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Economics Group

Special Commentary

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Consumer Outlook in a Rising Rate Environment

Executive Summary

Conventional wisdom has it that rising interest rates are bad for consumer spending because swelling financing costs put a squeeze on a household's capacity for other outlays. What if conventional wisdom is wrong? Our analysis finds that a rising interest rate environment does not immediately snuff out consumer spending growth.

As the current expansion stretches further into its tenth year, the economy is on track to eclipse the expansion of the 1990s as the longest on record. In this report we consider the outlook for consumer spending against this backdrop of a record-setting expansion and consider how long the good times will last. Our base-case scenario, spelled out in this special report, anticipates a modest pick-up in consumer spending, at least in the near term. Eventually, like all good things, the longest economic expansion on record will come to an end and consumer spending will come back down with it. That will likely occur alongside financial conditions that warrant rate cuts by the Fed. The precise timing of these events is tough to get right, but by signaling this drop-off in activity in late 2020, we are essentially saying that while the end of the party is not imminent, no cycle lasts forever.

Figure 1

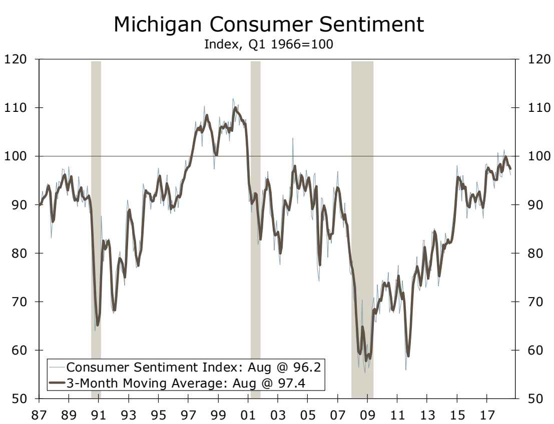
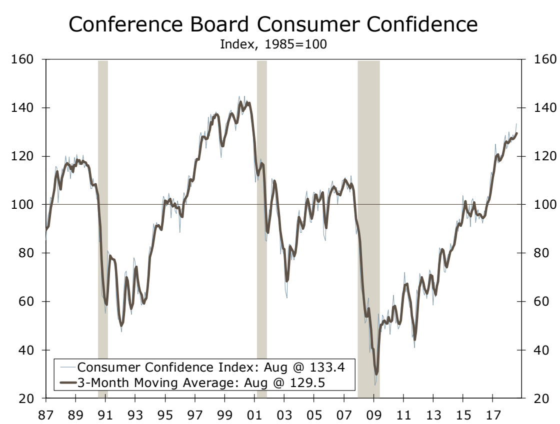


Figure 2



Source: Bloomberg LP, The Conference Board, University of Michigan and Wells Fargo Securities

Measures of consumer sentiment and confidence are at levels last seen in the late stages of the 1990s expansion.

A Consumer Spending Framework in the Context of Rates

As we would at any time in the business cycle, we consider the macro drivers of consumer behavior. Consumer sentiment and confidence, by about any measure, are at or near high levels last seen around 2001; which, not coincidentally, was in the late stages of that prior long-lasting expansion (Figures 1 & 2). We also look at the purchasing power in consumers' wallets, be it in the form of personal income, which is at last picking up (albeit in only a modest way) or in access to capital through borrowing, where measures of revolving consumer credit growth indicate a levelling off more recently. Finally, we tally the actual spending numbers reflected in the personal income and spending report and the monthly retail sales numbers, both of which have been on a roll in recent months.

For seven years in the current cycle, the Fed kept rates near zero and at various points was engaged in a broad expansion of the balance sheet.

In an effort to better inform a consumer outlook, it is essential to have a framework for thinking about these fundamentals and how households will manage finances at this late stage of the cycle. The trouble with considering this period in the context of what has happened in prior cycles is that for a long stretch in the current cycle, from December 2008 until December 2015, the Federal Reserve maintained a near zero interest rate policy (ZIRP), and at various points during those years was engaged in a broad expansion of the balance sheet through quantitative easing (QE), (Figures 3 & 4).

The Fed has historically purchased Treasury securities to expand the monetary base, although the monetary policy "medicine" applied during that era, including the purchases of mortgage-backed securities and other assets, had not been tried before, at least not in the United States.

Figure 3

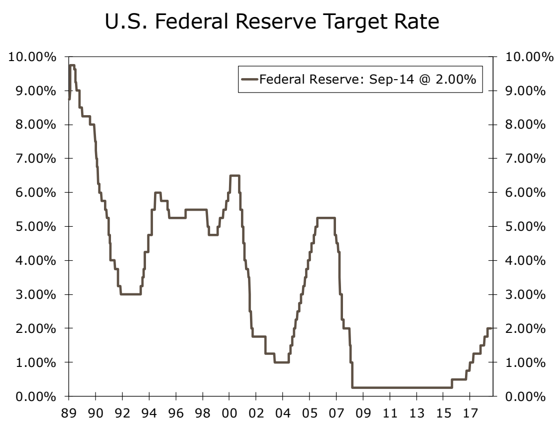
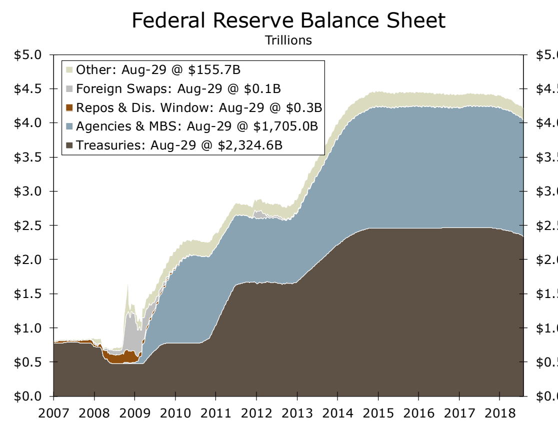


Figure 4



Source: Federal Reserve System and Wells Fargo Securities

Central bank actions, no doubt, are a factor in the remarkable duration of the current cycle, and on that basis any informed outlook for consumer spending ought to not only consider these macro drivers (like confidence, access to capital and willingness to spend) but to consider them in the context of Fed policy.

To that end, we went back to just before the 1990s expansion began in 1989 and divided the years since into four broad categories based on what the Federal Reserve was doing with monetary policy at the time: (1) lowering the fed funds rate, (2) a "stable" rate environment, (3) raising the fed funds rate and (4) ZIRP with QE.

The date ranges for each of these periods is spelled out in Table 1 below. Most of the time periods are straightforward, although the one period that might invite critique is that we have characterized the time period from March of 1995 through January 2001 as "stable" (revisit Figure 3).

We divided the years since 1989 into four broad categories based on what the Federal Reserve was doing with monetary policy.

Table 1

Fed Policy Theme Dates			
Fed Cutting Rates	**Stable Fed Funds**	**Fed Raising Rates**	**ZIRP & QE**
5/1/1989 to 9/1/1992	9/1/1992 to 2/1/1994	2/1/1994 to 3/1/1995	12/1/2008 to 12/1/2015
1/1/2001 to 6/1/2003	3/1/1995 to 1/1/2001	6/1/2004 to 6/1/2006	
9/1/2007 to 12/1/2008	6/1/2003 to 6/1/2004	12/1/2015 to 8/1/2018*	
	6/1/2006 to 9/1/2007		

**Last Data Point Avilable*

Source: Bloomberg LP, Federal Reserve System and Wells Fargo Securities

One could reasonably observe that the fed funds rate actually moved up and down during that nearly six-year stretch. Our argument for calling it "stable" is that this period was essentially from the "mid-cycle" slowdown until the end of that expansion. Admittedly, there were adjustments up and down throughout the period, but from the start of the period to the end, the funds rate finished just 50 basis points higher. Reasonable minds could disagree, but in our view, the idea of thinking of that period as four unique rate cycles would unnecessarily complicate our analysis.

With our various Fed cycle dates established, we looked at our macro drivers for consumer spending through the lens of the Fed policy that was in place at the time. For each interest rate backdrop, we calculated the average levels for various measures of **consumer confidence**, the average annualized growth rate of **personal income**, the average net monthly expansion in **consumer credit** and finally the average annual growth rates of both **real personal consumption expenditures** and of **nominal retail sales**.

With our Fed cycle dates established, we looked at our macro drivers for consumer spending through the lens of Fed policy.

A key takeaway from our exercise, depicted in Table 2 below, is that measures of consumer fundamentals tend to do best in periods of stable interest rates. Interestingly though, a rising rate environment is almost as good for these same consumer fundamentals. Perhaps that is not altogether surprising, considering that the Fed is apt to raise rates when the economy is at full employment and inflation is heating up beyond the Fed's comfort zone. Those factors tend to exist when the economy is doing particularly well or even overheating.

Table 2

Consumer Indicators by Fed Policy Theme

Fed Policy Theme	U of M Consumer Sentiment Index	Conf. Board Consumer Confidence Index	Real Personal Income Growth	Real PCE	Consumer Credit (Millions of USD)	Nominal Retail Sales
	Avg Index Level	*Avg Index Level*	*Avg CAGR*	*Avg CAGR*	*Avg Net Monthly Change*	*Avg CAGR*
Fed Cutting Rates	81.10	84.50	1.57%	1.69%	$5,090	1.22%*
Stable Fed Funds	95.84	108.58	3.97%	3.85%	$9,050	6.28%
Fed Raising Rates	92.81	105.58	3.24%	2.99%	$12,767	5.91%
ZIRP & QE	76.70	68.64	2.59%	1.81%	$9,103	4.54%

****Does not include all cycles of Fed Policy Theme***

Source: Bloomberg LP, Federal Reserve System, The Conference Board, University of Michigan, U.S. Department of Commerce and Wells Fargo Securities

The inverse of that dynamic may explain why the worst rate theme for consumer spending is during periods when the Fed is lowering rates. Personal income and spending as well as nominal retail sales all performed worst during periods when the Fed was cutting rates. Interestingly, the lowering of interest rates does not compel consumers to increase their appetite for credit, at least not immediately. The average net monthly increase in consumer credit came in a distant last during periods when the Fed was actively lowering rates.

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2020 Vision

So what sort of Fed policy theme should we consider looking forward? To judge from the Fed's dot-plot, a visual rendering of policymakers' own forecasts for the fed funds rate, the FOMC is closing in on its neutral rate for fed funds. With most dots clustered around 3.00 to 3.25% and the current fed funds rate at 2.00%, there are only four or five quarter-point rate hikes left to go in the current cycle, barring some change in forward guidance from the Fed (Figure 5). Our forecast anticipates two more hikes this year and another three next year. After that it stands to reason we would be in a stable rate environment slightly above the neutral rate until the Fed's understanding of r* changes (favoring another hike) or until conditions warrant a cut. In a separate special report[1], we explained our use of an analytical framework we recently developed to inform our view of Fed policy going forward and why we look for the FOMC to raise rates another 125 bps before it cuts rates at the end of 2020.

[1] **Bryson, Jay. *How Much More Is the Fed Likely to Tighten?* Wells Fargo Economics. September 12, 2018.**

In forming our outlook for the consumer, we take the findings of our rate-environment study and overlay them with our expectations for Fed policy over the next couple of years. If things play out the way we anticipate, monetary policy is entering an era of transition unlike anything the economy has seen in more than a decade. For a number of factors including the longevity of the cycle, growing fiscal budget imbalances and a potential fallout from the global economy, we indicated in our initial 2020 forecast that by the end of our forecast horizon the Fed would likely begin cutting the fed funds rate.[2] A rate-tightening environment is expected to prevail at least through the first part of 2019, which will be followed by a stable rate for another year or so before the Fed begins to signal eventual rate cuts.

By the end of our forecast horizon the Fed is expected to begin cutting the fed funds rate.

Figure 5

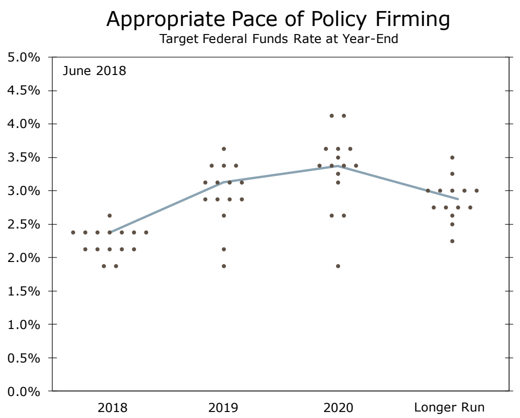
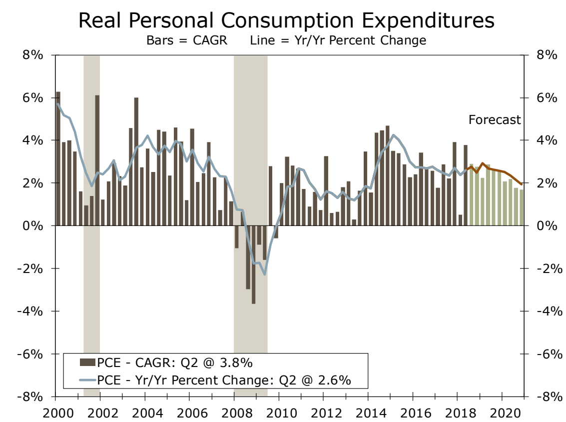


Figure 6



Source: Bloomberg LP, Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Securities

For the consumer, this Fed forecast implies a pick-up in the pace of consumer spending in the near term before an eventual slowing the further out we go in the forecast period. Full year PCE growth was 2.5% in 2017. By the time we close the books on the current year, we expect the comparable number for 2018 to pick up to 2.6%, prior to quickening to 2.7% in 2019 and slowing to just 2.2% in 2020 (Figure 6).

Outlook

Consumers may be better prepared to endure a slowdown than in the past. The saving rate, currently at 6.7%, is rather elevated given the late stage of expansion, while real median household income surpassed its pre-recession peak in 2017. With the unemployment rate currently matching low levels last seen in the late 1960s, there remains little slack in the economy. The labor market is expected to grow increasingly tight, with the unemployment rate trending to as low as 3.3% by 2020. Similarly, inflationary pressures that continue to gradually build over our forecast horizon will put downward pressure on real income gains.

We anticipate consumer spending will grow at a gradually slower rate throughout the forecast period.

The length of the current expansion is expected to surpass that of the 1990s, taking the title as the longest expansion on record. While monetary policy changes act as signals to markets about the health of the economy and/or concerns about inflation expectations, we must be sensitive to policy movements and their implication for consumer spending. Our initial 2020 forecast expects the Fed to surpass its neutral rate, prior to beginning to cut policy by the end of 2020. With this signal of a slowdown in activity, we are essentially saying that this expansion will eventually draw to a close. The rate cutting environment will act as a last call announcement – and for the consumer sector it serves as a valuable indication for longevity of this expansion.

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[2] For our initial publication where we extend our forecast to include 2020 estimates, please see our September *Monthly Economic Outlook* report.

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