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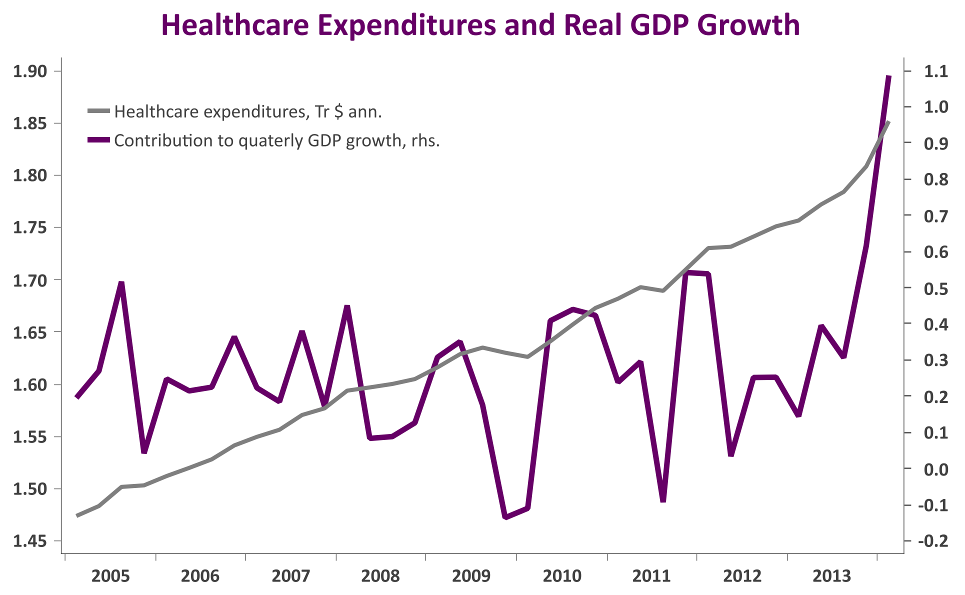
With Americans taking care of their health, can the Fed relax?

In the first quarter, Americans allocated over half of the increase in consumption spending to healthcare, which represents an increase of 10% on an annualized basis compared with previous quarter. Without this acceleration, real household consumption would not have increased 3%, as published the day before yesterday, but rather a mere 1.3%; GDP would not have flat-lined but fallen 1.0%, all other variables held constant.
A detailed analysis of these numbers undoubtedly curbs the newfound optimism resulting from the announcement of a 4.6% increase in spending on services in the first quarter and the publication of an encouraging April jobs report. The Fed is not likely to be able to ignore this news.

More than half of the increase in consumer spending in Q1 was allocated to healthcare

The effects of the healthcare reform enacted by president Obama are far from minor. According to the most recent official data, the number of new people who have enrolled in the Affordable Care Act, which provides private health insurance coverage, has reached 5.4 million since January. Although short of expectations (7 million initially forecast by the CBO), the reform has quickly generated positive knock-on effects. Americans are willing to seek care now that they have health insurance, In the first quarter, $1,851 billion (on constant terms) were spent on health expenses, which was an increase of $43 billion (in annualized terms) compared with the previous quarter. It was also more than four times higher than the normal increase in US spending on healthcare, which in real terms, has risen at a relatively stable 2.5% per year in recent times. This one-off rise in healthcare spending had a particularly big impact on economic growth in the first quarter and compensated for drops in all other economic growth drivers: investment, net exports, public spending and inventories.



Sources: RichesFlores Research, Macrobond

What should be made of these developments?

There answer to this question is not a simple one. The new reform distorted economic data in recent quarters and could have both good and bad effects in the next few months:

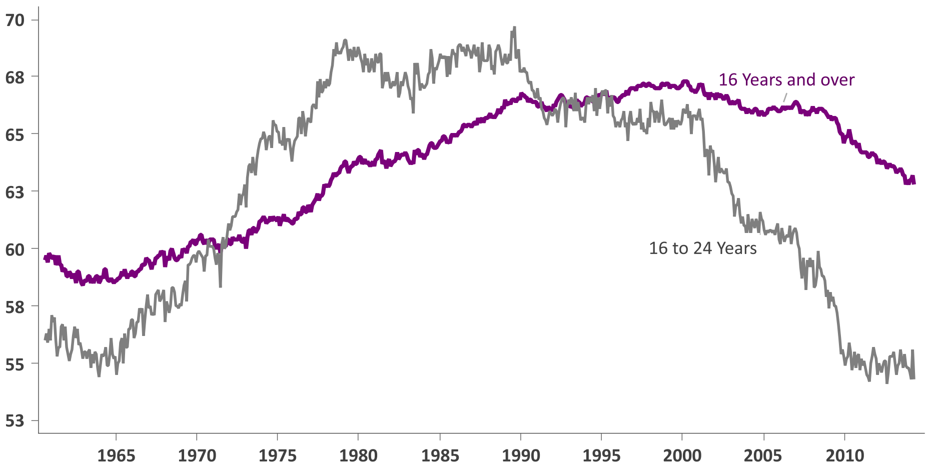
- The obligation to enroll in private insurance was a serious drain on household income and estimates of its impact are quite unclear. With the enrolment period now over, purchasing power should tick up.
- Moreover, since the middle part of 2012, healthcare spending seemed to have stalled, as if Americans were deferring treatment because they knew they would have insurance in the near future. Besides the effects of the reform on demand for care, a catch-up effect could therefore boost spending for some time yet, as was probably the case in the first quarter.

These first two points are mostly favorable for the outlook of consumption for the early part of the year. Although national accounts lump healthcare spending in with "consumer spending", Americans do not pay the full price of healthcare out of pocket…especially since Americans now have better coverage. It is therefore hard to believe that the extra healthcare spending is to be blamed for the feeble increase in other areas of consumer spending (i.e. Americans are spending less because they are spending more on healthcare) areas that could strengthen after distortions from the healthcare reform dissipate. Stripping out health expenditure, household consumption failed to exceed 1.7% on an annualized basis in the first quarter. This was poor, whether in absolute terms or compared to the 2.8% increase in the last quarter of 2013. Durable goods purchases, household appliances and other ordinary spending have been, in fact, weak in early 2014. At the same time, households' appetite for real estate seems to have seriously abated: housing investment has been down for the second straight quarter, at -5%, and property indicators, although they have pointed somewhat higher since the cold snap, are well off their levels from before the winter.

Can the Fed ignore these signals?

It will take more than just a rebound in the ISM and one good month of job creation numbers to dispel uncertainties on the actual situation for households and the US economy's prospects. Although the April jobs report was incontestably encouraging, a closer look depicts, yet again, a situation that is a great deal off from what we would expect at this point in normalization. Despite a four-tenths drop in unemployment, to 6.3%, the new drop in the participation rate, particularly by young people and the droves of Americans required to work part-time are all evidence of persistent problems in the job market.

Labour Participation Ratio, %



Sources: RichesFlores Research, Macrobond

The situation for households remains precarious and, at this point, far too uncertain to bet on a return of robust consumption, which would, however, be necessary if the Fed's optimistic 2014 forecasts are to be met. Could the Fed ignore these signals? If it were to turn a blind eye, upwards tension on rates could be rekindled, which would affect the real estate market…and future growth.

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