

October 1, 2010

# Record Transfers Help Moderate Recovery in Income and Spending

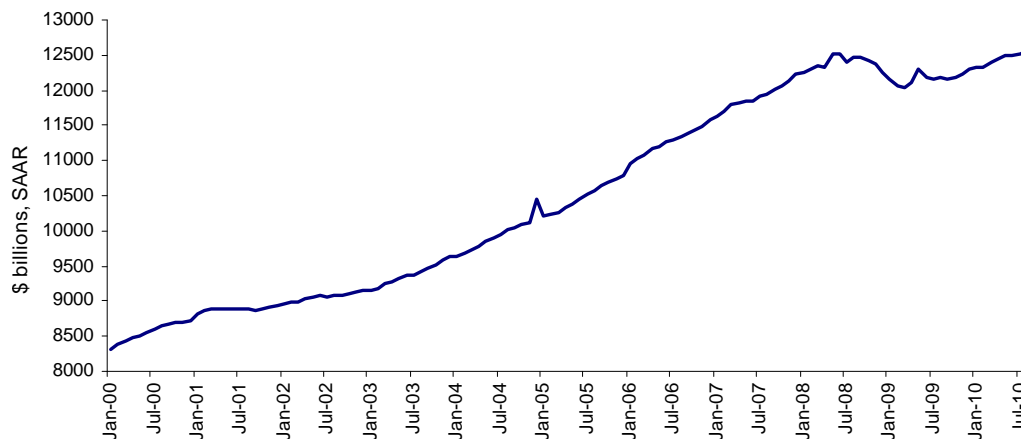
We think the economy has resumed a gradual recovery after hitting extra strong head winds in the second quarter. Those included the discouragement over the Gulf oil spill, Europe's debt crisis, and the legislative shocks on health care, tax risks (given no congressional budget), and sprawling, ill-defined financial regulation.

- The head winds are still strong -- the distinct possibility of a major tax increase at year end (won't know until mid-November); rising prices for manufacturers (see today's ISM); the expansion of federal spending and power; the centralization of key financial decision making in Washington regulators, impeding small business; and the burden from complex, changing regulations in health care, environment, and labor. Wage and salary income is up only 1.9% over the last year.
- Even so, we expect a gradually strengthening recovery in the remainder of 2010 and into 2011 – moderate growth from a low base. We note today's data on income, consumption and manufacturing, pent-up demand (especially for autos), foreign growth, idle cash, and the short-term stimulus from the absorption of debt into the federal government (through subsidies to states, auto bailout, the mortgage bailout process, transfer payments, etc.)

## Income and Consumption Grew in August

Personal income grew 0.5% nominal in August from July and 3.3% from August 2009, reaching \$12.6 trillion. Personal income is just above the June 2008 peak (all data nominal terms) while consumption expenditures are well above their previous peak.

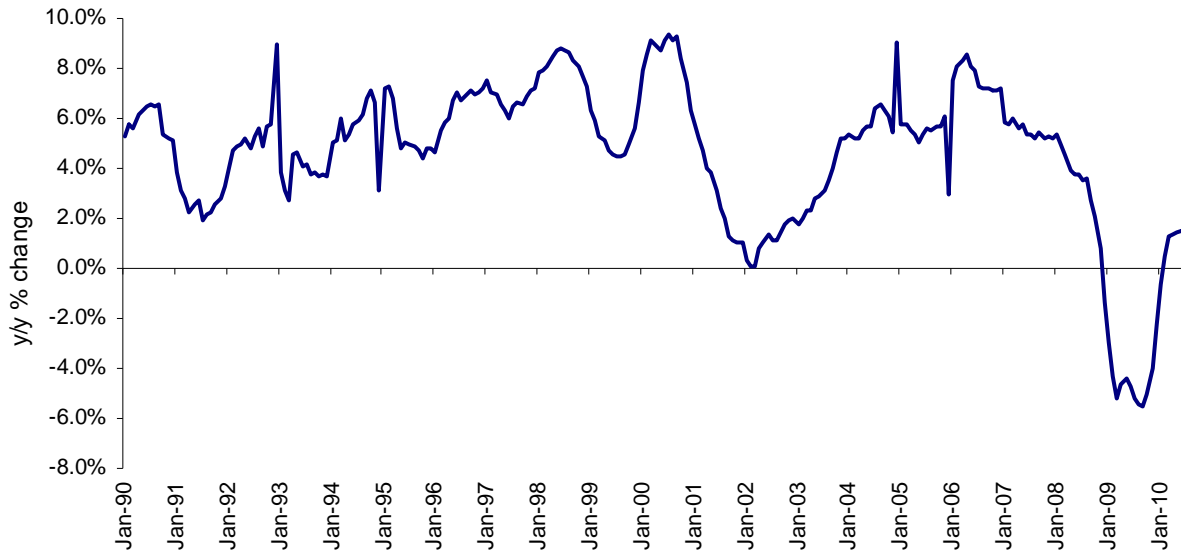
## Personal Income (last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- However, excluding transfers, personal income is up only 2.3% year-over-year,

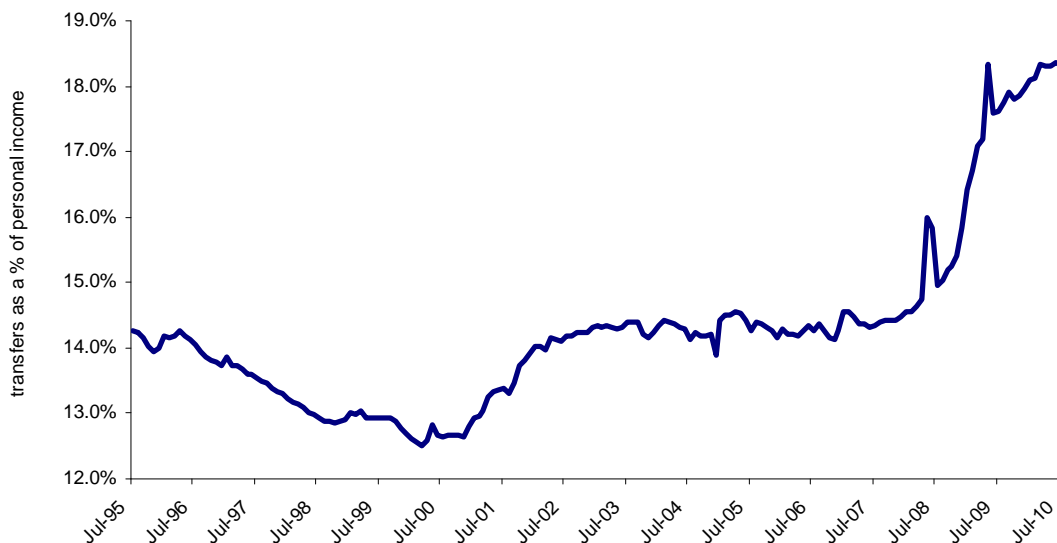
### Personal Income excluding transfers y/y (last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- Transfer payments in August hit a record \$2.3 trillion annual rate, 18.5% of personal income. Transfer payments directly boost personal income and the personal savings rate at the expense of increased government debt. We think they cause a small boost in consumption in the short-term but discourage business investment and hiring.

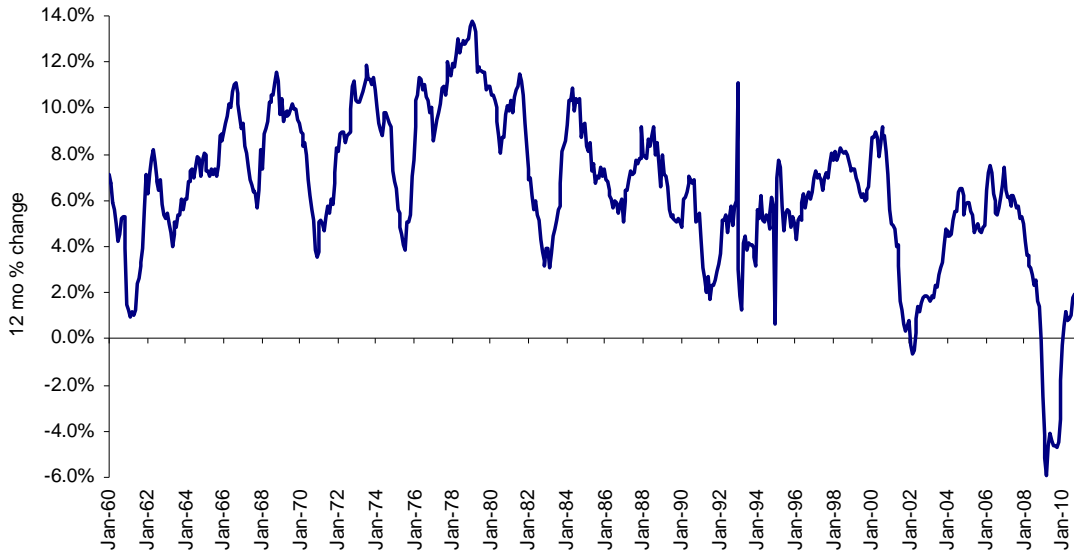
### Transfers as a percentage of Personal Income (last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- The August data showed that income from wages and salaries (which don't include transfer payments) rose 0.3%, to \$6.39 trillion annual rate, compared with 0.4% in July. On a year over year basis, wage and salary income is up only 1.9%, after a much deeper decline than in previous recessions. Weak recovery in the year-over-year data reflects an improving employment situation from a reduced base, consistent with our outlook for a moderate expansion from the economy's lower base.

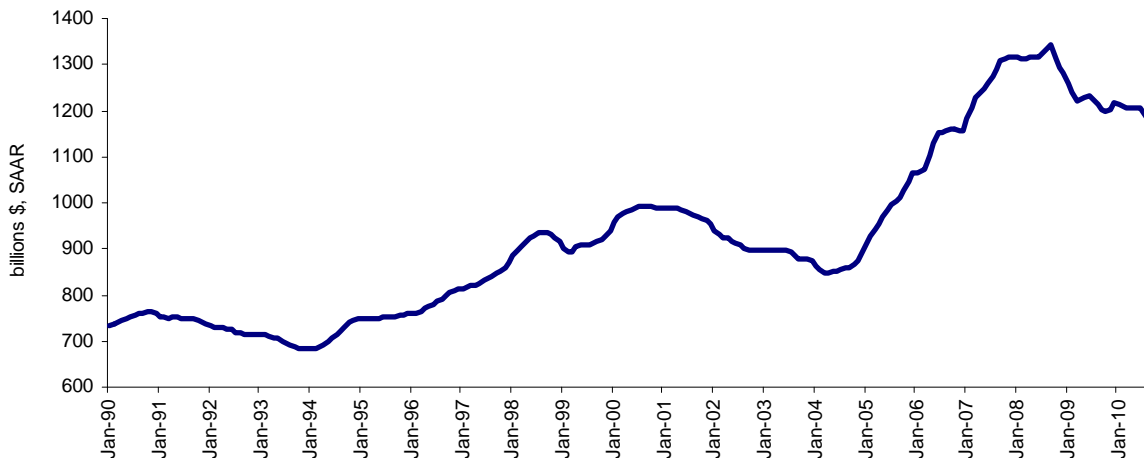
### Wages & Salaries (y/y change, last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- Interest income fell to a \$1.18 trillion annual rate in August, down 2.5% from August 2009. With interest rates very low, interest income is at its lows for this cycle, down from a \$1.34 trillion annual rate in the 2008 peak.

### Interest Income (last obs. August 2010)

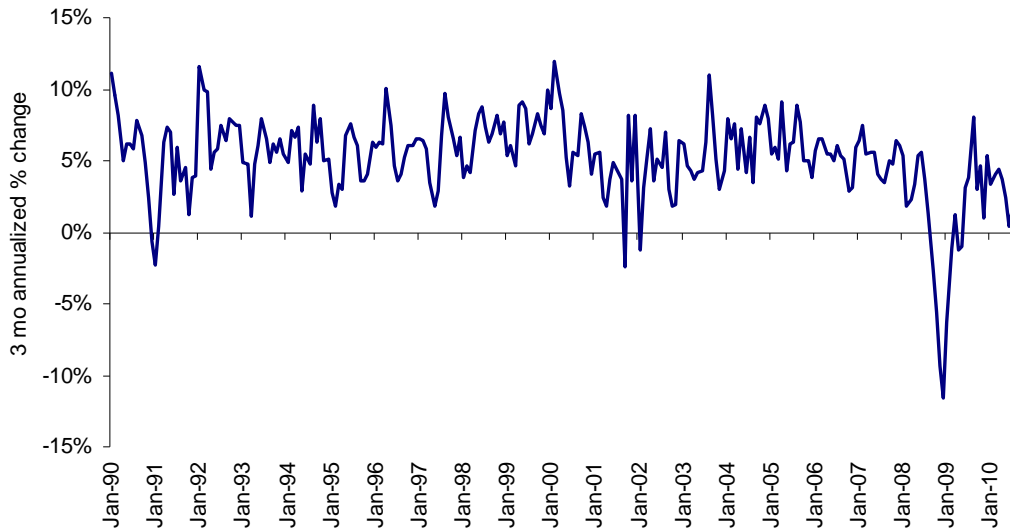


Source: Bureau of Economic Analysis; Encima Global

## Consumption Growing From Very Low Base

Consumption rose 0.4% nominal in August from July and 2.7% from August 2009, reaching \$10.4 trillion. It had grown 0.4% in July and 0% in June, bringing the three-month annualized growth rate to 3.1% in nominal terms.

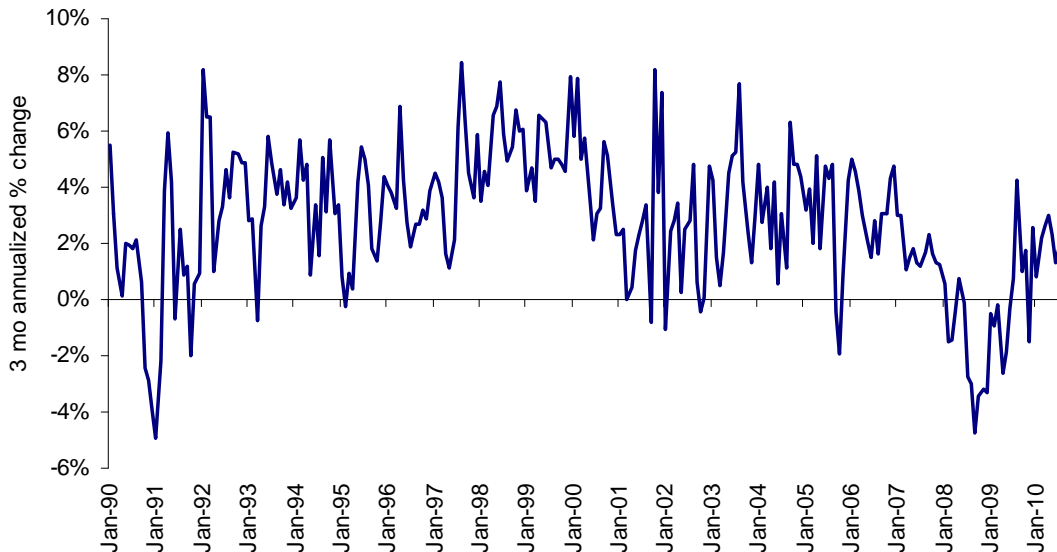
### Nominal PCE (3 mo % change annualized, last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- Real PCE rose 0.2% in August from July and rose 1.8% annualized for the three months ending in August, well below the growth at similar stages in previous recoveries.

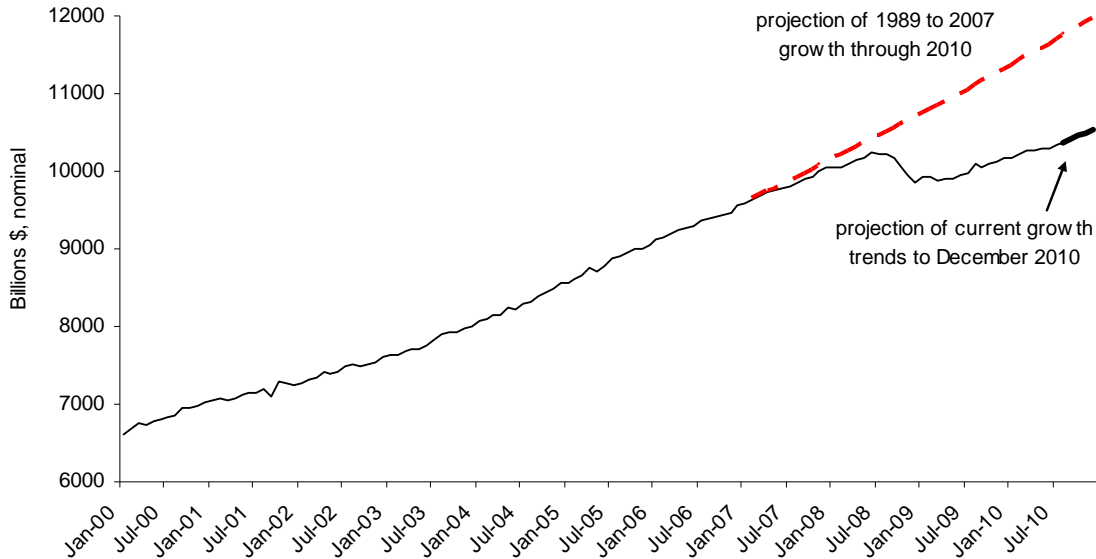
### Real PCE (3 mo % change annualized, last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- Current consumption trends will leave consumption almost \$1.5 trillion (annual rate) below the pre-Lehman trend at the end of 2010.

### Nominal PCE (last obs. August 2010, broad line projects through Dec 2010)

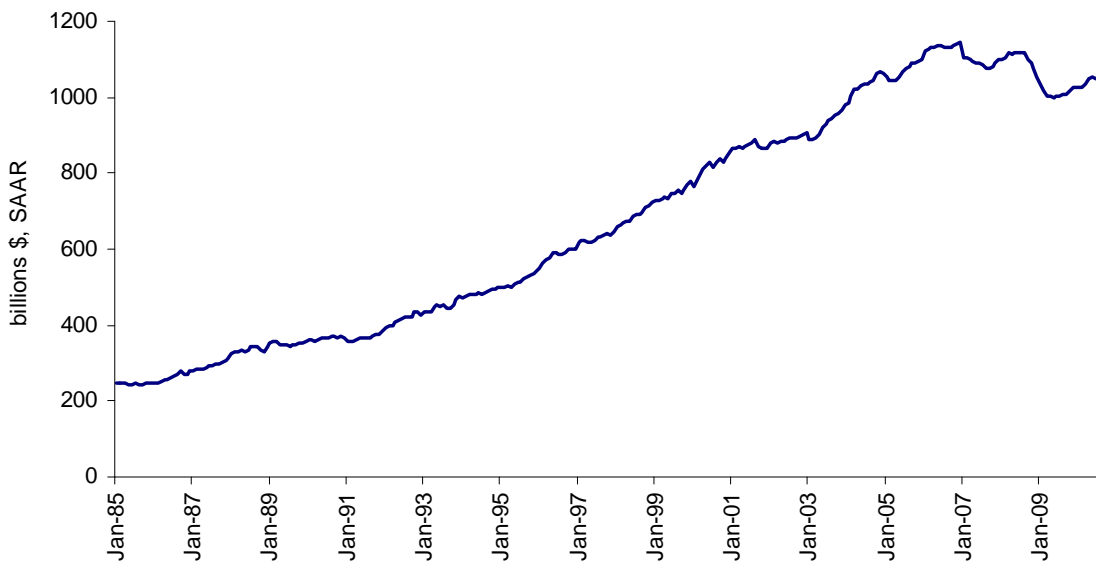


Source: Bureau of Economic Analysis; Encima Global

### Small Business Income

Proprietors' income rose \$10.1 billion or 1.0% to \$1.061 trillion in August from July. On a year over year basis, it's up 5.3% but it is still down 7.5% from the peak in December 2006.

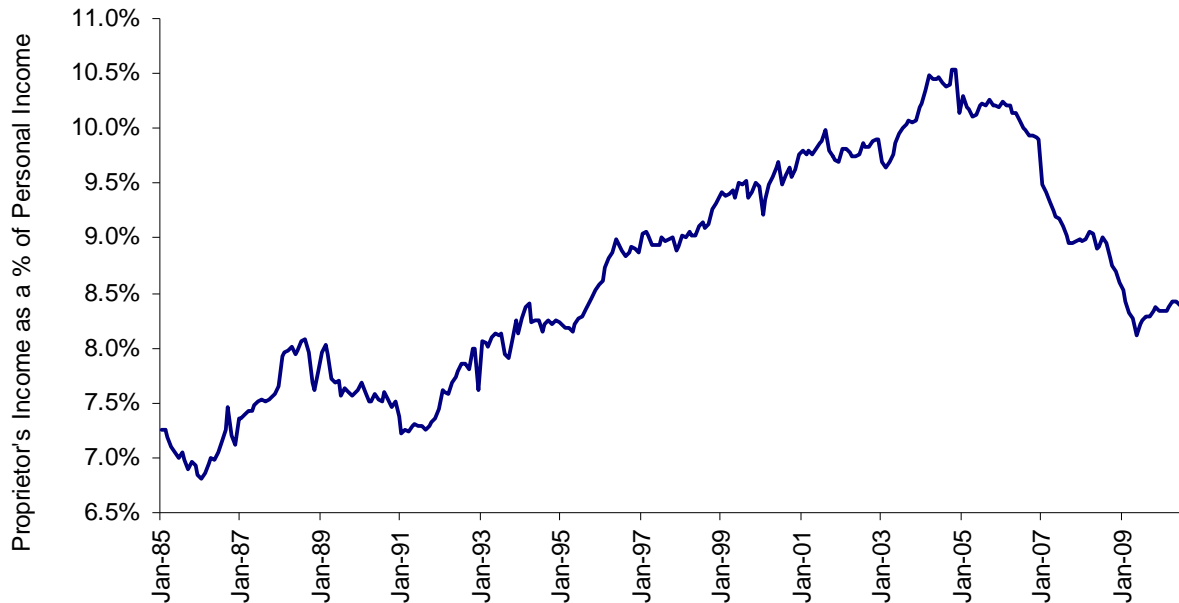
### Proprietors' Income with IVA and CCAj (billions, last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- While governments, big corporations and banks are doing well, small businesses have lost a major part of their share in the economy. As a percentage of personal income, proprietors' income stood at 8.4% in August, about the same proportion as in the 1990s. It had peaked in November 2005 at 10.5%. With the economy less dynamic as the federal government expands into new businesses, we expect a sustained expansion, but not enough strength to rapidly lower unemployment.

### Proprietors' Income as a share of Personal Income (last obs. August 2010)

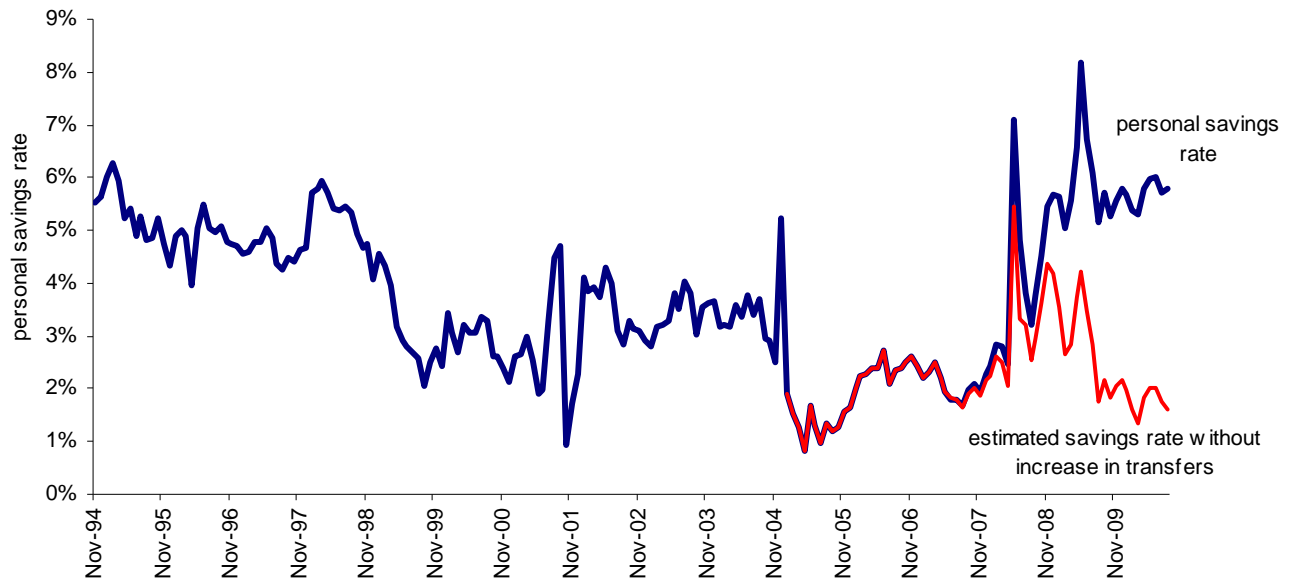


Source: Bureau of Economic Analysis; Encima Global

### Personal Savings

The official personal savings rate stands at 5.8% in August up from 5.7% in July. Without the increase in federal transfer payments since the end of 2007, however, we estimate the PSR in August would be 1.6%. The PSR has been negatively affected by the low yield on savings. We think it's unlikely that the consumers are saving as much as the official PSR when the yields are near zero.

## Personal savings rate, excluding increase in transfers (last obs. August 2010)



Source: Bureau of Economic Analysis; Encima Global

- As discussed in detail in our previous pieces, we note problems with the PSR which make it unusable for economic purposes: it doesn't reflect the flow into savings nor can it be reconciled to the stock of savings (which the Fed correctly tracks in its savings data); it doesn't help predict consumption; it derives savings using a cash-basis measure of consumption (outlays from any source) and a narrower measure of income (excludes realized and unrealized capital gains and the inside buildup in pensions and 401ks.)
- We don't think the official measure of the personal savings rate has significance in the outlook. It won't be picked up in the Fed's measures of actual savings and doesn't by itself point to a change in consumption trends (though the unemployment rate will have an impact.)
- Bottom line: Wage and salary growth remained weak in August (up 0.3%). Transfers as a percentage of total income rose to a new peak. Low rates have hurt savers and reduced interest income. Consumption grew enough to sustain a weak recovery.

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