US Daily: The Consumer Remains More Likely to Cruise than Crack (Briggs)

- Overall spending remains healthy but concerns around the consumer (particularly at the lower end) have picked up on the back of weaker company commentary, a weak April retail sales report, and signs of a slowing labor market.
- Despite the recent softer signals, we maintain our long-held view that a worker-friendly labor market will support consumer outperformance. Under our baseline labor market assumptions of 150-175k monthly job gains and 3.5% wage growth through end-2024, we forecast a healthy 2.5% pace of real income growth with positive gains for all income quintiles in 2024, which should translate to healthy spending growth.
- We put some weight on the softer signals this spring, however, and see three factors that likely led to some slowing. First, increased tax withholding and capital gains tax payments at the start of 2024 raised the effective tax rate, thereby lowering discretionary cash flow. Second, tax refunds declined in real dollars. Third, upside inflation surprises in Q1 weighed on real income and spending growth and likely lowered consumer sentiment. The good news is that these headwinds are all backward looking, assuming inflation cools in line with our forecast.
- We also see two risks that could slow spending growth going forward. First, rising delinquency rates and signs that some lower-income households are exhausting borrowing capacity raises the possibility that households will have to cut back on spending, but the impact on overall spending should be small. Second, we see more meaningful spending risks if the recent labor market softening extends too far, as each 1pp increase in unemployment would likely lower overall spending by 0.6%, led by a 1.2% spending hit for lower-income households.
- On net, we put more weight on the likelihood that spending momentum will continue and forecast 2.6% real PCE growth in 2024 on a Q4/Q4 basis, well above consensus. That said, we continue to see risks around our spending growth forecast as asymmetrically skewed to the downside, mostly because the saving rate is already low and there is no clear catalyst for an acceleration in spending going forward.

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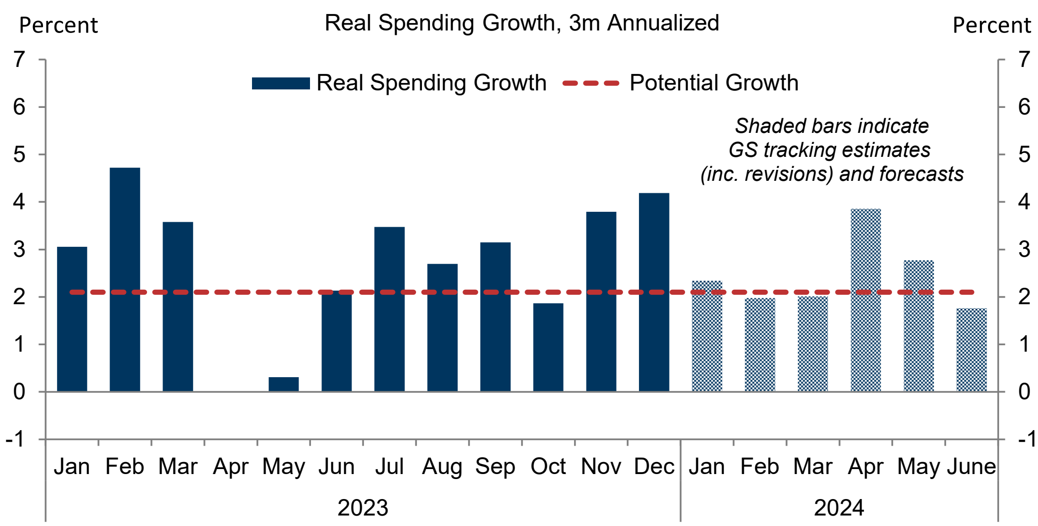
The Consumer Remains More Likely to Cruise than Crack

Concerns around the consumer have picked up on the back of weaker company commentary, a weak retail sales report in April that also revised down prior months' spending, and signs of a slowing labor market. Despite these negative signals, overall spending growth remains strong. As shown in Exhibit 1, real spending growth tracked comfortably above potential in the second half of 2023 and at a near-potential pace in Q1 (even after accounting for downward spending revisions), and we expect it to remain healthy through Q2 (in part due to strong spending momentum).

Exhibit 1: We Expect Real Spending Growth to Remain Healthy



Source: Haver Analytics, Goldman Sachs Global Investment Research

Nevertheless, investors remain concerned that overall strong spending growth could mask weakness under the surface, especially since companies increasingly called out a weaker lower-end consumer in Q1 earnings calls (Exhibit 2). In particular, many companies suggested that higher rates and price levels have forced consumers in lower income strata to make increasingly difficult trade-offs that could eventually lead to a pullback in spending.

Exhibit 2: Concerns Around the Consumer Have Risen, Particularly at the Low End

Source: GS Data Works, Goldman Sachs Global Investment Research

From the perspective of the overall economy, we are less worried about the consumer weakening, continue to expect that strong household cashflow (including at the bottom end of the income distribution) will support consumer spending, and see several of the factors that negatively affected the consumer in Q1 as backward looking. We therefore continue to forecast 2.6% real PCE growth in 2024 on a Q4/Q4 basis, but see risks around our spending growth forecast as asymmetrically skewed to the downside, mostly because the saving rate is already low and there is no clear catalyst for an acceleration in spending.

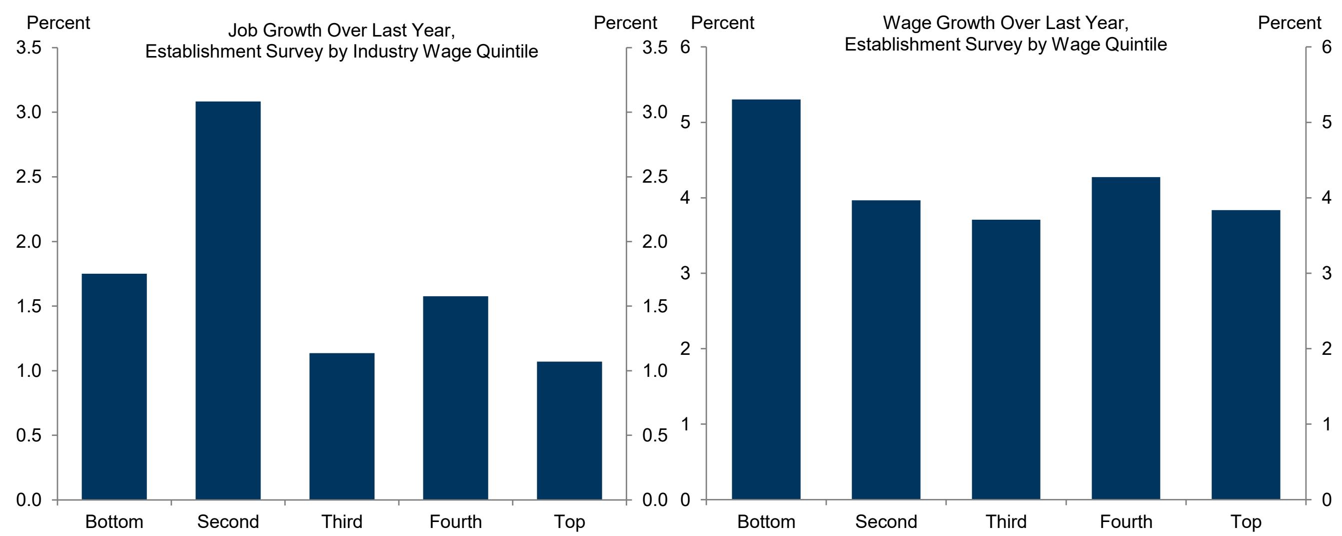
Consumer Fundamentals Still Look Strong

The main reason that we anticipate that consumer spending—including among lower-income consumers—will prove more robust than expected is that the labor market has driven and will likely continue to drive healthy real income gains.

Despite the stepdown in April job growth, monthly job gains have averaged 242k over the past 3 and 6 months, and our estimate of the underlying trend pace of job growth based on payrolls and household employment is 209k. And while wage gains have slowed from their peak in 2022-2023, our wage tracker continues to point to an above 4% pace of wage growth, and we forecast 3.9% wage growth in 2024 on a Q4/Q4 basis.

These patterns are also true if we focus on the lower-income cohorts that have received the most scrutiny. Over the last year, job gains have disproportionately accrued to lower-income workers (left chart, Exhibit 3) due to outsized increases in leisure and hospitality and lower-wage health care employment, and wage growth remains firmest for workers at the bottom end of the earnings distribution (right chart, Exhibit 3). These patterns imply that labor income is outperforming for lower-end consumers, in some contrast to the popular narrative of low-end weakness.

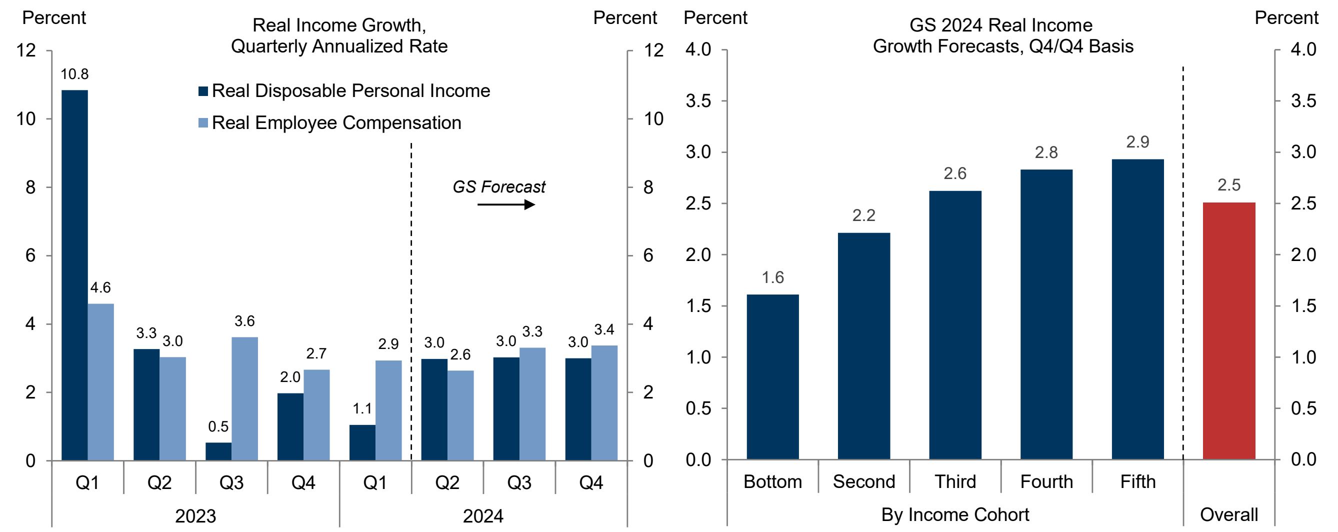
Exhibit 3: Job Gains and Wage Growth Remain Healthy, Particularly for Lower-Income Workers



Source: US Bureau of Labor Statistics, Goldman Sachs Global Investment Research

As a result, our income outlook remains on track despite softer real disposable income growth in Q1, and we forecast that real DPI will grow by 2.5% in 2024 on a Q4/Q4 basis (in line with its historical average; left chart Exhibit 4). Furthermore, we expect comfortably positive income growth for all income quintiles (right chart, Exhibit 4), although we anticipate underperformance for lower-income households due to weaker growth in transfer income (largely reflecting a post-pandemic normalization in Medicaid enrollment) and outperformance for higher-income households due to outsized gains in interest income on the back of higher rates.

Exhibit 4: Household Income Should Grow at a Healthy Pace in 2024 Due to Continued Labor Income Gains



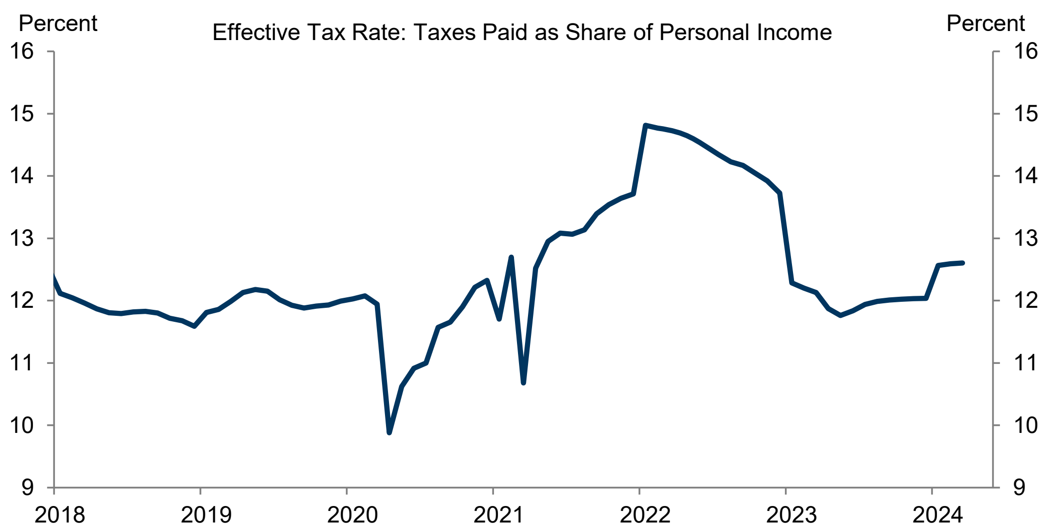
Source: Haver Analytics, Goldman Sachs Global Investment Research

Consumer Headwinds This Spring Should Prove Temporary

We put some weight on the softer signals this spring, however, and see three factors that help explain the negative sentiment around consumer spending, particularly at the end of Q1 and start of Q2.

First, tax withholdings—which are based on tax brackets that reset to realized inflation with a lag—increased by more than expected at the start of 2024. The effective tax rate (tax payments divided by personal income) rose by 0.6pp relative to end-2023 through March, effectively lowering real disposable personal income (DPI) growth by 2.4pp on a quarter-on-quarter annualized basis in Q1 (Exhibit 5).

Exhibit 5: Higher Tax Withholdings Have Weighed on Cashflow Since the Start of 2024

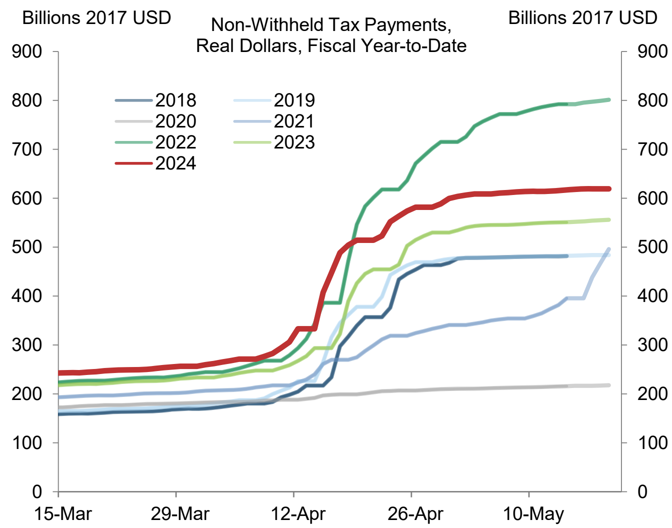


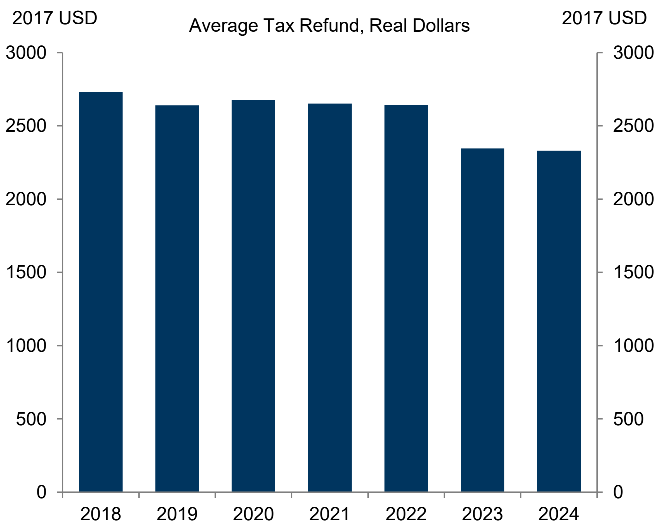
Source: US Bureau of Labor Statistics, Haver Analytics, Goldman Sachs Global Investment Research

Second, capital gains tax payments (proxied by non-withheld tax receipts) increased by more than expected this spring and are currently tracking more than $60bn above 2023 levels in real terms (left chart, Exhibit 6), thereby creating a headwind to spending around the April tax deadline. Furthermore, this increase in tax payments, as well as a hit from a moratorium on employee retention tax credit (ERTC) claims, can explain some (but not all) of a decline in real average tax refunds in 2024 relative to prior years (right chart, Exhibit 6).

Although capital gain payments and ERTC credits are generally more relevant for higher-income households, tax refunds account for an outsized share of income for households toward the bottom-end of the income distribution (16% of total annual income for households making $10-25k per year; 8% for households making $25-50k per year). While it is hard to tell which households received lower tax payments in 2024, we suspect weaker tax refunds (in real dollars) explain some of the softening noted by companies in recent months.

Exhibit 6: Higher Capital Gains and Lower Tax Refunds Likely Created a Spending Headwind in March and April

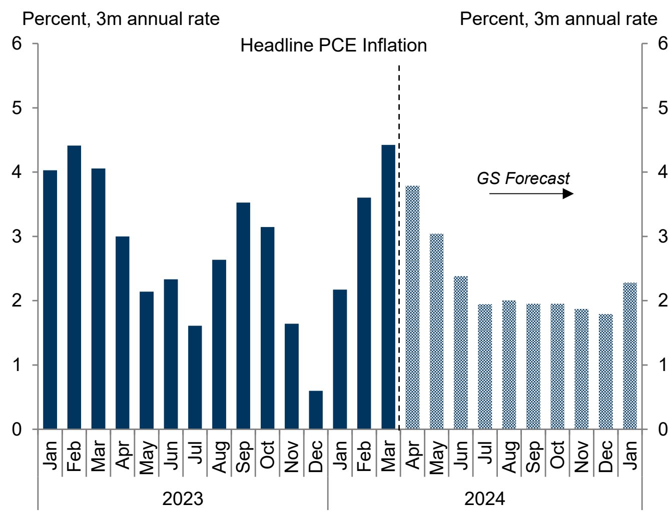


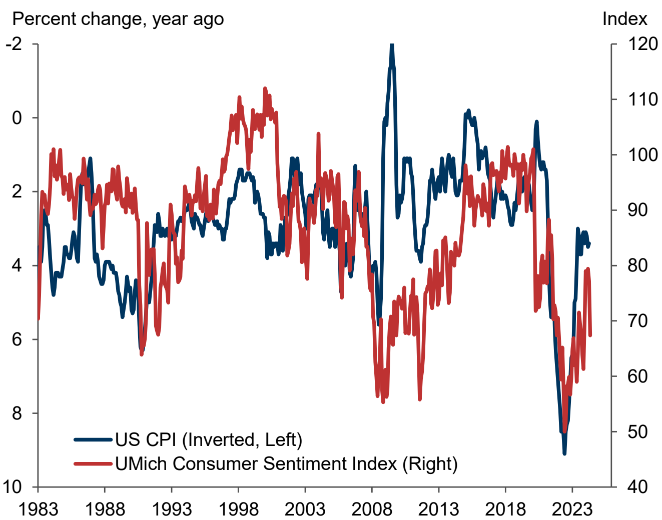


Source: Haver Analytics, Goldman Sachs Global Investment Research

Third, upside inflation surprises in Q1 (left chart, Exhibit 7) likely weighed on consumer spending for two reasons. First, larger-than-expected price increases eroded nominal income gains and household spending power. Second, consumer sentiment is highly correlated with inflation (right chart, Exhibit 7), implying that the Q1 inflation surge likely lowered households' assessment of the overall economic outlook, particularly for lower-income households who remain most exposed to price increases.

Exhibit 7: Higher Inflation Likely Weighed on Consumer Spending Power and Sentiment in Q1





Source: Haver Analytics, Goldman Sachs Global Investment Research

Assuming that recent consumer softness is mostly explained by higher taxes and inflation, any recent consumer setbacks should prove temporary. In particular, the increase in tax payments will not repeat now that we are past tax season, and our inflation forecast implies a more benign pace of inflation for the remainder of 2024.

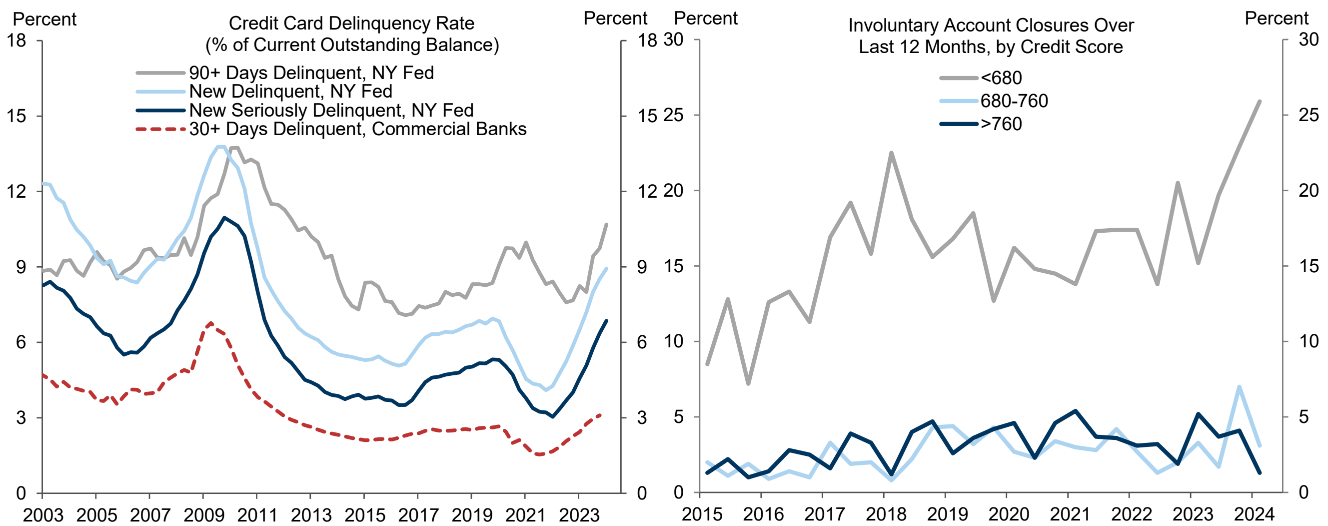
Two Risks for the Consumer Going Forward

Recent data raise two risks that could lead to some incremental slowdown in spending, particularly for lower-income consumers.

First, the NY Fed's Consumer Credit Panel showed an incremental rise in credit card delinquency rates in Q1 (left chart, Exhibit 8) with an accompanying note from NY Fed staff noting that this rise is disproportionately driven by younger, lower-income borrowers that have maxed out credit cards, potentially reflecting greater inflation exposure and the restart of student loan payments. This rise in delinquency rates and finding that some younger and/or lower-income households over-borrowed in the aftermath of the pandemic aligns with our findings from the end of last year and raises risks that some households will have to cut back on spending if credit constraints bind.

The right chart of Exhibit 8 suggests that credit for lower-income and riskier borrowers may be pulling back. The share of households reporting an involuntary account closure has recently increased to its highest level since 2015 according to the NY Fed's Survey of Consumer Expectations, which combined with the increase in rates of maxed out borrowers mentioned above, suggests that credit-driven spending may be ending for some households.

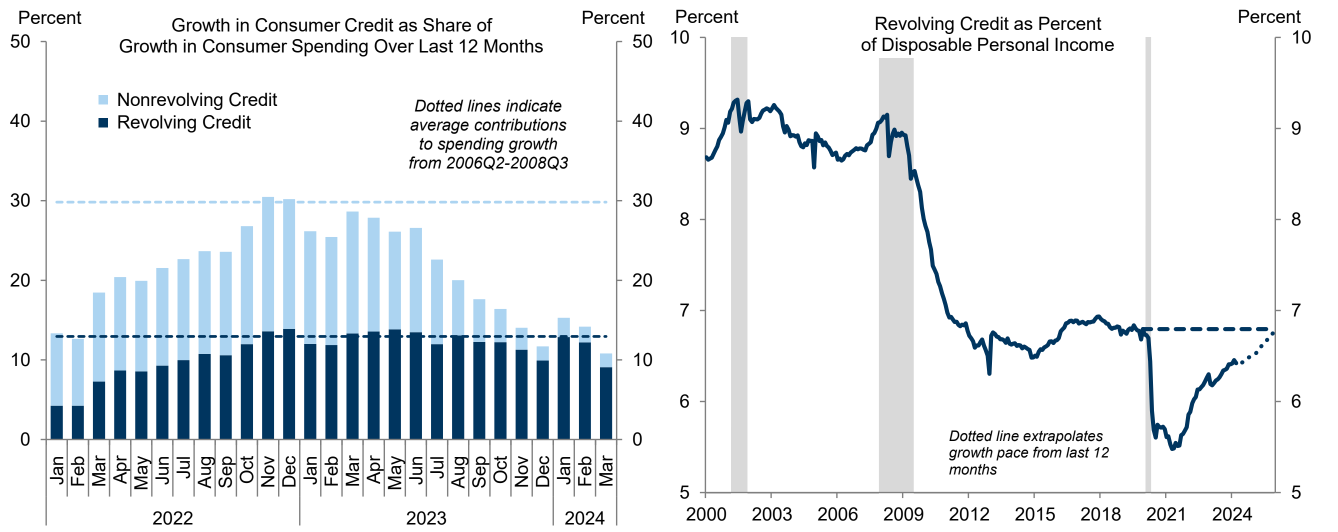
Exhibit 8: Rising Credit Delinquencies Signal Some Stress Among Lower-Income Borrowers...



Source: New York Federal Reserve, Haver Analytics, Goldman Sachs Global Investment Research

However, we do not see rising delinquency rates or lower borrowing capacity as a significant risk to overall spending. Consumer credit accounted for just 9% of spending growth over the last year, a relatively low share by historical standards (left chart, Exhibit 9). To put this contribution in perspective, if household credit growth had contributed nothing to spending growth over the last 12 months, real spending would still have grown at a robust 2.8% pace (rather than the 3.1% pace observed). Furthermore, household credit card balances as a share of income remain comfortably below 2019 levels (right chart, Exhibit 9), suggesting most households still have spare borrowing capacity and are unlikely to face forced spending cuts anytime soon.

Exhibit 9: ...But Slower Credit Growth Suggests the Risk to Overall Spending Is Small



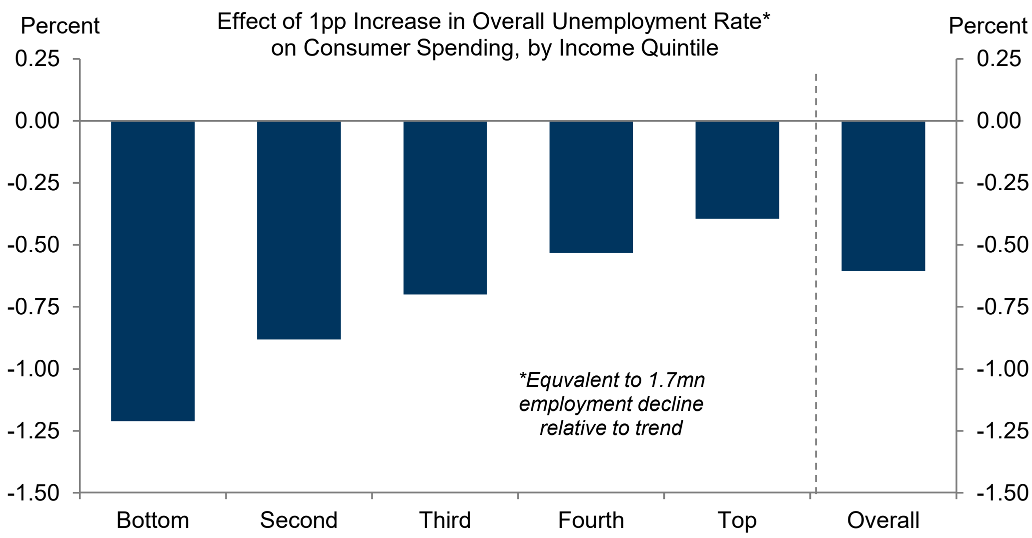
Source: Federal Reserve Board, Haver Analytics, Goldman Sachs Global Investment Research

Second, despite our positive labor market outlook, we see increasing signs that US employment growth is slowing. Nonfarm payrolls grew only 175k in April, the unemployment rate rose to 3.9%, the employment components of the ISM and S&P/Markit purchasing managers' indices have fallen below 50, and the New York Fed Survey of Consumer Expectations shows a notable decline in job-finding expectations in the event of job loss over the past several months. While none of these patterns are worrisome when viewed in isolation, the broad set of signals raises some risk of a labor market slowdown.

We expect such a slowdown would disproportionately hit spending of lower-income households, as they tend to be most exposed to job loss in downturns and are more likely to cut spending when job losses occur.

Exhibit 10 shows our estimates of spending hits after accounting for differences in exposures to job loss, effects on wages, offsets from unemployment insurance and other transfers, as well as spending responses to lost income. We estimate that each 1pp increase in the overall unemployment rate lowers spending by 1.2% for households in the bottom income quintile but only 0.4% for households in the top income quintile. As a result, we continue to see an unexpected labor market deterioration as the biggest risk to our relatively positive consumer outlook, particularly at the low end.

Exhibit 10: A Slowing Labor Market Could Weigh on Spending, Particularly for Lower-Income Households



Source: Goldman Sachs Global Investment Research

Reiterating Strong Baseline Spending Outlook, but With Upside Limited

On net, we put more weight on the likelihood that spending momentum will continue and forecast 2.6% real PCE growth in 2024 on a Q4/Q4 basis. That said, we continue to see risks around our spending growth forecast as asymmetrically skewed to the downside. While this view partially reflects the downside risks to spending discussed above, it mostly reflects that the saving rate is already low and there is no clear catalyst for an acceleration going forward, so we put little weight on the possibility that spending meaningfully accelerates from its current pace.

Joseph Briggs

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Ronnie Walker, Manuel Abecasis, Tim Krupa, Elsie Peng, Jessica Rindels and Joseph Briggs, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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