THE SPENDING MIRAGE

Stocks riding high on illusions of continued consumer spending may be in for a nasty surprise

MANDEL ON ECONOMICS

If you are an investor, this is the moment in the business cycle when fortunes can be won or lost. The U. S. economy is in recession, for the fourth time in the past quarter century. Will the stock market soon take off with a whoosh, as it did during the downturns of 1981-82 and 1990-91? Or will stocks continue to slump, like they did during the 2001 recession and beyond?

Forecasting the stock market is a fool's game—but there are grounds to believe there's another drop in the market yet to come. The reason: a broad decline in consumer spending, which so far has been masked by a quirk in the government's statistics. Combine that with a rapidly unraveling job market, high energy prices, and the continuing credit crunch, and you have the recipe for a drop in consumer stocks. A big decline there could take the rest of the market down with it.

Right now it's looking like the recession started in November, 2007. That's when private-sector employment peaked, according to the latest job report from the Bureau of Labor Statistics. Since then, the private sector has shed 300,000 jobs, with the cuts concentrated in construction, manufacturing, retail trade, and temp services.

SKEWED STATISTICS

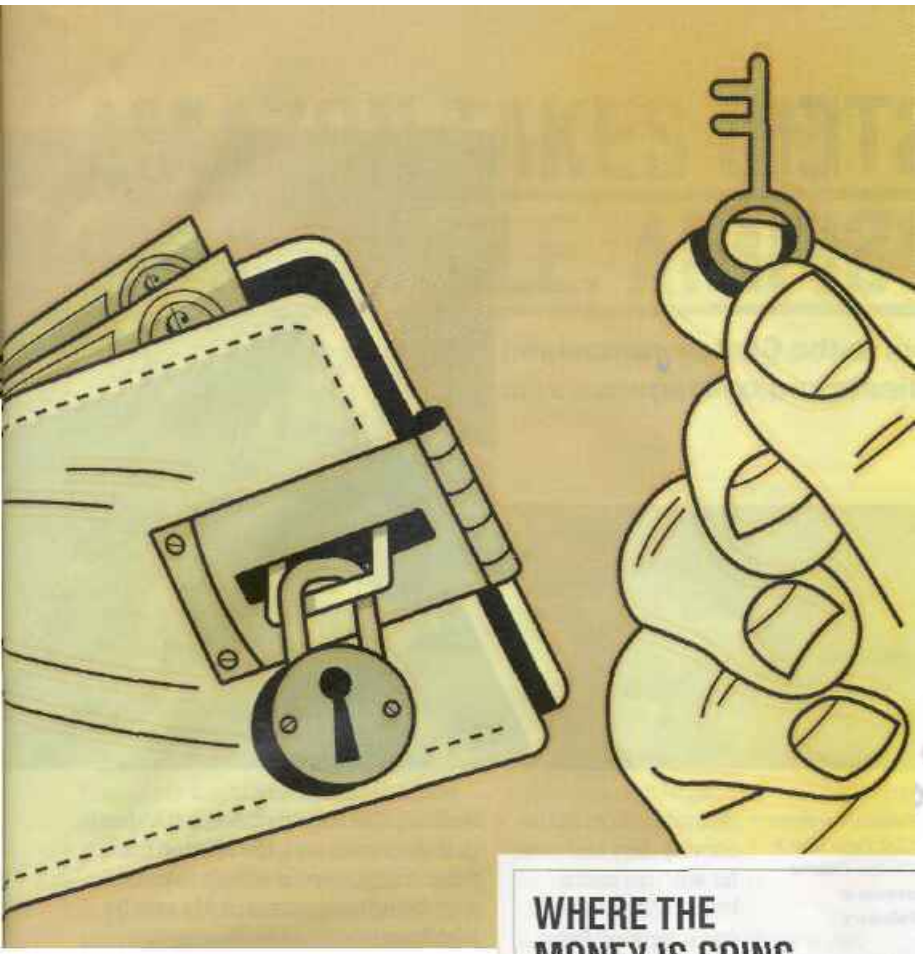
Despite those job losses, government statistics show that consumer spending, although slowing, is at an all-time high when adjusted for inflation. In fact, if you go by these numbers, it looks like Americans have boosted their purchases at a 1.4% annual rate since last summer, a respectable pace considering the chaos in the financial markets and the massive overhang of consumer debt they have piled up since 20OO(pagen).

The apparent ability of the U.S. consumer to keep spending helps justify the remarkable rise in many top consumer stocks over the past few months, despite the housing bust. Increases in share prices since the end of August, 2007, include Wal-Mart, up 24%; Colgate-Palmolive, up 19%; Avon, up 15%; Coca-Cola and McDonald's, both up 13%, and Procter & Gamble, up 7%. Meanwhile the S&P 500 - stock index as a whole has lost *8%*.

In one sense the strength of these particular companies isn't a surprise. They have all ridden the two - decade - long consumer spending boom, giving investors average annual gains ranging from 14% to 17% since 1988, including dividends. By comparison, the S&P 500 has returned an average of 11% per year over the same period.

But a closer look at the numbers shows that the consumer spending boom may already have come to an end, without investors noticing. The problem is this: What the government calls "personal consump-

Many leading consumer stocks have risen in recent months, even though the spending boom may have already ended



tion" is actually a grab bag of items, some of which don't really fit the usual notion of consumer spending.

For example, the nation's current annual personal consumption of $10 trillion includes about $1.8 trillion in outlays by Medicare, Medicaid, and private health insurance providers. This is real money—but consumers don't control or even see most of it, since it usually goes right to the health-care provider.

The government's count of personal consumption also includes "imputed" categories—that is, entries that don't involve any money changing hands. Two of the biggest examples: $1.1 trillion for "rent" that homeowners theoretically pay to themselves to live in their own homes, and $240 billion for "services furnished without payment by financial intermediaries"—in other words, the value of services like no-fee checking accounts.

In fact, once medical outlays and those two imputed categories are set aside, it turns out that the rest of personal spending has actually fallen since November, adjusted for inflation. The decline is pretty much across the board: inflation-adjusted purchases of food, clothing, furniture, and motor vehicles are all down. The part of health-care spending that individuals control most directly—prescription drugs—is down as well.

WHERE THE MONEY IS GOING

Change in real consumer spending since November, 2007

PRODUCT OR SERVICE	CHANGE
Televisions	4.2%
Bank service charges and fees	1.6%
Religious and welfare activities (including political organizations)	1.3%
Telephone	0.9%
Medical services	0.8%
Higher education	0.8%
Food	-0.2%
Clothing and shoes	-0.4%
Furniture	-0.6%
Alcoholic beverages	-1.1%
Motor vehicles and parts	-1.9%
Prescription drugs	-1.9%
Passenger fares for foreign travel	-2.4%
Home computers	-2.9%
Jewelry and watches	-3.9%
Casino gambling	-4.7%

Data: Bureau of Economic Analysis

CONSUMER CLIFFHANGER

Spending on vices is also dropping. According to the government's figures, alcohol consumption and casino gambling have been declining since November. Indeed, Nevada gambling revenues are down by 4% over the past year.

There are signs that affluent individuals are pulling back, too. Purchases of jewelry and watches are off 3-9% since November, adjusted for inflation. A survey of high-net-worth Americans found that 42% are likely or very likely to change how they budget and spend their money. "These folks are tightening the belt a little bit," says George H. Walper Jr., president of Spectrem Group, the consulting firm that commissioned the survey. "Just because someone is wealthy doesn't mean that they don't get cautious."

Some categories of spending are still rising. Real outlays for the category "religious and welfare activities "which includes political donations, are up because of the Presidential campaigns. And at least up to this point, Americans still are buying more televisions and talking longer on their phones.

Some economists think the combination of economic stimulus checks soon to arrive from the federal government and lower interest rates should keep consumer spending from falling off a cliff. "We think consumers will narrowly skirt a downturn despite the recession in the overall economy," write Richard Berner and David Greenlaw of Morgan Stanley in a just-released report.

Certainly, that's what the market seems to be expecting, given the performance of the top consumer stocks. But if the decline in consumer spending continues, it's going to be hard for the market not to follow.; BW

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