

## **Consumer Outlook: A Linchpin of Growth**

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- Atlanta Fed President and CEO Dennis Lockhart, in a May 6, 2015, speech to the Baton Rouge Rotary Club in Louisiana, discusses the disappointing first-quarter output growth, his economic outlook, and the anticipated FOMC decision to move the federal funds rate off zero.
  - Lockhart says that the underlying fundamentals are strong enough to propel the economy along a growth path that delivers a bounce-back in the second quarter followed by a resumption of a pace of growth between 2.5 and 3 percent.
  - With a resumption of stronger growth, Lockhart expects to see further progress toward the FOMC's policy objectives: full employment and movement toward a healthier rate of inflation of around 2 percent.
  - Lockhart's confidence that growth will resume rests importantly on evidence of a pickup in consumer spending. Real consumption growth slowed sharply in the first quarter after healthy gains over the second half of last year.
  - As support for growing consumer activity, Lockhart will be looking at the upcoming April employment numbers and over the longer term for direct, confirming evidence that consumer spending is accelerating.
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I'm very pleased to be back in Baton Rouge.

I'll start by setting the scene. The policy of a near-zero federal funds rate has been

in place for more than six years. As you know, the federal funds rate is the Fed's official policy rate—the rate from which other interest rates are determined by market forces.

There is much anticipation of a decision by the Federal Open Market Committee (the FOMC) to move off zero sometime this year. And the Federal Reserve has been busy with technical preparation for what's being called "liftoff."

In its official communication, the FOMC has laid out a framework for making this important decision. There are two key criteria. The Committee is looking for further progress in labor markets, and the Committee wants to be reasonably confident that the rate of inflation will move higher and converge to the target of 2 percent over the medium term. The assessment that these two criteria have been adequately met is data-dependent. That is to say, the Committee will be looking for evidence in incoming economic data. Those of you in the business world know the expression "cash flow is king." Well, for us, data are king.

Today, I would like to walk you through the data from the first quarter, the back story of my baseline outlook for the rest of the year. I normally prefer to think in terms of a medium-term horizon. But because the FOMC will likely soon be considering a major policy change, the incoming data over the coming days, weeks, and near-term months must be intensely watched and carefully interpreted. For policymaking purposes, the relevant timeframe has been foreshortened. I will provide you the key markers that I will be monitoring.

As always, I will be presenting my personal views. I am not speaking for the FOMC or the Federal Reserve. My colleagues in the Federal Reserve may not agree with my views.

### **The first quarter**

After real GDP (gross domestic product) growth readings of a strong 5 percent in the third quarter of last year and 2.2 percent in the fourth quarter, the initial estimate of first-quarter 2015 GDP growth showed a marked deceleration. According to this first estimate, the economy grew at an annual rate of just 0.2

percent. There will be two more official releases on the first quarter by the Bureau of Economic Analysis, so revisions are possible, but as of now, it appears the quarter was unusually weak.

Early estimates of the current quarter's rate of growth are disappointing. I'm not overly concerned, however. Any estimate at this early date is based on just a few data points. Readings tend to get more accurate as more data on the current quarter stream in.

While we can't say for sure, it appears that a variety of transitory or non-persistent factors restrained first-quarter growth.

Severe winter weather was one such factor. My staff has a weather impact model that analyzes temperature patterns. This tool has produced an estimate that the economy lost a half percentage point of growth last quarter due to weather.

Although the news, in February particularly, fixed our attention on weather in the Northeast, the temperature for the country as a whole was significantly colder than typical. Data from the National Oceanic and Atmospheric Administration measure the deviation in temperature from the long-term average. This source shows that seven of nine census divisions experienced significantly colder-than-normal temperatures in February. So severe weather was widespread.

Weather effects on the economy are transitory. There were other factors at work in the first quarter. I'll call these transitional factors. These factors may not dissipate quickly like weather influences and may constrain growth beyond a single quarter. In any event, the bite of economic adjustment from these factors was likely felt most strongly in the first quarter.

One such factor was the drop in oil prices, the effects of which are quite apparent to you here in Louisiana, I'm sure. Lower crude oil prices have interrupted momentum in energy-related structures investment. Total investment in business structures, led by the sharp decline in the energy sector, is estimated to have shaved three-fourths of a percentage point off real GDP growth in the first quarter.

The damper on energy-related investment from lower oil prices may persist for a while. Baker Hughes's count of active oil rigs continues to decline. According to the company's numbers, active rig count has fallen from 813 on March 27 to 679 as of May 1.

It should be said that adjustment to lower oil prices goes further than upstream exploration drilling and related investment. As this audience knows well, downstream users of petroleum industrial inputs tend to benefit when costs fall. So there will be offsets to the falloff in oil and gas investment as we go forward. In addition, consumer activity is expected to demonstrate gains from lower gasoline prices, but this was not evident in the first quarter.

A second transitional factor affecting first-quarter growth was an adjustment to the stronger dollar. The dollar has appreciated by roughly 15 percent since mid-2014, according to a common measure of dollar exchange-rate movements. The stronger dollar was likely reflected in a drag on net exports.

The GDP component "net exports" measures the relative impact on economic activity of exports and imports. Looking at exports in isolation, after solid expansion over the previous three quarters, exports fell sharply in the first quarter. Import growth, while a bit slower than its recent trend, still increased, which widened the trade deficit. In last week's GDP report, weak net exports subtracted 1 1/4 percentage points from first-quarter growth. We just received revised international trade statistics yesterday, and it appears that the rise in the trade deficit was even larger than originally thought—perhaps due to the effects of the now-settled port closures on the West Coast. This raises the possibility that first-quarter GDP growth was even slower than originally reported. Looking ahead, I expect net exports to be a modest drag on economic activity over much of the year.

It should be noted, however, that in recent weeks the dollar has stabilized and oil prices have begun to move up a little. These developments, if they stick, could dilute somewhat what would otherwise be drags on the economy in the near term. We shall see.

## **My outlook**

My lengthy discussion of the first quarter sets up the question of the moment—how much weight should we put on weakness in the first quarter? I am looking through first-quarter weakness. That is to say, I am not taking much of a signal from the first quarter in my forecast of the second quarter and the rest of the year.

We've seen this movie before. It's a pattern we've seen over the years of the recovery. Since 2010, the first quarter has averaged 0.6 percent annualized growth while growth over the remainder of the year has averaged closer to 3 percent.

I'm just making an observation. It reminds us there are often weak quarters that turn out to be aberrations.

I believe the underlying fundamentals are strong enough to propel the economy along a growth path that delivers a bounce-back in the second quarter followed by a resumption of a pace of growth between 2.5 and 3 percent.

This is certainly consistent with what I hear, on balance, from contacts across the Southeast. Business sentiment seems to be positive and optimistic.

With a resumption of stronger growth, I expect to see further progress toward full employment and movement higher toward a healthier rate of inflation around 2 percent. These are the FOMC's ultimate policy objectives. Growth is the vehicle for achieving these objectives.

As I assess the possible and necessary contributors to a rebound in the second quarter and thereafter, attention has to fall on consumer spending, in my view. So a critical question is, how plausible is the assumption that consumer activity will strengthen and support resumption of growth?

Let me paint the picture as regards consumption. The rate of real consumption growth slowed sharply in the first quarter after healthy gains over the second half of last year. Monthly details show a bit of an acceleration in March following a flat reading in February, perhaps because of weather. But taking a little longer view,

since last December consumption growth has been rather soft.

What's up with the consumer? It's puzzling. The fundamentals supporting consumption growth seem strong. I consider consumer fundamentals to be real personal income growth, household wealth, access to credit, and consumer confidence. Consumer confidence is, in turn, highly influenced by the broad employment outlook.

Let's look at these factors. Growth of real disposable income (income after taxes, inflation-adjusted) jumped in the first quarter, partly because falling gasoline prices brought a decline in overall consumer prices. And real income is up almost 4 percent over the past year.

Growth in aggregate personal income as an economic statistic stems in large part from job gains (more people working) or wage gains (people earning more). With the exception of last month, the pace of job gains has been strong for more than a year. I should mention we will get the April report this Friday. Stay tuned.

Along with employment gains, accelerating wage growth raises the potential for consumption growth. Over most of the recovery, wage growth, by any measure, has been quite sluggish and has trended well below prerecession averages. Recently, we've seen a bit of an acceleration in some measures. Friday's employment report for April will include average hourly earnings. We'll be looking for confirming evidence of wage growth.

The wealth position of households, or household balance sheet strength, also influences consumption patterns. Household balance sheets have improved significantly since the recession. The ratio of household net worth to disposable personal income has risen sharply over the past year alone. Homeowners' equity is at its highest level since 2007.

The willingness and ability of consumers to access credit is another fundamental underpinning consumption. Households were deleveraging in aggregate until late 2013. Household debt began to grow again in 2014 and accelerated through much of last year, according to data from the New York Fed's credit panel. I take this as a healthy sign. Also, the willingness of banks to lend to consumers has

continued to improve over the balance of the recovery. Lending standards have eased even if they are still much more stringent than precrisis levels.

Finally, consumer sentiment measured in surveys has improved markedly over the past few months. The University of Michigan's Index of Consumer Sentiment has risen 16 percent since mid-2014. It is now at its highest level since January 2007.

Prices of gasoline at the pump affect consumer sentiment. And the recent sharp decline in gasoline prices, which was reflected in the jump in consumer attitudes, should have bolstered spending growth. Instead, we saw a sharp, nearly full-percentage-point increase in the personal savings rate in the first quarter, from 4.6 percent to 5.5 percent.

Consumers seem to be behaving cautiously in most categories of spending. Notwithstanding what they say in consumer sentiment surveys, consumers don't yet seem confident enough to increase discretionary spending in bellwether spending categories such as restaurants, movie theaters, and apparel. If there is an exception, it is durable goods, especially autos. Auto sales saw an annualized sales pace of 16.5 million units as of April.

So, as I said, the recent consumer behavior is something of a puzzle, and, at the same time, consumption spending is the key factor that will make my forecast of resumed solid growth come true.

### **Concluding comments**

Let me sum up. Monitoring of incoming data is normal practice at the Fed. Given the possibility of a major policy decision in the near term, you can be sure we will be watching the data intently and putting great effort into their interpretation.

The near-term growth picture has yet to come into focus. There are many considerations that go into assessing economic conditions. No single number, or even a small set of numbers, tells the full story. That said, the outlook I've laid out depends heavily on the health of consumer spending. As support for growing consumer activity, I will be looking this Friday to see if job gains resume the

robust monthly increases we saw prior to March.

And over the coming weeks and months, I will be looking for direct confirming evidence that consumer spending is accelerating.

The FOMC has set out clear criteria for a decision to begin raising interest rates. Those criteria are further progress in the labor market and arrival at a position of reasonable confidence that inflation will move toward the 2 percent target over a medium-term horizon. Central to my own assessment of the sustainability of progress toward these objectives will be my confidence that growth is back on track. And, at this juncture, my confidence that growth will resume rests importantly on evidence that consumer spending is picking up.