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## How resilient are DM consumers?

The resilience of developed market consumption has been a key factor extending this cycle. Resilience should wane in the second half of the year, but some economies are more vulnerable than others.

### Key Takeaways

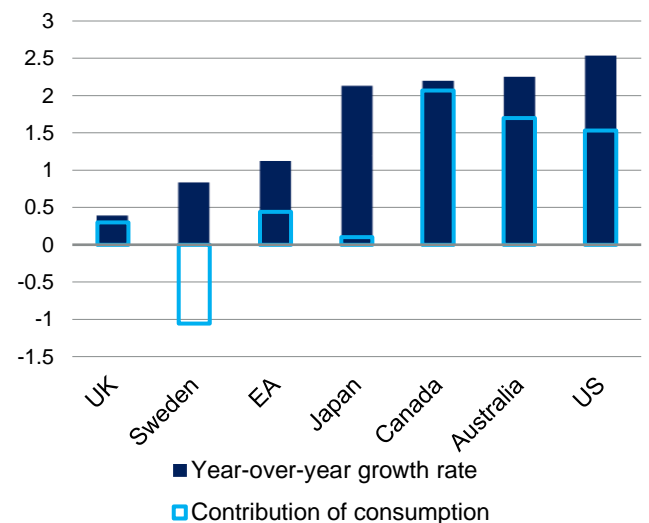
- Developed market consumers have proven resilient despite significant monetary policy tightening. We decompose consumption into income and savings to understand the vulnerability of consumers to changes in interest rates and the macro environment.
- Income dynamics, despite becoming more favourable as headline inflation falls, should be negatively impacted by rising debt servicing costs and slowing wage growth.
- For consumers in economies with mortgages that are fixed for longer periods, like the US, the pass-through of higher rates remains tempered. But Australia, Canada, the UK, and Sweden will see more households refinancing at higher rates, weighing on disposable incomes.
- On the savings side, consumers have drawn down pandemic-era savings to differing degrees to support consumption. In Australia, the US and Sweden we estimate that excess savings are nearly depleted, but the Eurozone, UK and Canada retain big overhangs.
- Savings decisions going forward will impact the share of income left for households to spend. Higher returns on savings and expectations of a slowing economy could cause households to increase saving rates.
- Sweden is looking vulnerable already, but high levels of debt in Australia and Canada, and mortgage headwinds for already constrained UK consumers should see pullbacks in spending in these regions too. Although sheltered to some degree from mortgage market dynamics, the resumption of student loan

repayments as well as a slowing labour market should temper US consumption.

### Consumers are proving resilient despite a significant tightening in policy

One of our key calls is that several developed market (DM) economies will enter recessions by early 2024, but we need to see some softening in consumer demand for this to materialise. In Sweden, Japan, the UK, and Eurozone, this is already happening, but consumption remains very resilient in the US, Canada and Australia (see Figure 1).

Figure 1: Consumption key growth driver for most DMs



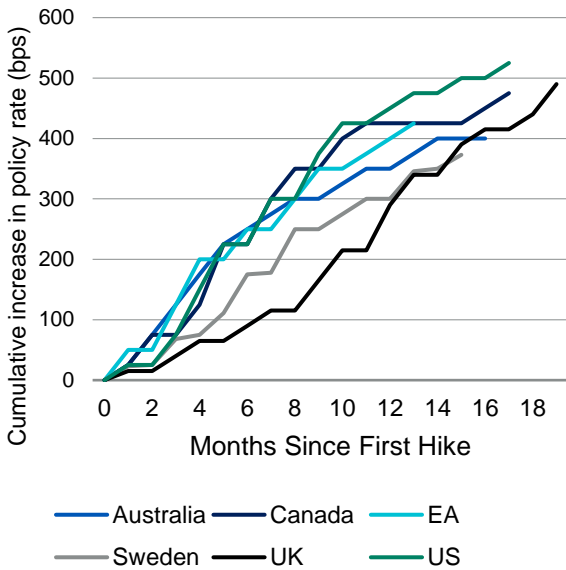
Source: Haver, abrdrn, August 2023

Consumer resilience persists even in the face of a fast and significant policy tightening from many central banks. Rates have risen around 400bps on average over a 12–18-month



period (see Figure 2). A puzzle of this cycle is why this has not weighed more on consumers.

**Figure 2: Policy has tightened significantly**



Source: Haver, abrdrn, August 2023

**The timing of policy pass-through is hard to predict**

It is hard to estimate both the point at which policy becomes restrictive – when policy rates exceed the unobservable neutral rate of interest – and how quickly higher rates impact consumers.

Milton Friedman famously called these lags ‘long and variable’. But going into this tightening cycle, many were emphasising that forward guidance and a more financialised economy had reduced the length of monetary policy lags. This is because financial markets anticipate monetary tightening well ahead of the central bank delivering rate

hikes – meaning that financial conditions tighten ahead of actual policy changes.

If this were the case, it would imply that much of the tightening in interest rates has already been absorbed by the economy. In those economies that have made most progress on lowering core inflation pressures, such as the US, this raises the likelihood of a soft landing. In those that have made less progress, such as the UK, this would raise the probability of the central bank tightening further to bring inflation back to target.

Both “soft landing” and “two bites of the cherry” are part of our scenario distribution. But our baseline view is that the tightening in policy will drive inflation back to target via recessions in many DM economies.

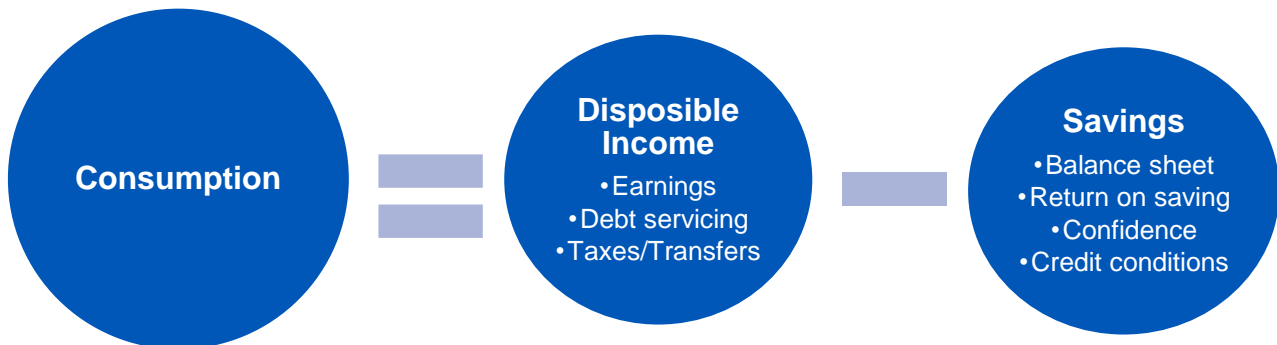
**Mapping the pass-through of policy tightening to the consumer**

Consumption functions are one way in which we can understand household consumption decisions. They break down consumption into the household’s disposable income (income net of interest, taxes, and transfers) after allocating towards savings or investment. In Figure 3, we illustrate how policy tightening changes disposable income dynamics for households but also influences the savings/investment decisions that households make.

**Tight labour markets have supported incomes**

Starting with gross incomes, these have been supported by the continued tightness of the labour market (see Figure 4). With jobs available outstripping unemployed workers across several DMs, consumers remain confident in their job prospects and wage growth strong.

**Figure 3: A simple consumption decomposition**

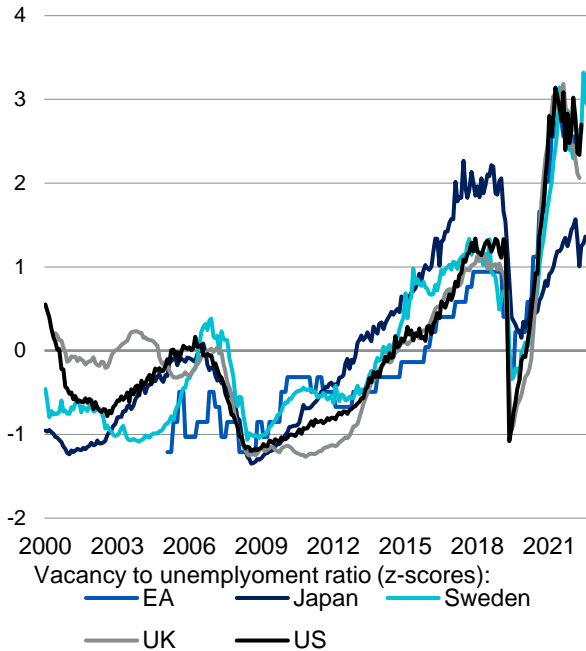


Source: abrdrn, August 2023



But given we anticipate that the labour market should begin to soften more markedly through H2, as corporates feel the strain of higher financing costs and tighter credit conditions, we will be watching these dynamics closely for signs that consumers are less confident in their job prospects as demand for labour slows.

**Figure 4: Labour markets are still historically tight**



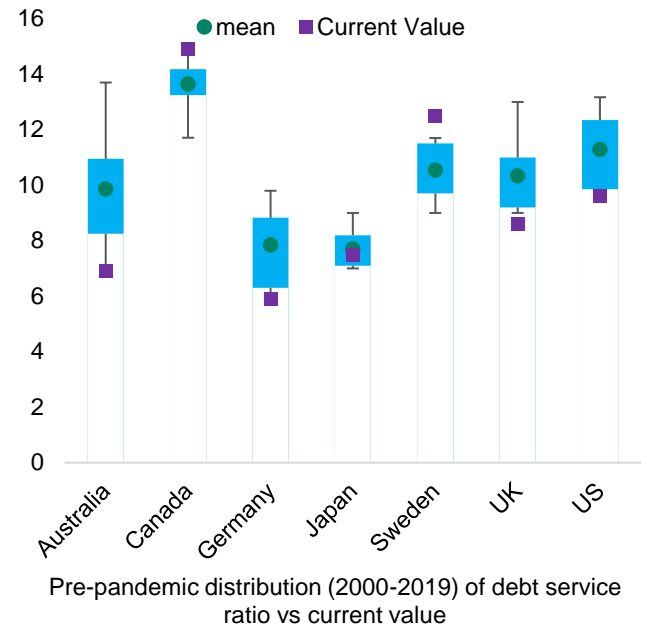
Source: Haver, abrdrn, August 2023

**Disposable incomes should also be squeezed by increasing interest costs for households**

As policy rates have risen so too has the cost of servicing debt for households. Debt service ratios – the ratio of debt payments to disposable income – have risen to varying degrees across DMs. This reflects differences in the structure of mortgage markets, the extent to which households are indebted and the degree to which financing via debt is prevalent.

In Canada and Sweden debt servicing costs are already at or above pre-pandemic peaks (see Figure 5). While Australia hasn't yet breached this, it is sitting above average. At the other end of the spectrum, Germany, the UK, and US have seen debt servicing costs *decline*. This reflects the fact that debt burdens relative to incomes have declined to a greater degree than interest rate costs on the existing debt stock have risen.

**Figure 5: Debt servicing costs have been rising**



Source: Haver, abrdrn, August 2023

**Mortgage costs are a large component of household debt**

The structure of mortgage market borrowing differs greatly across economies. This means that this channel of pass-through will differ in terms of timing and extent.

Firstly, the prevalence of homeownership matters and varies across DMs. A far higher proportion of people own their homes outright on average in the EU and UK than in Canada, the US and Sweden.

Then for those countries with a higher prevalence of mortgages, the terms on which people borrow for house purchases varies.

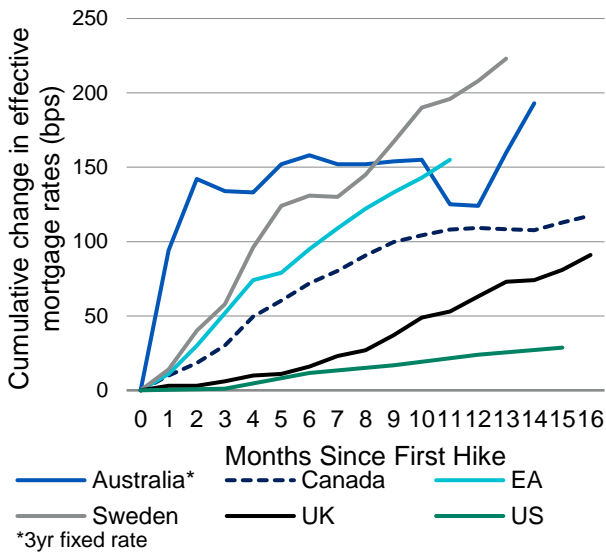
In the US for example, most mortgages are fixed for long time periods – typically 30 years. This is in stark contrast to Sweden, where a large share of mortgages are fixed for much shorter terms.

Therefore, those economies where mortgages are more common and are more likely to be variable or fixed at shorter terms are those where we will likely see both a quicker and stronger pass-through of monetary policy tightening. Effective rates which measure the average mortgage rate faced by households by considering interest payments as a share of total debt outstanding, have risen sharply in countries that are most exposed to this channel (see Figure 6).

Sweden, where nearly all the mortgage stock is fixed for less than five years, and Australia where the most common fix is three years, have seen their effective mortgage rates rise more quickly and to a greater extent. Contrastingly, the US has seen effective mortgage rates move up only slightly.



**Figure 6: Differences in mortgage market structure shelters households**



Source: Haver, abrdrn, August 2023

Therefore, for those economies where mortgages tend to be fixed for longer periods, the effect of higher policy on activity via the mortgage channels tends to be on *new* activity in the housing market rather than via weighing on disposable incomes.

To monitor the degree to which debt servicing costs affect household spending we look to delinquency rates – shares of borrowers which are late making payments – and default rates, for signs of household stress.

**Savings decisions also impact household consumption**

The rate at which consumers decide to save or invest their income dictates the share left for consumption.

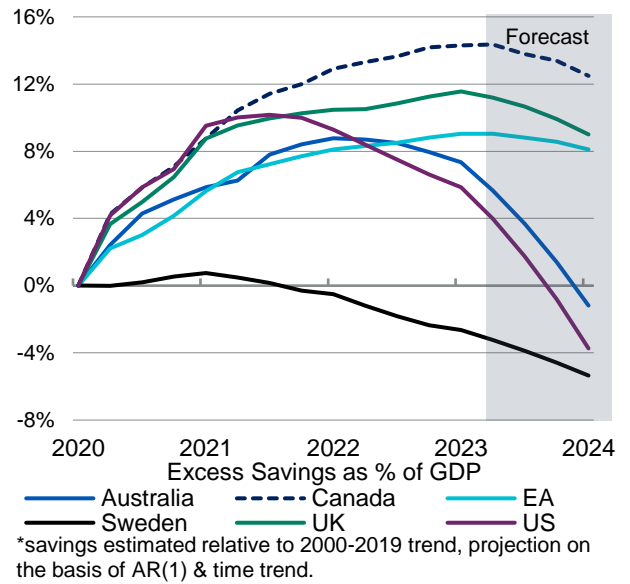
Fiscal support through the pandemic, alongside forgone consumption, led to large excess savings as consumption declined. Figure 7 estimates a degree of divergence in both the size and trend in excess savings in DMs.

Sweden stands out, given its different approach to managing the pandemic. With lockdowns less restrictive, consumers built up very small savings buffers and these look to have already been depleted.

In the US and Australia, consumers weathered high inflation rates through 2022 by drawing on their savings piles with these peaking as a share of GDP in late 2021 and mid-22 respectively. They still stand around 4% of GDP, so can support consumption for a while longer, although are likely to be exhausted around year-end.

In the UK, Canada and the Eurozone, savings rates continue to be more than pre-pandemic trend levels which means that the stock of excess savings as a share of GDP is yet to peak for these regions.

**Figure 7: Household savings buffers have supported spending**



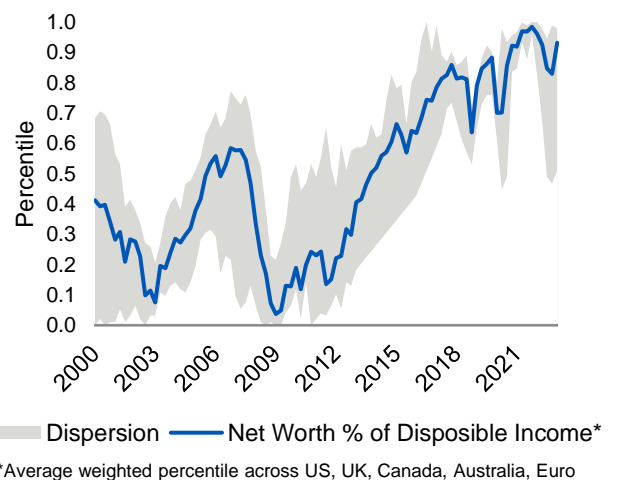
Source: Haver, abrdrn, August 2023

It is worth noting though that savings buffers are not equally distributed across the income spectrum, consumers at the lower end are more likely to have both built up smaller stockpiles but also exhausted savings at a quicker pace. Those at the upper end of the income spectrum – who likely still have larger savings piles – have a lower propensity to use these for consumption.

These cash piles were not just used to fuel consumption, though. Households also paid down existing debt piles and funnelled cash into financial assets like stocks and bonds, and non-financial assets like real estate.

Overall household wealth had risen sharply in the wake of the pandemic, before stronger inflation through 2022 depressed asset valuations which have since improved moving net worth higher again (see Figure 8).

**Figure 8: Household net worth high across DMs**



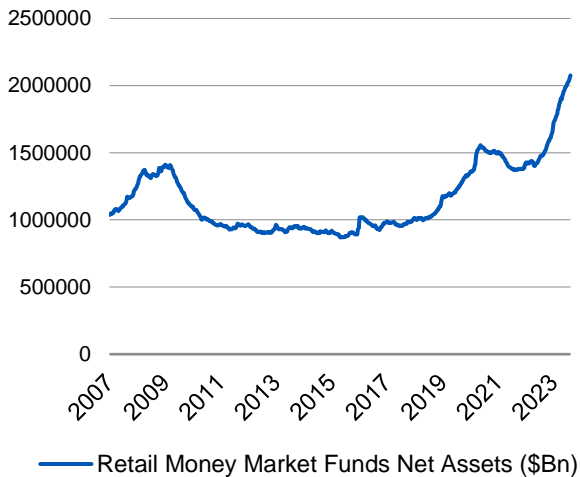
Source: Haver, abrdrn, August 2023



### Interest rates affect saving decisions in real-time

Excess savings piles represent an accumulation of past decisions households made through the pandemic. Current savings rates depend on rates of return available for households as well as their confidence in future earnings. In line with higher rates, yields on money market funds have risen, attracting assets from households (see Figure 9).

**Figure 9: Money market funds are attracting assets**



Source: Bloomberg, July 2023

In addition to the return on savings that consumers can get, consumers' confidence about the future can influence the extent to which they choose to build up precautionary savings.

In some economies, we are beginning to see savings rates increase again after softening through the bout of high inflation. While it is unlikely that households are building precautionary savings buffers given the strength of the labour market and consumer confidence generally, Sweden and the UK perhaps buck this trend with savings rates beginning to increase again. In the UK, this is more likely a

function of higher mortgage costs and the prospect of higher energy costs in the upcoming winter.

### For credit constrained consumers, dis-saving becomes more expensive and harder to fuel

For consumers whose spending outweighs their disposable income, dis-saving is required to fund current consumption. In this instance, it is important to consider the debt dynamics discussed previously but also the degree to which credit conditions have tightened. Since the banking stresses earlier this year, we have seen banks across DMs increasing the stringency of lending standards, which could mean that more consumers find it harder to dis-save and fuel consumption via borrowing.

We will be watching spending patterns in higher frequency measures like credit card spending to ascertain if consumers are spending less on discretionary items. This would perhaps give us an indication that consumers are feeling some strain.

### Final thoughts

For those economies where consumers are more readily exposed to higher mortgage costs, or where debt burdens have been increasing, we anticipate that consumers will likely need to pull back on spending as savings piles dwindle.

However, those where these channels are less pronounced or with larger pools of liquid assets may well be able to weather higher rates more readily than in previous hiking cycles.

Therefore, we remain vigilant that one size does not fit all and that country specific dynamics likely impact each economy's likelihood of recession, soft landing or perhaps the need for further policy tightening in the face of inflation pressures.

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