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CONSUMER WATCH

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Canadian Consumers—More Confident But Less Capable

by Benjamin Tal

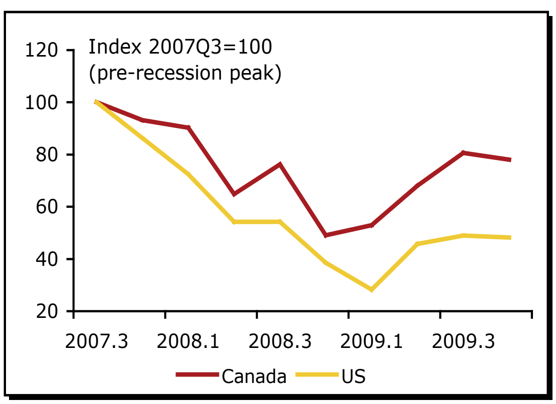
The Canadian consumer turned in another strong performance in the fourth quarter, as real personal spending climbed by nearly 4% annualized. But a closer look at the data reveals that the recent surge in spending is not backed up by rising consumer fundamentals. In fact, the "V-shaped" recovery in consumer confidence that we have seen throughout the second half of 2009, has actually coincided with a drop in the ability of households to spend.

Measuring Consumer Capability

After reaching a 15-year low in late 2008, consumer confidence, as measured by the Conference Board's Consumer Confidence Index, has improved by 60%, and is now back to its long-term average. Although still almost 20% below its 2007 peak, it is in a much better position than the corresponding measure south of the border, where consumer confidence is now almost 60% below the level seen in late 2007 (Chart 1).

Chart 1

Canadian Consumers More Confident Than Americans



Source: Conference Board, CIBC

The improving mood of Canadian shoppers over the past few months led to a jump in real consumer spending over the second half of 2009. But while improved sentiment can provide a short-term lift to household spending, a sustainable boost in activity must eventually be backed up by improving consumer fundamentals such as income growth, falling unemployment and reduced debt burdens.

To get a better sense of the trajectory of these household fundamentals, we looked at seven key macro-economic factors to construct a proprietary ***Consumer Capability Index*** (Table 1). Unlike a confidence survey which is based on the results of a subjective survey, this measure does not address the self-reported mood of Canadians, but rather their objective capacity to continue spending. The goal of this indicator is to shed light on consumers' *ability* to spend as opposed to their *willingness to* spend.

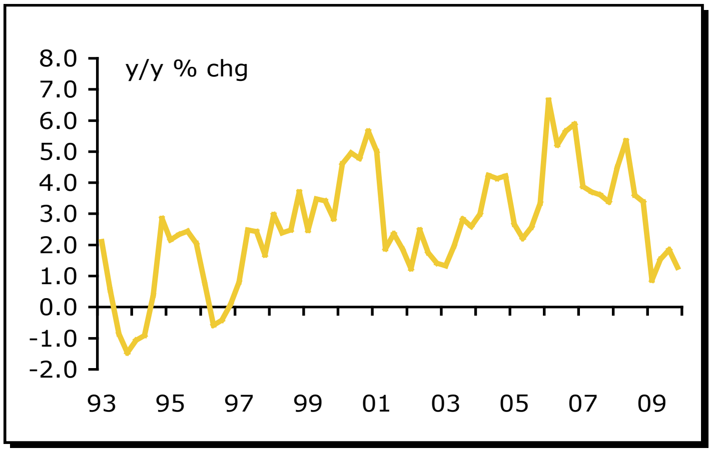
Chart 2

Components of Consumer Capability Index

1. *Debt-to-income ratio*
2. *Debt-to-asset ratio*
3. *Real income growth*
4. *Long-term unemployment rate*
5. *House price to income ratio*
6. *Personal saving rate*
7. *Personal bankruptcies*

Chart 2

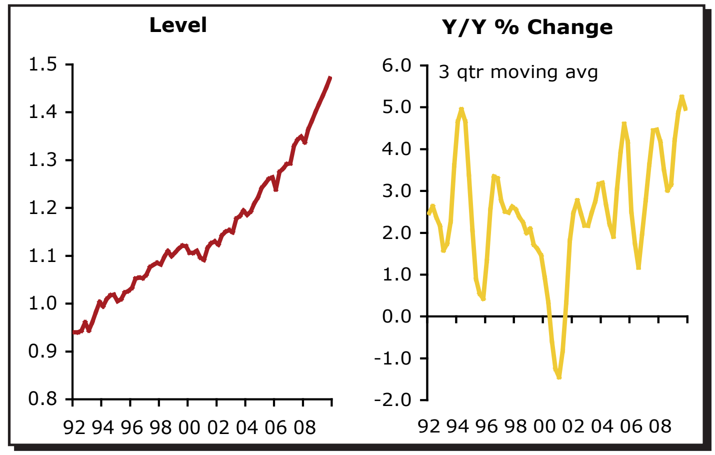
Real Disposable Income Growth



Source: Statistics Canada, CIBC

Chart 3

Debt-to-Income Ratio



Source: Statistics Canada, CIBC

In constructing this index, we focused on both the level of our selected macro-economic indicators in relation to their long-term average (*Level Variables*), as well as their most recent trend (*Trend Variables).* Based on this methodology, each variable received five different scores based on its deviation from its mean. For example, at a given point in time, if the long-term unemployment rate was above its long-term average and/or was rising faster than its historical trend, then it received a low capability score. Conversely, if the long-term unemployment was below its long-term average and/or was rising slower than its historical trend, then it received a high capability score. The rationale here is that a relatively high and/or accelerating rate of long-term unemployment suggests increased consumer vulnerability down the road, while the opposite points to relatively less consumer vulnerability.

Despite Canadian consumers' high spirits, their recent consumption pattern has not been supported by an equivalent increase in income. In fact, growth in real disposable income has been trending downward over the past year (Chart 2), and to a certain extent debt is replacing income as a major driver of consumer purchases. The rising importance of debt as a determinant of consumption can be seen in the fact that the 2008-09 recession was the first economic contraction on record to show overall expansion in real household credit. As of February, overall household credit was up by more than 7% on a year-over-year basis—more than three times faster than income growth.

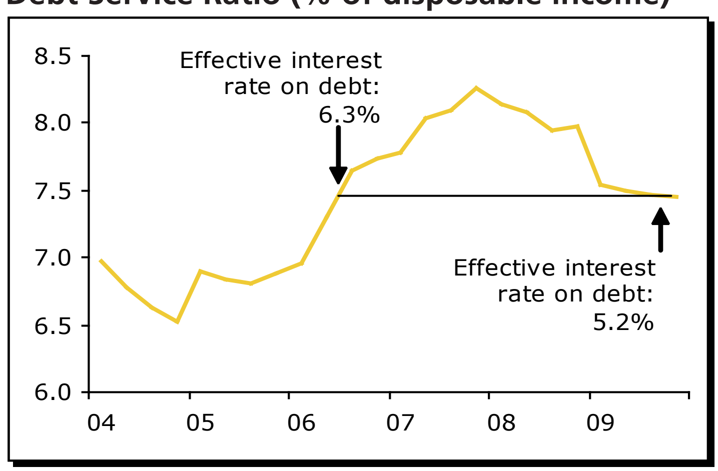
Consequently, the household debt-to-income ratio in Canada has continued to head higher, and as of December 2009 stood at a new all-time record of 147% (Chart 3, left). More troubling is the fact that this ratio is accelerating at a rate not seen since the mid-1990s (Chart 3, right).

That said, households are not relying much on credit for day-to-day consumption. After all, roughly 70% of the increase in household debt over the past year has been mortgage debt due to a strong revival in housing activity. Of the other 30%, only roughly one-fifth of the increase in non-mortgage consumer credit is used to finance daily purchases. Furthermore, despite rising debt loads, ultra-low interest rates kept the Canadian debt-service ratio falling throughout this latest recession—a factor that is a clear positive for our index.

While this ratio is only back to the level seen in 2006 Q3, back then the effective interest rate on household debt was 1.1 %-points higher than it is now (Chart 4). With interest rates most likely to rise in the near future, this

Chart 4

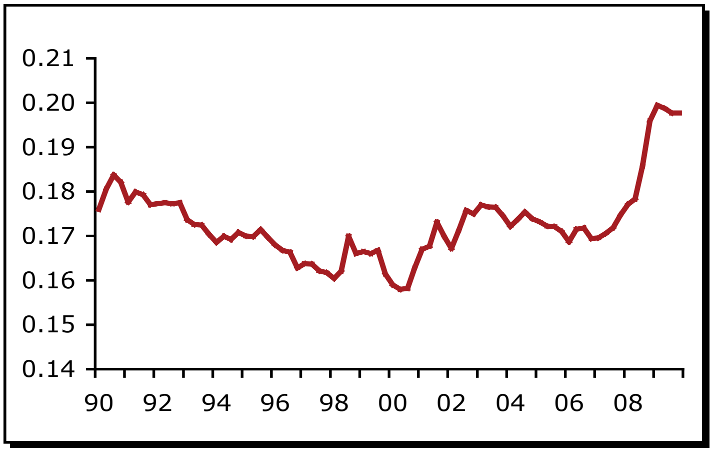
Debt Service Ratio (% of disposable income)



Source: Statistics Canada, CIBC

Chart 5

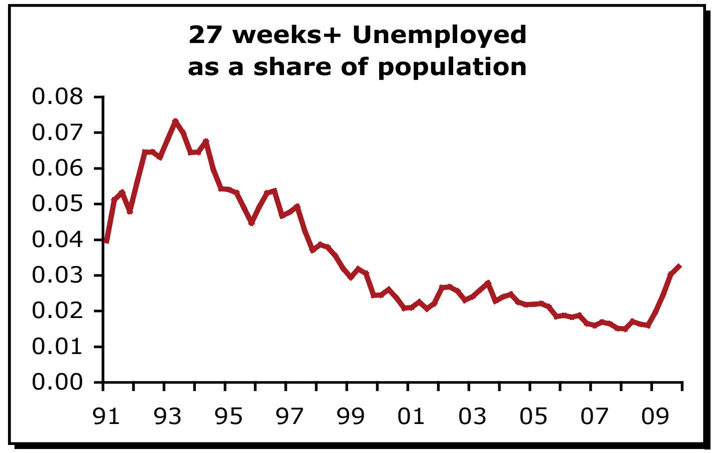
Debt-to-asset Ratio



Source: Statistics Canada, CIBC

Chart 7

Long-Term Unemployment Rate



Source: Statistics Canada, CIBC

relatively elevated debt service ratio suggests an earlier debt-service squeeze and a quick response by households to any monetary tightening.

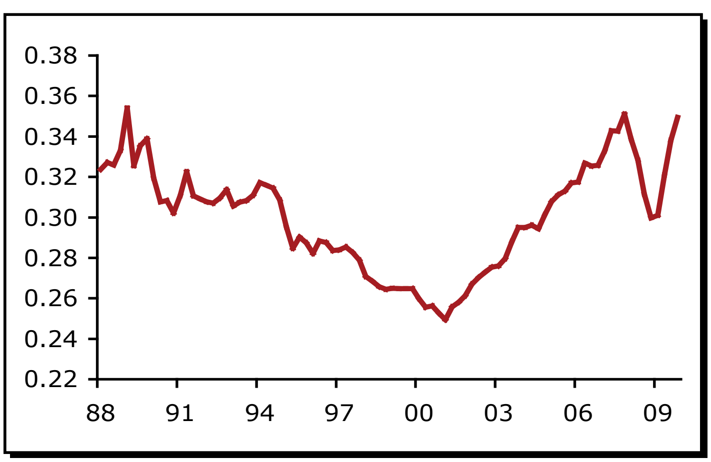
A further negative for household spending is the fact that household debt is also rising faster than assets. As illustrated in Chart 5, the debt-to-asset ratio (as reported in Statistics Canada's National Balance Sheet Account) has trended upwards during the recession. Despite the rebound in stock valuations and the recent surge in home prices, over the past two years Canadians have seen their liabilities rising twice as fast as their assets. Recent quarters have seen some stabilization in this ratio but its level remains relatively elevated.

In addition, with growth in personal income softening up over the past few years, the gap between real estate gains and income growth is also widening, with the ratio of house prices to income hovering at a 20-year high (Chart 6). From a consumer resiliency perspective this is also negative, since it implies either stagnating or falling real estate markets over the coming years, particularly given now-higher housing starts creating supply pressures and higher mortgage rates ahead.

On the other side of the equation, the rise in the saving rate since 2008 is a positive development, since savings can act as a buffer between the economic downturns and individual finances. Likewise, the long-term unemployment rate is also an important ingredient in our resiliency index. While this measure has trended upwards over the past year, it is still relatively low in relation to past cycles (Chart 7). Also, of note is the recent slowdown in the pace of consumer bankruptcies in Canada. However, that measure is still well above its 15-year average (Chart 8).

Chart 6

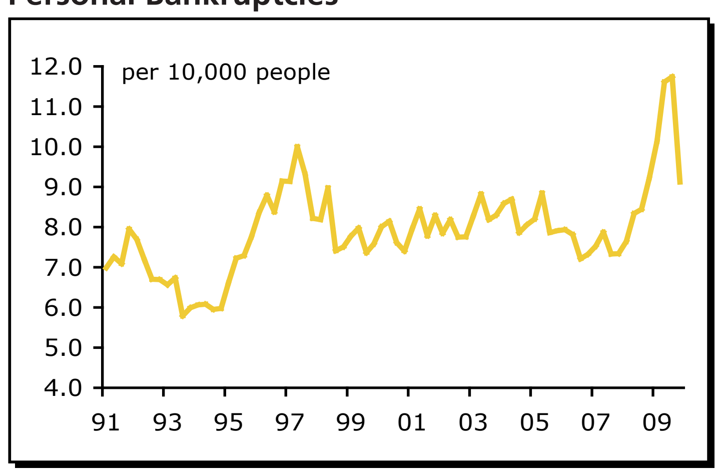
Ratio of House Prices to Income



Source: Statistics Canada, CIBC

Chart 8

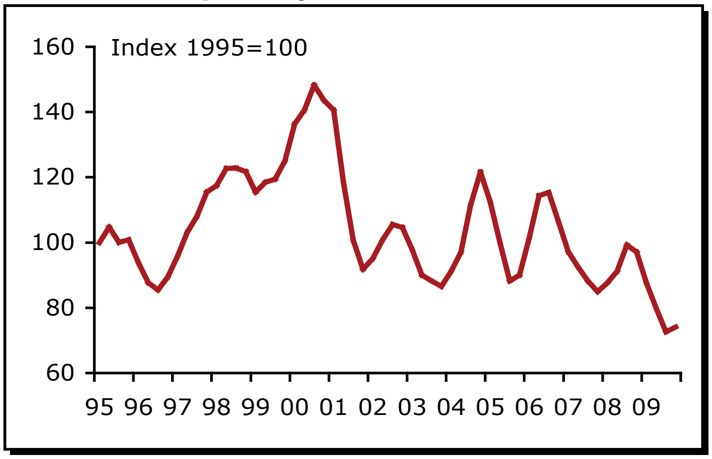
Personal Bankruptcies



Source: Statistics Canada, CIBC

Chart 9

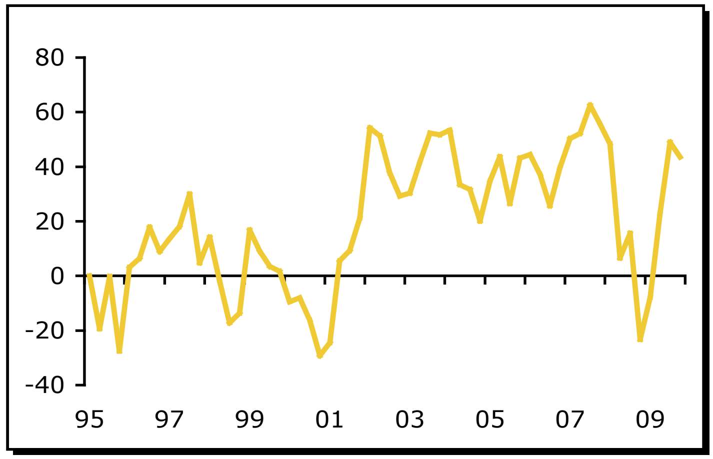
Consumer Capability Index



Source: CIBC calculation

Chart 10

Gap between Consumer Confidence and Consumer Capability



Source: Conference Board, CIBC calculation

Confidence vs. Capability

Combining all of the above information into one index reveals that Canadian consumer fundamentals are weaker than they have been in almost 15 years (Chart 9). The rapid acceleration in the household debt ratio, the loss of net worth, the softening in income growth, and a relatively high bankruptcy rate are definite negatives. Those minuses are moderated by the recent increase in the saving rate, and a low long-term unemployment rate, but overall the balance is still weighted to the downside.

Interestingly, when we zoom in on the gap between the Conference Board's Confidence Index and our Consumer Capability Index (Chart 10), we find that during the 1990s the average gap between the two measures was minimal, suggesting no deviation between sentiment and capability. However, for most of the past decade increased reliance on credit and surging real estate prices have materially widened that gap. That changed during the recession as confidence plunged to match capability, but recently headed back once again to pre-recession levels.

The practical implication of the reduced consumer capability as measured by our index is that consumer spending will disappoint in the coming twelve months. While most of the recent focus of the potential impact of higher interest rates has been on the risk that this move will trigger a new wave of debt defaults, our analysis suggests that the focus should be on the overall impact of these rate hikes on consumer spending. And given the vulnerable starting point of the consumer, the Bank of Canada will soon find that even a moderate monetary squeeze will be sufficient to drive a material deceleration in consumer spending.