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Consumers Are Still Spending Like Crazy—and That’s a Problem

By all accounts, summer travel plans and bookings to Europe are exceptionally strong despite lingering pandemic effects, soaring airfares and lodging costs, and a savage war taking place on the continent; travel insurance vendor Allianz Partners recently estimated that Americans’ summer travel to Europe will increase sixfold over last year¹. Chalk it up to “revenge spending,” a term that has recently entered the lexicon in the wake of COVID-19. Anecdotally, most mid-tier and upscale restaurants in Manhattan are packed again despite menu price increases of 10%-20% in the last few months. Car rental prices in most major cities are through the roof — and cars often are sold out.

The anticipated migration of consumer spending back to services and experiences in the aftermath of the pandemic is occurring, but retail sales of goods have barely decelerated. Earnings of global food & beverage companies in 1Q22 were exceptionally strong, with several CEOs specifically commenting that consumers were absorbing price hikes, accounting for much of their earnings strength. While many millions of Americans struggle with high inflation and are forced to make difficult spending choices and tradeoffs, those who have money are spending it abundantly, and

this is contributing largely to the persistence of an inflation problem that took root just over a year ago. The resilience of consumer spending, normally a good thing for business and commerce, instead has become symptomatic of a consumer economy that needs to cool down.

The White House and their spokespeople are quick to attribute spiking inflation on supply chain disruptions, price gouging, global COVID impacts and the war in Ukraine, which are all contributing factors. But it has become increasingly

¹ <https://www.travelweekly.com/Europe-Travel/American-travel-Europe-expected-increase-sixfold>

evident in recent months that inflation is persisting and that excess demand in an overstimulated U.S. economy, brought on by the confluence of unprecedented monetary stimulus, pandemic financial relief, and strong jobs growth and wage gains, is primarily to blame. That's an important distinction to make because it puts the fight against inflation squarely within the purview of the Federal Reserve rather than deflect its causation and remedy to forces outside the control of policymakers.

Foremost, this is a money problem, and in recent weeks financial markets have come to the realization that the Fed will need to act more quickly and aggressively to get inflation under control rather than engage in gradual and deliberative policy moves. This expectation now includes five more rate hikes in 2022 (including perhaps one more increase of 50 bps), three to four more rate hikes in 2023, a targeted Fed Funds rate of 2.75%-3.00% by the end of next year (it's 0.75%-1.00% currently) and a more aggressive runoff of its securities portfolio that will put added upward pressure on interest rates—forceful measures that were considered unlikely as recently as late 2021². With these heavy-handed measures comes the increased risk of inducing a recession, and that is the tightrope the Fed will have to walk over the balance of the year and into 2023.

Can't Stop, Won't Stop

How do we know the consumer economy is overheated? The data are practically screaming it. Personal consumption expenditures (PCE), the consumer component of GDP, registered **double-digit** percentage gains (YoY) for 12 consecutive months through February following 11 straight months of smaller contractions (**Exhibit 1**). Recent monthly gains in PCE have far exceeded previous declines, and the CAGR of PCE's two-year stack, which eliminates the whipsaw effects of the pandemic and subsequent rebound, has produced an annual growth rate of 5.9% since February 2019 (not shown), nearly 200 bps above PCE's long-term average nominal growth rate. On an inflation-adjusted basis, real PCE has been growing at more than twice its long-term average growth rate since mid-2021 despite soaring inflation –evidence that strong consumer spending

continues unabated even after the impact of price increases are removed – before slowing in March as inflation took an even larger bite out of spending.

As for U.S. retail sales, which benefitted enormously during the pandemic as spending shifted to goods from services, its share of total PCE has moved to 35% from 31% prior to COVID's arrival. This is a huge shift in just two years, representing a windfall of approximately \$600 billion of annual sales that have moved to retailers due to the pandemic, and they have retained these gains so far. The expectation that sales of retail goods would flat-out decrease as consumer spending on services resumed has not materialized to date. This is not just an online shopping phenomenon; monthly in-store sales grew at a low double-digit rate (YOY) for most of last year and have slowed just slightly from that mark in 2022. Year-over-year monthly retail sales growth will begin to slow (at best) or show declines as we anniversary the passing of the American Rescue Plan, which set off the current spending spree beginning in April 2021. However, retail sales through 1Q22 continued to grow at a CAGR exceeding 10% based on a two-year stack (**Exhibit 2**) and remained decidedly positive and above average even after adjusting for inflation.

What about the prevailing media narrative that surging prices, primarily for gasoline and food, were forcing shoppers to cut back on discretionary spending?³ That's certainly true for millions of households, perhaps most, but as we pointed out in a previous column, consumer spending is highly skewed by income cohort, with the top 20% of households by income now spending as much as the bottom 60% combined. This means that the impact of inflation on households forced to cut back their spending has been obscured by the robust spending of others. For instance, soaring gas prices are painful for most Americans but aren't denting spending in the aggregate. Gasoline prices at the pump are at or near record highs and monthly gas sales have topped \$50 billion for eight consecutive months, easily an all-time high, including \$63 billion in March. However, gasoline sales as a percentage of total retail sales are in the 13%-14% range currently, well below the 16% range experienced in 2011-2014 and the 17% range in 2008 when

2 <https://www.reuters.com/world/us/feds-bostic-sees-6-rate-hikes-this-year-risks-war-2022-03-21/>

3 <https://www.cnbc.com/2022/05/01/inflation-forces-consumers-to-rethink-spending-habits.html>

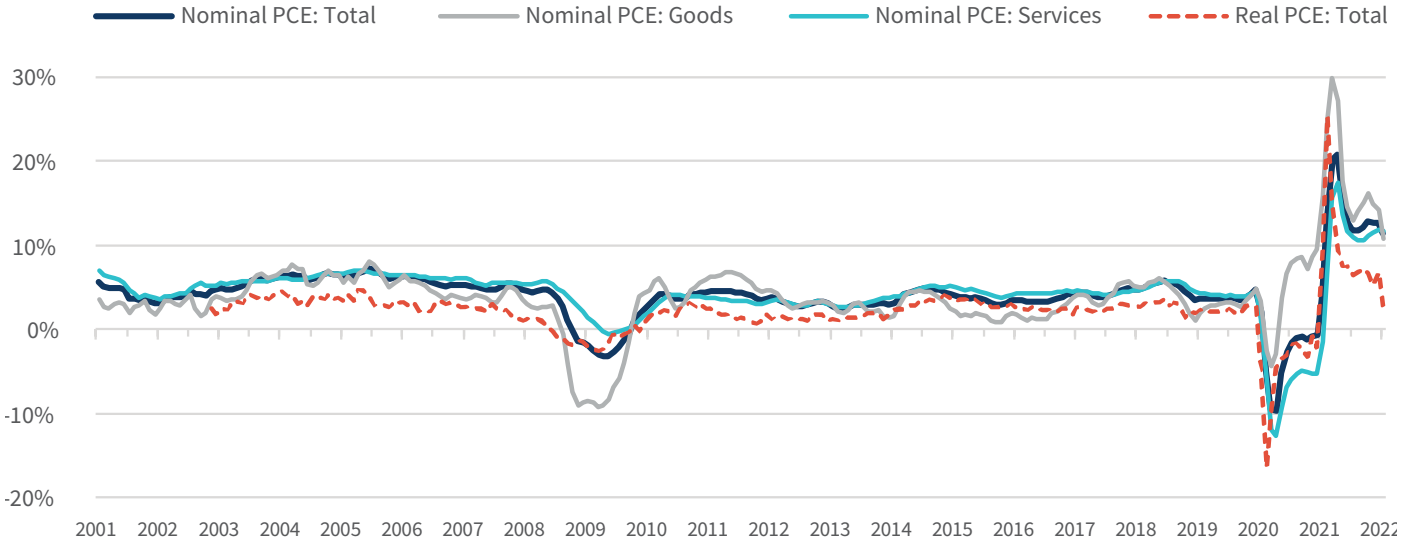
oil prices topped \$140 per barrel — meaning that Americans today are spending a lot more money on other stuff too.

Retailers and other consumer-facing businesses are mostly satisfied with the current economic environment despite its challenges, and it may be tempting to view these consumer spending trends favorably, that is, as a reflection of the strength of the U.S. economy. That would be a mistake. While some retailers and consumer product manufacturers have the pricing power to pass on their cost increases to buyers for a while, most don’t have that luxury and are having to absorb some portion of these price increases⁴. Many corporate earnings announcements in 1Q22 were punctuated by callouts on the harmful impact of inflation and product shortages, and their damaging effects on operating margins despite respectable topline growth. The automotive sector comes to mind⁵. Moreover, as inflation

persists or intensifies, an increasing share of shoppers will be priced out of markets and their discretionary spending will be reduced until the overall consumer economy suffers while only the more affluent can afford to spend freely. That is not a healthy economy.

Most consumer-facing companies will readily acknowledge that a bit of inflation benefits their top and bottom lines, but we already are far past that point. However, as the Fed moves to slow down this train, there is a good chance that Americans already struggling in this economy will be further challenged as the effects of slowing growth ripple through country. Moreover, there’s a risk of Fed overreaction, with many Fed watchers expecting aggressive rate hikes in the coming months, just as spending growth seems poised to decelerate on its own. For the Fed, its current mission is indeed a highwire act without a net.

Exhibit 1 – Personal Consumption Expenditures (YOY % Change)

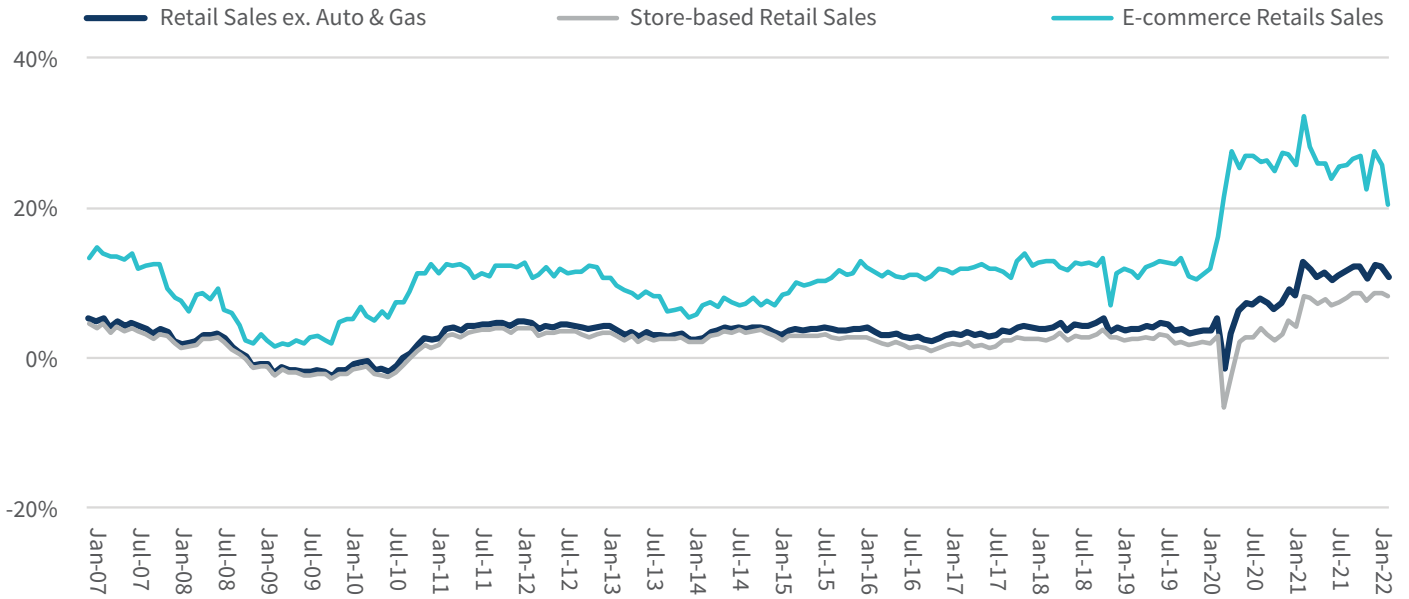


Source: FRED, the Federal Reserve Bank of St. Louis

4 <https://www.afr.com/companies/retail/retailers-face-pricing-dilemma-as-costs-soar-20220217-p59xa6>

5 <https://www.nbcnews.com/business/autos/chips-seating-foam-plastics-parts-shortages-continue-cripple-auto-industry-n1261773>

Exhibit 2 – Retail Sales: Store-based vs. Online Sales Growth (CAGR based on 2-Year Stack)



Source: U.S. Census Bureau and FTI Consulting analysis

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