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Consumer spending, inflation data provide grounds for anxiety

a professional economist, I'm an outlier. In January I wrote here that the infusions of tax rebate money and the stimulus of interest rate cuts would provide only a temporary prop to the economy. I predicted that the inflows of foreign money that have provided essential support for our economy would dry up; within a year Americans would be in for some serious belt tightening.

The consensus among economic experts was then, and remains now, far more optimistic. A panel of 50 academic and private sector business economists surveyed last month by the Federal Reserve Bank of Philadelphia estimates the U.S. economy will dodge this year's recession bullet; by 2009 they say we can expect a return to robust growth. But here is an interesting fact: Careful analysis of the survey data and comparison with previous versions of the same forecast reveals a widening dispersion in the experts' opinions, and evidence of their own declining confidence surrounding their predictions. I take that to mean that even mainstream economists are starting to worry.

Economic data accumulating since January provide ample grounds for anxiety. Here is my thumbnail sketch of how events are playing out.

Everyone is aware of the problems in the housing market. While the issues there have not fully played out, key financial data indicate that the worst is past. For a while there, a cascading collapse of credit was a real possibility, but the Federal Reserve did a good job of preventing that. Tough times are ahead for the financial sector, however, as consumers find it increasingly difficult to repay the money they've borrowed, particularly their credit card debt.

The effects of higher prices for energy and food are having a devastating effect on households. Mainstream economists, whose focus has been on

consumer spending, have largely overlooked this. Households in Fairbanks, to take an extreme example, have lost 13 percent of their purchasing power since November just through the increasing share of their budgets eaten up by energy costs. It's as if everyone in the community suddenly lost an eighth of their income.

Nationally, the hit to disposable income has been smaller, probably about 5 percent if we include the increases in food costs. Yet in April, the most recent month, consumer spending was still growing at a 2.4 percent annual rate. The explanation for this disconnect is found in two statistics published by the Federal Reserve. During the most recent quarter household wealth in the U.S. declined at an astounding 12 percent annual rate; meanwhile, consumer debt hit new highs. Consumers, hoping that the energy and food price increases are temporary, have put off the painful process of adjusting their spending. They have done this by borrowing, liquidating assets and drawing down their savings.

The coming consumer debt crisis, like the housing crisis that preceded it, will likely be manageable as it relates to the financial sector. But soon consumers will have to start tightening their belts and household demand will fall, most likely with dramatic speed.

What unfolds after that won't be pretty. My most optimistic scenario has the decline in spending being moderated by government fiscal policies. These policies would boost direct stimulus payments to taxpayers, and reduce taxes on low and moderate-income households. Efforts to control inflation will have to be abandoned, at least temporarily, in order to ease households down to spending levels that are sustainable. A big drop in defense spending would be essential.

My most pessimistic scenario has a collapse of U.S. consumer spending propagating to Asian economies through dramatically reduced demand for those countries' exports. Rising protectionist sentiments in the U.S. (consider Obama's proposed changes in U.S international trade policies) and elsewhere (consider Saudi Arabia's plan to preserve more of it's oil "for future generations") could also put the brakes on trade.

Lots of folks have asked me what these upheavals might mean for their retirement investments. Whatever happens, inflation is likely to dominate the investment picture. That suggests considering increased allocations to inflation-protected securities and other inflation hedges. It also suggests decreased allocations to investments that are vulnerable to rising price levels, such traditional long-term bonds. As to stocks, my own view is that the equity markets won't suffer as seriously as the economy as a whole.

And before you do anything based on the above, keep in mind that as economists go, I'm definitely an outlier.

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