HIGHTOWER

FARR MARKET COMMENTARY

WITH MICHAEL FARR, HIGHTOWER'S CHIEF MARKET STRATEGIST

Know the Arguments!

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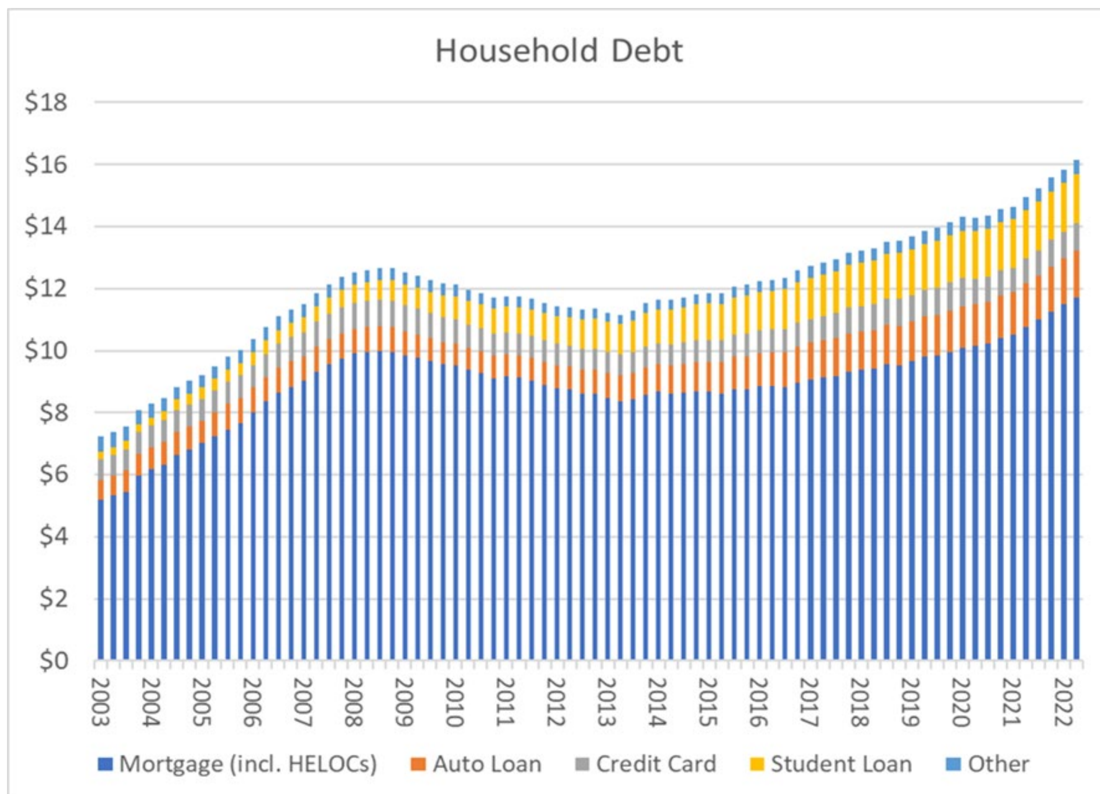
I had a conversation with a client the other day, and he made a comment that made me think. He said he can't stand to watch the cable financial news channels anymore. I asked why, and he said that he is tired of hearing all the negativity about the economy and he doesn't believe any of the positive commentary. I can understand the exasperation, and it would be nice if we could somehow get just the facts without all the editorial commentary. But it's also helpful to hear both sides of every story. There are often many ways to interpret the same data, and knowing the arguments is often helpful. So, without further ado…

The New York Fed released its quarterly Household Debt and Credit Report yesterday. The report had some interesting clues about the state of the consumer, which I'll get to in a bit. Overall, household debt rose by $1.2 trillion, or 8%, year-over-year and by $312 billion, or 2%, sequentially to a new record of $16.2 trillion. The sequential growth of $312 billion was led by higher mortgage debt, which grew by $209 billion. The surge in mortgage debt isn't too hard to explain. There has been a dramatic dearth of houses for sale relative to relatively robust levels of demand. There are many factors that have led to this mismatch of supply and demand, but the most compelling are the inadequate new home construction since the Great Financial Crisis and the very low level of mortgage rates in recent years. In any case, the dramatic mismatch between supply and demand has cause housing prices to surge at rates as high as 20%+ in recent months. Bigger loans are obviously required to finance more expensive houses.

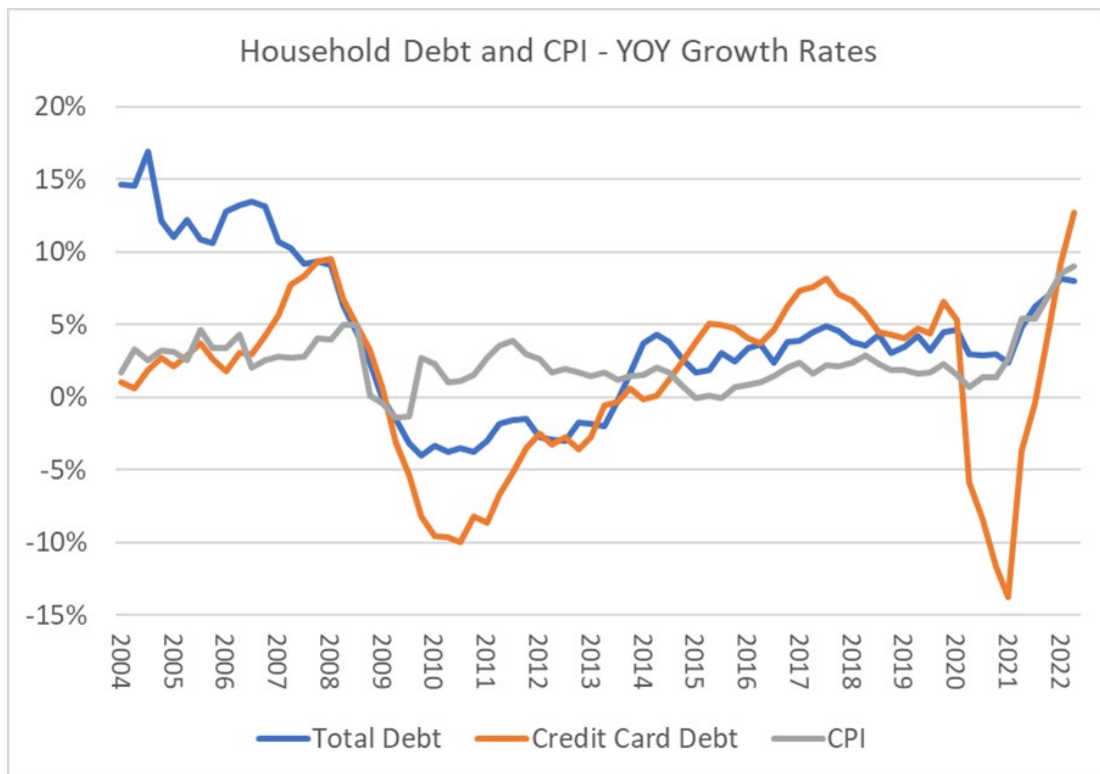


Source: New York Fed.

That explanation seems to work for the $33 billion growth in auto loans outstanding during the quarter as well. We've all heard about how supply-chain disruptions have negatively impacted production rates at the big auto manufactures. In particular, the auto makers have been having trouble sourcing semiconductors. As a result of the production disruptions, there has been a shortage of both new and used vehicles. That shortage, along with steady demand and low interest rates, has sparked massive increases in the prices of new and used vehicles. Bigger loans are required to finance more expensive cars.

Perhaps the most striking statistic in the report was that credit card debt outstanding increased 13% year-over-year in the second quarter, which was the fastest growth rate in 20 years. It's not surprising that credit card debt is surging, especially since inflation has had such a negative impact on the finances of low- to moderate-income folks. But it is a little counterintuitive that demand for credit is surging even as the cost of that credit is surging. Normally, when the price of something increases, demand falls. And so the increase in demand for credit in the face of higher interest rates, in this case, could suggest that many consumers have no other choice but to borrow so they can pay for the rising cost of living. This is especially true given that most credit card loans, unlike most mortgage and auto loans, carry adjustable rates that go up as interest rates are rising.

In the chart below, you will see that the surge in the growth rates of both total household debt (blue line) and credit card debt (orange line) in recent months has corresponded to a surge in inflation (gray line).



Source: New York Fed.

What can we glean from this data? As is often the case, there is an optimistic way to interpret the data, and there is a pessimistic way to interpret the data. First the pessimistic point of view. The report on household debt seems to contradict the portrait of a healthy consumer who is well-positioned to withstand a slowing economy and high rates of inflation. The consumer, in the aggregate, is obviously relying more and more on debt to make ends meet. The most rational explanation for this is that prices, especially for non-discretionary expenses like food, energy, transportation and shelter, are rising faster than incomes. Further evidence of this thesis can be found in the consumer savings rate, which dropped to the lowest level (5.1%) since 2009 in June. Consumers cannot continue to dip into savings indefinitely as the savings (still relatively considerable in the aggregate) will eventually be depleted.

The more optimistic interpretation of the data is that despite the surge in inflation and the uncertainties surrounding the possibility of an economic recession, the consumer's spirit (again, in the aggregate) has not been broken. Consumers continue to spend, and they are increasingly willing to borrow to maintain their lifestyles in the face of rapidly rising prices. Given that consumer spending represents more than two-thirds of GDP, it is unlikely that the economy will fall into recession as long as the consumer continues to spend. If credit remains available (perhaps a big assumption), the economy should be just fine during this temporary period of rapid inflation.

Which camp are you in? My best suggestion is to not go "all in" on either point of view. It makes most sense to evaluate all the incoming data, both positive and negative, and then position your portfolio to both benefit from the optimistic interpretation as well as defend against the pessimistic interpretation. From where I sit, the data argue for a defensive posture with a heavy emphasis on high-quality companies with rock-solid balance sheets as this period of uncertainty plays out.

Peace,

Michael

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