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US Economics, Securitized Products Strategy, and Consumer Finance | North America

How rate cuts will affect consumption

We expect rate cuts to boost consumption but not enough to offset other headwinds near-term. Models show wide ranges of potential effects, and several factors could limit the support cuts will provide. Durables consumption and low-income consumers likely benefit most from cuts.

We expect the Fed to lower the target range for the federal funds rate by an additional 125bp by the middle of next year, to a terminal range of 2.75-3.0%.

Our forecast is relatively dovish, with two more cuts next year than the median dot in the Fed's SEP and one more cut more than the market is pricing. This is largely because our macro outlook is not quite as bright as the median FOMC member expects. Even with this expectation, the Fed still only gets to the vicinity of neutral (according to most estimates).

Models show unanticipated rate cuts should boost consumption relative to a scenario of unchanged monetary policy, but with wide confidence intervals around the magnitude of the boost. We cannot fully extrapolate model results to our forecast, since our model assumes cuts are unexpected and occur all at once. Still, we find the results to be a useful starting point. The model estimates a potential increase of 20bp - 100bp in the level of consumption over the 2 years after a 150bp decline in the target funds rate.

Several factors could mean the boost to consumption is smaller than might otherwise be expected. The first and in our view most important factor is that rate cuts do not come as a surprise; markets have been pricing in rate cuts for the past year, suggesting that some of the support for consumption may already have been realized. In addition, less restrictive policy is different than saying monetary policy is easy; while monetary policy should restrain consumption by less and less as the Fed cuts, we do not expect policy to be stimulative. Finally, even with cuts, we expect consumer loan rates will still be relatively high, and ~85% of consumer debt is fixed rate.

We still expect softer real consumption growth in coming quarters. We continue to expect softer real spending growth in Q4 and Q1 as real income growth slows, and these forecasts already factor in the additional rate cuts we expect. As we progress throughout 2026, we expect spending to start to reaccelerate, but growth remains moderate overall. Durable goods spending, which is more reliant on credit, and low-income consumers, who have relatively more floating rate debt, will likely benefit more from lower rates. That said, goods spending and low-income consumers also bear the brunt of tariff effects near-term.

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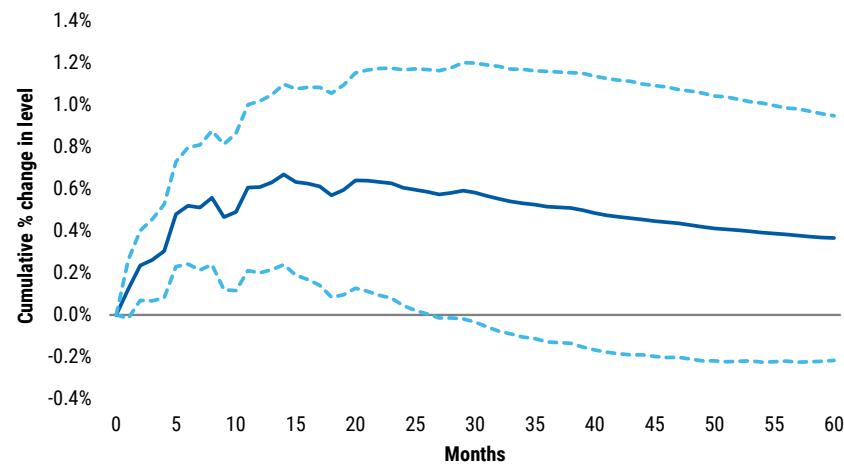
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Exhibit 1: Total real consumption response to an *unexpected -150bp shock* in the federal funds rate



Source: Morgan Stanley Research

Executive Summary

As we progress into the end of 2025 and start of 2026, there are several headwinds and tailwinds for the US consumer: headwinds include accelerating inflation from tariffs and slower growth in labor income, while tailwinds include the fiscal impulse from the OBBBA, elevated household net worth, and rate cuts from the Fed. The question is how these factors will net out: will the fiscal push and rate cuts be enough to offset the negative effects of tariffs and a slowing labor market? In a previous note [we quantified our expectations](#) for the OBBBA and how it could add about 40bp to real GDP growth in 2026 under reasonable assumptions for fiscal multipliers. In this note, we explore potential tailwinds from Federal Reserve policy rate cuts on consumption.

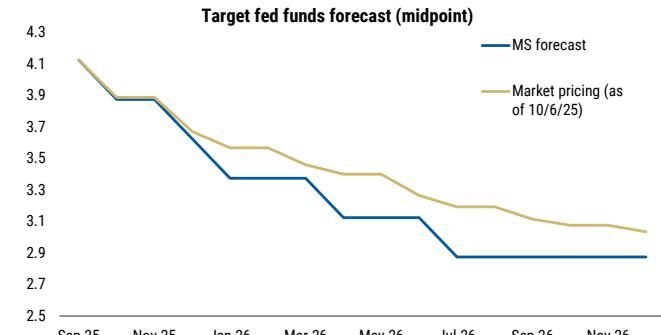
Overall, rate cuts should boost consumption relative to a scenario with unchanged monetary policy, but we see several factors that could limit the support they provide: 1) the Fed is not surprising financial markets, which have been pricing in rate cuts for much of the past year, 2) monetary policy is becoming less restrictive, as opposed to loose, and 3) tariff pass-through to inflation appears delayed versus our prior expectations, potentially extending their drag on activity further into 2026. In the near-term, we still expect growth in real consumption to moderate as the headwinds from restrictive trade and immigration policies increase. On net, rate cuts should help the outlook, but we think it's an open question of just how much.

The Fed resumed its easing cycle in September after a nine month pause, cutting the federal funds rate by 25bp and signaling that more cuts were ahead. In our base case, we expect the Fed to cut a total of six times by mid-2026, inclusive of the September cut, to a

terminal range of 2.75-3.0%. Right now the market is pricing in 5 total cuts by the end of 2026 ([Exhibit 2](#)). Hence, our forecast is not altogether different than market expectations, though our forecast calls for the Fed to arrive at its terminal rate a few months earlier. Regardless, it is clear that the most likely scenario is further cuts ahead. In the September FOMC meeting, the updated "dot plot" showed a median of three cuts this year and one next, and when asked about the outlook for further rate cuts, Chair Powell said, "Well, I didn't say that I thought a quarter point would make a huge difference to the economy but you've got to look at the whole path of rates and the market has already been baking in expectations."

It seems obvious to state that rate cuts and expectations for future rate cuts should lead to easier financial conditions and boost consumption. Nonetheless, the exact magnitude

Exhibit 2: We expect 5 more 25bp cuts to a terminal rate of 2.75-3.0%



Source: Bloomberg, Morgan Stanley Research forecasts

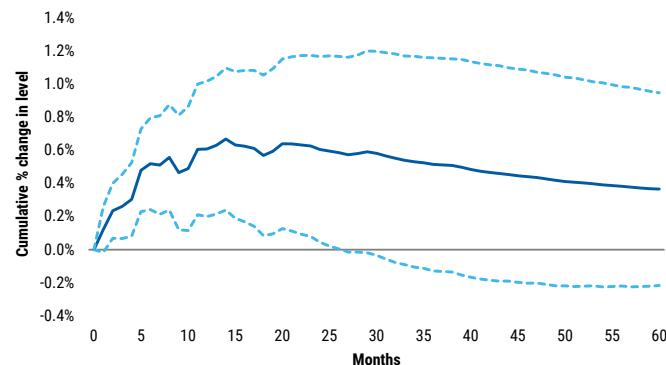
and timing of any support is hard to predict. To get an idea of what might be coming, we first turn to a workhorse model of time series economics, the vector autoregression (VAR). Estimates of the effects of rate cuts on consumption from these models tend to be noteworthy, though we suggest readers take these results with a grain of salt. After all, VAR estimations typically assume rate cuts come as unexpected shocks, which is of course not the case today. Actual rate cuts that validate expectations of rate cuts should be less stimulative. Nonetheless, we think the results of our exercise can provide a useful guide to thinking about policy lags and the range of potential outcomes.

In estimating the effect of surprise rate cuts on consumption, we find that the peak impact to the level of consumption should come around five quarters after the shock, with growth rate effects on consumption front-loaded. The effect on the level of consumption is significant and positive in the first two years following the surprise rate cut, but with wide confidence intervals. Our results indicate that a one-time surprise 150bp reduction in the federal funds rate should boost the level of real personal consumption after one year by about 60bps, with confidence intervals ranging from 20bp to 100bp ([Exhibit 3](#)). Our findings are in line with results from the academic literature on the subject.

While our model estimates the relationship between policy rate changes and consumption, it is largely agnostic to the transmission channel of monetary policy. Several factors here could potentially limit the support from cuts. Rate cuts should help boost demand for loans, but given the levels of rates and prices, affordability may remain challenged. Put simply, the longer-term Treasury yields that underpin auto loans and mortgages, two of the largest consumer lending markets, already reflect expectations of rate cuts. If the Fed simply delivers the cuts the market is expecting, longer-term rates may not decline further (though our rates strategists do expect some further rally). In our model, if we consider a -25bp shock to the federal funds rate, the difference between current market pricing and our expectations, this would imply a boost of only around 10bps to the level of real consumption after one year. In addition, about 85% of consumer debt is fixed rate, meaning the flow through to household balance sheets may take longer and be more muted compared to history. Our model framework is largely agnostic to these channels; it says the level of consumption should rise, but it does not say how.

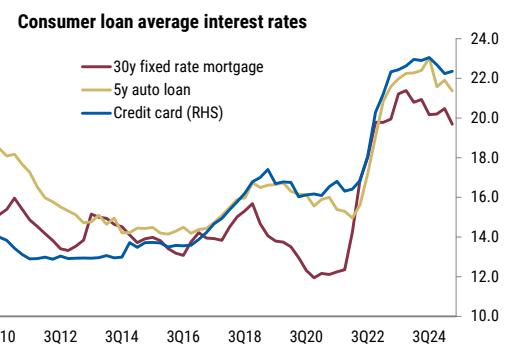
Our VAR model also does not take into account the starting point for policy, which is important. The target fed funds rate is currently at 4.0-4.25%, which is restrictive compared to most estimates of the neutral rate. Even with the cuts we expect, we have the ending point next year at 2.75-3.0%, likely right around neutral. In our view, there is a difference between going from restrictive policy to neutral policy, than from neutral to easy. Monetary policy will be restraining consumption by less and less as the Fed cuts, but it is not becoming stimulative. While rate cuts should provide support and boost consumption, we do not expect a surge.

Exhibit 3: Total real consumption response to a -150bp shock in the fed funds rate



Source: Morgan Stanley Research

Exhibit 4: Interest rates on consumer loans remain relatively high, despite rallies in longer-term rates already



Source: Federal Reserve Board, Wall Street Journal, Haver Analytics, Morgan Stanley Research

We can envision how Fed rate cuts will be relatively more beneficial for certain cohorts and areas of spending than others. Since lower-income cohorts have higher percentages of floating rate debt and in many cases higher debt-to-income ratios, lower rates should benefit these consumers more. In terms of types of spending, models show that durable goods spending is boosted more after cuts than spending on nondurable goods and services. This makes sense considering durable goods are more reliant on credit and more closely linked to the housing market. The factors above will limit this relative to a scenario of easy policy, but we still expect an acceleration in durable goods spending in mid-to-late 2026.

Our forecasts still assume headwinds to consumption over the next couple of quarters. We expect the peak pass through into inflation from tariffs in Q4 and Q1 (in terms of the level of the PCE inflation index). We also expect labor demand to remain muted, slowing nominal income growth. These factors will likely outweigh any boost from rate cuts near-term, resulting in weaker real consumption growth through the start of next year. While low-income consumers may benefit most from cuts, they are also most negatively impacted by higher inflation and slower income growth. As these headwinds subside and lagged monetary policy effects continue, we expect consumption to begin to accelerate again in 2H26, though spending still grows at a moderate pace in 2026 as a whole.

Modeling Effects on Consumption

To model the effects of changes in the policy rate on consumption, we run a structural vector autoregression (SVAR) model. Here we note the difference between a traditional vector autoregression (VAR) and a structural autoregression (SVAR). A traditional VAR estimates the interconnectedness between changes in interest rates and other economic variables of interest. The advantage of using a VAR framework is that it can capture complex relationships between interrelated data without imposing a theoretical structure on the data. The disadvantage of VARs is that they can be difficult to interpret (e.g. they can pick up correlation more than causation) and they lack theoretical underpinnings. Whether lack of structure is an advantage or disadvantage is in the eyes of the beholder.

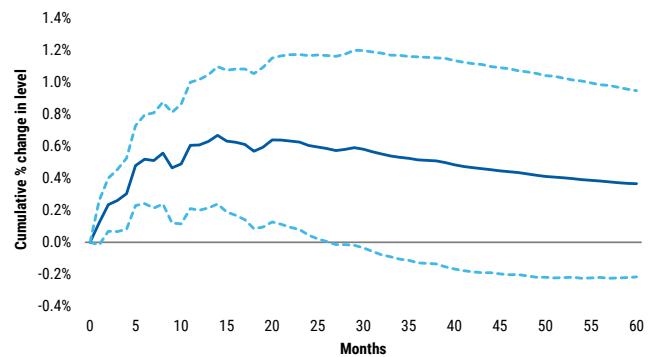
We lean in the direction of preferring some structure. By imposing identifying restrictions based on economic theory, we believe the SVAR can improve our ability to interpret model outcomes. That said, we remind readers of two key points. First, our model estimates the affect of an *unanticipated* shock in monetary policy, which is not the case right now; the market is currently pricing in five cuts by the end of 2026, as it has been for a couple months. Fed rate cuts today validate market expectations more than create them. Delivering what markets expect is different than saying the Fed surprised markets by easing unexpectedly. Whether interest rate changes are expected or come as a surprise surely must alter their effects.

Our model is also linear in nature. In other words, the results will be symmetrical for a 150bp cut versus a 150bp hike, and the model does not take into account the initial starting point or magnitude of total changes. As a result of these factors, we cannot extrapolate the exact results to our expectations for consumption. Still, we find the results of these models useful in demonstrating the lags of policy changes and in giving a range of potential magnitudes; we think it is a useful starting point for understanding the relationship between policy rate reductions and future spending from households.

Our model includes four variables: the log of real consumption, the log of core PCE prices, the log of commodity prices, and the federal funds rate, in this order. The ordering of variables is an important assumption because it dictates how contemporaneous shocks are

decomposed. Ordering attributes the correlation between shocks to the variables, with the first variable in the order receiving shocks that are not affected by others (the most exogenous of the variables). In contrast, the last variable is affected by all other shocks in the system (least exogenous). This allows for a more accurate interpretation of how

Exhibit 5: Total real consumption response to a -150bp shock in the Fed Funds rate



Source: Morgan Stanley Research.

shocks to one variable affect others over time.

We include 12 lags and run the model using monthly data from 1980-2019. We stop before the COVID pandemic to avoid the statistical difficulties of controlling for the unique aspects of the pandemic. The model is similar to the model used by [Bernanke and Gertler \(1995\)](#). In [Exhibit 5](#) we show the cumulative impact to the level of consumption over five years of a -150bp shock in the federal funds rate. The peak impact is around five quarters after the shock, with a magnitude of a 65bp increase in the level of real consumption at that point. We also show 95% confidence intervals which are quite wide, ranging from 20bp to 100bp at that point. The shock to the level of consumption is permanent with consumption about 40bp higher after five years than would be the case without the surprise rate reduction.

Although our model is relatively simple, the results are largely consistent with the literature. In the [Fed's study using their FRBUS model](#), they find a 100bp fall in rates would lead to a 30bp increase in real consumption after one year, similar to the 40bp boost our model would imply for that size shock.

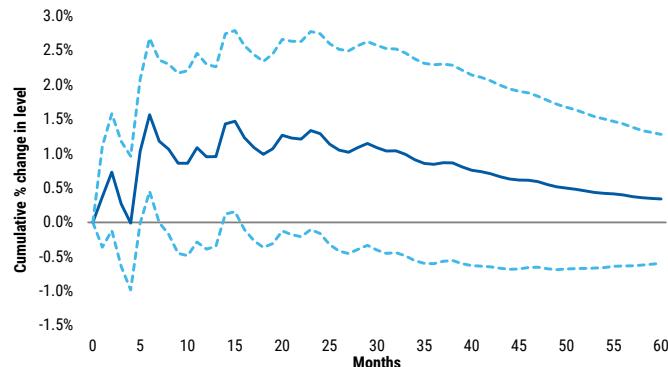
If we translate the output into growth rates, we see that the growth rate effects on consumption are front-loaded. The -150bp shock in the Funds rate results in an average boost of around 60bp per quarter to annualized consumption growth in the first year, and around 20bp per quarter in the second year. After 8 quarters, the effect on consumption growth turns negative, though we note the effects of the shock on consumption also become insignificant at that point.

Since the model shows the effects of unexpected shocks, we can also apply the model to the present situation by considering instead a 25bp shock, since this is the amount of additional cuts we are expecting versus market pricing. In other words, some of the 65bp increase mentioned above is likely behind us, but if our forecast is correct, at least 25bp of currently unexpected cuts will still come. The model shows that a -25bp shock in the federal funds rate would increase the level of real consumption by about 10bp after one year.

The effects of rate cuts on different types of consumption are also interesting. In the below exhibits, we show the results from running two separate SVAR models similar to the one above, but replacing real consumption with real durables consumption and real nondurables consumption. Again, while we do not take the magnitude to be an exact estimate of what should happen, especially considering the lack of significance, we find the comparison of the results useful and intuitive. As expected, the effect on durables consumption is much larger in magnitude than that of nondurables ([Exhibit 6](#) and [Exhibit 7](#)). This is true compared to the effect on services consumption as well.

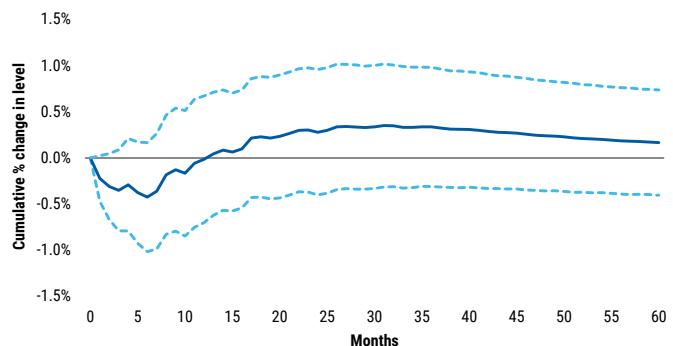
Other models also show that an unexpected easing in financial conditions can have a positive impulse on spending, specifically for durables. We consider a transitory, unanticipated shock to the FCI-G index (the Federal Reserve Board's [Financial Conditions Impulse on Growth Index](#)) that corresponds to the index falling by $\frac{1}{2}$ point, in line with easing in the index between April and August 2025. Using monthly data on spending, for the 1990-2019 period, the easing in the FCI-G is associated with an increase in durables spending: we see approximately a 2% increase in spending 12 months after the shock. The increases in other spending categories (non durables, services) are less than half of this magnitude.

Exhibit 6: Real durable goods consumption response to a -150bp shock in the fed funds rate



Note: Model includes data from Jan 1980 through Dec 2019. Source: Morgan Stanley Research.

Exhibit 7: Real nondurable goods consumption response to a -150bp shock in the fed funds rate



Note: Model includes data from Jan 1980 through Dec 2019. Source: Morgan Stanley Research.

In the above models, we note that the choice of sample period seems to be important. When we examine different start and end points, we conclude the model results are heavily influenced by identification in the 80s. The rapid moves in rates in the early 80s help the model identify shocks and responses. Shortening the sample period by excluding the 1980s can lessen or eliminate some results (e.g. loss of statistical significance).

In our view, this finding is not surprising given the greater weight of manufacturing in GDP in previous decades. Since the 80s, manufacturing has fallen from around 20% of GDP to around 10%. Similarly, goods made up 45% of total nominal consumer spending in the early 80s versus just over 30% today. As demonstrated above, goods are more cyclical and more impacted by policy rate changes than services. Other factors have also evolved considerably since then: the availability of credit and the framework for monetary policy, to name a couple.

In various academic studies, the magnitude of the monetary policy transmission strength varies over time and states of the economy: the effects were larger in the 1970s–early 1980s; smaller during the Great Moderation. During the Effective Lower Bound period, the Fed's forward guidance and asset purchases transmitted via longer yields. Two aspects of the literature are useful to highlight in our context: with monetary easing durables (especially autos and household durables) move most strongly, and there are much more modest and slower moves for nondurables and services. Also, the refinancing channel creates state dependency in monetary policy transmission, and this is an important issue in the current framework as we discuss below.

Assessing Channels of Transmission

Although our simple SVAR approach does not strictly identify the transmission channels between rate cuts and stronger consumption, we can rely on other well-supported theories to draw conclusions. In this report we focus on the primary channels through which lower policy rates may support consumption; namely the interest rate, credit, and balance sheet channels for monetary policy.¹

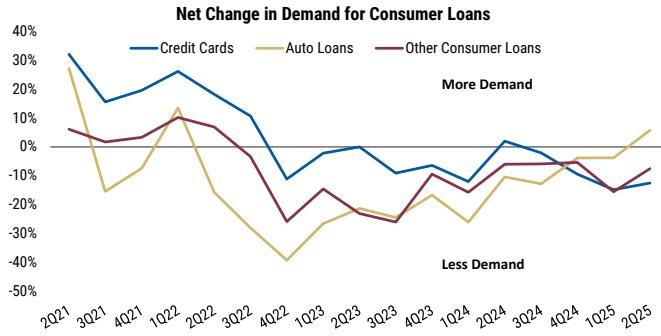
Interest Rate and Bank Credit Channels

Beginning with the interest rate channel, rate cuts should lead to lower borrowing costs for consumers, increasing aggregate demand via greater willingness to spend. We see this as especially important for durable goods spending, since these items are typically bought on credit. In addition, consumer borrowing costs appear elevated relative to financial conditions for the nonfinancial business sector. Even a small reduction in borrowing costs could prove supportive for lending.

The interest rate channel often works alongside the credit risk channel. While the former ties together changes in real interest rates and their effect of the cost of capital and borrowing, the latter focuses on the availability of credit. The credit channel can be thought of as an accelerator to what is happening in the interest rate channel.

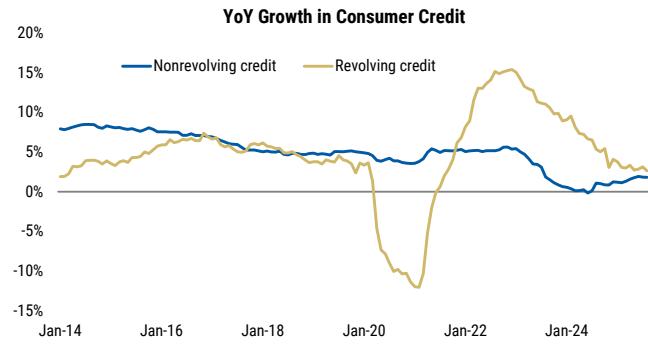
Over the past three years, demand for consumer loans has fallen, based on the Fed's Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS) ([Exhibit 8](#)). This has contributed to slower loan growth across consumer loan types. Revolving credit (mostly made up of credit card debt) grew 15% y/y in 2022 coming out of the pandemic. That has since slowed to 2.6% as of the most recent data from August 2025. This is below the 3.8% average growth from 2012-2019 despite higher inflation now. Similarly, growth in nonrevolving consumer credit (including auto loans and student loans) slowed from over 5% in 2022 to just 1.8% as of the August data ([Exhibit 9](#)).

Exhibit 8: Demand for consumer loans has been declining for three years...



Source: Federal Reserve Board, Morgan Stanley Research

Exhibit 9: ...While loan growth has slowed



Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research

1. Another channel would be through net trade, whereby interest rate cuts lead to a weakening in the foreign exchange value of the dollar, weakening imports and supporting exports. To the extent higher goods prices deter spending, the trade channel would provide some offset to the direct effects of lower rates on consumption.

Consumer debt that is floating rate and linked to short-term rates will be most directly affected by rate cuts. Credit cards, for example, typically price off the prime rate, which is linked to the fed funds rate. As a result, we can see the correlation between interest rates on credit cards and the fed funds rate is relatively strong over time, but it is not a one-to-one relationship. Back to 2010, for every one percentage point change in the fed funds rate, credit card interest rates on average moved by 64bp in the same direction. Similarly, after the 100bp of cuts last year, card rates fell around 70bps from their peak.

If we assume a similar relationship as historically, with 150bp in total cuts, we might see a 100bp drop in credit card rates. While helpful, the average rate would still be over 21%, much higher than historical averages ([Exhibit 10](#)). Our banks team expects only modest acceleration in credit card loan growth, with 4.6% y/y growth expected in 2026 compared to 3.9% in 2025.

For some other consumer debt types, movements in longer-term rates will be more important. As we describe in the next section in more detail, mortgage rates are most closely correlated with the belly of the curve. Auto loans are fixed rate, typically 5-7 years in term and thus also more dependent on the belly of the curve. Since the market has been expecting the Fed to act, some of the benefit of the upcoming cuts is already priced in. The 10y Treasury, for example, has rallied 65bps since the start of the year and 35bps over the past few months. Similarly, rates on auto loans fell 30bps in Q2. Given our expectations for five more cuts and the skew of risks around that, our rates strategists do expect further rallies across the curve. If the market does not begin to expect more cuts or prices in a higher term premium, though, longer-term rates may not move, which would mean less benefit ahead for these consumer loans.

Exhibit 10: Credit card interest rates are based on the prime rate

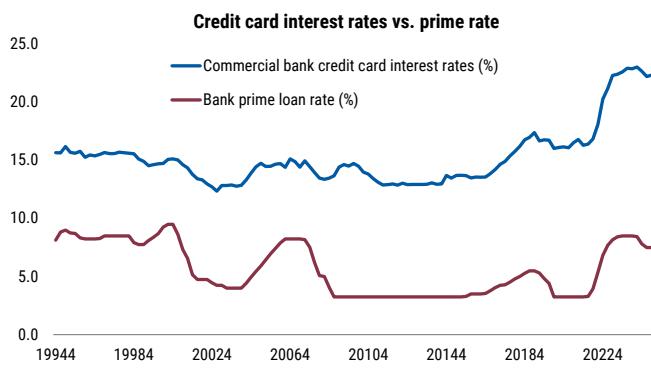
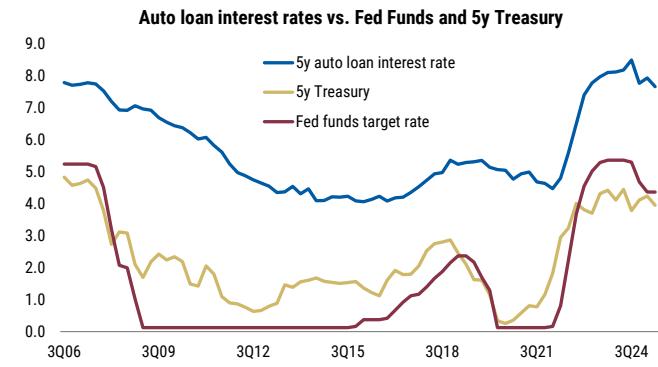


Exhibit 11: Auto loan rates do not price directly off another rate, but loans tend to be 5-7yr terms



For autos, lower rates should help, but what happens with prices may matter more for affordability. In [their study](#) from fall 2024, the Fed broke down the increase in auto loan monthly payments into the portion driven by higher loan size and the portion driven by higher auto loan rates. They found that for subprime borrowers, loan size (rather than rates) explained almost all of the 30 percent increase in monthly payments over the prior four years. For prime borrowers, loan size also explained a "significant portion" of the increase. They estimate that from 2020-2024, the rise in auto loan interest rates only led to increases in monthly payments of \$15 for subprime borrowers and \$40 for prime borrowers.

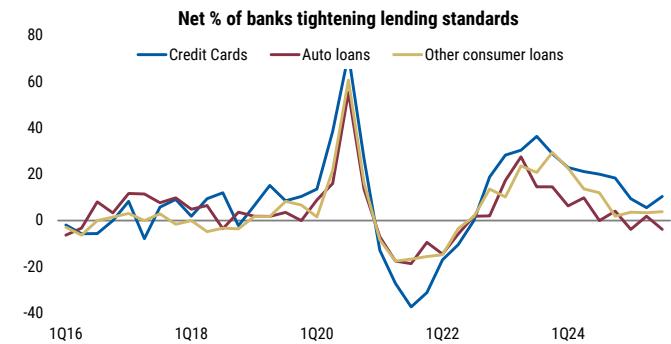
Our autos team estimates that every 100bp decline in auto loan interest rates would reduce monthly payments on auto loans by \$20 ([Exhibit 12](#)). Considering the average auto loan monthly payment is \$749, \$179 above that of five years ago, this is a relatively small benefit.

Exhibit 12: Change in auto loan payments based on changes in auto loan interest rates

Interest Rate (%)	Loan Term (Months)						
	66	68	70	72	74	76	78
0.0%	652	632	614	597	581	566	551
1.00%	669	650	632	615	599	584	569
2.00%	687	668	650	633	617	602	587
3.00%	705	686	668	651	635	620	605
4.00%	723	704	686	669	653	637	623
5.00%	741	722	704	687	671	655	641
6.00%	759	740	722	705	689	673	659
7.00%	777	758	740	723	706	691	677
8.00%	795	776	758	741	724	709	695
9.00%	813	794	776	758	742	727	713
10.00%	831	812	793	776	760	745	730

Source: Experian, Morgan Stanley Research

Exhibit 13: Lending standards have been tightening the past few years



Source: Federal Reserve Board, Morgan Stanley Research

Finally, lending standards will also be important to how much rate cuts can boost consumption. Banks have been tightening their lending standards for the past three years, which has also played a role in the slower loan growth ([Exhibit 13](#)). Our banks team expects the trend of less tightening in consumer lending standards continues into next year, with potential for modest easing in some pockets. However, they think banks likely will remain on guard and will be ultimately dependent on the macro (employment, inflation) as well as how delinquencies evolve from here.

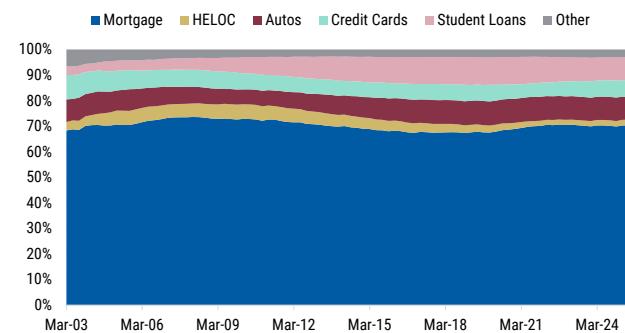
Balance Sheet Channel and Wealth Effects

Lower rates can also boost consumption through lower costs of carry on current debt. If consumers are able to pay lower rates on floating rate debt, or refinance fixed-rate debt into lower payments, this will lower their interest burdens, increasing their disposable income.

The composition of currently held debt will be important for this channel, and consumer debt has become increasingly fixed rate over time. We estimate 85% of debt currently on consumer balance sheets is fixed rate ([Exhibit 15](#)). This is

because mortgages make up a majority (~70%) of consumer debt, and a very small share of mortgages today (<10%) are variable rate ([Exhibit 14](#)). Auto loans and student loans, the two next largest shares of debt, are also mostly fixed rate. While both HELOCs and

Exhibit 14: Breakdown of household debt by debt type



Source: NY Fed, Morgan Stanley Research

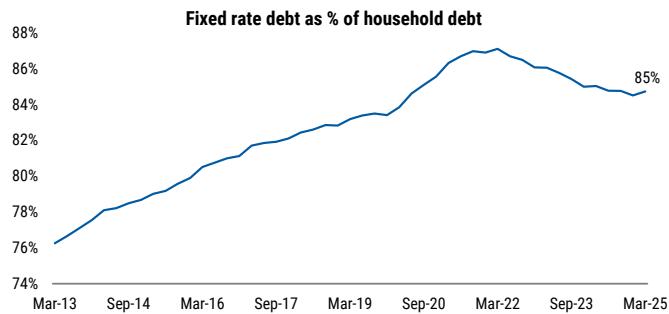
credit cards have grown in share over the past two years, they are still relatively small.

High percentages of fixed rate debt, slowing credit growth, and strong income growth over the past few years meant household debt service ratios remained relatively low, despite the 500bp in rate hikes that occurred from 2022-2023. Monthly debt payments as a percent of disposable personal income were 11.3% as of Q2. This is lower than the 2011-2016 average of 12%, when the Fed Funds rate had already been at the zero lower bound for multiple years. While debt service ratios for the marginal borrower are likely higher than they would have been pre-2022, the average for all consumers is relatively low.

Despite low percentages of floating rate debt, if consumers are able to refinance fixed rate debt, then lower rates would still be beneficial through this channel. As shown above, with the short terms of auto loans, most of the payment is principal, and thus lower rates do not lower the monthly payments significantly. For mortgages, lower rates can result in significant declines in monthly payments, which will be beneficial to those who have mortgage rates higher than the prevailing rates. In other words, those who have taken out mortgages over the past three years will benefit, as described in more detail in the next section.

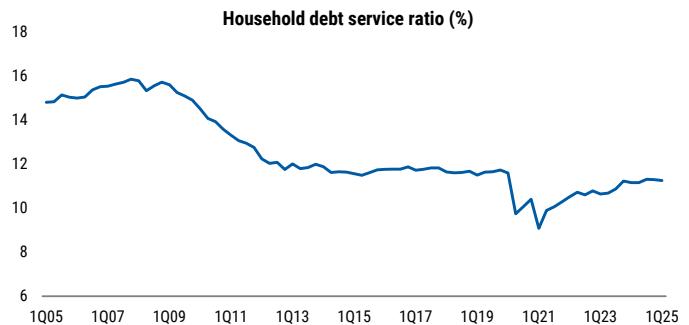
As rates fall, consumers will also receive lower interest on their savings. The net effect of these two forces will determine the overall boost, or drop, in disposable income.

Exhibit 15: We estimate around 85% of household debt is fixed rate



Source: NY Fed, FHFA, Morgan Stanley Research

Exhibit 16: Despite 500bp in rate hikes, debt service ratios remain below pre-Covid levels



Source: NY Fed, Morgan Stanley Research

Finally, rate cuts could also lead to higher consumer spending through elevated asset prices. Lower rates are typically associated with rising asset prices, and if so, this could increase net wealth (household assets minus household liabilities) and lead to positive wealth effects. Our equity colleagues [have noted](#) that valuations rarely contract in periods of both above median EPS growth and accommodative monetary policy. Expectations for cuts are therefore contributing to their view for continued positive S&P returns through next year.

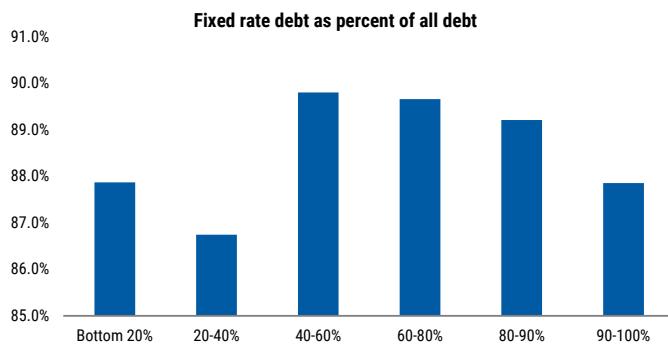
According to the life-cycle theory of consumption, households do not like excessive variability in spending and adjust their saving and wealth to hold spending as constant as possible. This model predicts that increases in lifetime resources should lead to proportionate increases in consumption in all periods of life. If households experience an unexpected change in wealth, this "surprise" should lead households to formulate a new plan. An increase in asset prices that leads households to believe their wealth is

permanently higher should therefore boost spending (see [here](#) for more detail).

Differences Among Cohorts

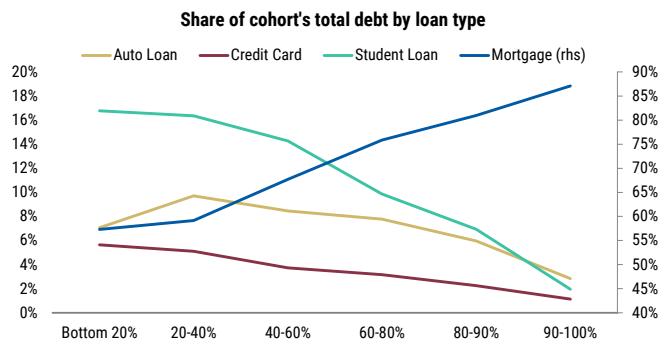
While high-income consumers will benefit more from positive wealth effects, low-income consumers have slightly higher shares of floating rate debt and thus will likely benefit more through that channel ([Exhibit 17](#)). For the low-income cohorts, still a large majority of their debt is fixed rate. However, compared to high-income consumers, a smaller share of their debt is mortgages and a larger share is credit card debt ([Exhibit 18](#)). These consumers are also more likely to roll credit card balances month-to-month and thus be affected by the change in rates.

Exhibit 17: Though all cohorts have very high shares of fixed rate debt, it is lower for low-income cohorts



Source: Federal Reserve Board, FHFA, Haver Analytics, Morgan Stanley Research

Exhibit 18: Debt of higher income cohorts is very concentrated in mortgages, while lower cohorts have relatively more student loans and credit cards

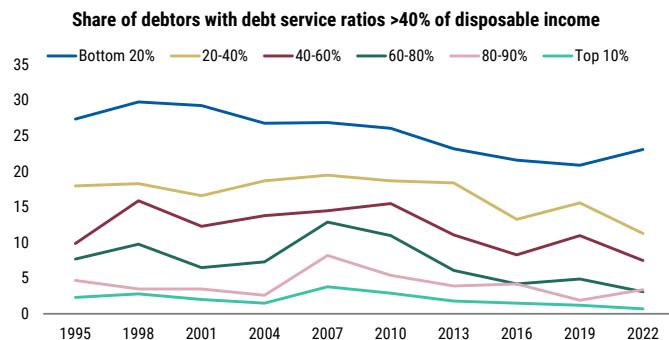


Note: Data is based off 2019 Survey of Consumer Finances, though trends are similar over time. Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research

Historically, average debt service ratios have been similar across income cohorts, but lower cohorts have much larger shares of debtors whose debt payments make up greater than 40% of their income ([Exhibit 19](#)). Larger increases in delinquency rates among these cohorts over the past few years indicate more hardship in making payments, so any decline in monthly payments and thus boost in disposable income should be relatively more beneficial to these consumers ([Exhibit 20](#)).

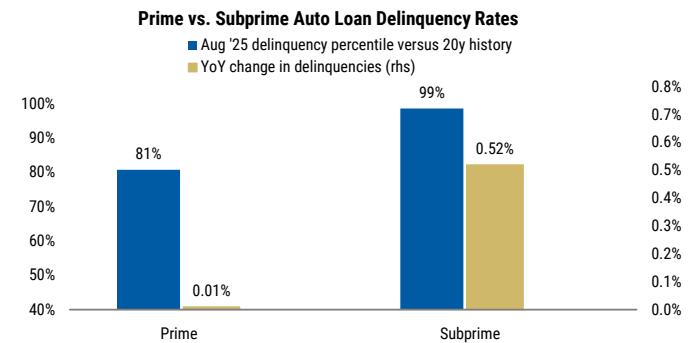
Also, given the faster depletion of excess savings, it is possible more low-income consumers needed to take out credit at high rates over the past few years. In a recent [Boston Fed paper](#), they found that high-income consumers' credit card debt remains below its pre-pandemic level, while low-income consumers now have more credit card debt than they did then. For high-income consumers who do not have recent debt, lower rates may actually result in a decline in disposable income; the impact of lower rates on their asset income may outweigh the impact of lower rates on credit.

Exhibit 19: Low-income cohorts have higher percentages with >40% debt service ratios



Source: Federal Reserve Board, Haver Analytics, Morgan Stanley Research

Exhibit 20: Performance of subprime auto loan borrowers has been worse recently than that of prime borrowers



Note: This only includes data from loans in Auto ABS deals. Source: Intex, Morgan Stanley Research

A Deeper Dive into Housing

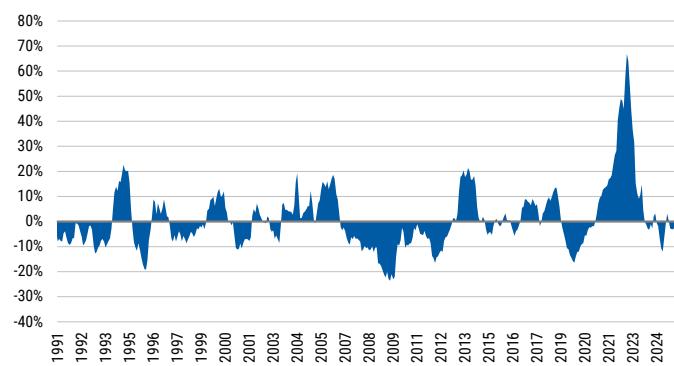
James Egan & Jay Bacow

The housing market should be important to consumption in a few ways. First, increased transaction volumes and sales can be linked to more spending, specifically on durable goods. Second, if current homeowners are able to refinance their mortgages to lower rates, that could free up disposable income and boost spending. Finally, changes in rates can affect home prices through unlocking supply and/or demand, which would be important for wealth effects.

However, today's housing market is unique when compared to the past several decades. As discussed above, the elevated concentration of fixed-rate mortgages in the US housing market has muddied the proverbial waters of the transmission mechanism of monetary policy within the housing market. Mortgage rates moved higher quickly throughout 2022 and 2023. As that happened, current homeowners who were able to lock in historically low mortgage rates in 2020 and 2021 saw no increase in payments. Instead, those higher rates and the record deterioration in affordability that accompanied them ([Exhibit 21](#)) made it increasingly difficult for first-time homebuyers to step into the housing market, and made it far more expensive for those who did manage to buy a home ([Exhibit 22](#)).

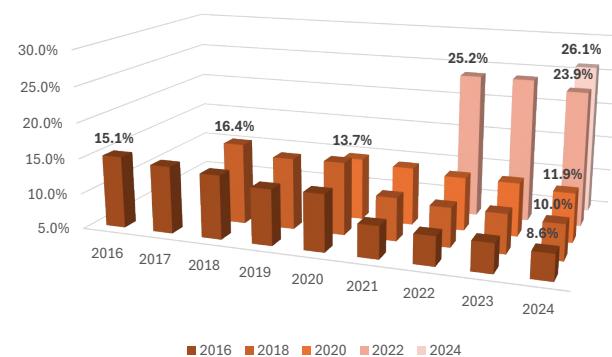
The end result of higher rates: home sales plunged to their lowest levels in decades (when controlling for the size of the US housing market), and for-sale housing inventory retreated well below the lowest levels we have on record; these helped to send home prices to new all-time highs.

Exhibit 21: YoY change in affordability shows a record pace of deterioration in 2022/23



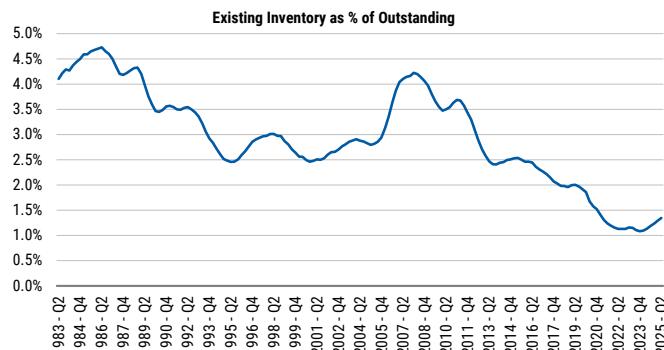
Source: NAR, Freddie Mac, Morgan Stanley Research

Exhibit 22: Evolution of mortgage payments to income by the year a home was purchased



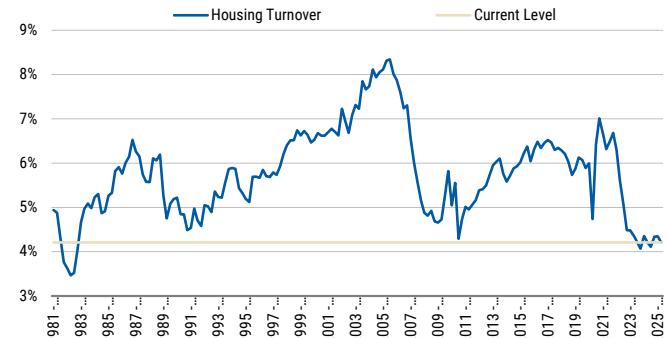
Source: NAR, Freddie Mac, US Census Bureau, Morgan Stanley Research

Exhibit 23: Inventory as a share of the ownership housing stock reached historical lows



Source: NAR, US Census Bureau, Morgan Stanley Research

Exhibit 24: Existing home sales as share of the outstanding market at its lowest levels in decades



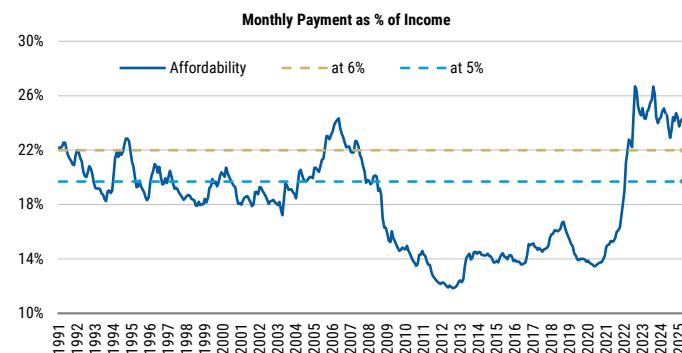
Source: NAR, US Census Bureau, Morgan Stanley Research

Looking ahead to the potential implications of rate cuts on housing activity, it is worth highlighting that mortgage rates are not directly tied to the fed funds rate. If we look at the correlation of changes since 2000, we can see that changes in the primary mortgage rates are correlated mostly to changes in either 5yr or 10yr Treasury rates, with diminishing correlations as you get further from the belly of the curve (see [here](#) for more detail). As mentioned in prior sections, bond markets are already expecting 4-5 additional cuts from the Fed. If the Fed does what the market expects, then bond yields shouldn't react much.

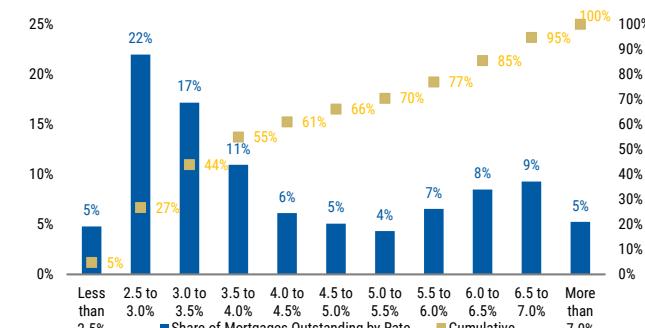
Given our expectation for rate cuts and the distribution of risks, our rate strategists do expect further rallies across the curve. If so, affordability for homebuyers would improve ([Exhibit 25](#)). However, given the current distribution of mortgage rates, it could take quite a large move in rates before a significant portion of the current owner base is incentivized to list their home for sales and get the housing market moving again ([Exhibit 26](#)).

In our view, we would need about a 10% improvement in affordability in order to see sustainable growth in sales volumes, which equates to a 30yr mortgage rate of approximately 5.5%. If we were to get to those levels in the coming year, we forecast a 5% increase in existing sales volumes, putting them in the context of 4.3-4.4 million in 2026. This is an acceleration in sales compared to the current rate of 1-2% growth.

We think the real potential for accelerated growth is beyond next year in this scenario. In historical examples of significant affordability improvements, we find that it is much more likely that housing activity increases in the 12 months *after* affordability improves. A shallower decrease in mortgage rates could lead to a brief increase in sales – especially considering the relative concentration of mortgages in the 6-7% range compared to the universe between 4-6% – but one that we think would be short-lived without any further improvements in affordability.

Exhibit 25: Housing affordability at different mortgage rates

Source: Freddie Mac, NAR, Morgan Stanley Research.

Exhibit 26: Distribution of outstanding mortgages by mortgage rate

Source: eMBS, Morgan Stanley Research

In terms of potential refinancing, the significant increases in mortgage rates over the past few years have resulted in a real bifurcation between those who purchased in 2020 and earlier, and those who bought in 2022 and later. As we show in [Exhibit 22](#), the median household of those in the first camp has debt-to-income ratios (DTIs) for their mortgage payment of below 12%, while the median household for each vintage in the latter camp has DTIs of 23.9% or above. If we do get something along the lines of a 100bp move in mortgage rates, this could lead to refinancing for households that took out mortgages in 2022 and later. For these individuals, the ability to refinance could free up disposable income.

The magnitude of the move in mortgage rates will of course determine how much income is freed up and for how many borrowers. We estimate that around 23% of currently outstanding mortgages today have rates above 6%. For context, a 100bp decline in the mortgage rate for the median-priced home today would decrease the monthly payment by \$215 or 10%.

Finally, the net effects of lower rates on supply and demand will affect home prices. Right now, an increase in the supply of homes for sale off of their historical lows, combined with moribund sales volumes, is leading to a decelerating pace of home price growth. If affordability remains a challenge, we not only expect home price growth to continue to slow, but also expect home prices to be well supported at these levels. The distribution of mortgage rates for existing homeowners discussed throughout this section should continue to play a role – homeowners will not need to sell at the discounts necessary to introduce any real weakness to home prices.

Lower mortgage rates should lead to higher listing volumes alongside increased demand. In this environment, we expect a simultaneous increase in supply and demand to result in very range-bound home price performance. Taking both these scenarios into account, we therefore do not expect significant wealth effects from home price appreciation, but it also should not be a drag on spending.

Overall, federal reserve rate cuts alone should not be enough to get the mortgage rate down. Mortgage rates are correlated with the belly of the Treasury curve, capacity constraints, risk premia in mortgages, and vol/shape of curve. We think it likely will take mortgage rates falling to 5.5% to materially and sustainably restart home sales, though smaller moves could lead to refinancing activity from those who bought post-2022.

What The Hiking Cycle Has Taught Us

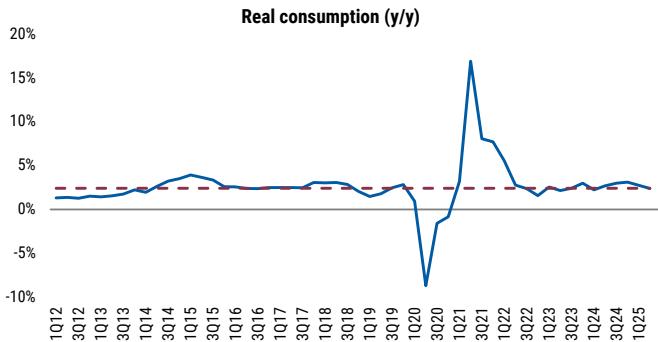
One question we have received around the potential impacts of rate cuts is: some say that over the past few years, rate hikes had less of an impact on consumption than might have been expected, so should we expect a similar muted impact on the way down?

The Fed began hiking rates off the zero lower bound in March 2022 and proceeded to hike through August 2023, up to a target range of 5.25%-5.5%. They then were then on hold at those levels until September 2024. Real consumption growth rebounded strongly in 2021 after the pandemic. Though consumption growth slowed in 2022, it remained right around the 2012-2019 average of ~2.5% from 2022-2024, despite higher rates.

At face value, this might seem like rate hikes did not slow consumption growth. However, we would need a counterfactual to conclude that, and other factors could have meant consumption would have been higher than many people assumed. In addition, while the nominal policy rate rose to levels not seen in years, high inflation meant the inflation-adjusted policy rate was still negative for much of the tightening cycle.

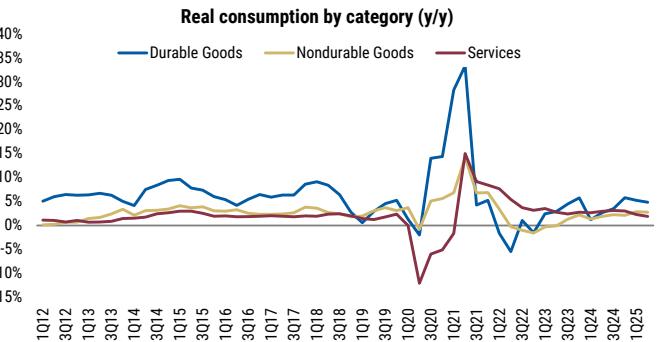
Nonetheless, when we look at the more detailed data on types of spending, we do see signs of higher rates having constrained consumption. Services consumption growth throughout the past few years remained above its pre-Covid average. Meanwhile, consumption of durable goods, which we would expect to be most impacted by rate hikes, declined in 2022 (albeit after a very strong 2021) and has remained below its pre-Covid growth rate since. This lines up with the slower credit growth shown in the previous section.

Exhibit 27: Real consumption growth has been solid throughout the past few years



Source: BEA, Haver Analytics, Morgan Stanley Research

Exhibit 28: Durable goods consumption growth, though bumpy, has remained below its pre-covid average



Source: BEA, Haver Analytics, Morgan Stanley Research

This slowdown in durables consumption does signal that higher rates had an effect, but the question still arises as to why consumption did not slow more. Part of this was likely due to the still relatively low *real* interest rate though much of the hiking cycle, as mentioned above. Aside from this, though, we note three other factors that likely contributed: high percentages of fixed rate debt, elevated excess savings coming out of the pandemic, and exogenous factors such as elevated immigration that boosted consumption.

First, as mentioned in the section above, a large majority of consumer debt today is locked

in at a fixed rate. The share of fixed rate debt is much higher than it has been historically, largely because a higher percentages of mortgages used to be variable rate: we estimate around 85% of consumer debt is fixed rate today versus 75% in 2013 and likely even less pre-GFC. As a result, higher interest rates may not have had as immediate an impact on consumer balance sheets as in past cycles.

The second factor that played a role was excess savings coming out of the pandemic. With elevated savings, consumers may not have needed to rely as much on credit, enabling them to spend even as rates rose. Excess savings, defined here as cash and short-term deposits, peaked in

early 2022. Consumers drew down on these excess savings in 2022 and 2023, resulting in a low saving rate and helping them to smooth their consumption through the period of tighter financial conditions ([Exhibit 29](#)).

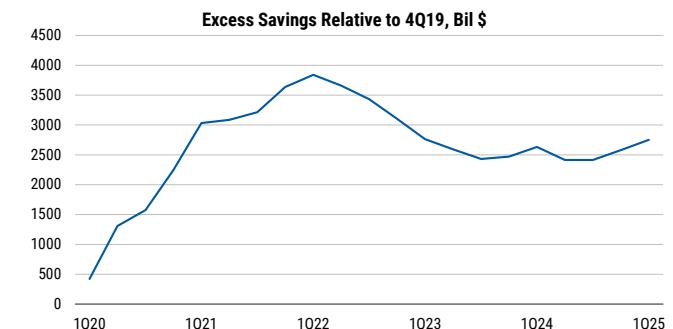
Finally, many other factors exogenous from monetary policy affect spending. For example, from 2022-24, net immigration averaged about 3mn per year, about twice the historical run rate. Higher net immigration meant faster population growth. In past notes, we estimated that this raised potential GDP growth from around 2.0% in 2019 to 2.5-3.0% in 2022-24. Similarly, this likely contributed to faster consumption growth. While this is not directly related to monetary policy, it likely made it harder to discern the impacts of higher rates just through aggregate spending trends alone.

What role will these factors play now?

As we progress into the cutting cycle, we think these factors are important to keep in mind. As discussed in the prior section, it is still true that most of consumer debt is locked into fixed rates, and this could limit immediate impacts of cuts. However, this may be relatively less of a barrier to transmission of rate cuts as opposed to hikes. As an example, consider someone who had a mortgage, likely at a low fixed rate, before rate hikes occurred. Higher mortgage rates would not impact their monthly payments. If someone has a 7% mortgage rate today, though, and mortgage rates fall to 5.5%, they can refinance and benefit from the cut. Lower mortgage rates could help some existing homeowners as well as new homebuyers. In a 2021 [Boston Fed paper](#) examining the mortgage cash flow channel of monetary policy, they found that the impact of rate cuts on expenditures was larger than that of rate hikes because of this phenomenon.

In terms of excess savings, the saving rate has been relatively constant over the past two years, and we think the peak of consumers drawing down excess savings is behind us. We therefore do not think excess savings have been driving recent spending, so this should be less of a factor affecting transmission than it was three years ago.

Exhibit 29: Consumers drew down on excess savings in 2022 and 2023 but savings have since stabilized



Source: Federal Reserve, Morgan Stanley Research

Similar to over the past few years, though, there will be many other factors driving consumption that are somewhat exogenous to the effects of rate cuts. As discussed earlier, we expect the peak impacts from tariffs on consumption are still ahead of us as higher prices weigh on real income and consumer purchasing power with a lag. Meanwhile, with weaker growth, labor demand will likely remain muted. As a result, though we expect rate cuts will help consumption relative to a scenario with no cuts, we still expect moderate real consumption growth overall.

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Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1499	41%	389	46%	26%	702	41%
Equal-weight/Hold	1618	44%	375	44%	23%	782	45%
Not-Rated/Hold	4	0%	1	0%	25%	1	0%
Underweight/Sell	577	16%	88	10%	15%	234	14%
Total	3,698		853			1719	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the " % of total" column may not add up to exactly 100 percent.

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