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Expansion Leaning A Bit on Bull Stock Market

*Based on a June 2013
client bulletin.

In the second quarter, one element in the profits equation may be playing a somewhat more positive role than expected: personal saving. As we expected, the saving rate has risen from its January low, partly as timing distortions fade and, we believe, partly because of the delayed effects of tax increases. Still, whether this rise is continuing through the spring months is not clear (chart 1). Indications of consumer behavior have been mixed in the second quarter so far, with no clear weakening yet. *One factor that may be giving a bit of a lift to spending is the bull stock market, and whether it persists through the year, stalls, or reverses will effect both the saving rate and profits.*

We have flagged household spending/saving behavior as a particularly important influence in 2013 because, given our forecast for profits to remain roughly on a plateau this year (absent major negative international developments), surprises in the saving rate could mean the difference between a moderately rising profits trend and a meaningful slide in profits as the year progresses. In addition, large swings in disposable income from tax increases at the turn of the year, shifts in the timing of income dispersals to avoid the increased tax burden, and the BEA's problems in measuring and in estimating these effects have all contributed to a larger than usual amount of fog surrounding the saving rate data in recent months.

The wealth effect caused by the stock market's powerful rise during the first five months of the year has provided a moderate boost to spending. (The wealth effect is the tendency of people to spend more relative to their incomes as their net worth rises.) Although measuring wealth effects is an exercise with inherently limited accuracy, one could reasonably say—based on our own and others' empirical work—that this year's run-up is by now depressing the personal saving rate by a few tenths of a percentage point. Moreover, because reaction to stock gains is partly lagged, if the market were to hold its ground or

continue rising through December, the depressive influence of the wealth effect on the saving rate could grow to the better part of a percentage point relative to the end of 2012. On the other hand, a market reversal could limit this effect and even begin to reduce it by yearend.

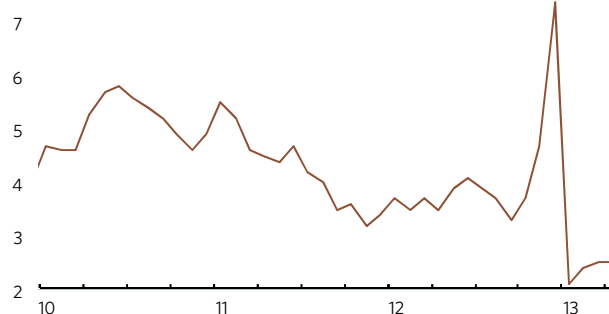
Put another way, by depressing personal saving, the stock market might be adding as much as a couple of percentage points to domestic profits in the second quarter, and that effect will increase through the year even if the stock market merely holds its ground. Because of the lags, it would take a bear market to prevent the wealth effect from being a continued positive influence through yearend.

Of course, the wealth effect is working in opposition to another phenomenon, the 2013 tax increases, especially the payroll tax hike. We stand by our forecast from early in the year that households would keep spending much as before at the beginning of the year but would increasingly cut back as the cumulative effect of smaller paychecks impacted their balance sheets.

Household Saving Rate

CHART 1

BEA: Household Saving as % of Disposable Personal Income
seasonally adjusted, annual rate, last data point April 2013



One implication of these cross currents is that they favor discretionary spending by the affluent while eating away at spending by middle and lower income households. Stock market holdings are of course heavily skewed to the upper end of the income distribution, and payroll taxes are proportionately larger for lower income workers. These influences thus tend to heighten the effects of an increasingly uneven income distribution on consumer spending. *Accordingly, we expect generally better collective performance by stores, producers, and services catering to high-end consumers than by the consumer subsector serving clientele of more modest means.*

With all of this in mind, it is worth taking a look at recent behavior in more detail.

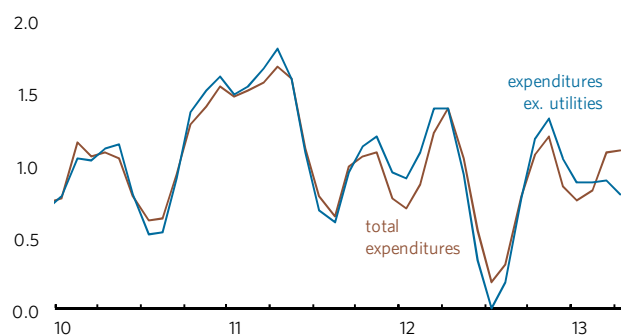
- While headline consumption expenditures have grown apace through April, expenditures show a notably weaker trend if utility outlays are excluded (chart 2).
- “Core” retail sales flattened somewhat in the first four months of the year (chart 3). Indeed, growth was the slowest since early 2010.
- However, more recent data are now pointing to a slight pickup in consumer activity. Vehicle sales, which had been eroding since a Hurricane Sandy-related surge in November 2012, showed some resilience in May (chart 4).
- Higher frequency data also confirm a late-spring acceleration. Weekly chain store sales growth, which had slowed considerably through April, showed a little more life in May (chart 5). This pattern likely reflects, at least in part, the late arrival of spring and the accompanying burst of spring apparel and other weather-related sales.

Although we expect U.S. equities to outperform many other global markets this year, they will have a difficult time matching their 2013 performance to date in the second half of the year. To the extent that equities maintain a rising trend, they will

provide some help to spending, with the effect likely skewed toward spending by upper-income households. On the other hand, if the bull market breaks, the wealth effect could cease providing a boost to spending in the second half of the year. Meanwhile, for lower income households with less of their wealth in financial assets, the higher payroll tax rates in 2013 will likely lead to moderately rising saving over the course of the year. The key question for the economy is the net effect of the trends in saving among these different cohorts of households.

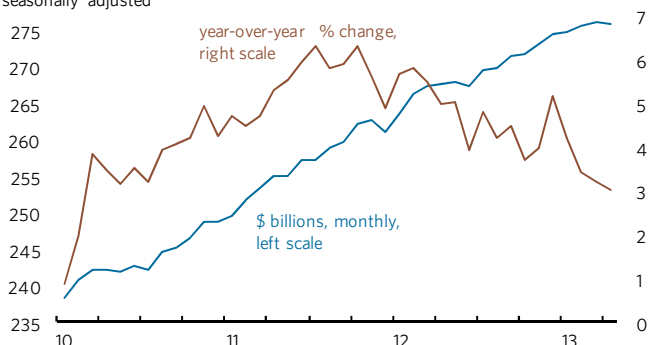
Consumption Ex. Utilities Weaker Than Headline CHART 2

BEA: Personal Consumption Expenditures
3-month moving average of 3-month % change



Retail Sales Measure Slowed through April CHART 3

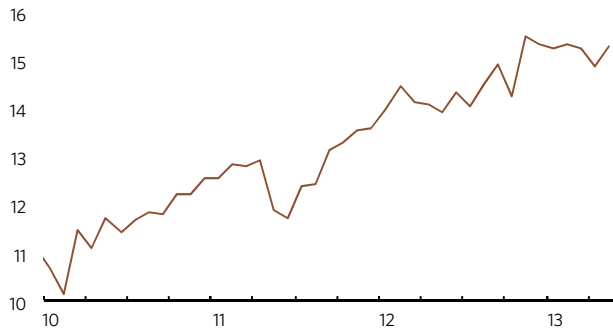
Retail Sales excluding Autos, Gas Stations, and Building Materials
seasonally adjusted



Auto Sales Bounce in May

CHART 4

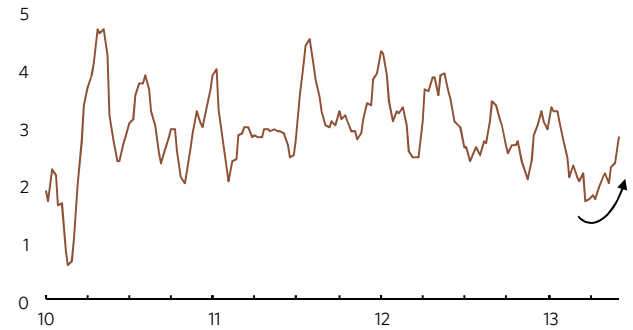
Autodata: Total Light Vehicle Sales
millions of units, seasonally adjusted, annual rate



Chain Store Sales Offer Slightly Brighter Picture

CHART 5

ICSC: Weekly Chain Store Sales (last data point June 1, 2013)
4-week moving average of year-over-year % change



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