"Try to save something while your salary is small; it's impossible to save after you begin to earn more."

Jack Benny

Overview

Consumer purchasing is responsible for about two-thirds of the American economy. Whether it is spending on durable goods, such as cars or housing, or on services, such as education and health care, consumption drives economic growth and performance. The financial health of the consumer is a critical factor in the stability of our domestic economy for our prospects for growth.

This paper explores the state of the consumer in the post-Financial Crisis era and some of the conditions that could be influencing changes in behavior.

Consumer since the Recession

Today's consumer has a higher savings rate and less debt than just before the recession of 2008-9. The U.S. job market has steadily improved and wages have largely recovered: The unemployment rate has been nearly cut in half since early 2009 (Chart 1); and, median incomes have moved gradually higher in the last two years and have nearly regained the inflation-adjusted levels of 2007 (Chart 2).

Chart 1: U.S. Unemployment Rate

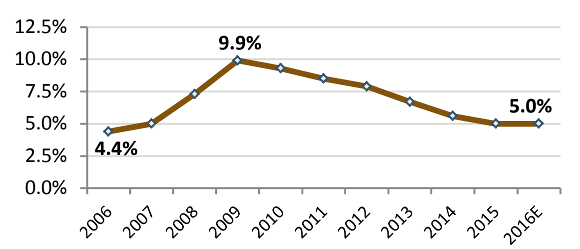
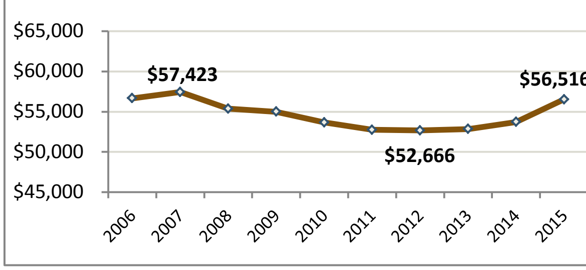


Chart 2: U.S. Median Income *(2015 $)*



From 2002 through 2007, the American consumer went on a spending spree, concentrated on housing. New home sales skyrocketed to more than 350,000 units per quarter from a long-run rate of roughly 175,000. This boom was financed by a reduction in savings (the savings rate plummeted from nearly 6% in the early 2000s to a low of 2.2% around 2006) and by a huge increase in housing debt.

When the financial crisis hit, consumers realized they had overspent and over-borrowed. Over the past 7 years, consumers have rebuilt their balance sheets to a more sustainable level of demand. Today, quarterly new home sales are in the 150,000 range and the savings rate is back to around 5.5% which is consistent with longer-term averages (Chart 3). Adding to the improved consumer balance sheet, debt service, as a percent of income, has dropped from 13% in 2007 to only 10% today. The benefits of higher savings and lower debt service are potentially very positive signs for consumer spending.

Chart 3: U.S. Savings Rate & New Home Sales

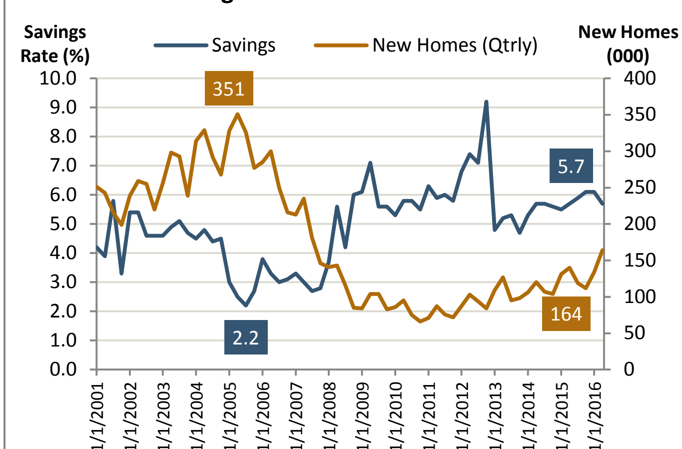
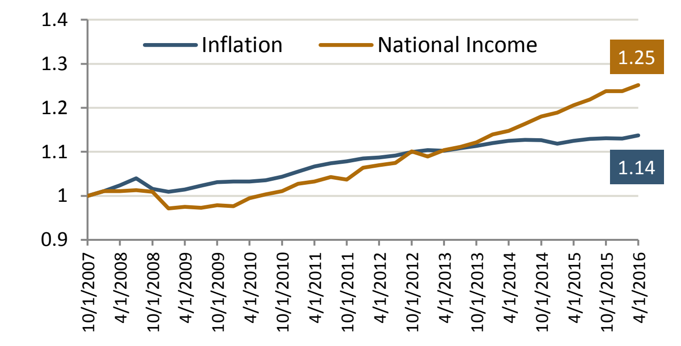


Chart 4: Inflation vs. Compensation *(2007 index)*



During 2008-2009 the economy lost nearly 10 million jobs, but since then has added back over 14 million jobs. Overall compensation has outpaced inflation since 2009 (Chart 4), leading to a net increase in real spending power.

Currently, the typical American consumer enjoys the position of having less debt and more savings than in 2007, and has experienced sufficient income gains to drive an increased level of overall demand for goods and services.

Consumer Outlook

Given the current environment of roughly 200,000 new jobs per month and better than 2% annual wage growth, we would expect consumer spending to grow roughly 3% per annum, assuming no further rise in the savings rate. So why does the economic recovery continue to feel so uncertain? Why haven't we seen the combination of increased consumer income, low gas prices, and lower food prices at the grocery store translate into a meaningful increase in retail sales?

The rising costs of large non-discretionary budget items such as health care, education, and housing are claiming an increasing share of consumer wallets. The level of discontent with inflation in these sectors has raised political debate about how to limit further cost escalation.

Consumer taste has also shifted over the past decade. Changing consumption patterns for discretionary spending are creating challenges for traditional retailers. Some of these changes include: 1) the enormous shift to online purchasing at the expense of traditional retail, 2) a preference to spend on experiences over physical goods, and 3) diminished capacity for brands to attract premium pricing and loyalty. For a consumer economy built on the fundamentals of a brick-and-mortar retail presence and brand recognition, this causes significant challenges for legacy retailers.

Going forward, we see continued growth in online purchasing. This makes pricing more transparent to the benefit of consumers. Success will be predicated on companies that offer consumers either unique products, experiences, or a compelling value.

We expect the recent trends of increasing median income, sensible savings rates, and manageable debt levels to continue. The resulting higher available disposable income should flow through the economy, likely keeping GDP in the +2% level through 2017.

The more complex and rapidly shifting landscape for businesses that compete for the consumer's discretionary dollars will create selected opportunities for investment. At Aureus, we continue to evaluate and assess the changing consumer to find and invest in attractive companies.