

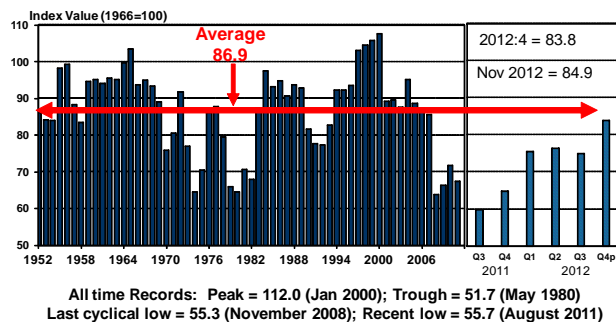
Consumers Adapt to a New Economic Era: More Optimism with Less Achievement

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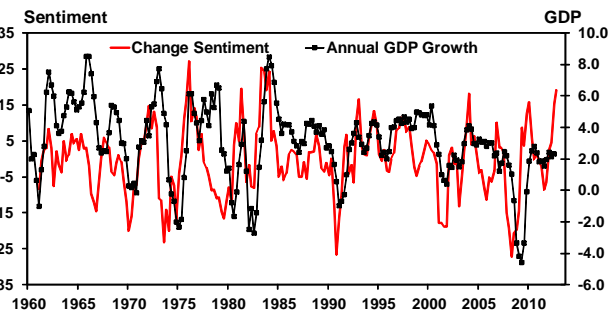
Introduction

We live in extraordinary economic times. Despite the high anxiety expressed on Wall Street and within the DC beltway, consumers have become much more optimistic about future economic prospects. They have become so optimistic that many believe it can only lead to disappointment. The Index of Consumer Sentiment rose to 84.9 in early November, a 21.2 Index-point gain from last November. This is the most optimistic consumers have been in five years (see Chart 1). The surge has been so large that consumer confidence is now nearly equal to its long term average of 86.9. How can consumers justify such renewed optimism given their diminished incomes, continuing high unemployment, and the looming fiscal cliff? Sure, it has always been true that consumer expectations begin to improve just when conditions in the economy seem bleakest. That is why the data from the Surveys of Consumers is part of the Index of Leading Economic Indicators. But the recent runup in optimism seems to many observers to be well beyond what the economy can reasonably accomplish in the year ahead. This judgement seems to be confirmed by consumers themselves based on the historical relationship between changes in the Sentiment Index and annual GDP growth (see Chart 2). Even when using a regression model to more closely align changes in the two series, the Sentiment Index is now consistent with a GDP growth rate of about 4% in 2013. Most economists think the economy is incapable of delivering such a rapid pace of growth in 2013. Moreover, in this hyper partisan atmosphere, it will be difficult enough to even partially bridge the fiscal cliff before the end of the year. What were consumers thinking?

**Chart 1: Consumer Sentiment Posts Strong Gains:
Can Gains Be Sustained?**



**Chart 2 : Sentiment Signals Robust GDP
Growth During Year Ahead**



To make the situation even more confusing, the re-election of President Obama was a record-breaking achievement given the weak economy. Over the past half century, whenever a President ran for re-election, if the Sentiment Index was above 90.0, he won, and when the Sentiment Index was below 80, he lost (see Chart 3). While elections are always contests between two individuals, Obama clearly won his second term against the economic odds. Consumers' evaluations of economic policies is another indicator. Presidents Carter and Bush senior as well as Obama mounted their re-election campaigns during times of highly negative evaluations of their economic policies (see Chart 4). Carter and Bush lost, while Obama won. To be sure, opinions became slightly more positive as the election approached, but Obama nonetheless beat the odds on this count as well. I will leave this conundrum to political scientists to explain, I only will note that the lockstep nexus between economics and politics has lessened. Is something new afoot? Has the Great Recession changed consumer behavior in a more fundamental way?

Chart 3: Consumer Sentiment and Reelections: Obama is the Exception.
(Sentiment Index level in quarter prior to election)

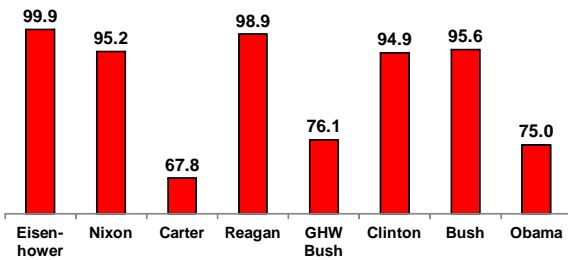
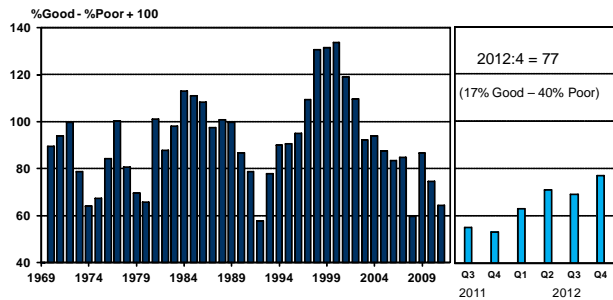


Chart 4: Government Economic Policies: Small Rise in Confidence in Obama's Policies



Most of the recent gains in confidence were attributed by consumers to ordinary economic factors such as improved prospects for jobs and incomes, a reduced debt burden, and rising home values. Consumers' concerns about the looming fiscal cliff were neutralized by Obama's repeated assurances of no new taxes, except for wealthy families, and no cuts in entitlement programs. Despite the close polls among likely voters, two-thirds of all consumers in the September and October surveys expected an Obama victory. This implies that most people had already anticipated an Obama victory when they expressed their much more favorable expectations in the past few months. It is hard to believe that a byproduct of this bitter election was a surge in economic optimism. It is more likely that the spark of optimism was due to the usual economic factors that were reported by consumers. Likewise, the upturn in confidence depends on continued gains in jobs and incomes as well as a safe and timely passage across the fiscal cliff. Importantly, these economic concerns represent the usual suspects of economic expansions and contractions and hardly indicate any fundamental shifts.

Four years ago at this conference I outlined five stages of economic discontent. In the final stage, people relinquish hope that their economic losses will be restored and increasingly favor economic security. It is now time to expand that discussion by noting that the last stage of discontent sets the stage for recovery. In the final stage of discontent, consumers are forced to lower their material aspirations. There is nothing pleasant about this process, but once it is done, it allows people to view what would have otherwise been unacceptable economic outcomes much more positively. In retrospect, it is always surprising how easily people adapt to new economic limitations. People show a remarkable acceptance of economic conditions that were previously considered intolerable. At the time, of course, any accommodation seems impossible.

Nonetheless, this accommodation sets the stage for renewed growth in material aspirations, and the cycle then repeats. While public policies and institutions have long attempted to eliminate the development of economic booms and busts, those human instincts have proven to be irrepressible.

I suggest that consumers' very favorable expectations are due in small part to their resetting the yardstick they use for comparisons. The economic fallout from the Great Recession was so deep and so damaging, consumers now judge even an unchanged economic situation much more favorably. This shift in comparison standards is best shown by how consumers evaluate their personal financial situation, but it also extends to how they view the overall economy.

Personal Financial Prospects

A careful examination of people's views about their financial situation reveals that the financial reversals that have plagued U.S. households during the past several years have eased considerably. Importantly, it is the mere absence of financial reversals that consumers now judge a cause for celebration. Rather than fearing accelerating job losses, consumers generally feel more secure in their jobs. That renewed sense of security has offset even the expectations of stagnant wage growth. Even the modest inflation rate that now prevails is larger than the income gains most consumers expect. Indeed, consumers now anticipate outright declines in their inflation-adjusted incomes in the years ahead. At no other time in the past half century have consumers been so positive about prospects for slowly eroding living standards!

An improved financial situation was reported by 36% of all consumers in the latest survey, the highest proportion since November 2007 (see Chart 5). Despite this welcome gain, a slightly larger share of households (37%) reported that their finances had worsened during the past year. Nonetheless, this represents a substantial improvement from last year, when worsening finances were reported nearly twice as frequently as an improving financial situation. When asked to explain how their finances had changed, consumers cited as frequently income gains as losses for the first time since 2007 (see Chart 6) as well as more positive trends in household assets and debts. References to wealth declines fell to just 8% in the most recent survey, down from a peak of 24% in early 2009. While household income and wealth is still depressed for most households, consumers justly took the recent gains as a very positive sign.

Chart 5: Current Financial Situation of Consumers Improves

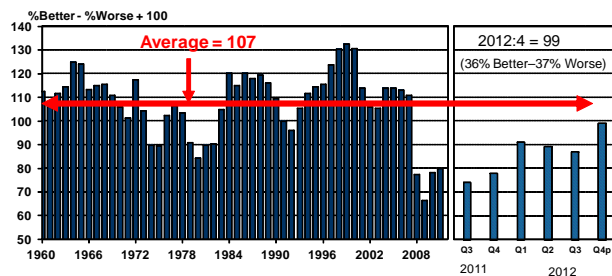
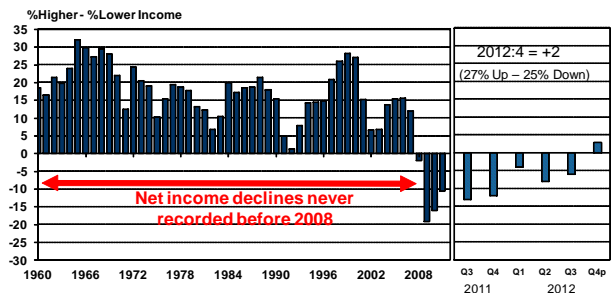


Chart 6: Recent Income Changes Barely Positive After Years of Record Lows



When asked about future financial prospects, consumers clearly expected to avoid any additional setbacks, as worsening finances were expected by just 12% of all households (see Chart 7). While the proportion who expected financial gains improved to 29% in late 2012, by far the most common response,

reported by half of all consumers, was that they anticipated their finances would remain largely unchanged during the year ahead. The chief reason was that half of all consumers expected no increase in their household income (see Chart 8). The median expected annual income increase was just 0.65%, barely above the extraordinary lows recorded in the past four years.

Chart 7: Improved Personal Financial Prospects Expected During Year Ahead

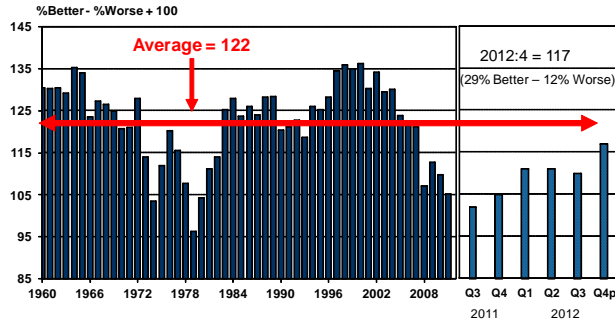
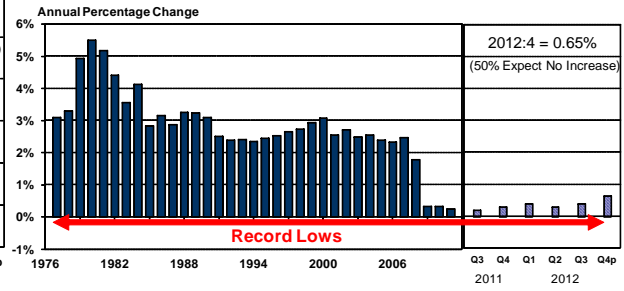
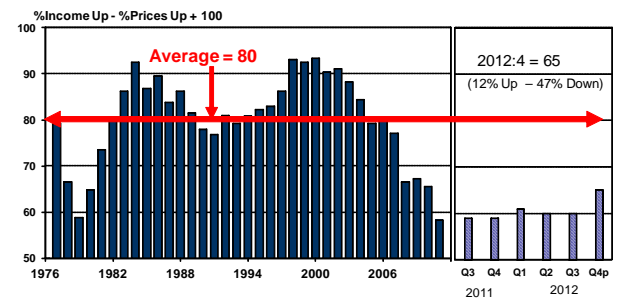


Chart 8: Income Prospects Remain Grim: Majority Expect No Gains in Nominal Incomes



Although consumers anticipate a low inflation rate in the years ahead, the expected inflation rate was four times as large as the expected growth rate in income. As a result, most households anticipated a declining inflation-adjusted income during the years ahead (see Chart 9). While the last observation did show some improvement, it is still much more negative than over the past several decades. And other data suggests that consumers view the decline in real incomes will be long lasting. Half of all consumers (51%) thought their chances of real income gains were less than one-in-four in late 2012. In comparison, just 13% thought their chances for a higher inflation-adjusted income were better than three-in-four. Overall, consumers reported in 2012 the lowest probabilities of long term real income gains recorded since this question began a decade ago.

Chart 9: Consumers Expect Declines in Inflation Adjusted Incomes During Year Ahead

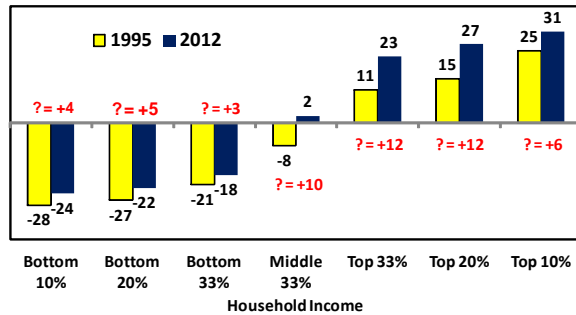


Income Aspirations

Consumers were asked in the September and October 2012 surveys a set of questions about their material aspirations and living standards, repeating questions that were asked in 1995. According to Census data, household income was nearly identical in those two years, as the median inflation adjusted household income differed by just \$119 or about two-tenths of one percent. Differences in the responses to these questions were expected to mostly reflect differences in the comparative standards that are used by consumers to assess their living standards.

The first question simply asked consumers whether their total household income was enough for their families to live comfortably. Nearly equal numbers of consumers reported their incomes allowed them to live “very comfortably” as “not at all comfortably” in both years. This judgement differed significantly by income, however, with higher income households replying much more frequently that they could live “very comfortably.” That is hardly surprising. The main issue investigated was whether and how these judgements have changed since 1995. Whether household income was in the bottom 10% of the distribution, the top 10%, or anywhere in between, consumers were uniformly more positive about their current income in 2012 than in 1995 (see Chart 10). Although the change from 1995 was generally greater for higher income households, even those in the bottom 10% of the income distribution recorded positive—or less negative—change from 1995. These results provide some indirect evidence that consumers have lowered the level of income they feel they need to live comfortably. This is not definitive, however, since it is widely suspected that adjustments for price level differences may not completely account for quality differences. Nonetheless, it is an indication that consumers have not become even more materialistic, and may have slightly lowered their aspirations in the face of limitations.

Chart 10: Whether Can Live Comfortably on Current Household Income
(% Very comfortably - % not at all comfortably)



Consumers were then asked how confident they were about achieving their desired future standard of living (see Chart 11). In response to this question consumers expressed a great deal of confidence, as three times as many people expressed an optimistic rather than pessimistic outlook. Although the overall distribution of responses were again quite similar in 1995 and 2012, with all income groups more negative about their chances of achieving their desired living standard. The gap in confidence between upper and lower income households, however, widened considerably. Compared with 1995, much larger negative changes were recorded among lower income than upper income households. This reflects rising concerns about inequality, as well as the fact that even upper income households are less confident about achieving their desired living standards.

Chart 11: Confidence in Achieving Desired Future Standard of Living
(% Quite sure - % Pessimistic)

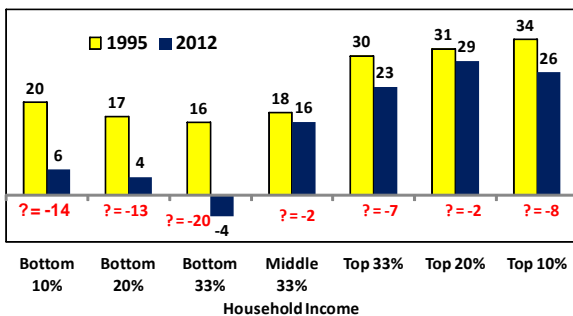
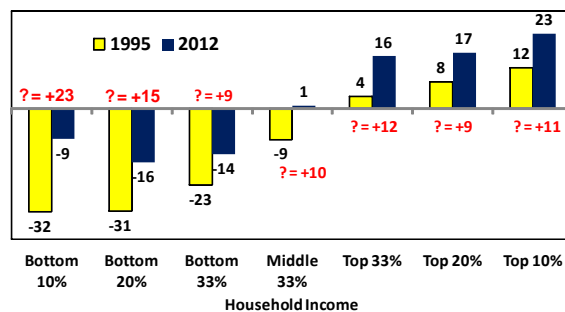


Chart 12: Reaction To Unchanged Living Standards Over the Next Five Years
(% Very satisfactory - % Rather Disturbing)



Finally, consumers were asked about their reactions if their living standards were to remain unchanged over the next five years (see Chart 12). About equal proportions found that prospect “very satisfactory” as though it would be “rather disturbing.” The proportion that found it “very satisfactory” rose slightly in 2012, and the proportion that found it “rather disturbing” declined somewhat in comparison to 1995. When the differences were examined by income, households regardless of their income position, were uniformly more positive if their living standards would remain at the same level for five years in 2012 than in 1995. Somewhat surprisingly, the lower the relative income, the more satisfactory they would find unchanged living standards. This may indicate the dominance of economic security over economic advancement among these groups.

Overall, these results do not indicate a large change in material aspiration, but they do suggest that people would be as satisfied with a somewhat lower but more secure standard of living in 2012 than in 1995. The same downward adjustment in standards may apply to how consumers judge conditions in the economy.

Outlook for Economy and Employment

Despite GDP growth of only 2% in the 3rd quarter, consumers held very positive views about the national economy. In the most recent survey, three times as many consumers expected the economy to improve rather than weaken during the year ahead. The last time consumers held such favorable expectations was in 2004. Although consumers had anticipated economic conditions would slowly improve for most of the past year, few consumers were ready to expect that improvement would re-establish favorable financial conditions in the economy as a whole. Recently, however, even this opinion has changed considerably. Over the past year, the proportion that anticipated good times financially doubled (see Chart 13). Moreover, the fewest consumers in five years expected bad times in the economy as a whole. The significant improvement in the past year still left consumers evenly split between an optimistic and pessimistic outlook. Nonetheless, the data suggest consumers anticipate continued growth over the years ahead. When asked about long term prospects for the national economy, consumers were more likely to expect continuous improvement rather than renewed declines over the next five years (see Chart 14). Indeed, the last time consumers judged the long term outlook for the economy more favorably was in 2004, with the current reading well above the average over the past half century.

Chart 13: Best Year Ahead Outlook for National Economy Since 2007

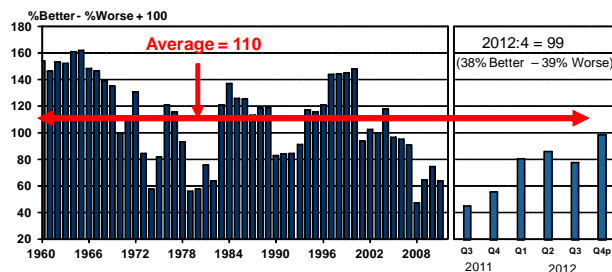
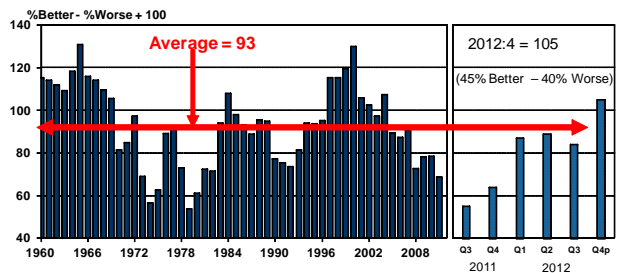


Chart 14: Best Five-Year Outlook for National Economy Since 2004



Creating new jobs is the most important implication of a stronger pace of economic growth for consumers. The latest survey provides ample evidence that consumers anticipate faster job growth in the year ahead. The surveys regularly ask consumers to describe in their own words what recent economic

developments they had heard and could recall. Job gains and losses are by far the most common items reported. Consumers' responses to this question bear a remarkable correspondence to changes in payroll employment (see Chart 15). Note, however, in recent years consumers' references to job gains and losses have been much more volatile than in the past. Consumers have developed a heightened sensitivity to employment news, and this sensitivity sometimes results in over-reactions. Despite the recent volatility, these reports clearly suggest that consumers anticipate that more jobs will become available in the year ahead.

Chart 15: Consumer Reports of News about Jobs And Changes in Total Nonfarm Employment
(Three month moving averages)

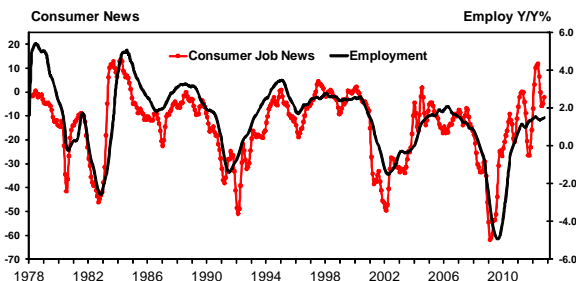
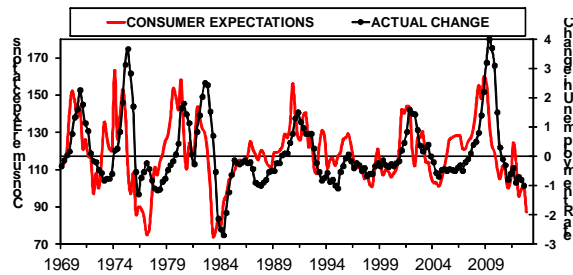


Chart 16: Consumers Expect Large Decline in Unemployment Rate During Year Ahead



Aside from this indirect question about job prospects, consumers are specifically asked how they expect the unemployment rate to change during the year ahead. Consumers in late 2012 held the most favorable expectations for the national unemployment rate since 1984. Twice as many consumers expected the unemployment rate to decline rather than increase in the year ahead in the recent survey. Just one year ago, nearly twice as many expected increases rather than declines in unemployment. Consumers' unemployment expectations have shown a close correspondence with changes in the national unemployment rate (see Chart 16). At present, consumers now anticipate a drop in the unemployment rate exceeding one percentage point during the year ahead.

Trends in unemployment have differed sharply across the population. While the overall unemployment rate is now 7.9%, among married workers it is 4.8% and among workers with a college degree it is just 3.8%. In sharp contrast, among those without a high school diploma unemployment is 12.2% and among those under 25, unemployment is 16.0% (see Chart 17). The employment situation is even more troubled when labor force participation rates are taken into consideration. Nearly the entire decline in the national unemployment rate has been due to falling labor force participation rates not to increases in the proportion of employed workers (see Chart 18). To be sure, some of the decline in labor force participation has been due to the growing numbers of baby boomers that are retiring. Nonetheless, a growing share of the elderly are continuing to work (see Chart 19). Indeed, one-in-three men aged 65 to 69 now work, and one-in-four women in that same age range currently work. More surprising, one-in-

Chart 17: National Unemployment Rate

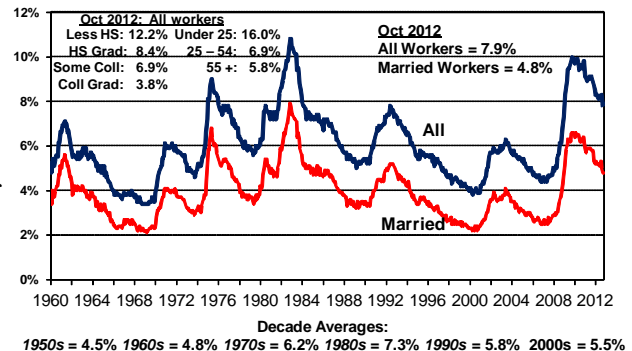


Chart 18: Unemployment Decomposition: Ratio of Employed to Labor Force Participation Rates

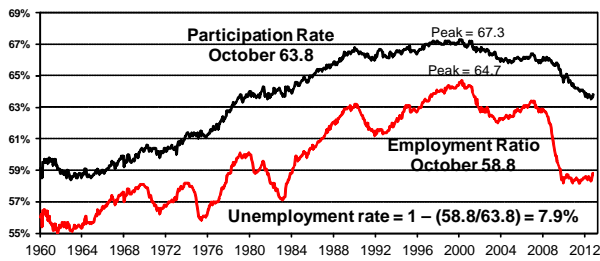
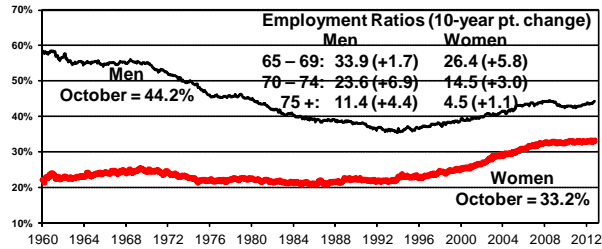


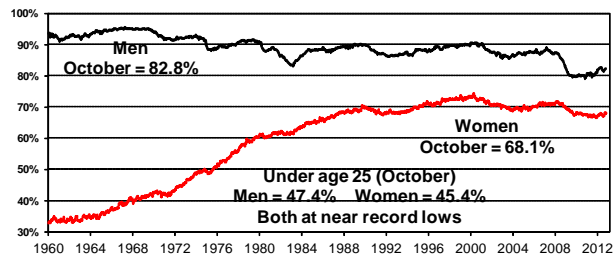
Chart 19: Employment Population Ratios: Men and Women Over Age 55 Slowly Rising



ten men and one-in-twenty women age 75 or older now work. While loss of retirement assets may be involved, this trend has been ongoing for ten years.

I will not comment on the employment rates among those under 25, other than to note that they remain near all-time lows. Higher enrollments in colleges and consequently lower employment rates would be good for the individuals involved as well as the overall economy. The employment trends of those aged 25 to 34 is of greater concern (see Chart 20). While employment of both men and women in this age group is a bit above the recent lows, employment is still below the levels recorded prior to the Great Recession, especially among men. It is in this age range when workers rapidly gain experience and skills, and the repercussions for those who lost this opportunity may be long lasting for those involved as well as for the overall economy.

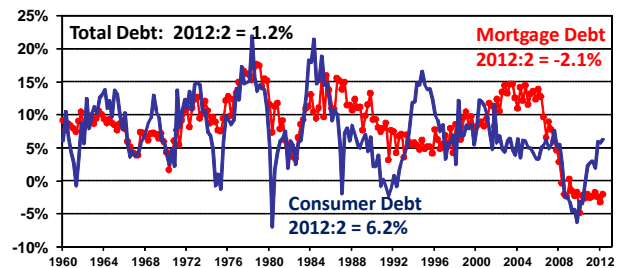
Chart 20: Employment Population Ratios: Men and Women Age 25 - 34 at Diminished Levels



Housing Market

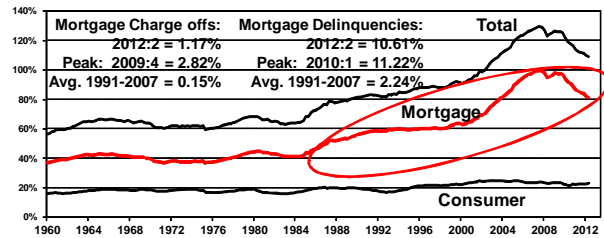
The last area I would like to discuss is how consumers view the housing market. Housing played an important role in shaping the steep downturn as well as the weak upturn. The loss of household wealth and the increased burden of mortgage debt diminished people's sense of financial welfare and curtailed their overall spending. The mortgage debt overhang has diminished because new home purchases and new mortgage originations have been near record lows. Foreclosures also diminished household debt. Mortgage debt has declined in every quarter since the start of 2008; before 2008, mortgage debt had posted continuous increases over more than a half century. Since 2008, outstanding mortgage debt declined by 10% or by about \$1 trillion dollars. The amount of outstanding mortgage debt declined by an additional 2.1% in the 2nd quarter of 2012 (see Chart 21).

Chart 21: Mortgage Debt Slump Offset by Increases in Consumer Debt



In sharp contrast, consumer credit increased by 6.2% in the 2nd quarter over the 1st quarter of 2012. This was largely due to increases in vehicle loans. When calculated as a percent of personal disposable income, increases in consumer credit have only slightly exceeded personal income gains (see Chart 22). In comparison, the declines in mortgage debt have been substantial. Nonetheless, at 80% of disposable income, mortgage debt is well above the 60% set in the mid 1990's and the 40% recorded in the 1960's to the mid 1980's. Mortgage delinquencies are still quite high at 10.6%, although down from the peak of 11.2% in 2010, they are nearly five times higher than the average of 2.2% from 1991 to 2007.

Chart 22: Mortgage Debt Still Excessive
(Debt as a Percentage of Personal Disposable Income)



Except for first time buyers, home buyers are also home sellers. The Michigan surveys have asked consumers about home buying conditions for more than a half century, and began to ask consumers about home selling conditions since the start of the 1990's. While trends in the two questions were similar in the 1990's and early 2000's, the recent trends have moved in the opposite direction. The vast majority of consumers think home buying conditions have never been more favorable than at present and the vast majority of consumers think home selling conditions have never been more unfavorable. Nearly every consumer cites low home prices for favorable buying conditions, and nearly every consumer cites those same low prices for making the sale of their home unfavorable. Record low mortgage rates have been an advantage for home buying, but home selling has suffered from the one-in-five homeowners who owe more than the home is currently worth.

Neither the very positive levels of home buying attitudes nor the very negative levels of home selling attitudes predict recent trends in the housing market. A straightforward solution is to average home buying and selling conditions, and this solution appears to track the housing market very well (see Chart 23). The combined home buying/selling series provides a reasonably accurate leading indicator of new housing starts. The housing index has improved mainly due to record low mortgage rates, and indicates continued gains in housing starts in the year ahead. Housing starts are likely to nearly reach 1.0 million in 2013. Perhaps the best news for the housing market is that consumers anticipate a higher rate of appreciation in home values (see Chart 24). The real rate of appreciation is still negative, especially for the year ahead, but over the next five years consumers expect home prices and inflation to differ by just a few tenths of a percent. Despite these gains, consumers still do not view housing as a good investment. It now seems so long ago when consumers commonly voiced the adage that “a home is the best investment you can make.”

Chart 23: Home Buying and Selling Conditions and Housing Starts
(Three month moving averages)

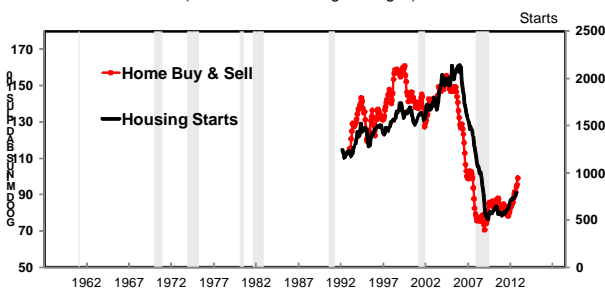
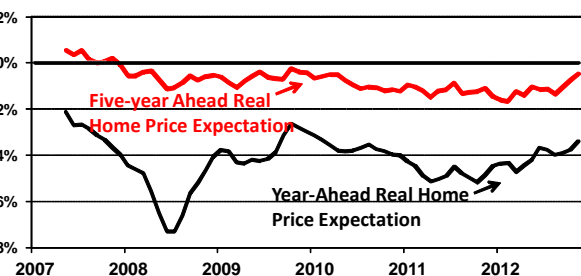


Chart 24: Real Home Prices Expected to Decline Over Foreseeable Future
(Three month moving averages)



Summary Outlook

Finally, I now return to the initial question I posed. Are consumers rationally or irrationally optimistic? For the most part, consumers based their renewed optimism on more favorable prospects for jobs, incomes, and home values. There was some evidence that consumers have lowered their performance expectations for the economy, and thus, consumers may have judged economic conditions more favorably than they would have in the past. There is nothing unusual about these shifts in comparison standards; indeed, the process is similar to what economists are now doing by adjusting upward the lowest rate of unemployment the economy can sustain without accelerating inflation, or NAIRU in econospeak.

The main complaint of economists about the current level of optimism is that consumers seem oblivious to the looming fiscal cliff. Don't consumers understand what's at risk if nothing is done? All forecasts are contingent on the economic model used, the data inputs, and the assumptions about government policies. This is true for consumers as well as economists. The difference is that consumers assume a settlement will be forthcoming, most likely at the last possible moment. Moreover, consumers have assumed for several months that President Obama would be re-elected and would make good on his promise of no higher federal taxes in 2013, with the lone exception of higher taxes on the wealthy. Needless to say, this would increase the federal deficit in the near term, with consumers implicitly counting on more robust economic growth to diminish the relative size of the deficit. The same position is held by some economists. And like all forecasters, if their assumptions about taxes are wrong, so too is their forecast.

One key assumption may prove faulty. What consumers heard about taxes may have been the result of an artful dodge employed in the Presidential campaign. The pledge of no higher taxes did not include payroll taxes. The end of the payroll tax holiday will immediately reduce disposable personal income and have an impact on aggregate consumer spending. Insofar as consumers have conflated income and payroll taxes, the higher payroll taxes will be an unpleasant surprise and could cause a more substantial downward revision in optimism. This impact can be mitigated by clear communications in the weeks ahead about the critical importance of higher taxes to support this crucial entitlement program. Blaming the hikes on the inability of one political party or the other to come to an agreement will heighten people's sense of injustice rather than their sense of shared sacrifice for the common good.

Another potential fallout that could affect consumer confidence is the partisan debate about the vast number of details in the final resolution. I find it hard to imagine that this matter could be finalized anytime soon, although a temporary extension or preliminary settlement on some details is likely to emerge soon. The Congressional debate about the debt ceiling in August of 2011 had a disastrous impact on consumer confidence, and this debate is likely to be treated by all sides as a continuation of the bitter election campaigns. Moreover, if uncertainty about the final mix of taxes and spending cuts persists in the months ahead, consumers may well adopt a more cautious spending outlook.

So what is bottom line? First, the current level of consumer optimism is unlikely to be sustained in the months ahead. That news is not as bad as it sounds, since the current level is well above where it would need to be to generate a 2% growth rate in real personal consumption expenditures in 2013, including light vehicle sales at just below 15 million and housing starts just under 1 million. This forecast is based on slowly improving incomes and jobs as well as continuing small gains in home prices. The primary risk to this modest forecast involves the outcome of the face-off at the fiscal cliff.