ECONOMIC OUTLOOK
REGIONS
October 2017

Household Balance Sheets: Here We Go Again?

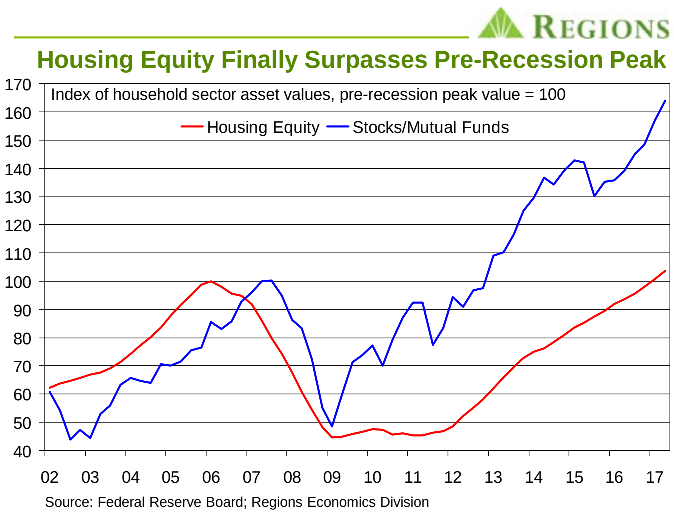
Anyone who follows the financial and economic news can be excused for feeling somewhat confused when it comes to the state of the U.S. consumer. After all, over the past several months, three story lines have garnered significant attention in the press, but each story line seems to say something different about the state of household finances. Specifically, over the past few months the data have shown a new record high for the level of household debt, a new record high for household net worth, and a sharp decline in the personal saving rate.

The good part about these differing story lines, at least for those with a firmly entrenched bias, is that one can grasp the story line that backs their view and conveniently ignore the others. For instance, those clinging to the "hard-pressed consumers" narrative can tell a tale of consumers having to dig into savings and take on debt to make ends meet. The record high level of household net worth is proving to be very versatile, being used by some to support arguments that there are no worries at all in the household sector and by others who argue we are on the verge of a significant "correction" in asset prices.

For the rest of us, however, trying to divine the meaning of the data lying beneath the headlines is a more complicated endeavor. Having discussed the saving rate in our August *Outlook* and having discussed (some would say nagging about) the details of household debt on numerous occasions, including our write-ups of the quarterly reports from the Federal Reserve Bank of New York, our discussion here will focus on household balance sheets. The recently released Q2 2017 edition of the Federal Reserve's *Financial Accounts of the United States*, more commonly known as the *Flow of Funds* report, touched off the round of stories on household net worth, most of which focused on net worth hitting a new record high, $96.156 trillion, in Q2. And, indeed, "record high" applies to Q2 household net worth no matter how you slice it, i.e., nominal, adjusted for inflation, or per capita.

In keeping with our usual "the headlines get the attention but the real story is in the details" approach, at this point record high net worth is old news. After all, nominal household net worth surpassed the pre-recession peak in Q4 2012 and has risen in every quarter since save for Q3 2015 when a decline in equity prices pushed net worth lower. And, while it took longer for inflation adjusted and per capita net worth to hit new highs, those occurred prior to Q2. Instead, what we find to be of more interest is the composition of household net worth and the contributions of the various asset classes to growth in overall net worth.

For instance, rising stock prices have been the major force behind the steady increase in household net worth over the past several years, particularly in the early stages of the recovery from the 2007-09 recession. After hitting a trough in Q1 2009, at less than 50 percent of the pre-recession peak, the value of household equity holdings has risen dramatically and now stands 64 percent above the pre-recession peak. Conversely, while owners' equity in real estate also hit a trough in Q1 2009, the subsequent rebound took longer to launch and has been, at least until recently, more measured. As of Q2 2017, owners' equity in real estate stood 3.8 above the pre-recession peak, as seen in the following chart.



Note that, combined, equity holdings and owners' equity in real estate accounted for 24.3 percent of total household net worth when net worth hit a trough in Q1 2009, but as of Q2 2017 these two asset classes accounted for 40.4 percent of total net worth. Clearly, they have been the primary drivers of rising household net worth in the post-recession years, and as noted above stock holdings more so than owners' equity in real estate. There are several implications of this, including distribution effects. For instance, many dismiss reports of record household net worth on the grounds that the focus on the aggregate number tells us nothing about the distribution.

One way to think about the distribution issue is to compare the incidence of stock ownership and home ownership across U.S. households. The incidence of home ownership (63.7 percent) is significantly above the incidence of stock ownership (51.9 percent as of 2016), whether directly or indirectly through mutual funds or retirement vehicles such as IRAs or 401-k accounts. As such, that rising stock prices have been the primary catalyst of rising household net worth means that the gains in net worth have been fairly concentrated across a relatively small number of households. This, however, is why the growing contribution of owners' equity in real estate should not be overlooked, as increasing housing equity means gains in total net worth are more broadly distributed.

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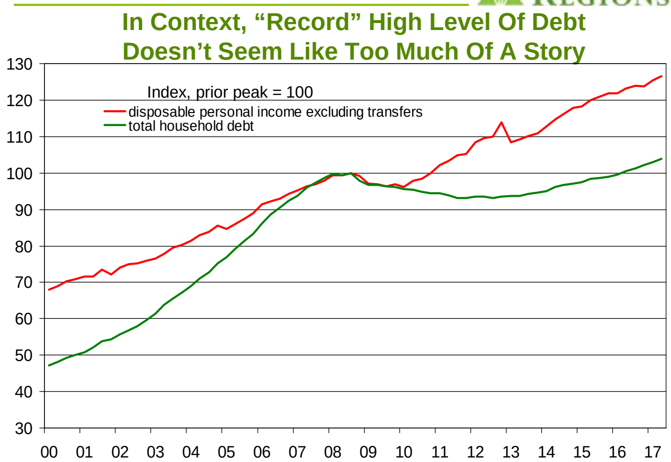
This is borne out by the Federal Reserve's *Survey of Consumer Finances* (SCF), for which the 2016 data were recently released (the 2016 SCF is the source of the ownership rates for homes and stocks cited above). The 2016 SCF data show rising net worth for households across the income distribution between 2013 and 2016 (the SCF looks at changes over three year intervals), which was not the case with the prior two editions of the SCF. To be sure, increases in net worth for those in the lower income quintiles were modest relative to those seen for the higher income quintiles, but that net worth rose across the income distribution is nonetheless worth noting. And, it is rising housing equity that for the most part is driving rising net worth in the lower income quintiles.

The magnitude of wealth effects generated by rising net worth also depends on the underlying drivers of growth in total household net worth, though this point is often overlooked. For instance, over the past few years we have seen a number of analysts expressing surprise that rising household net worth didn't seem to be providing much of a lift for consumer spending, causing some to doubt the existence of wealth effects (i.e., the premise that rising asset prices induce households to spend more as consumers feel wealthier). What these analysts overlook is that the sources of rising net worth matter. There is a considerable body of empirical research making a compelling case that wealth effects from rising stock prices are at best modest but wealth effects from rising house prices are larger. Our own work along these lines has yielded the same conclusion.

In the context of the chart on the prior page showing the relative growth in stock prices and owners' equity in real estate, the seeming lack of wealth effects becomes much less mysterious. But, that rising housing equity is making a larger contribution to growth in overall household net worth suggests wealth effects may have a bigger impact on consumer spending going forward. Obviously rising housing equity is a necessary but not sufficient condition for this to be the case – homeowners must be willing to tap into this equity and lenders must be willing to facilitate this. But, there are signs that both homeowners and lenders are moving in this direction, and this will be something worth watching over coming quarters. To be sure, no one is suggesting a return to the frenzied pace of housing equity extraction seen in the years prior to the 2007-09 recession is likely, or even desirable, but it is nonetheless reasonable to expect a pick-up in such activity.

As for the liability side of household balance sheets, we do think it worth addressing household debt, even though it's a topic we've covered on many occasions. One thing that strikes us in accounts of household debt is the emphasis on what, each quarter now, is a new record level of household debt. Many such accounts take on an ominous tone, with the premise seeming to be that, since the prior record level of household debt came right at the start of the 2007-09 recession, the fact that we are now at a new record high level of household debt must mean that . . .

Okay, we'll leave it to you to fill in the rest, but for anyone tempted to go down that path, we'd offer that, much like life in general, a little perspective can go a long way in any discussion of what it means that the level of household debt is at a new record high. This of course is what's (sorely) lacking in most of the discussions we see on this topic. For instance, while we've seen many point out that the level of debt is at a new record high, we are hard pressed to recall anyone noting that so too is the level of disposable personal income excluding transfer payments. This of course matters as ex-transfer disposable income represents the pool of funds out of which debt service payments are made. For the record, while the level of household debt (as reported in the *Flow of Funds* data) stands 3.8 percent above its prior peak, ex-transfer personal income stands 26.6 percent above its prior peak, as seen in the following chart.

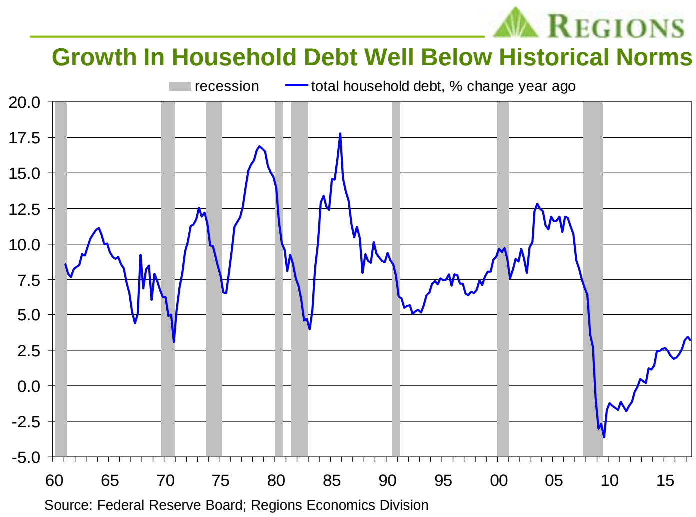


Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

The stark disparity in the rates of growth of ex-transfer disposable personal income and household debt is one obvious difference between now and the last time debt was at a record high. Another equally obvious difference is the composition of household debt and the basis on which the debt has been underwritten. In the pre-recession years, growth in overall household debt was driven by growth in mortgage debt, much of which was underwritten on unrealistic, and unsustainable, valuations on underlying assets (i.e., house prices). By now everyone knows how that worked out when house prices turned lower, but many seem to overlook the details on the composition of debt and the underwriting standards in the current cycle, which have been significantly different.

Still, delinquency rates on some forms of consumer credit have ticked higher over recent months, which is also part of the narrative for some who see the new record level of household debt as a harbinger of doom. It helps to recall, however, that rising delinquency rates have come after a prolonged period of low, in some cases record low, delinquency rates. What we are seeing is delinquency rates beginning to revert to more normal levels, which to a large extent reflects the fact that as the current expansion has endured, underwriting standards did begin to relax. As such, the rising delinquency rates we are seeing largely reflect delinquencies amongst subprime borrowers. Sure, one could argue that's where it began last time around, which is a fair point, but there is little to suggest a repeat of the rapid, and broad based (across income and credit buckets) wave of defaults seen in the last cycle.

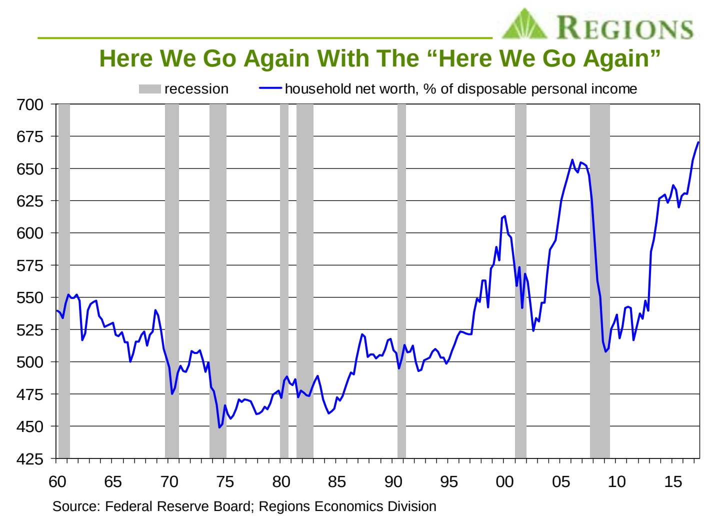
We are by no means suggesting we have no worries when it comes to household debt. As our regular readers know, we worry that the debt-to-income ratio is, despite having fallen sharply from the prior cyclical (and, yes, record) peak, still elevated above historical norms. But, this has been offset, at least thus far, by what has been a prolonged period of notably low interest rates, which has left household debt service burdens, and the broader financial obligations ratio, hovering near record lows. Our concern is that a material increase in interest rates would lead to significant increases in debt service burdens. To the extent a preponderance of fixed rate debt renders that less of a concern, higher interest rates could, in conjunction with a still-elevated debt-to-income ratio, act as a material drag on further growth in debt, and turn, overall household spending. Still, the broader point here is that those who simply point to the level of household debt and conclude "here we go again" are ignoring several material differences between the current cycle and the last cycle.



We'll wrap our discussion of household balance sheets with yet another case of the "here we go again" syndrome. Okay, not being medical doctors and not even playing medical doctors on TV we don't know if that's an actual medical thing, but it certainly is a thing in our line of work. In any event, a prolonged period of rapid growth in asset prices is clearly the driving force behind record levels of household net worth. As this cycle has gone on, however, there has been an increasing level of discussion as to whether or not asset prices are out of line with the underlying fundamentals.

This discussion is not limited to private sector market participants, as many FOMC members have noted, perhaps with more than a little concern, that asset prices seem "somewhat rich,", to borrow a phrase from Fed Chairwoman Yellen. Indeed, over recent months there has been considerable discussion as to whether even in the absence of a meaningful pick-up in inflation concern over asset prices could lead the FOMC to continue raising the Fed funds rate out of concern that misaligned asset prices could potentially pose a threat to financial stability.

One manner in which some private sector analysts have framed this issue is to look at the ratio of household net worth to disposable personal income. As of Q2 2017, this ratio stood at 670.4 which, you guessed it, is a new record high. On the surface, we're not quite sure what this ratio is actually telling us, or even what it is supposed to be telling us. But, we will concede that looking at the current value of this relationship relative to past episodes does give us pause, and it is easy to understand why some are looking at this ratio and sounding the alarm over asset prices. Whether or not that is justified, however, or whether or not the alarm bells are simply premature, will only be known ex-post, i.e., after the fact.



What catches one's eye are the prior two peaks in the ratio of household net worth to disposable personal income, specifically, how far above historical values of the ratio both peaks were and, perhaps more ominously, the proximity between the last two peaks and the beginning of the last two recessions. The ratio peaked at what was then a record of 613.2 in Q1 2000 – the "tech bubble" burst in March 2000 – and by March 2001 the economy was in recession. The next record high in the ratio, 654.5, came in Q4 2006 – house prices peaked in late-2005 (or in early-2006, depending on what measure one looks at) – and by year-end 2007 the economy was in recession.

To be perfectly clear, we are by no means making any judgments about whether asset prices are unsustainably high or have further room to the upside. But, in the context of the past two cycles, it is easy to understand why some look at the current ratio of household net worth to disposable personal income and conclude "here we go again." It is worth noting that in earlier cycles the relationship between peaks in the net worth-to-income ratio and the start of recessions was spotty, i.e., there is not a clear pattern in the timing of the two. In other words, the last two cycles notwithstanding, the next recession could begin before, after, or at the same time as the next peak in the net worth-to-income ratio.

No one of course knows when that peak will come. Well, sure, someone might actually know, but it certainly isn't in their interest to share that knowledge with the rest of us. The other unknown at this point is what the catalyst would be for the ratio to roll over. Some would argue that, to the extent prices of risk assets have been inflated over recent years by central banks around the globe providing monetary accommodation to degrees never before imagined, let alone seen, as that accommodation is withdrawn prices of risk assets are prone to decline, perhaps significantly so.

The jury is still out on this point, and will be for some time to come. After all, when looked at from a global perspective, central banks have barely even begun down this path, and the FOMC beginning to pare down, at a very gradual pace, the Fed's balance sheet is but the first step. At the same time, however, the ongoing expansion in the U.S. economy, now in its ninth year, shows no signs of fraying and indeed could very well get a boost from changes in regulatory and tax policy, if designed and implemented properly. A big "if" perhaps, but the possibility should not be totally discounted. At the same time, we are seeing synchronized global economic growth for the first time in over a decade, which stands to benefit U.S. corporations and, in turn, U.S. workers.

The point here is that even to the extent a prolonged period of artificially low interest rates has pushed asset prices higher than would otherwise have been the case, one can plausibly argue that ongoing improvement in the underlying economic fundamentals will support asset prices, particularly stock prices, even as central banks dial down the degree of monetary accommodation. At the very least, these improving fundamentals should act as a buffer for asset prices as monetary accommodation is withdrawn.

Sure, history doesn't always repeat, but sometimes it does. That helps explain why some look at metrics such as household debt, or the ratio of household net worth to disposable personal income, and greet each new record high with a sense of dread, i.e., "here we go again." We don't simply dismiss any such arguments out of hand. After all, there are two things we all know with certainty about economic cycles – a) no two are the same, and b) they all come to an end eventually.

But, in focusing on the latter, it is easy to lose sight of the former. In other words, the factors that lead to new highs in various metrics vary with each cycle, as do the factors that ultimately bring about the end of the cycle. As such, whatever metric one chooses to focus on, the value of that metric at any point in time must be put in the context of current, not historical, conditions in order for it to have any meaning. What current conditions tell us is that, while by no means pristine, household balance sheets are indeed in better condition than has been the case for many years.

Hurricanes Distort The Data

As we've noted many times, the U.S. economy had a good deal of positive momentum prior to Hurricanes Harvey and Irma. Even allowing for the high degree of hurricane related noise that we anticipated would plague the economic data for the month of September, nothing we've seen thus far has changed our outlook.

No, not even the September employment report, which shows total nonfarm employment fell by 33,000 jobs. This brought an abrupt end to a record-long streak of 83 consecutive months of job growth. Still, the details of the report clearly show the effects of Hurricanes Harvey and Irma, which were highly concentrated in the states with the second (Texas) and fourth (Florida) highest job counts of any states. The two industry groups most impacted by the storms were leisure & hospitality services, in which payrolls fell by 111,000 jobs in September, retail trade, which lost 2,900 jobs (though not all of this can be attributed to Harvey and Irma), and construction.

To help put the impact of the storms on the labor market in perspective, 1.474 million people with a job did not work at all during the reference week while an additional 2.934 million worked only part-time as opposed to their normal full-time hours. The not seasonally adjusted data show that nonfarm employment rose in September, but the magnitude of the increase was roughly half of what is typically seen in the month of September, hence the decline in the seasonally adjusted, or, headline, number. The reported job losses in September are clearly transitory noise, and there will be payback in subsequent months, with most of that likely coming in the October data.

Though many seem to have overlooked this point, if the count of jobs was distorted by the hurricanes, then so too are the other metrics drawn from the establishment survey. For instance, estimates of average weekly hours and average hourly earnings were biased higher due to the mix of industries impacted by the hurricanes. Leisure & hospitality services and retail trade are the two industry groups with the lowest average hourly earnings and the lowest average weekly hours, so that such a large number of jobs in these industry groups fell out of the data in September biased the overall averages higher for these two metrics. This effect was magnified by what was a substantial amount of overtime, and in turn overtime pay, in the utilities industry, which is the industry group with the highest average hourly earnings.

The September employment report will not be the only the only release to show the effects of the hurricanes, which should be kept in mind as you digest the headline numbers over coming weeks. For instance, the post-hurricane spike in retail gasoline prices after Hurricane Harvey took down over 20 percent of the nation's refining capacity will add almost half a point to the change in the headline CPI for September, and we expect at least somewhat of a lift to food prices, though mostly from Irma. Moreover, even core inflation in September will likely show the effects of the hurricanes. To the extent that the post-hurricane surge in motor vehicle sales, reflecting replacement demand, firmed up motor vehicle prices, new and used, that will turn up in core inflation. Additionally, to the extent higher demand from those either evacuating ahead of the storms of needing shelter after the storms helped push lodging prices higher, that too will turn up in core inflation.

That spike in motor vehicle sales along with significantly higher gasoline prices will make September retail sales look much stronger than would otherwise have been the case, and a post-hurricane jump in spending at building materials stores will also support retail sales. It is worth noting that the spike in motor vehicle sales in September reflects mostly the effects of Hurricane Harvey in Texas, by all accounts there was little impact from replacement demand in Florida in the September data but that should come in October, which will be apparent in the retail sales data. Residential construction and sales will be significantly depressed in the September data, particularly given the extent to which Florida and Texas dominate the data for the South region. While subsequent months will show payback, that is likely to come in small doses as opposed to all at once as with some of the other data series. With builders already facing with shortages of labor and materials and working to clear order backlogs, we expect the rebuilding process to take longer than would normally be the case.

These are just some of the ways in which the upcoming economic data will show the effects of Hurricanes Harvey and Irma. As such, making sense out of the data will be even more difficult than is normally the case. The key will be to sift through the high volume of noise – admittedly easier said than done – and look for any signs that the momentum seen prior to the hurricanes has been halted. We don't expect to see many, if any, such signs.

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Q1 '17 (a)	Q2 '17 (a)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
1.2	3.1	2.8	2.5	1.8	2.4	2.5	2.3	Real GDP[1]	1.5	2.2	2.4	2.0
1.9	3.3	2.0	2.7	1.7	2.4	2.4	2.2	Real Personal Consumption[1]	2.7	2.7	2.3	1.9
								Business Fixed Investment:				
5.0	6.7	5.6	3.9	3.2	2.8	2.6	2.4	Equipment, Software, & IP[1]	0.3	3.9	3.6	2.2
14.8	7.0	3.7	2.3	3.6	2.5	2.7	2.9	Structures[1]	-4.1	6.8	3.2	2.1
11.1	-7.3	0.6	2.8	6.7	9.9	11.9	11.3	Residential Fixed Investment[1]	5.5	1.9	5.8	8.9
-0.6	-0.2	0.0	0.5	0.6	0.9	0.8	0.8	Government Expenditures[1]	0.8	-0.1	0.6	0.8
-622.2	-613.7	-610.1	-617.4	-626.4	-629.2	-632.3	-636.1	Net Exports[2]	-586.3	-615.8	-631.0	-649.1
1.238	1.167	1.169	1.187	1.234	1.281	1.332	1.377	Housing Starts, millions of units[3]	1.177	1.190	1.306	1.436
17.1	16.8	17.1	17.3	16.5	16.4	16.4	16.4	Vehicle Sales, millions of units[3]	17.5	17.1	16.4	16.1
4.7	4.4	4.3	4.3	4.2	4.2	4.1	4.1	Unemployment Rate, %[4]	4.9	4.4	4.1	4.1
1.6	1.6	1.4	1.3	1.3	1.3	1.3	1.2	Non-Farm Employment[5]	1.8	1.5	1.3	1.0
2.0	1.6	1.6	1.5	1.5	1.7	1.9	1.9	GDP Price Index[5]	1.3	1.7	1.8	2.0
2.0	1.6	1.4	1.4	1.4	1.8	2.0	2.0	PCE Deflator[5]	1.2	1.6	1.8	2.0
2.6	1.9	2.0	1.7	1.4	2.0	1.9	2.0	Consumer Price Index[5]	1.3	2.0	1.8	2.0
1.8	1.5	1.4	1.5	1.5	1.8	2.0	2.0	Core PCE Deflator[5]	1.8	1.5	1.8	2.1
2.2	1.8	1.7	1.7	1.6	2.0	2.2	2.3	Core Consumer Price Index[5]	2.2	1.8	2.0	2.3
0.67	0.92	1.13	1.18	1.41	1.63	1.64	1.88	Fed Funds Target Rate, %[4]	0.39	0.97	1.64	2.02
2.45	2.26	2.20	2.40	2.50	2.60	2.70	2.80	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.65	2.95
4.17	3.98	3.88	4.02	4.18	4.32	4.42	4.51	30-Year Fixed Mortgage, %[4]	3.65	4.01	4.36	4.68
-2.4	-2.6	-2.6	-2.7	-2.6	-2.7	-2.8	-2.8	Current Account, % of GDP	-2.4	-2.6	-2.7	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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