Standard Life Investments

Weekly Economic Briefing

Global Overview

A tale of two consumers

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The global economy is currently beset by a number of cleavages: commodity importers are outperforming exporters, developed economies are in better shape than emerging markets (EM), and domestic demand is outpacing trade and manufacturing activity. Nowhere are they more evident than in the retail and vehicle sales data compiled by JP Morgan. According to its latest figures, global vehicle sales volumes are currently growing at a six-month annualised rate of 3.1%, which is 0.7 percentage points above the average since the turn of the century. Global retail sales volumes are growing at a similar 3.2% pace, though that is bang in line with the 15-year average. However, these global figures mask enormous discrepancies between the developed market (DM) and EM complexes. Whereas vehicle and retail sales volumes are growing at a well-above trend pace in the developed world, they are growing at a considerably weaker rate in the emerging world (see chart 1). It can be argued that these components of spending are in fact at recessionary levels in EM as a whole. No wonder that EM GDP growth is currently at its weakest since the global financial crisis.

A number of factors explain the divergence in goods consumption patterns between DM and EM. For a start, most DM economies are oil and commodity importers and thus benefited more from the collapse in prices since the middle of last year. The pass-through of lower oil prices into household incomes tends to be curtailed in EM. Currency effects also play a role; consumer goods are highly traded and thus the depreciations experienced by many EMs have increased their cost in local currency terms. Meanwhile, in some EMs, but particularly China, the composition of consumer spending has shifted away from goods and towards services. At a deeper level, demand has weakened because many EMs are adjusting to new economic realities: the supportive role of China is fading, developed economies are increasingly relying on domestic conditions, credit cycles have turned and domestic imbalances must be addressed. There is scope for a modest cyclical recovery in EM consumer spending over the next 12 months - but the heady days of the previous decade will not return.

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The myth of the missing oil effect

A common lament among economy watchers is that households have not been spending the proceeds of the oil-price-driven surge in real incomes. Unfortunately, **the missing oil effect is a myth: consumption has responded to the drop in oil prices much as we should have expected.** Households' real disposable incomes (aggregate incomes adjusted for inflation and changes to taxes and transfers) have increased by 3.6% since July 2014 when oil prices began to drop, while real spending has increased by 3.8%. As a consequence, the personal saving rate, at 4.6%, is slightly lower than it was in July last year and is only 0.3 percentage points above its post-crisis trough. The benefits of lower oil prices are also reflected in the composition of spending. Light vehicle sales have jumped 10% since the peak in gasoline prices; vehicle miles travelled have been growing at the strongest pace since the early 2000s, while core retail sales are up by more than 4% in real terms. If real consumption growth has closely tracked real income growth where does the myth of the missing oil effect come from? The story first gained traction when the personal saving rate surged between November and February, as consumption growth was sluggish despite the plunge in oil prices during that period (see charts 2 and 3). In **hindsight, the missing consumption was simply a timing issue.** Much of the US experienced an unusually bad winter. It is also common for consumers to wait until they are sure that lower oil prices will be sustained before committing to large purchases. The episode serves as an example of why it is wise not to put too much weight on short-term data fluctuations and rely more on longer-run trends, as well as the lessons from past experiences.

However, it is not all peaches and cream on the consumer front. When we shift our gaze from the rear-view mirror and look ahead, **real consumption growth will probably slow over the next year.** Unless oil prices drop further and the dollar appreciates significantly, headline consumer price inflation is likely to pick-up to between 1.5% and 2% by the end of 2016. If the current rate of nominal disposable income growth is maintained, real income growth will slow to a little less than 2% over the same period. That implies that if the current personal saving rate remains unchanged, then the expansion in real consumption will also slow significantly, bringing GDP growth down with it. Two things could change this dismal equation. One would be the re-ignition of the dormant wealth effect, which would allow personal spending to grow more quickly than disposable incomes. Unfortunately, that seems unlikely, leaving hopes of continued strong consumption increases resting on an acceleration in nominal labour income growth. Stronger labour income gains could come from two channels - a pick-up in the growth rate of the number of hours worked in the economy and faster nominal wage increases. The first is improbable given that employment growth appears to have peaked for the current cycle. That leaves wages to take up the slack. Wage growth has been sluggish because spare capacity in the labour market has not yet been fully eroded and because of the turgid pace of productivity expansion. **In theory, wage and productivity growth should begin to rise when the economy reaches full employment sometime next year and firms substitute increasingly scarce labour for cheaper capital.** The ability of the economy to keep growing at an above-trend pace over the next few years rests on that also being true in practice.

Chart 2: Timing of spending distorted

Source: Bureau of Economic Analysis, Haver (as of August 2015)

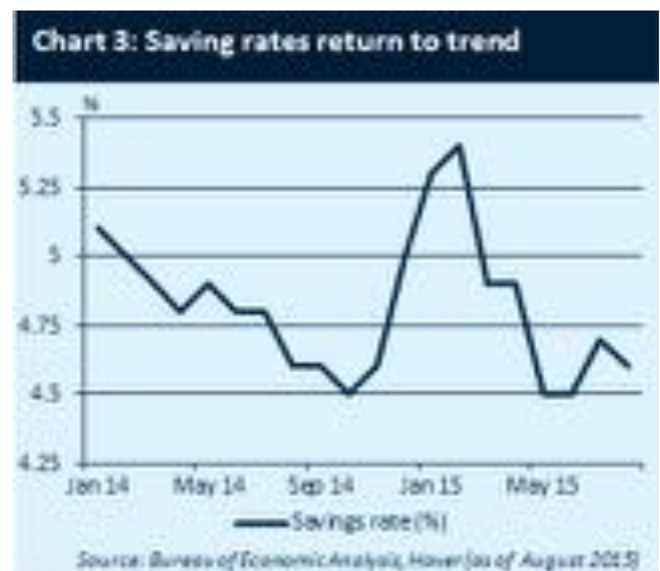

Chart 3: Saving rates return to trend

Source: Bureau of Economic Analysis, Haver (as of August 2015)