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JVB FINANCIAL

Weekly Commentary
by Bill Sullivan, JVB Chief Economist

ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

Mr. Sullivan received his Bachelor of Arts Degree in Economics from Fairfield University.

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Income and Consumption: Inextricably linked

The Department of Commerce's recent revisions to the National Income Accounts confirmed the devastating effect that the recession has had on household income growth. Equally important, the data underscored the strong linkage between earnings and spending since the business cycle contraction got underway as 2007 came to a close. Given this relationship, it is quite apparent that in order for consumption to rise on a sustained basis, job creation must strengthen and take-home pay must register a visible rebound.

Notwithstanding a building sense that the worst for the economy may be in the past, consumers remain very reluctant to bolster their spending. Indeed, real personal consumption expenditures fell again during June, the latest period for which statistics are available. The June contraction was the thirteenth month in the last nineteen that inflation adjusted outlays have registered an outright decline. Total spending since November, 2007, when the interim peak in real P.C.E. was reached, is off by almost $200.0 billion or by 2.1%. Whereas outlays on services have climbed marginally over this period, spending on non-durable goods is down by 3.4% while durable goods-related expenditures have plunged by nearly 13.0%. The dollar value for June spending is at levels that haven't prevailed regularly since the second half of 2006.

The pullback in consumption comes as no surprise given the pronounced decline in wages and salaries in both nominal and real terms that has transpired since the recession began. To provide perspective, current dollar salaries at private industries posted $5.411 trillion in November, 2007, the last month of business cycle expansion for the U.S. economy. Based upon the latest Commerce report, private wages as of June, 2009, were pegged at $5.051 trillion, down $360 billion or 6.6% from the November, 2007 reading. Government workers have fared somewhat better over this interval, with this group experiencing an $82.0 billion increase in earnings over the last nineteen months.

Another approach to help explain the shortfall in spending over the last 1 ½ years is to extract the influence of the Federal Government on household income positions, particularly when allowing for ongoing changes in the cost of living. As is widely known, other sources of income, including dividends and interest, have moved lower during the recession, adding to the reduction in spending power that has occurred via eroding wages. In response to the slippage in private income growth both the Bush and Obama Administrations have introduced a variety of programs to prop personal incomes. Oftentimes the level of support that is forthcoming from the Government is underestimated, especially when viewed over a longer period of time. As an example, total personal income, excluding government transfer receipts and reported in chained (2005) dollars, was pegged at $9.669 trillion in November, 2007. As of June, 2009, this measure posted $9.002 trillion, down $667.0 billion or 6.9% since the recession began. This measure is a clear indication of how most households probably view their purchasing power, particularly when allowing for underlying shifts in inflation. Effectively, there is an awareness that a significant share of income of late has been provided by the Federal sector and it is doubtful the majority of families regard these inflows as being permanent. As a result, longer range spending decisions for households are more than likely linked to

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personal earnings experience, not government subsidies, as has been the case over recent quarters.

Admittedly, past is not prologue and there could always be some upside surprises for consumer spending. However, it does appear as if some behavioral modifications have occurred during the last year or so of steep job losses and reduced access to credit. Specifically, households may be tailoring their spending judgments in the context of their individual flow of income, exclusive of the Government's support, which has been huge since the recession began. Despite that largess, real personal consumption expenditures still declined in June, with the trail-off in wages most likely being the deciding influence behind the weak pattern of outlays.

The key to the spending outlook will therefore revolve around the performance of wages, salaries and other sources of income in the months ahead. As Commerce Department data indicate, there will be occasional monthly jumps in inflation adjusted expenditures. But the sustained trend over the last few years has largely been shaped by the performance of personal income, suggesting that a consumer-led recovery will take place only if earnings begin to rise consistently for most households. Unfortunately, available evidence points toward continued weakness in wages and salaries as the third quarter got underway. Specifically, the Treasury, based upon its Daily Statement, collected $131.42 billion in payroll tax receipts during the month of July, 2009. The overall inflow was down 8.1% from the comparable month last year and is similar to the 9.2% average decline during the April/June period. The relatively sharp erosion in payroll revenues points towards another weak performance for labor market activity last month that is likely to be associated with a further decline in private wages and salaries. As long as incomes remain under pressure, it seems doubtful that there will be any meaningful pick-up in personal spending that would eventually create the conditions for a robust recovery process later this year and into 2010. ■

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