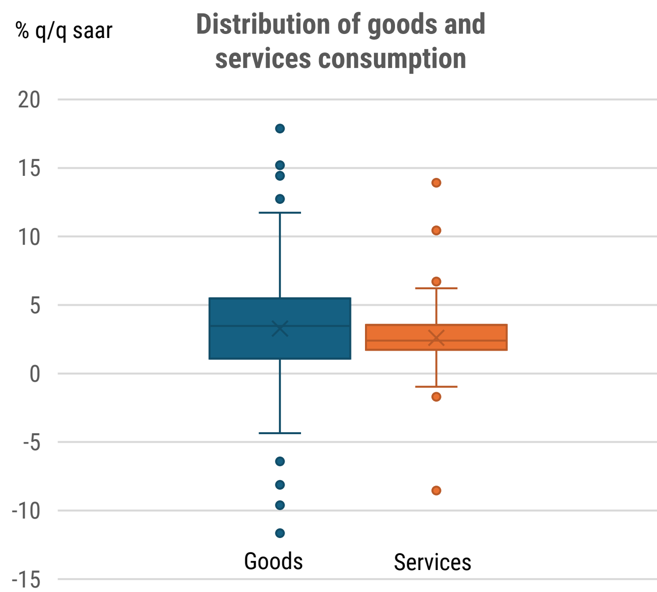
In Q1, spending on services was particularly weak in recreation services (-5.1% q/q saar), food services and accommodations (-1.8%), and financial services and insurance (0.1%). In addition, air transportation within transportation services was down 5.3%. These categories account for about 26% of total services spending. Elsewhere, spending in housing and utilities, healthcare, and other services remained broadly in line with recent trends.

In terms of revisions from the advance estimate to third estimate of US GDP, transportation services saw downward revisions to motor vehicle services, maintenance, and ride sharing services (including taxis). Recreational services was revised down by 6.5pp. The categories within recreation that saw the largest downward revisions were in membership clubs and sports centers, while household spending on package tours was revised down by 43pp. In food services and accommodations, spending on hotels and motels saw a larger downward revision than the headline category. Finally, within other services, household spending on social services and religious activities was revised down by 6.5pp.

The data, taken at face value, send a potentially troublesome signal about the strength of consumer spending. After all, household spending on services is less cyclically sensitive than spending on goods given the non-discretionary nature of many services components. In the 141 quarters from Q1 1990 to Q1 2025, household spending on goods fell in 26 quarters, while spending on services declined in only eight. In other words, consumer spending on goods falls in one out of every five quarters, on average, with many of these observations occurring during expansions, while spending on services only falls during recessions.

Altogether, the data point to weakness in discretionary services spending and adverse financial market conditions, the latter of which likely weighed on commissions and fees in the quarter. Softness in discretionary services spending, particularly in recreational activities, has been a general feature of the US consumer over the past few quarters as households adjust to a cooling labor market, a higher price level, and shifting preferences. Spending on discretionary services may also have been suppressed by the front-loading of durables purchases ahead of tariff announcements. We noted the slowdown in discretionary services in our most recent update on the US consumer (see Exhibit 12 in US Economic Briefing: The Consumer Diaries, 4 June 2025).

Exhibit 4: Spending on services is less volatile than spending on goods



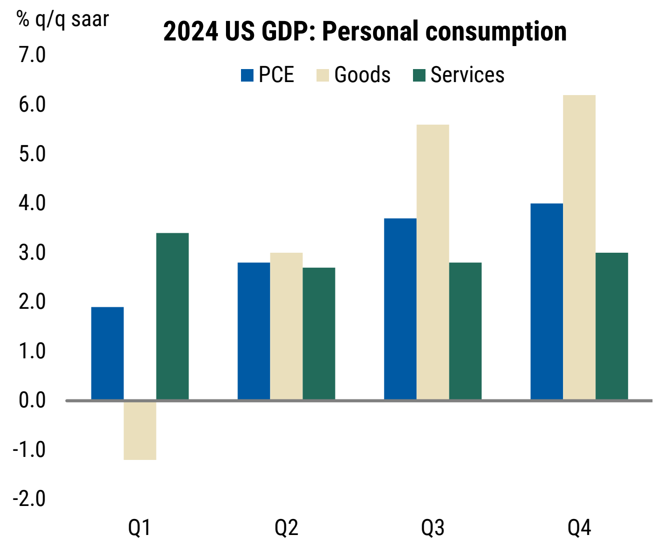
Note: Quarterly observations from 1990 Q1 to 2025 Q1. Box edges represent the first and third quartiles, below which the lowest 25% of the data falls and above which the highest 25% of the data falls. Outliers are points beyond the whiskers. Excludes 2020 Q2 and 2020 Q3 values from the pandemic. Source: BEA, Haver Analytics, Morgan Stanley Research

We suspect, but cannot say with certainty, that spending from lower- and middle-income cohorts is more vulnerable than the higher-income cohorts. Consumption among the lower- and middle-income cohorts is tied more directly to labor market income and the certainty around it, while spending of upper-income households is more closely linked to changes in net wealth. As employment growth has moderated, so has growth in labor market income, which could help explain less discretionary spending. In addition, tariff announcements caused a sharp drop in household confidence and an increase in household inflation expectations, which may have weighed on spending plans.

What happened? Payback, front-running, and purchasing power

We are willing to look through softness in Q1 consumer spending based on a confluence of factors that affected activity in the quarter, including payback from strong spending in 2H 2024, the front-running of tariffs which may have left less spend available for discretionary purchases, and residual seasonality in inflation which artificially weights on real activity.

Exhibit 5: Some give-back in spending was forthcoming; spending was well above trend in 2H 2024



Source: BEA, Haver Analytics, Morgan Stanley

Taking each in turn, households spent at a robust pace in the second half of 2024 and some giveback was likely. In particular, we expected payback in durable goods spending given the 7.6% and 12.4% annualized growth rates in this category of spending in Q3 and Q4, respectively. This came to fruition as durables spending fell 3.7% in Q1.

It was not as obvious to us that spending on services was markedly above trend, but it did grow at a solid 3.0% annualized rate in 2024. Perhaps a breather was required and households chose to temporarily hold back on discretionary purchases.

Second, spending on non-discretionary items was elevated at the turn of the year. This was particularly true with electricity and natural gas consumption, which rose 7.5% and 6.7% m/m in December and January, respectively. The number of heating degree days (population weighted by US region) was 58 days above normal, the largest outlier in four years. Households may have cut back on discretionary purchases in subsequent months as a result.

Third, the Trump administration moved forcefully on tariffs in Q1 and data on car sales suggest households front-loaded car purchases in advance of tariffs on autos and auto parts. Auto sales rose from 15.6mn units saar in January to 16.0mn in February and 17.8mn in March. Most households are budget constrained and purchases of high-cost durables could have translated into less spending on discretionary services.

Fourth, as we discuss in more detail below, growth in labor market income has moderated as the economy has cooled, but compensation has continued to outpace inflation by a wide enough margin to suggest that spending is not retrenching. The payroll proxy for production and nonsupervisory workers is up an annualized 5.2% in April and May over the Q1 average (2m/3m saar). Following the June employment report, this slowed to 4.1% q/q saar in Q2 on account of the dip in average weekly hours.

This is well above the current rate of inflation and about in line with our expectation for the 3-month annualized rate of inflation to peak this fall (4.5%) as tariffs are passed through. The payroll proxy is the product of employment, hours worked, and average hourly earnings and represents growth in economy-wide labor market income.

Fifth, it is well known that there is residual seasonality in Q1 inflation data. Put simply, residual seasonality refers to repeated, somewhat predictable patterns in prices that remain even after the statistical agencies apply well-known seasonal adjustment techniques that are designed to remove calendar-related and holiday effects. Residual seasonality has meant higher inflation at the start of the year, which leads to less real activity after nominal variables are deflated.

Altogether, we have taken on board some of the signal from Q1 services spending and have trimmed our Q2 forecast for consumption. That said, we remain of the view that the economy is cooling but not slowing sharply. Our outlook now is for services consumption of 1.2% and overall consumption of 1.5% in Q2, both down from 2.1% previously, largely reflecting lower base effects rather than new assumptions. We expect monthly growth in services consumption of 0.12% per month, versus the 0.14% per month average from October through March. Based on the data to date and our forecast revisions, we are tracking real GDP growth of 2.0% in Q2, with final sales to domestic purchasers (GDP less trade and inventories) at 1.3%.

Labor market income is still outpacing inflation

In this section we provide additional detail on the evolution of labor market income and its ability to sustain personal consumption. In doing so, we note that there have been distortions in personal income in recent months that are likely sending false signals about the health of the consumer.

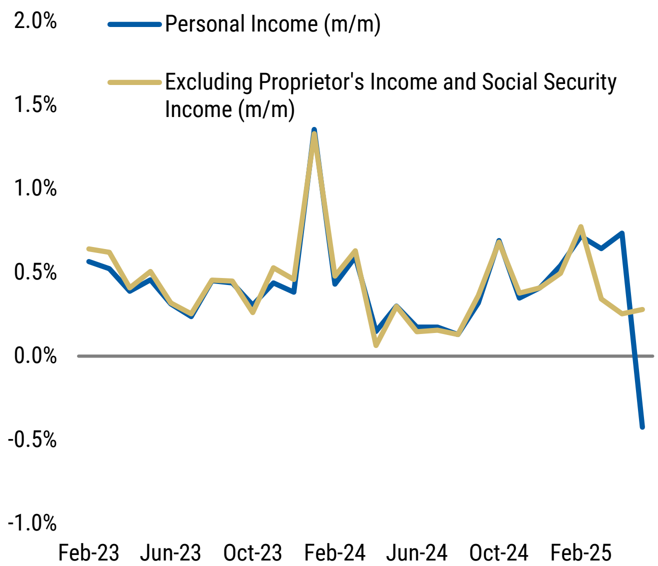
In particular, personal income declined in May. However, the decline in income was due to reversals from one-time programs that artificially boosted non-wage income in February, March and April. While income growth and labor market income have slowed from last year's pace, we do not think income has fallen at a concerning rate, and income growth is still outpacing inflation by a healthy margin.

On a nominal basis, personal income fell 0.4% m/m in May. The two drivers of the decline were Social Security income (-7.3% m/m) and proprietor's income (-2.3% m/m). We had been expecting a decline in Social Security income due to a reversal of one-time payments from the Social Security Fairness Act, which resulted in a 6.9% m/m increase in April. Proprietor's income had significant m/m gains in March and April as well due to payments from the Emergency Commodity Assistance Program as part of the American Relief Act. Part of this increase reversed in May. Removing these components, personal income would have been up 0.3% m/m.

In addition to the evolution of the payroll proxy, which measures growth in nominal economy-wide labor income, we also look to real labor income for signals on the underlying trend in income. Both variables inform our forecast of household spending. Growth in real labor income has slowed since last year, but remains robust, up 2.5% y/y. Real labor compensation was up 0.3% m/m in May, with the 3m average monthly increase at 0.2%, in line with that observed in 2024.

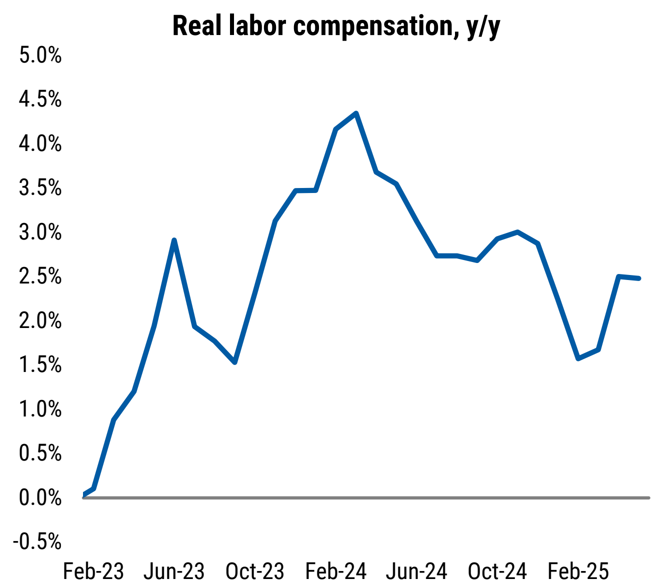
We expect growth in the payroll proxy and real labor compensation to slow in coming quarters as payroll growth slows and inflation temporarily accelerates on the heels of a higher effective tariff rate. So far, though, we have not seen a significant slowdown, as might have been feared from the headline income number from May.

Exhibit 6: Social Security and Proprietor's income drove the decline in personal income in May



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 7: Real labor income growth has slowed but remains solid



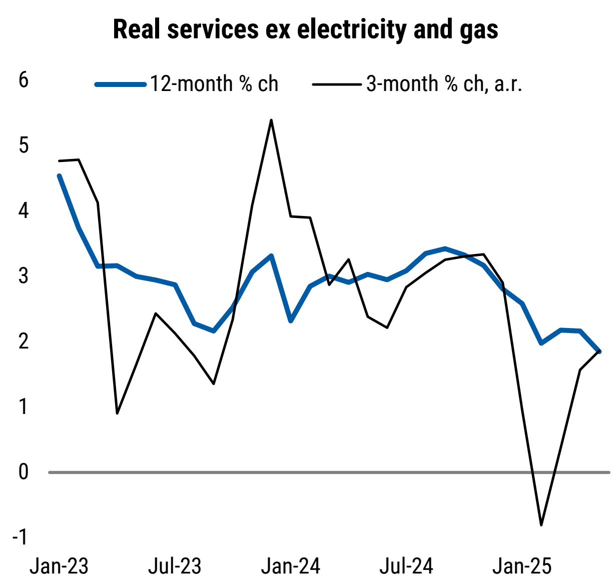
Note: y/y change in compensation of employees less y/y change in headline PCE inflation. Source: BEA, Haver Analytics, Morgan Stanley Research

We project acceleration in Q2 spending

Despite our rationale for looking through the softness in Q1 services spending, we remain watchful for signs that the data point to unexpected weakness in growth. We do expect tariffs and tighter immigration controls to slow activity over the course of the year, but we believe most of the policy-induced drag in activity remains in front of us. Hence, if the signal from Q1 services spending data is a turning point, it would represent deterioration in the economy much quicker than anticipated.

However, the incoming data so far in Q2 point to a modest rebound in consumer spending. We say "modest" since growth in consumer spending has slowed in 2025 versus 2024 as we noted above, but the April and May data to not suggest it has slowed further. In other words, the data in hand for the second quarter do not suggest the consumer downshifted to a slower pace of spending in the first quarter.

Exhibit 8: Real services consumption ex-utilities is pointing to a more benign slowdown in household spending, in line with our outlook



Source: BEA, Haver Analytics, Morgan Stanley Research

One way we draw this conclusion is exclude some of the special factors that we think distorted the data recently. For example, electricity usage was high at the turn of the year but has decelerated sharply since. The 18% annualized rate of decline in April-May over the Q1 average likely reflects weather rather than fundamentals, and therefore exaggerates weakness. The heat wave that has blanketed much of the Midwest and Northeast in recent weeks likely means utility usage will bounce higher in June. If we exclude spending on electricity and natural gas, remaining services expenditures are rising at a 1.5% annual rate, compared to 0.1% in Q1 and 3.2% in Q4. Smoothing through Q4 and Q1 gives a 1.7% annualized pace—about the same as the April-May data are suggesting. While this 1.5-1.7% pace suggests slowing from last year's average of 3%, it is not nearly as weak as Q1 data alone suggest.

Goods spending meanwhile is strong, up at a 2.2% pace 2Q-to-date. Auto sales in June even surprised modestly to the upside at 15.3mn units. The recent patterns in goods and services make us doubt that spending is slowing further.

There is room for error in judgement, however. There is always danger in saying "if we exclude the categories that fell, the other parts rose." Goods spending may still reflect demand pulled forward by fears of tariffs. And services expenditures in April and May could be revised lower, just as they were in Q1. The BEA uses employment data to help estimate of spending on services in the advance estimate of GDP. It isn't until the second release of GDP that more detailed services company revenues data are incorporated into spending data. But the initial indications for 2Q are positive.

Another reason we are willing to look through softness in discretionary services spending at the turn of the year is the behavior of business spending. Equipment spending rose by 23.7% on an annualized basis in Q1 and intellectual property investment rose 6.0%. While the acceleration in business spending to start the year likely benefitted from front-running of tariffs, stronger-than-expected durable goods orders and shipments for May led us to revise higher our estimate of equipment investment in Q2. We now look for equipment spending to be up 8.0% q/q saar in the quarter on the heels of the surge in Q1. Trade policy may be inducing volatility into business spending, but the underlying trend remains favorable.

We acknowledge there is a chicken-and-egg aspect to business spending and changes in aggregate demand, with the historical data suggesting that business spending lags changes in demand. As a result, it is possible that the slowdown in consumer spending presages a deceleration in business spending. That said, the strength in business spending could also be signaling that business output is not slowing much on the heels of softer discretionary services spending by households.

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