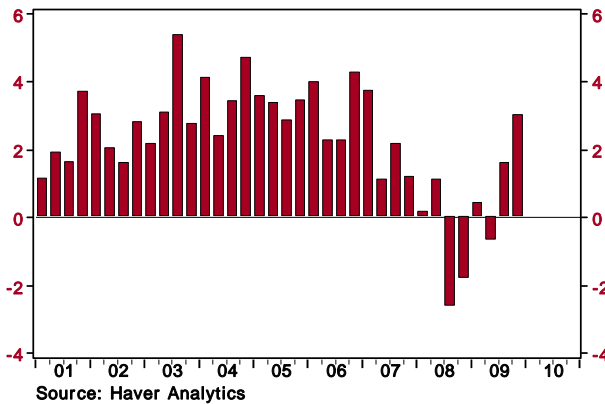


The (Relatively) Bullish Case for Consumer Spending

At present, we are forecasting that real GDP grows in the 4% - 4.5% range in 2010 while the consensus forecast is 2.9%. A large part of the difference between our forecast and the consensus is that we are more bullish on consumer spending. We think real (inflation-adjusted) consumer spending will grow 3% in 2010, while the consensus pegs it at 2.2%.

It is important to note that although our forecast about consumer spending is bullish relative to the current consensus, it is not particularly bullish relative to the historical norm for recoveries from deep recessions. In the first two years after the 1973-75 and 1981-82 recessions, real consumer spending grew at a 5.4% annual rate and 5.5% rate, respectively.

Real Consumer Spending (Ex-Autos)
% Change, Annual Rate



It is also important to note a growth trend in consumer spending has already begun and is not simply a function of the cash-for-clunkers program in place last July and August. Real consumer spending increased at a 2.4% annual rate in the second half of 2009 but grew at a 2.3% rate excluding autos. So, in effect, the consensus thinks there will a slight slowdown to consumer spending growth while we think spending growth will accelerate modestly.

What follows is a list of some of the reasons we think consumer spending will grow at a faster pace in 2010.

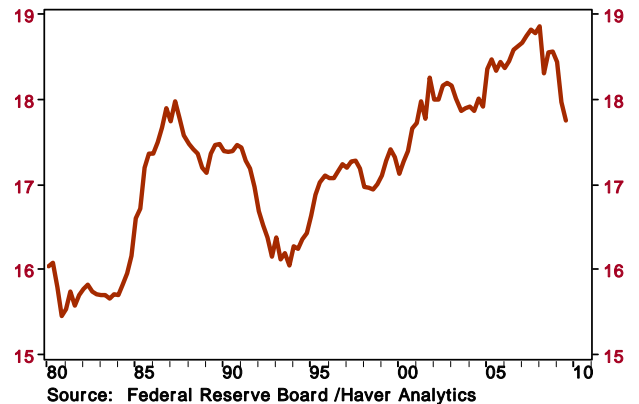
1. Consumer incomes are rebounding.

Excluding transfer payments, real personal income increased in five of the last six months of 2009 and rose at a 2.1% annual rate in the last three months of the year. Moreover, the job market is apt to strengthen in 2010, suggesting stronger growth in spending power.

2. Consumers have reduced their financial obligations.

The financial obligations ratio measures the share of after-tax income that consumers need to service their debts as well as make other recurring payments, like rent and car leases. In early 2008, the financial obligations ratio hit an all-time high of 18.9%. But our calculations suggest the ratio fell to 17.4% in Q4, the lowest level in roughly a decade and very close to the average over the past thirty years. This means consumers are in a better position to expand their spending. (Chart below only goes through Q3 2009).

Household Financial Obligation Ratio
SA, %



Moreover, in the current environment, the level of the financial obligations ratio may be overstating the true burden on consumers caused by their debts. For example, take a homeowner who owes so much more on his home than it's worth that he has decided to stop paying his mortgage. The government still counts his mortgage as a financial obligation and assumes he is making the payment. But if he is not making the payment his actual

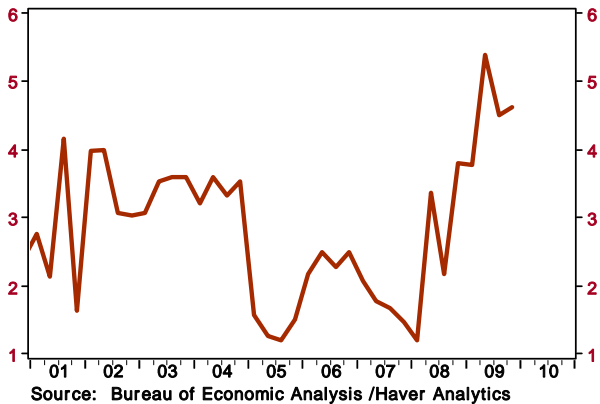
debt service payments are lower than the government assumes and his ability to spend on other goods and services rises (at least temporarily).

3. The personal saving rate is higher.

The personal saving rate is flawed. For example, it includes the spending of retirees but does not count as income the capital gains on their assets that the retirees are now spending. In addition, the saving rate calculation treats durable consumer goods (such as cars and furniture) and “durable” services (such as education and healthcare) like they are fully consumed immediately. If we recognized that these items as consumed over time the government’s measure of consumption would be lower and its measure of saving would be correspondingly higher.

Nonetheless, the personal saving rate hit a low of about 1% in the previous decade and is now back up to almost 5%. This increase provides additional wiggle room for consumer budgets and suggests consumers are in a position where they need not reduce spending relative to income, like they did in 2008 and early 2009.

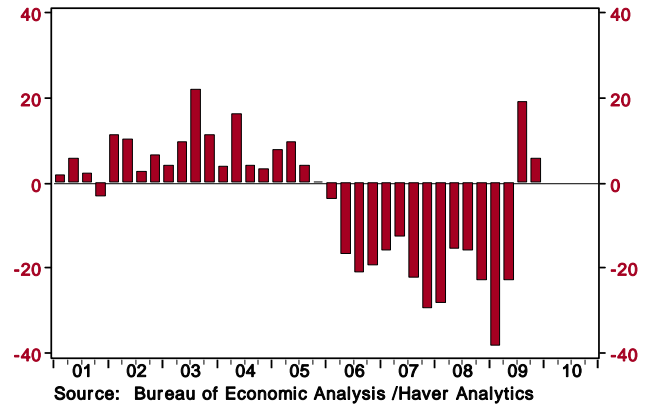
Personal Saving Rate
SAAR, %



4. Home building is rising again.

Traditionally, residential construction is a solid leading indicator for consumer spending. Home building bottomed in the second quarter of 2009 and increased in both Q3 and Q4. Although the housing market still has excess inventories, the pace of home building got so low last year that the sector can continue to work off excess inventories even as home building continues to rebound.

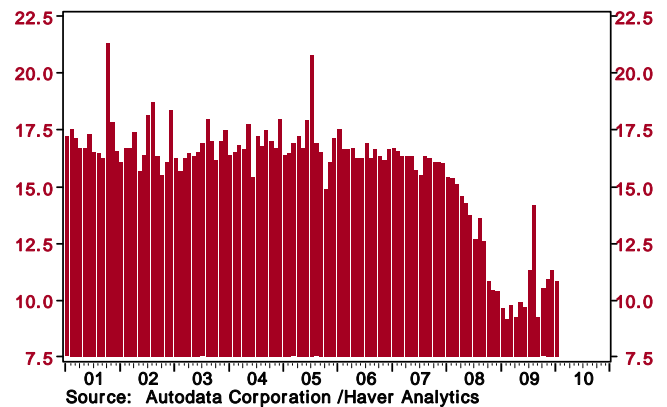
Real Private Residential Investment
% Change - Annual Rate



5. Autos still selling slower than the scrappage rate.

In a typical year, the US scraps more than 13 million autos per year (cars and light trucks, such as SUVs and pickups). Although auto sales are up significantly compared to the 9.5 million annual pace that prevailed in the first half of 2009, they are still way below the scrappage rate, meaning the number of autos on American roads is still declining. This process has been underway since late 2008 and must eventually come to an end.

Total Light Vehicle Retail Sales
SAAR, Mil. Units



In sum, consumer spending is already stronger than the consensus expects and it does not take aggressive assumptions to forecast a pace of consumption growth that will feed robust real GDP growth in 2010.

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