ARTICLE

Consumer Sentiment Is Lousy but Retail Sales Have Rarely Been Stronger - We'll Explain

Most economists were caught off-guard by the August reading of the University of Michigan's (UoM) Index of Consumer Sentiment (ICS), which showed one of the largest monthly declines on record and was mostly attributed to the fast-spreading delta variant of the COVID-19 virus and its economic implications.[1] The two components of the ICS (Current Economic Conditions and Consumer Expectations) both took sizeable hits. Surprisingly, the August ICS reading of 70.3 was lower than any month during the COVID-19 period. Less surprising, financial markets completely ignored it.

Granted, the August decline in the ICS was likely an emotionally charged response to the virulent fourth wave of the COVID-19 virus, but consumer sentiment was in the doldrums before that, with respondents also expressing concerns about higher inflation and slowing jobs growth and income gains. The July 2021 reading of 81 was far off the pre-COVID level of 101 in February 2020 and matched pre-pandemic lows not seen since 2014 (**Exhibit 1**). The national economy has nearly fully reopened and recently surpassed pre-COVID activity levels (as measured by GDP), the official unemployment rate has recovered to the mid-5% range and the stock market has doubled off its COVID lows of March 2020, but many consumers just aren't feeling it, judging by the ICS. A breakdown of the ICS by income groups reflects a widening divide in sentiment between higher-income and lower-income groups since the recovery began, which is historically typical. The intense public debates recently around ending various pandemic-related federal aid programs or moratoria speaks to the large numbers of Americans still struggling to gain their economic footing more than a year after the recovery got underway, while a fair share of other Americans are doing better than ever.

Curiously, U.S. retail sales have remained exceptionally strong compared to pre-COVID spending levels, despite sputtering consumer sentiment. Most retail spending aggregates are 18%-20% higher than spending levels immediately preceding the COVID-19 outbreak (**Exhibit 2**), or a CAGR of about 12% — a huge growth rate for total retail sales over a tumultuous 18-month period. Previously we've discussed some reasons why retail sales have shown such strength since the pandemic began: It's mainly due to the closing of much of the travel & leisure economy during the reign of COVID and the redirection of consumer spending towards goods, along with a huge federal response, including expanded and extended pandemic unemployment insurance and three large, untargeted rounds of direct stimulus payments to most Americans during this time — particularly those made under the American Rescue Plan in March 2021, which were arguably excessive. The acceleration of consumer spending after each round of stimulus payments (May 2020, January 2021, March 2021) is evident in **Exhibit 2**. What's important to note here is that consumer spending on goods hasn't merely recovered from the initial COVID-related slump in March-May 2020; U.S. retail sales today are far larger than pre-COVID sales levels.

The phenomenon of consumers' economic behavior belying their sentiment has been widely observed over time and is often attributed to a simplistic explanation that we humans can be contradictory creatures, and our actions often are inconsistent with our expressed feelings or sentiment. Many market watchers don't place much faith in consumer sentiment indicators for this very reason. But there's more to this divergence than meets the eye. Consumer spending overall is dominated by higher-income cohorts while the spending done by lower-income groups, who were hurt most by the pandemic (and all recessions, for that matter) is disproportionately small. So, while all consumer sentiment indicators capture respondents' answers across the income spectrum and count them proportionately when compiling their primary index values, spending itself is highly skewed towards higher-income households.

How do we know this factually? The U.S. Bureau of Labor Statistics compiles an annual Consumer Expenditure Survey which, among other things, breaks down consumer spending totals (and spending categories) by pre-tax income cohorts — in this case, income quintiles (five 20% buckets from lowest to highest income groups). The results are telling and reflective of the inequality issue that has dominated the public discourse in the last few years. The highest income quintile (top 20%, with average pre-tax income of $219K in 2019) accounts for a majority of total pre-tax income and a plurality of consumer spending. In fact, total spending of the highest income quintile is approximately the same size as the total spending of the bottom three income quintiles combined (**Exhibit 3**). These proportions have been mostly consistent over the last decade, with pre-tax income distribution skewing slightly more to the top income quintile in recent years. Consumer spending isn't as disproportionate as income distribution because more affluent families don't spend all their income, while lower-income families tend to do so.

Consider the implications of this skew. A 10% drop in spending by the lowest three income quintiles (bottom 60%) can be entirely offset by a 10% increase in spending by just the top income quintile (top 20%). Such an offset might not impact aggregate sales but certainly shuffles sales within the retail ecosystem. We suspect that this is what happened to some fair degree in 2020 — that is, any spending restraint by those directly hit by COVID-related job losses or income reduction, which was experienced mostly by lower-income earners in service industries, was more than offset by sizeable spending increases by higher-income households, which were mostly unscathed by the pandemic. Furthermore, most households in the second-highest income quintile and roughly one-quarter of the highest income quintile likely qualified for federal stimulus payments during the pandemic year. In all, we estimate nearly 30 million households in the top two income quintiles were eligible for federal stimulus payments. So, it's no coincidence that many higher-end omnichannel retailers enjoyed a banner year in 2020 amid a pandemic, partial shutdowns and ensuing recession.

To be blunt, because the spending of lower-income households is disproportionately small relative to their numbers, their economic struggles and hardship are easily obscured or offset by the spending power of more affluent consumers. We say this without any commentary; that's just the way it is. This largely explains why top-line aggregates of consumer spending can excel while many millions of Americans still haven't recovered financially from the COVID-19 episode.

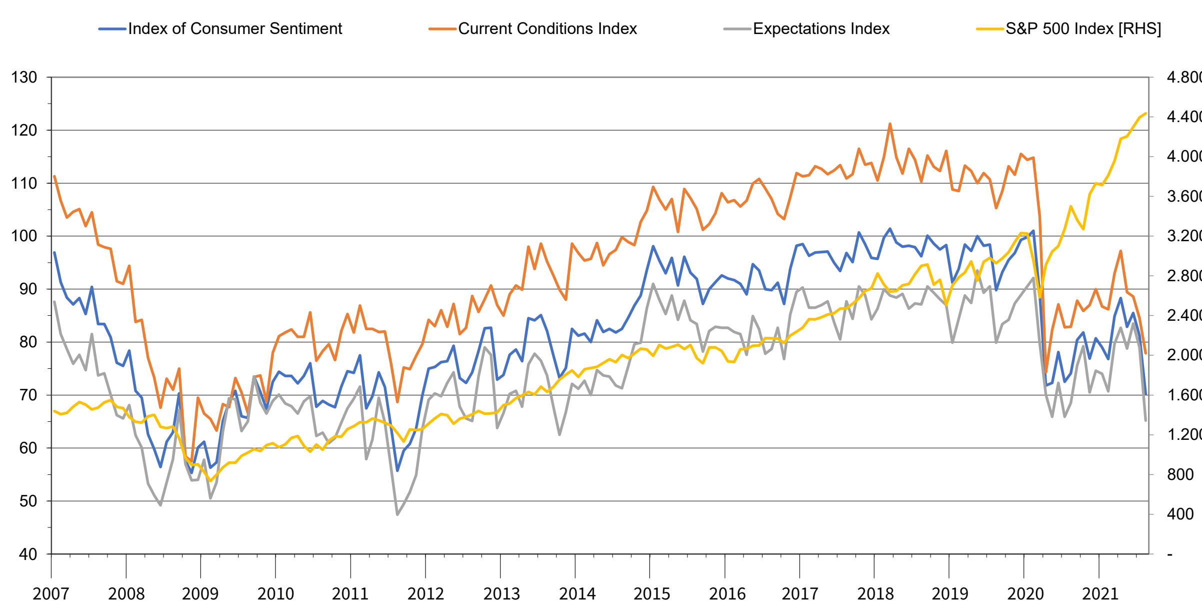
The resurgence of a COVID-19 variant is undoubtedly a primary contributor to weaker consumer sentiment in recent months, while many financially challenged Americans also recognize that federal financial relief soon will be ending. There's little political impetus in Congress to extend these various programs or measures beyond their impending expiration dates. The total cost of direct payments to individuals from the coffers of the U.S. Treasury since COVID struck has been enormous. A recent study by the Urban-Brookings Tax Policy Center (TPC) found that 61% of individual tax filers owed no federal taxes at all in 2020 compared to 44% in 2019, an increase of 31 million taxpayers.[2] Tax f ilers owing no federal taxes will again remain above 100 million in 2021, due mostly to payments received under the American Rescue Plan, but that's it. The TPC expects the percentage of individual filers paying no taxes will revert to pre-pandemic levels beginning in 2022. Such generous financial relief isn't sustainable or warranted given the pace of the ongoing recovery.

Retail sales growth has decelerated a bit in recent months as the spending impact of stimulus payments made in March fades away, but YOY growth rates remain healthy. There's evidence that a long-awaited recovery in spending on services/experiences began this summer (despite the rapid spread of the delta variant) but it hasn't dented retail sales so far. The COVID-19 vaccine uptake greatly diminishes the likelihood that Americans will choose to be housebound or that business shutdowns will be implemented even as the delta variant rages.

Large omnichannel retailers surely recognize that they have been beneficiaries of a unique set of circumstances since early 2020 that cannot continue intact, and we assume they are planning accordingly. Most have enough reasons to remain upbeat nonetheless. Retailers selling to down-market customers don't necessarily share that optimism.

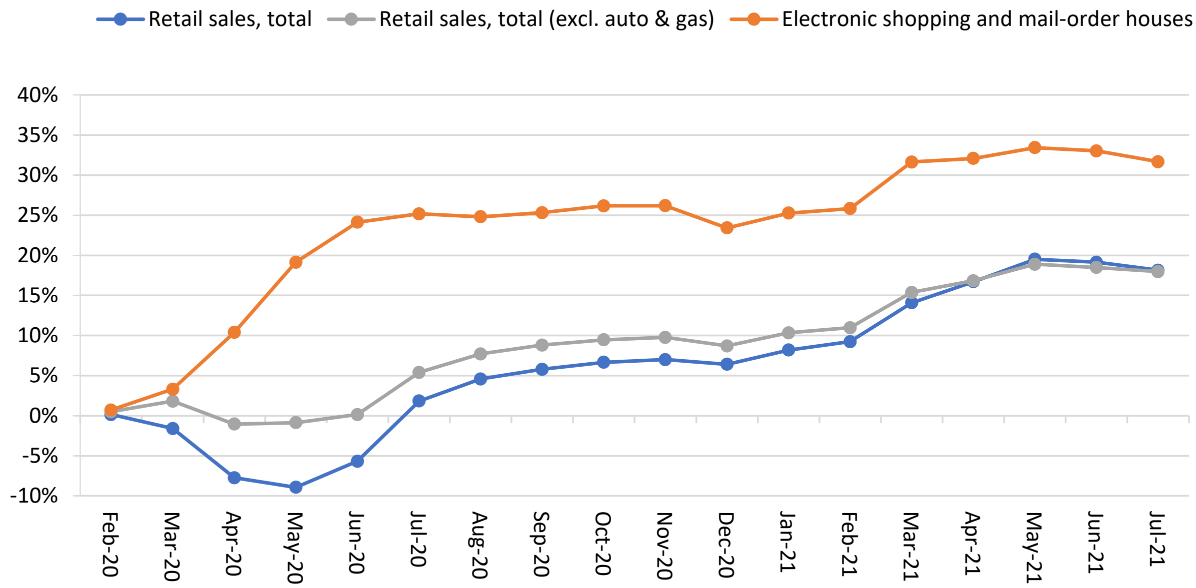
Consumer sentiment indexes, rather than serving as reliable, forward-looking indicators of spending behavior, fairly reveal the attitudes and outlooks of all survey respondents, including financially challenged ones whose struggles and anxieties are real but whose economic activity isn't proportionately reflected in top-line spending and consumption data. As with many issues these days, we are a divided country on this front as well.

Exhibit 1 - University of Michigan's Surveys of Consumers



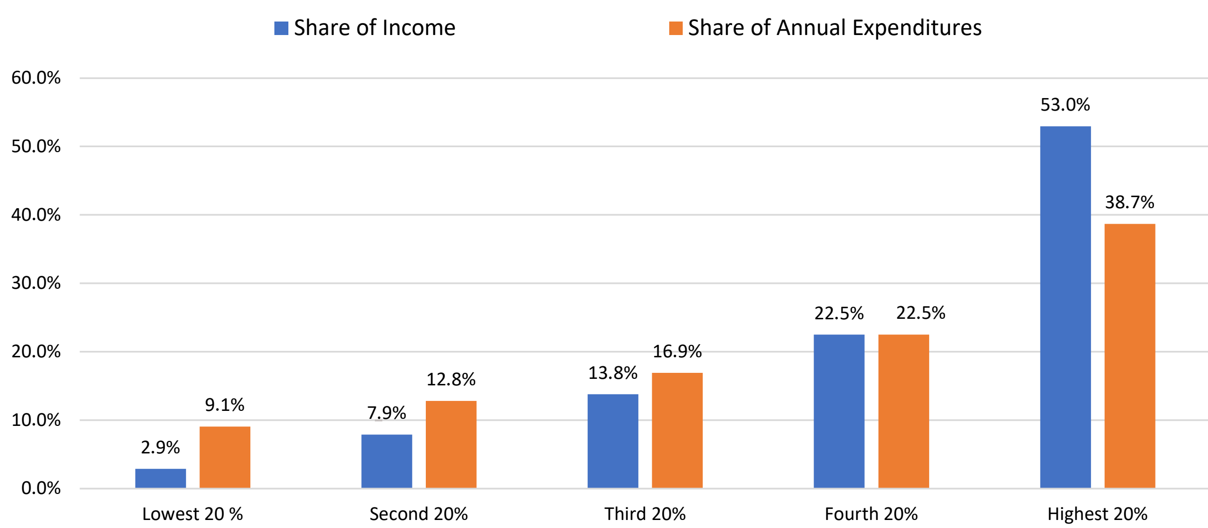
Source: Survey of Consumers, University of Michigan

Exhibit 2 - Quarterly Retail Sales Growth Compared to 4Q19



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

Exhibit 3 - Share of Consumer Expenditures and Pre-Tax Income in 2019 by Income Quintile



Source: U.S. Department of Labor Statistics

Endnotes

1. http://www.sca.isr.umich.edu/
2. The COVID-19 Pandemic Drove A Huge, But Temporary, Increase in Households That Did Not Pay Federal Income Tax | Tax Policy Center

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