

Subject: March 2017 survey results

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Consumer sentiment slipped in late March, although it still remained above the February reading. The continued strength was due to optimistic views on the three critical components of consumer confidence: higher incomes and wealth, more favorable job prospects, and low inflation expectations. There are two factors, one unique to the current situation, that influence how the surge in optimism should be evaluated. First, the data have been significantly affected by partisanship, with the data from Democrats indicating an imminent recession, while the data from Republicans point toward a new era of robust growth. That disparity has not narrowed since Trump's election. The Democratic and Republican parties have had initial success in convincing their members that government economic policies were by far the most important determinants of economic outcomes. Second, the Great Recession has reset the evaluative standards used by consumers to judge the current and prospective economic conditions, a shift I documented in 2015. It would be irrational for consumers to use outdated standards; just as economists have lowered long term growth prospects, consumers have done the same, and have thus judged lower rates of growth more favorably than they would have in an earlier era. It would be nice if one could determine to what degree the recent gains in optimism benefitted from lower standards and to what degree it was due to partisanship. Importantly, evaluative standards represent a more lasting shift, while the impact of partisanship is likely to fade in the months ahead. Nonetheless, the data still provide robust information on spending trends, with real spending expected to advance by 2.7% in 2017. Perhaps the more important finding is how consumers' inflation expectations have become more nuanced, especially concerning asset prices, product prices, and import prices. The impact of these growing distinctions on consumer behavior will make it more difficult for the Fed to use traditional interest rate policies to control inflation. Overall, the data indicate both rising optimism as well as rising uncertainty due to the partisan divide. Optimism promotes discretionary spending, and uncertainty makes consumers more cautious spenders, which will result in uneven gains over time and across products.

The impact of recent economic strength and the partisan influence on future prospects is amply shown by consumers' views of their personal finances. Among all families in March, 50% reported that their finances had recently improved, while just 18% reported worsened finances. This was the best net financial assessment since 2000. When asked to explain how their finances changed, half of all households mentioned income and wealth gains and just one-in-twenty complained that rising prices had reduced their living standards. Wealth gains were especially strong among those over age 65, due to increases in stock holdings and rising home values. While there were only small partisan differences in current finances, personal financial expectations showed large differences, with Republicans much more optimistic than Democrats: nearly twice as many Republicans as Democrats expected their finances to improve. Incomes were expected to increase by 3.0% among Republicans, while Democrats anticipated a 1.0% gain, with self-identified Independents expecting income gains of 2.7%. Year-ahead inflation expectations fell to 2.5% in March, between last month's 2.7% and December's 2.2%. An annual inflation rate of 2.4% was expected over the longer term in March, between last month's 2.5% and December's 2.3%. These lows were supported by the fewest complaints that rising prices eroded their living standards—just 5%, the lowest since 2000 and barely above the all-time low of 4%. Long term gas price expectations fell to their lowest level in more than a decade. Nonetheless, an average of 15% in the 1<sup>st</sup> quarter surveys favored buying-in-advance of rising (import) prices for household durables, the highest level since 1990. Buying-in-advance of rising home prices was favored by 13% in the 1<sup>st</sup> quarter of 2017, the highest since 1990, and borrowing-in-advance of rising mortgage rates was favored by 19%, the highest since 1995. Expectations regarding future economic conditions remained highly partisan. Continuous good times in the economy over the next five years were expected by 83% of Republicans, but only 24% of Democrats. In contrast, renewed economy-wide downturns were anticipated by 68% of Democrats, but only 13% of Republicans. Perhaps even more extreme were expectations regarding unemployment: 74% of Republicans anticipated lower unemployment versus 13% of Democrats.

|                                | Mar 2016 | Apr 2016 | May 2016 | Jun 2016 | July 2016 | Aug 2016 | Sept 2016 | Oct 2016 | Nov 2016 | Dec 2016 | Jan 2017 | Feb 2017 | March 2017 |
|--------------------------------|----------|----------|----------|----------|-----------|----------|-----------|----------|----------|----------|----------|----------|------------|
| Index of Consumer Sentiment    | 91.0     | 89.0     | 94.7     | 93.5     | 90.0      | 89.8     | 91.2      | 87.2     | 93.8     | 98.2     | 98.5     | 96.3     | 96.9       |
| Current Economic Conditions    | 105.6    | 106.7    | 109.9    | 110.8    | 109.0     | 107.0    | 104.2     | 103.2    | 107.3    | 111.9    | 111.3    | 111.5    | 113.2      |
| Index of Consumer Expectations | 81.5     | 77.6     | 84.9     | 82.4     | 77.8      | 78.7     | 82.7      | 76.8     | 85.2     | 89.5     | 90.3     | 86.5     | 86.5       |
| Index Components               |          |          |          |          |           |          |           |          |          |          |          |          |            |
| Personal Finances—Current      | 119      | 118      | 123      | 124      | 121       | 118      | 113       | 111      | 117      | 126      | 124      | 128      | 132        |
| Personal Finances—Expected     | 127      | 121      | 128      | 125      | 126       | 119      | 126       | 127      | 126      | 131      | 130      | 123      | 128        |
| Economic Outlook—12 Months     | 100      | 95       | 107      | 104      | 91        | 97       | 104       | 91       | 109      | 119      | 121      | 112      | 116        |
| Economic Outlook—5 Years       | 100      | 95       | 106      | 102      | 95        | 99       | 101       | 90       | 107      | 110      | 112      | 112      | 103        |
| Buying Conditions—Durables     | 155      | 158      | 162      | 164      | 162       | 159      | 158       | 157      | 162      | 164      | 165      | 161      | 162        |