Seeing Isn't Believing

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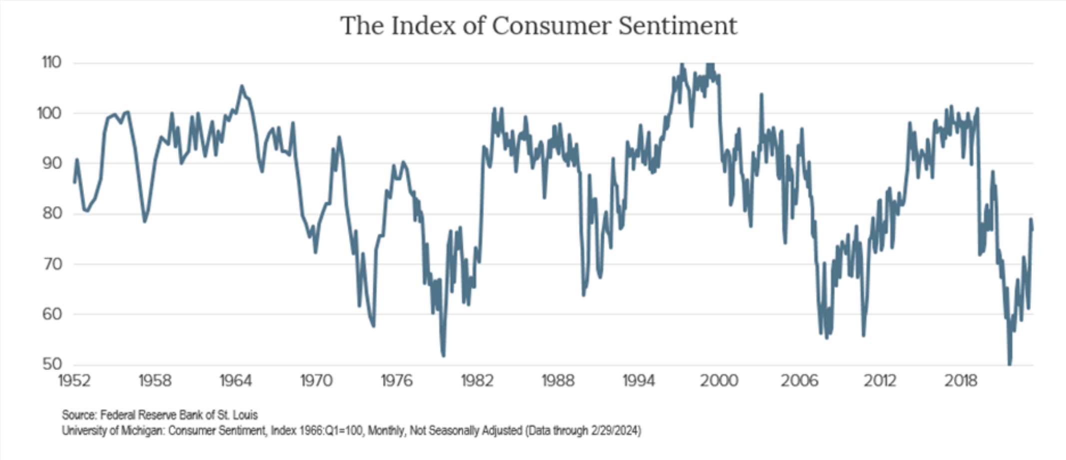
The U.S. economy is experiencing remarkable success at the moment. Justin Wolfers, professor of economics at the University of Michigan recently summed it up as follows: "...our economy this year is larger, more productive and will yield higher average incomes than in any prior year on record in American history. And because the United States is the world's richest major economy, we can now say we are almost certainly part of the richest large society in its richest year in the history of humanity."

Pausing to think about this, instead of concentrating on the minutia of the daily flow of economic data, maybe our focus should be on the fact that in its totality, the economic engine in this country is working so well that collectively we are experiencing the greatest level of wealth ever experienced by a major economy. This is an astounding achievement, certainly worth noting, and cause for celebration.

Yet, there is another side to the story. Despite all of this economic success, the average consumer either doesn't see it, or sees it but doesn't believe it. There is a puzzling lack of confidence. According to the University Of Michigan's Consumer Sentiment Index, the level of confidence is far below its highest readings and still resides below pre-pandemic levels.



For some reason, the average consumer just isn't seeing all the good things that are occurring in the economy. Why? What is the basis of the mismatch between consumer attitudes and economic reality? We can cite two factors that are inhibiting the confidence of the average man on the street, both of which are shock factors that foster negative emotional responses. The first is the cumulative impact of inflation over the last four years or so, and the second is the fact that higher interest rates are stressing the finances of many consumers.

INFLATION. The cumulative impact of inflation since the beginning of the Covid period is right around 20%. That means the average price of goods and services is 20% higher than it was four years ago. It is hard for the average consumer to get that out of her mind, even though average wage gains over the same period have risen by some 22%. The result is that the average consumer has 2% more purchasing power. Rationally, that should make consumers feel better. But according to economists, when prices and wages are both increasing, people tend to react differently: they feel they have worked hard to earn their wages while inflation has stripped them of their gains. It is the shock effect of high inflation that wins the day from an emotional standpoint.

Speaking of that 20% cumulative increase in inflation over the last four years, the sad truth is that it cannot be reclaimed. Actually, it could be reclaimed through deflation, but that is a condition that no one wants to experience. So how can the damaging effect of cumulative inflation be offset? The answer is that it just takes time - time enough for the consistent outperformance of wage or income gains to seep into consumer consciousness as recognition of economic progress and wealth creation. That is what is happening now; it is just too early in the process for the positive implications to have developed in the mind of consumers.

HIGH INTEREST RATES. The effect of higher interest rates is of course a direct offshoot of the inflation problem. We have higher interest rates because the Federal Reserve (Fed) has raised them in an effort to bring inflation back down to its 2% target. Their tool to accomplish this is the federal funds rate. Most consumers don't know what the federal funds rate is, but they certainly do know what the interest rates are on credit card debt, car loans, and home mortgages. They are well aware that home mortgage rates have tripled, car loan rates are up over 80%, and credit card debt cost them over 20% in some cases. It is understandable why these interest rates would be damaging to one's attitude, let alone to their personal finances.

Interest rates represent the cost of money, and to the average consumer it is a very real cost. However, the price of money is not included in the measures of inflation. A recent study* posits that if inflation measures included the price of money, it would go a long way in reconciling the gap between consumer sentiment and economic reality.

This discussion leads us back to the reality of just how damaging inflation is and why it is so important to restore it to a low level. Inflation gains don't get reversed, and their cumulative effect is persistent. As we see, inflation impacts confidence, not only in the consumer sector but also in the corporate sector. Confidence in the future is what compels companies to make future investments in plants, workers, and products. Low confidence impairs that process. For all of these reasons, it is imperative that the Fed remains diligent in its pursuit of low inflation. We believe they will, for it is simply too important to the future prospects of all aspects of our economy.

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Right now, seeing it isn’t believing it, but with success in restoring low and sustained inflation, as well as the passage of more time when wages and income are growing faster than inflation, all economic participants should feel better, and confidence in our economy should improve. At that point, seeing will be believing.

*The Cost of Money is Part of the Cost of Living: New Evidence on the Consumer Anomaly. National Bureau of Economic Research