

Consumer Myths

May 7, 2000

The Wealth Effect, Interest Rates and Other Misconceptions

- Barring an unlikely *meaningful* rise in unemployment and/or reversal of strong real wage growth, consumer sector likely to remain strong.
- Slower growth is *not* no growth. Even if U.S. real GDP growth were to slow from its torrid pace of recent quarters to economy's noninflationary "speed limit" (labor force + productivity growth) of 3-4%, that rate of growth should be more than sufficient to ensure continued real income gains.
- What ultimately drives consumer spending growth is income growth. Correlation coefficient of changes in consumer spending and changes in real income is a very strong 0.76. By contrast, correlation coefficient of changes in consumer spending and changes in stock prices is just 0.29. So, it's wrong to worry that strength of consumer spending is contingent on a strong stock market.
- Correlation coefficient of changes in consumer spending and changes in interest rates is even *less significant* than "wealth effect" (-0.12 correlation coefficient with 10-year Treasury; +0.13 correlation coefficient with 3-month T-bill). So, it's also wrong to worry that consumer spending will slow *materially* because of *modestly* higher rates.
- Some investors worry that, as wages continue to rise, inflation will pick up strongly, Fed will tighten aggressively, economic expansion will end. However, history shows that an *extended* period of solid wage gains is fully compatible with low inflation and solid economic growth.
- Nine Highlighted consumer stocks: Bed Bath & Beyond, Carnival Corp, Costco, Delta Airlines, Gap, Home Depot, Tandy, Tiffany, Wal-Mart.

The Wealth Effect (And Other Consumer Myths)

Today one hears many investors voice concerns about the consumer. Those concerns can be summarized as:

1. "It's late in the cycle and the consumer is bound to slow, especially with the Fed raising interest rates."
2. "As/when the stock market falls from its highs, the 'wealth effect' will curtail spending."

These are the most frequently cited reasons for being cautious on the consumer sector, and for avoiding consumer-related stocks. We take issue with both arguments.

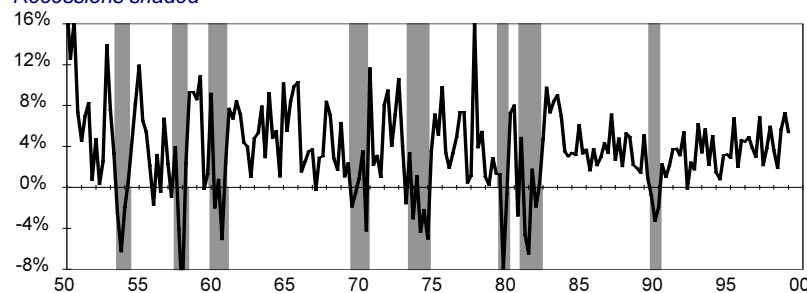
The "Consumer Comeback"

Because of rising real wages, we have been bullish on the consumer sector since 1995. In "Consumer Comeback" (September 4, 1995) we argued that, after 20 years of stagnation, real wage growth would improve in the late 1990s for three key reasons:

First, thanks to the muted business cycle (Chart 1), demand for labor will stay strong as we avoid a long or deep recession, comparable to 1979-82.

Chart 1: Real GDP

Recessions shaded

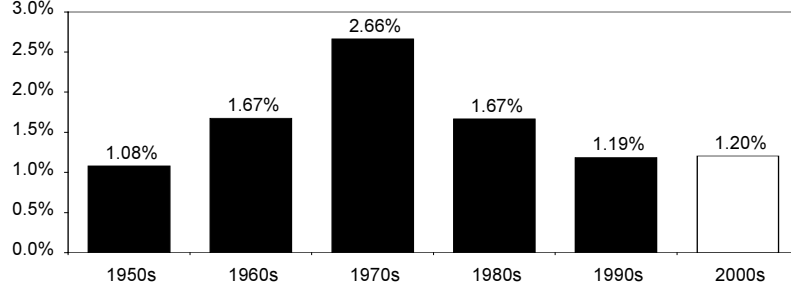


Source: Bureau of Economic Analysis.

- Second, for demographic reasons (i.e., women and boomers have already entered the labor force) the supply of labor will not increase very rapidly (Chart 2).

Chart 2: U.S. Labor Force Growth

By decade

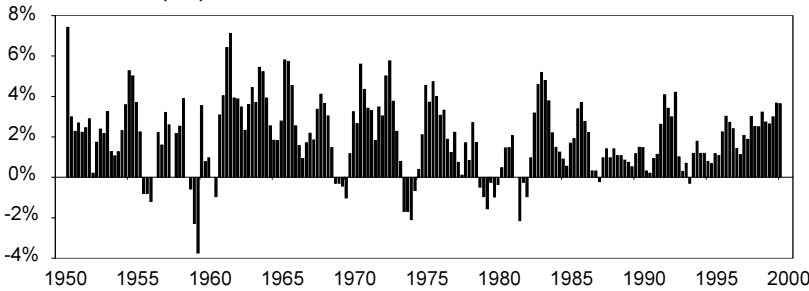


Source: DRI.

- Third, after years of corporate restructuring and productivity improvement (Chart 3), corporations can afford to pay higher wages without reigniting inflation or losing international competitiveness.

Chart 3: Productivity—Year-to-Year Percent Change

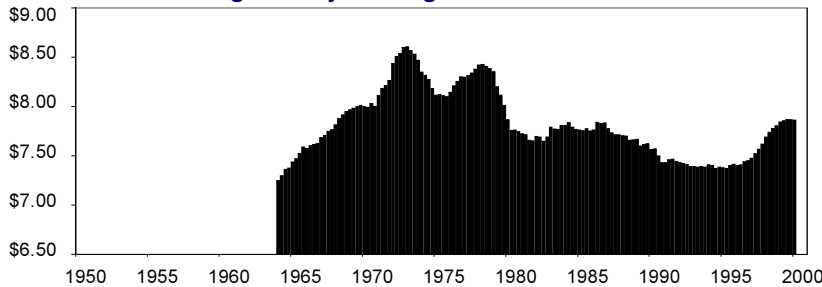
U.S. non-farm output per hour



Source: Bureau of Labor Statistics.

As Chart 4 illustrates, after years of decline, real wages have risen by 7% since 1995.

Chart 4: Real Average Hourly Earnings



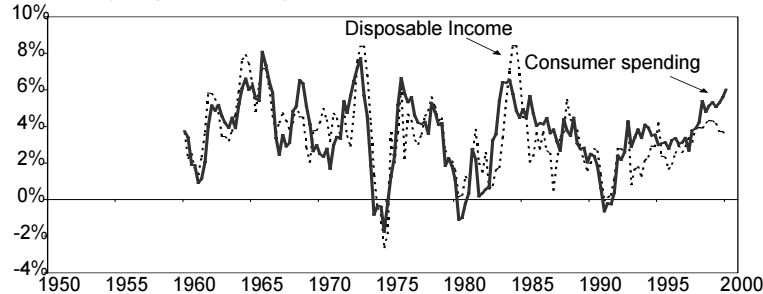
Source: Bureau of Labor Statistics.

Income Gains Drive Consumer Spending

Chart 5 illustrates why real income gains matter—because they drive consumer spending! Employment growth and low interest rates are both positive for the overall consumer environment, but *what ultimately drives consumer spending growth is income growth*. The correlation coefficient of changes in consumer spending and changes in real income from 1960 to 1999 is a very strong 0.76 (Table 1).

Chart 5: Real Disposable Income and Real Consumer Spending

Year over year percent change



Source: Bureau of Economic Analysis.

Table 1: Correlation Coefficient of Real Consumer Spending with 5 Variables

Quarterly data, year to year changes, 1960 - 1999

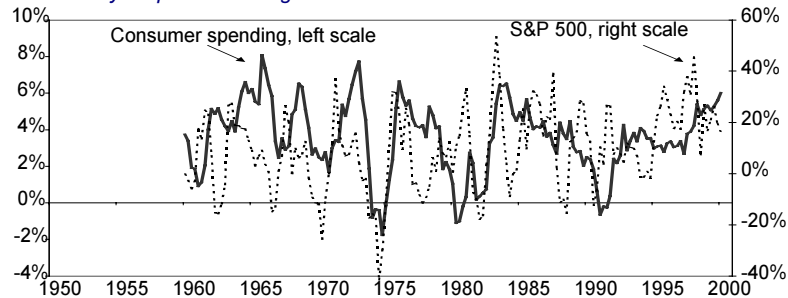
Real disposable income	0.76
Employment	0.61
Stocks (S&P 500)	0.29
Interest rates (10-year)	-0.12
Interest rates (3-month)	0.13

Source: PaineWebber.

However, as Table 1 and Chart 6 illustrate, the correlation coefficient of changes in consumer spending and changes in stock prices is just 0.29. For example, (driven by real income gains) consumer spending growth *accelerated* in 1988 (from 3.3% to 4.0%), even though stocks had plunged 22% in October 1987.

Chart 6: S&P 500 and Real Consumer Spending

Year over year percent change

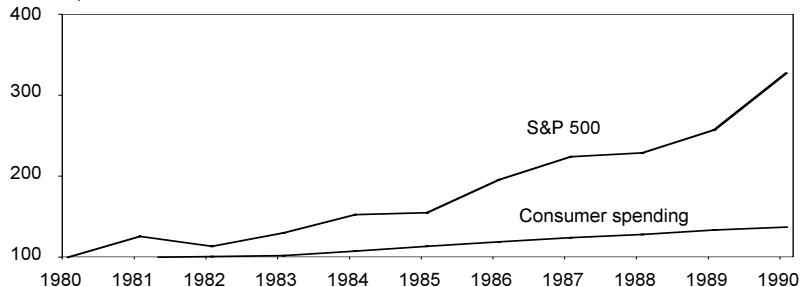


Source: Bureau of Economic Analysis, DRI.

On the other hand, Chart 7 illustrates that consumer spending grew very slowly in the early 1980s, even as stock prices soared as the bull market got under way. A key reason behind the strong stock price gains of the 1980s was the secular decline in interest rates. But with the correlation between changes in spending and changes in interest rates *even lower* than the correlation between changes in spending and stock prices (Table 1), the steep drop in rates in the 1980s didn't spark consumer spending either (Chart 8).

Chart 7: Stock Prices and Real Consumer Spending

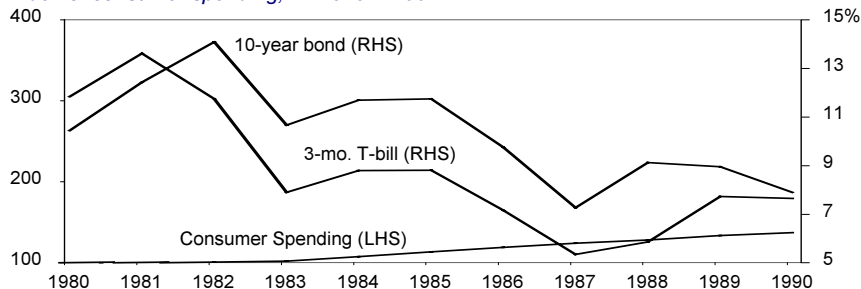
Indices, 12/1979 = 100



Source: Bureau of Economic Analysis, DRI.

Chart 8: Interest Rates and Real Consumer Spending

Index of consumer spending, 12/1979 = 100

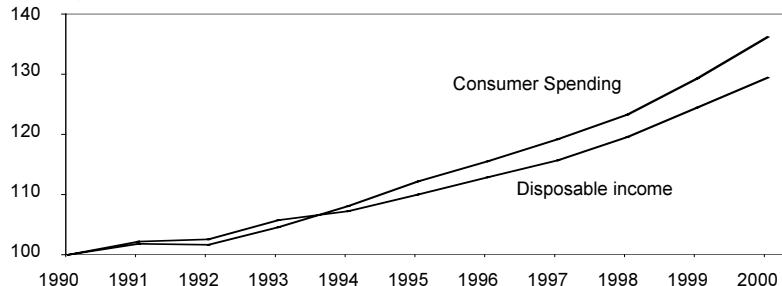


Source: Bureau of Economic Analysis, DRI.

Indeed, spending growth lagged income growth until real incomes began their steady rise in 1994 (Chart 9).

Chart 9: Real Consumer Spending and Real Disposable Income

Indices, 12/1989 = 100



Source: Bureau of Economic Analysis.

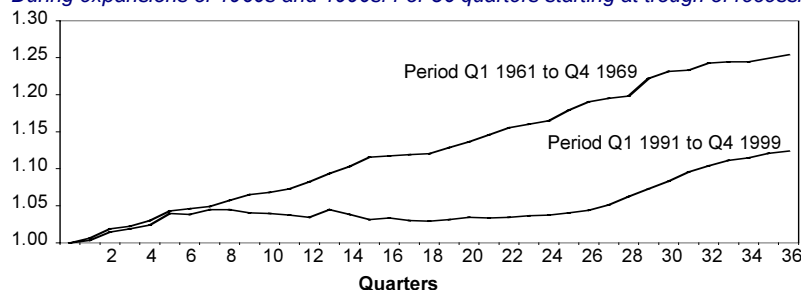
Solid Wage Gains *Are* Compatible with Low Inflation

A big worry of some investors is that, as real wages continue to rise (for the reasons outlined above), inflation will pick up strongly, the Fed will tighten aggressively, and the economic expansion will end. History shows, however, that an extended period of solid wage gains is fully compatible with low inflation and solid economic growth.

As Chart 10 shows, wage gains were much *stronger* in the 1960s than during the 1990s. But inflation was actually *lower* in the 1960s—2.5% versus 3.0% in the 1990s—because productivity growth was so strong.

Chart 10: Index of Real Non-Farm Hourly Compensation

During expansions of 1960s and 1990s. For 36 quarters starting at trough of recession



Source: Bureau of Labor Statistics.

The pickup in inflation in the late 1960s was caused in part by expansion of the Vietnam War, which, in tandem with growing spending on social programs (i.e., “guns and butter”), contributed to a large budget deficit that would not disappear for nearly 30 years. *None of those powerful inflationary forces are in evidence today.* With the U.S. and global economies booming and likely close to their peak growth, PaineWebber’s chief economist, Dr. Maury Harris, estimates 2000 PPI to be +2.5%, CPI +3.5%. However, the powerful secular forces at work today—e.g., a muted business cycle, strong productivity, a federal budget surplus—still lead us to believe that 2% is an appropriate secular inflation assumption. Indeed, the long-term U.S. inflation rate has been just 1.6%. In some years, inflation will fall below that normal 2% level: e.g., PPI was -0.5% in 1998, CPI +1.5%. In some years it will rise above that level: e.g., in 2000.

Slower Growth Is *Not* No Growth

Dr. Harris does *not* believe that tightening by the Fed will ultimately cause the economic expansion to end. Rather, he expects U.S. real GDP growth to slow from its torrid pace of recent quarters to the economy’s noninflationary “speed limit” (labor force + productivity growth) of 3-4%. That rate of growth should be more than sufficient to ensure continued real income gains. For example, in 1995, the first year of the “Consumer Comeback,” real GDP grew “just” 2.7% but real disposable incomes rose 2.7%. In 1997 and 1998, when real GDP grew at just over a 4% rate, real disposable incomes rose at an average 3.8% rate.

What's in the Price of Consumer Stocks?

Given the aforementioned concerns about the consumer, many consumer stocks have been poor performers lately. But, as Table 2 illustrates, at current prices, many consumer stocks are implying *much* slower growth rates than seem likely to occur.

Table 2 “works backwards,” calculating the growth rate implicit in the market’s current valuation of the nine consumer stocks on our Highlighted list. All are pricing in growth rates below the current forecast. And Bed Bath & Beyond, Carnival, Gap and Home Depot are pricing in secular earnings growth rates that are 10 percentage points below the current consensus growth rate.

Table 2: Highlighted Consumer Stocks

		5/5/00 Price	52-week high	% change off 52-wk high	Projected Normal 2000 EPS	Projected Growth Rate	Implied Growth Rate
Bed Bath & Beyond ²	BBBY	\$35.31	\$45.50	22%	\$1.05	23%	10%
Carnival Corp	CCL	25.13	51.88	52	1.88	14	3
Costco ²	COST	48.81	60.50	19	1.43	16	9
Delta Airlines ³	DAL	55.56	68.06	18	6.50	6	4
Gap	GPS	34.44	53.75	36	1.49	18	7
Home Depot	HD	53.31	70.00	24	1.20	22	12
Tandy	TAN	50.94	79.50	36	1.70	17	9
Tiffany	TIF	67.56	90.00	25	2.31	18	9
Wal-Mart	WMT	51.31	70.25	27	1.45	16	8

Source: PaineWebber.

Additional information available upon request.

2. PaineWebber Incorporated makes a market in this security.

3. PaineWebber Incorporated has acted in an investment banking capacity for this company.

The information contained herein is based on sources we believe to be reliable, but its accuracy is not guaranteed. PaineWebber Incorporated and/or Mitchell Hutchins Asset Management Inc., affiliated companies and/or their officers, directors, employees or stockholders may at times have a position, including an arbitrage or option position, in the securities described herein and may sell or buy them to or from customers. These companies may from time to time act as a consultant to a company being reported upon. *Copyright © 2000 by PaineWebber Incorporated, all rights reserved*