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Where are Interest Rates Headed? The Consumer May Hold the Key

Government survey data present a strong, stable consumer, but based on the surveys' collection methods, it may be fair to surmise that there are cracks in the foundation.

Government surveys have historically collected and reported *averages*, which have worked well in the past, when averages were more representative of the tails. However, post-2021 "the consumer" appeared to become bifurcated, with lower income consumers exhibiting different spending habits from higher income consumers, whereby the higher income consumer's spending has held up the economy over the last several years, creating the sense that the economy was humming, while the lower income consumer has been struggling.

A July 2025 Federal Reserve working paper titled "Lost in Aggregation: Geographic Mismeasurement of Income and Spending" contends that consumer spending appears to be heterogeneous. This paper finds that how retail sales have been calculated in the past produces results that are no longer representative of actual consumer spending today.

As shown below, using average spending by zip code to measure retail sales gives the appearance that consumer spending in every income bracket rises and falls in tandem.

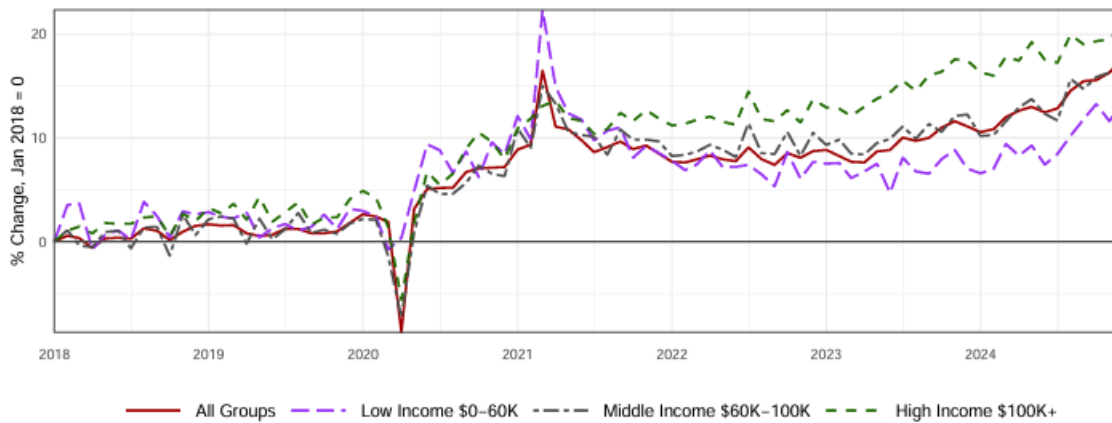
FIGURE 1: Real retail sales, total excluding motor vehicles and parts, constructed using Census Bureau estimates and Numerator panel data



Note: The solid red line is the Census Bureau's seasonally adjusted retail sales series excluding motor vehicles and parts. The dashed blue line is the retail spending measure we construct using the Numerator data, which we seasonally adjust. The dashed gray line is the non-seasonally adjusted Census series that we then seasonally adjust. The data are monthly from January 2018 through December 2024. Authors' seasonal adjustment method uses X13-ARIMA-SEATS. Inflation adjustment uses the chain indexed PCE deflator for goods and food services excluding motor vehicles. All three lines are indexed to 100 in 2019.

However, when looking at spending by actual income levels, the authors found that, while prior to the pandemic, all income brackets moved in a similar fashion, in the last 3-4 years consumer spending has diverged. The top consumer spending has increased (as indicated by the green line in the chart below), while the bottom consumers only spent at 2021 levels (purple line). This study points to weakness in a segment of the consumer base, which the cumulative data leaves out.

FIGURE 2: Growth of average retail spending decomposed by household income

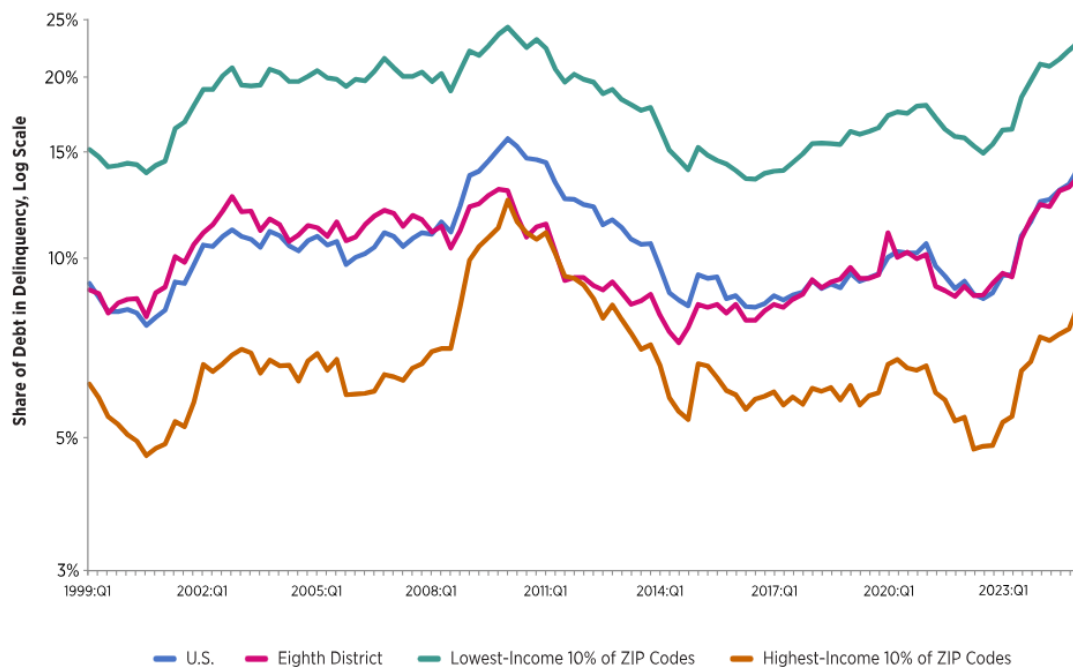


Note: The data are monthly from January 2018 through December 2024. All series are adjusted for inflation using the chain indexed PCE deflator for goods and food services excluding motor vehicles and are shown as growth relative to January 2018. All series are seasonally adjusted using X13-ARIMA-SEATS. Solid purple, dash-dotted gray and dashed green lines plot the spending by low-, middle- and high-income households.

A separate **study in February 2025 by Bureau of Labor Statistics** uncovered similar data. Nearly 50% of all spending came from the top 10% of earners. This is different from previous decades, when the top 10% accounted for 36% of spending. The spending by wealthier individuals is driven by gains in assets such as equities and real estate, an area that the bottom 80% has been unable to equally participate in. This study also points to a dependence on wealthy consumers' spending to support the economy.

Relying on a bifurcated consumer base can be risky if/when the wealthier consumers become unable to support spending. In fact, a study done by the **St. Louis Fed** reported that cracks are also slowly beginning to show in higher income consumers. "The highest-income 10% of ZIP codes experienced the greatest proportional increase; the delinquency rate for that geography climbed from 4.8% in the second quarter of 2022 to 8.3% in the first quarter of 2025, or 73% in relative terms (indicated by orange line in chart below). The delinquency rate for the lowest-income 10% of ZIP codes increased from 14.9% in the third quarter of 2022 to 22.8% in the first quarter of 2025, or 53% in relative terms (green line)."

Percentage of Credit Card Debt That Is 30 Days Delinquent



FEDERAL RESERVE BANK OF ST. LOUIS

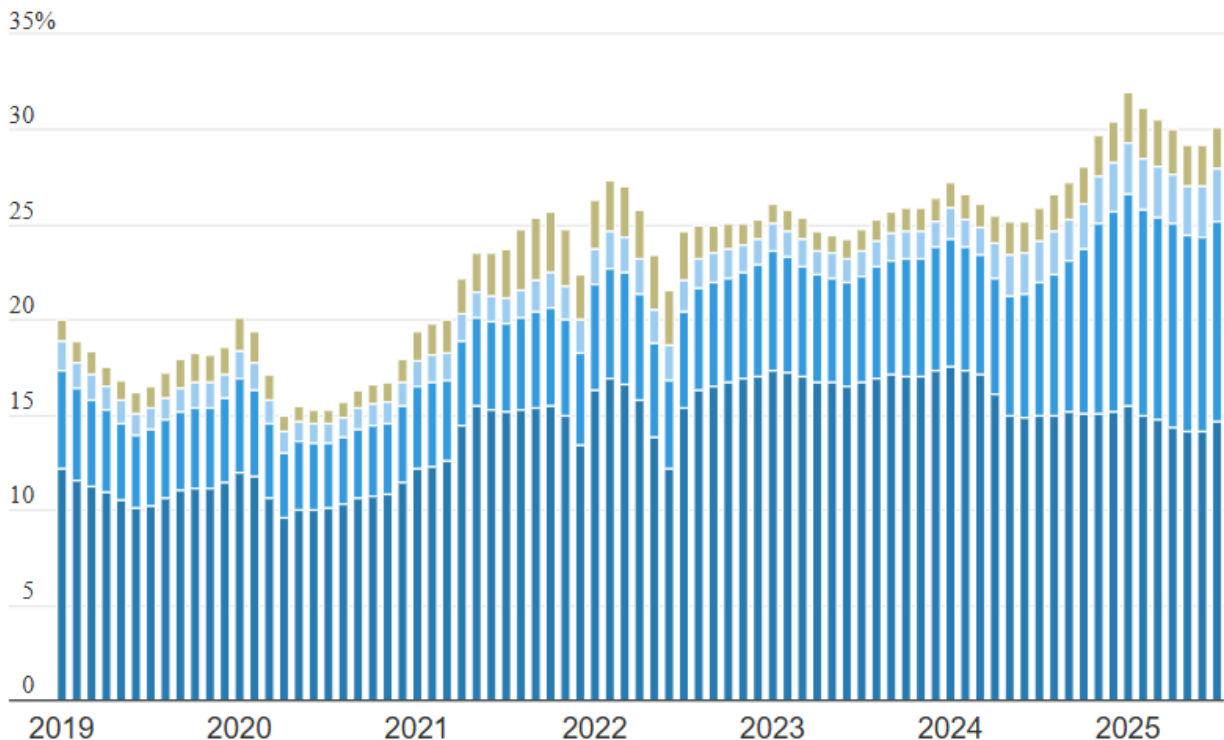
Housing and the Consumer

The largest purchase consumers make would have to be their homes. Consistent with other consumer spending, we find that **Housing** could also be on softer ground but remains buttressed by a tiered consumer. House price increases have slowed down from the run-up immediately following the pandemic. This is reflected by more days that homes for sale remain on the market. More sellers are willing to forgo low lock-in rates in order to move. And builders have ramped up supply of new homes to meet the need of buyers, offering incentives to diffuse near 7% mortgage rates.

For many buyers/consumers, even with somewhat lower prices and builder incentives, affordability is not within reach. As the supply of homes remains below the demand for homes, there are enough cash buyers and investors—in fact 30% of purchasers as indicated in the chart below—to keep the market moving. As a result, sellers are unwilling to lower prices to drastic levels to sell homes, so sales remain low, while prices are not collapsing.

Percentage of single-family home purchases by investors, monthly

■ Investors with 3-9 properties ■ Investors with 10-99 properties
■ Investors with 100-999 properties ■ Investors with 1000+ properties



Source: Cotality

Interest Rates and the Consumer

By economic fundamentals, the weaker consumer and housing **should** point to an economic slowdown, which in turn should result in lower rates. It is not, as the economy is being held up because the consumer is bifurcated.

Long term interest rates are also rising because of **inflationary expectations**. The market's concern is that the Fed's new makeup will push for lower interest rates, even in the face of higher potential prices brought on by tariffs and slower immigration. This dynamic has resulted in a steepening of the yield curve, as the market expects the Fed to cut rates at some point, which has brought short-term rates down. But cutting rates too soon could also lead to higher inflation, and this has been pushing up longer rates, resulting in a steepening of the yield curve.

The higher income consumer has supported these higher rates, but if the higher earners lose ground, as the data is beginning to show, the economy could weaken and rates across the yield curve could decline. The question is how long the bifurcation in the status quo can last.