ECONOMIC UPDATE
REGIONS
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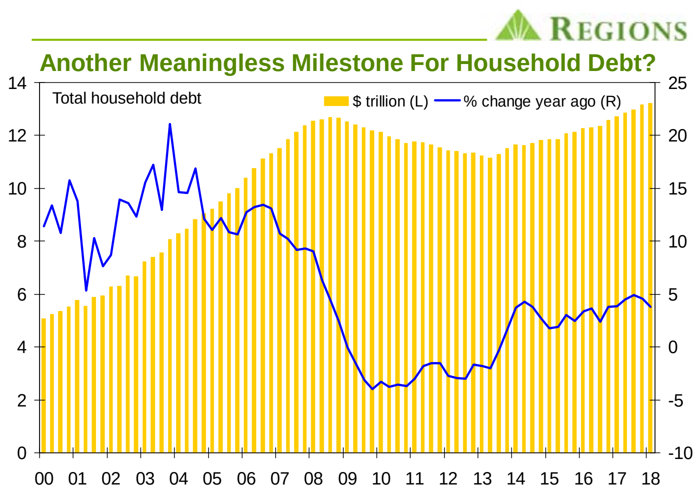
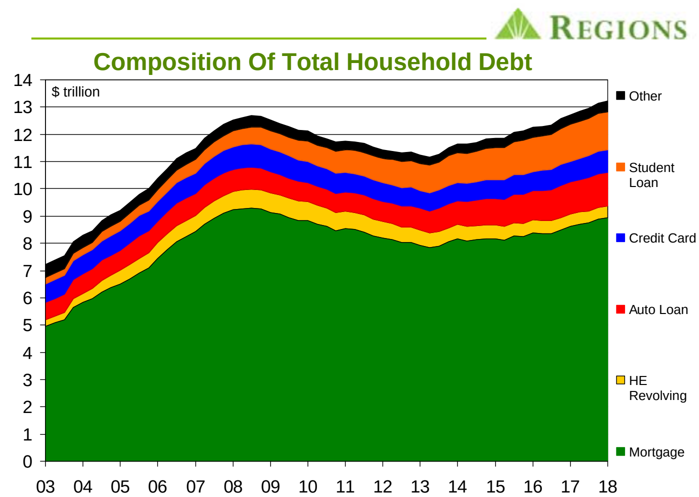
Q1 2018 Household Debt and Credit: "Record High Debt" A Headline In Search Of A Story

- Total household debt rose to $13.211 trillion in Q1 2018, an increase of $63 billion from Q4 2017
- Mortgage debt accounted for most of the growth in overall debt in Q3; credit card and HELOC balances declined
- As of Q1, 4.58 percent of outstanding household debt was in some stage of delinquency, the lowest share since Q3 2006

The Federal Reserve Bank of New York (New York Fed), in conjunction with Equifax, has released their latest quarterly report on trends in household debt. Total household debt rose to $13.211 trillion in Q1 2018, a $63 billion increase from Q4 2017 and the 15th consecutive quarterly increase in total household debt. As has become commonplace with each quarterly release, the headlines on most media accounts of the New York Fed's latest release focus on the record high level of household debt, and, sure, the $13.211 trillion is another new record high. To which our response is "and . . .?" Or, as we put it above, the latest record high level of household debt is a headline in search of a story, meaning that when put into any sort of meaningful context, such as growth in household debt in relation to growth in personal income, the latest record isn't all that impressive, or all that worrying, at least not to us.



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division

The $63 billion increase in total household debt in Q1 2018 was the smallest quarterly increase since Q3 2016, and left total household debt up 3.82 percent year-on-year. As seen in the first chart above, growth in household debt in the post-recession years has been much slower than was the case in the years leading up to the 2007-09 recession. While perhaps not news, we'll note that while the New York Fed/Equifax data only go back to 1999 the much longer series in the Federal Reserve's "Flow of Funds" data (which dates back to the 1950s) shows growth in debt in the post-recession years to be much slower than historical averages. In Q1, outstanding mortgage debt increased by $57 billion with student loan debt increasing by $29 billion and outstanding auto loan balances increased by $8 billion. Conversely, credit card debt decreased by $19 billion and outstanding balances on revolving home equity lines fell by $8 billion. Do not read too much into the decline in credit card debt, however, as the decline in Q1 2018 simply reflects a seasonal decline commonly seen in the first calendar quarter of any given year. As of Q1, mortgage debt accounted for 67.66 percent of all household debt, student loans accounted for 10.65 percent, auto loans accounted for 9.30 percent, credit card debt accounted for 6.17 percent, revolving home equity lines accounted for 3.30 percent, and other forms of consumer debt made up the remaining 2.91 percent of total household debt.

At $13.211 trillion as of Q1 2018, the level of outstanding household debt stands 4.23 percent above the prior cyclical peak (and one-time record high level) of $12.675 trillion seen in Q3 2008. What we've found is that, for those who insist on focusing on each quarter's new record high level of household debt, their story often follows one of two general characterizations of U.S. consumers: 1) U.S. consumers are shameless spendthrifts, reliant on borrowing to finance lavish lifestyles which they otherwise could not afford; or 2) U.S. consumers are struggling and forced to take on increasing debt loads in order to pay for the basic necessities. While the first of these story lines isn't worth bothering with, the second cannot be entirely dismissed, but the problem is that you cannot see any such effects by simply looking at the aggregated data. Lacking reliable and timely data on the distribution of debt and debt service burdens (i.e., monthly interest and principal payments) across income groups, it is hard to get a sense of what share of households would fit this

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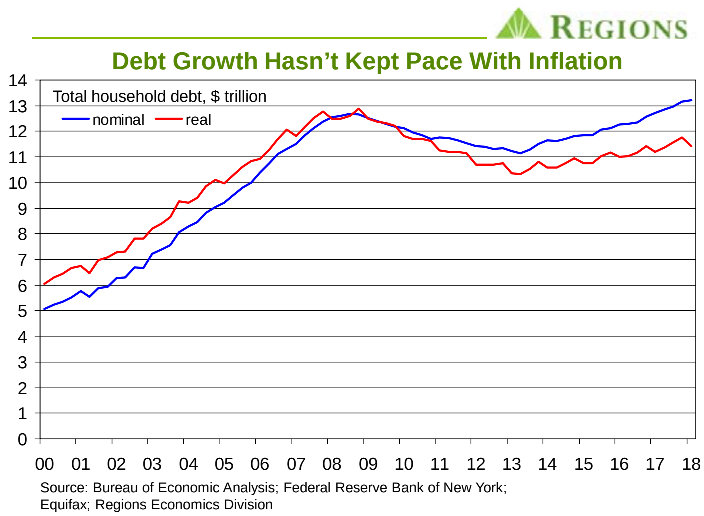
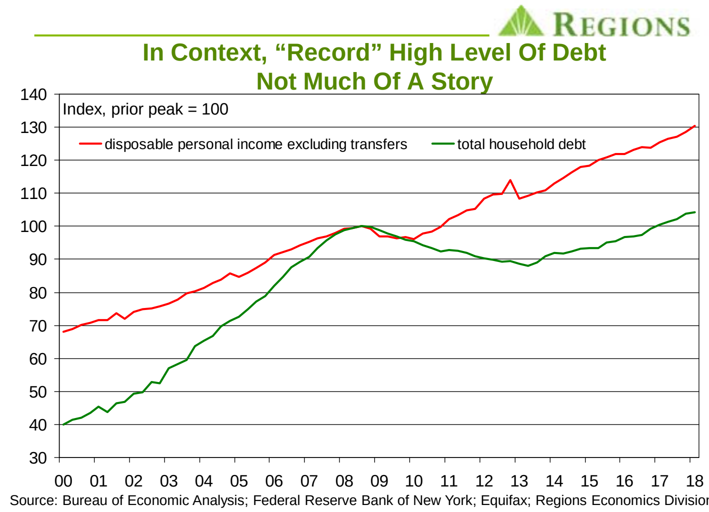
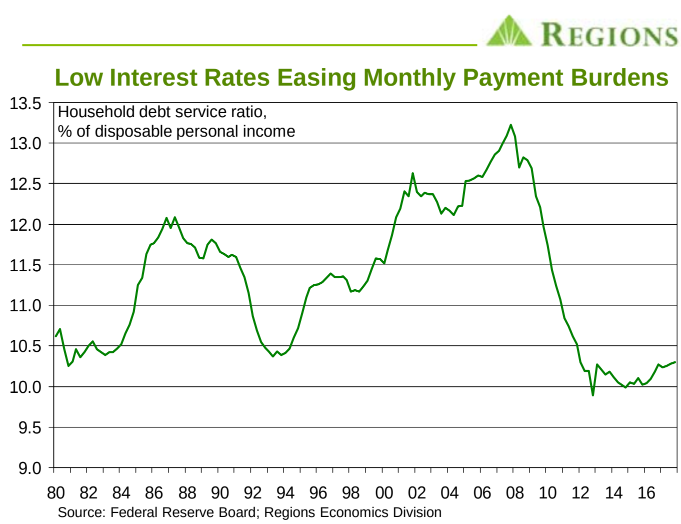
story line. So, while by no means would we ever dismiss this story line out of hand, neither will we generalize it to fit a pre-formed narrative, as some seem intent on doing.





In any event, the two charts above offer alternative ways of putting the growth of household debt into context. As shown in the first chart above, growth in nominal household debt has failed to keep pace with inflation over the past several years, to the point that real (or, inflation adjusted) household debt stands 11.30 percent below the prior peak seen in Q4 2008 – recall nominal household debt stands 4.23 above the prior cyclical peak. Or, more significantly, the second chart shows that growth in disposable personal income excluding transfer payments has far and away exceeded growth in household debt in the post-recession years. Note that we consider disposable (or, after-tax) personal income excluding transfer payments to be the relevant basis of comparison for two reasons. First, though they are booked as personal income, many forms of transfer payments do not reflect cash income to recipients, instead many are government payments to service providers (such as Medicare and Medicaid). Second, while some forms of transfer payments do reflect payments to recipients, such as Social Security or Unemployment Insurance benefits, the vast majority of these payments are spent on necessities and, as such, do not add to pool of funds used to service debts. In our view, then, after-tax income exclusive of transfer payments is the best gauge of the pool of funds out of which debts are serviced. As of Q1 2018, disposable personal income exclusive of transfer payments stood 30.51 percent above the prior cyclical peak while, again, household debt stood 4.23 percent above the prior cyclical peak.



One can, of course, legitimately question whether the level of outstanding household debt is still too high relative to the level of personal income. After all, even while growth in disposable personal income excluding transfers has significantly outpaced growth in household debt in the post-recession years, this has simply lowered the debt-to-income ratio to roughly 129 percent from the cyclical peak of just over 159 percent seen in Q4 2007 (the standard debt-to-income ratio, in which transfer payments are included in the measure of disposable personal income, stands at 104.84 percent, down from a cyclical peak of 132.94 percent).

Regardless of which measure of income you prefer, debt-to-income ratios are still well above longer-term norms. Whether, or to what extent, this matters, however, is grounds for debate. Many point to debt service burdens that, as seen in the chart to the side, continue to hover near all-time lows despite elevated debt-to-income ratios. Note that the last observation available for this series is as of Q4 2017, when combined principal and interest payments were equivalent to 10.30 percent of disposable personal income (inclusive of transfer payments in the Fed's methodology). With the 2017 tax bill having led to a bump in disposable personal income in Q1 2018, the Q1 debt service ratio should be lower than the Q4 2017 ratio. That said, with interest rates heading higher, and mortgage interest rates already at a seven-year high, many worry about debt service "payment shocks," i.e., significant increases in monthly debt service obligations due to higher interest rates. We do not, however, believe this will be nearly as significant of an issue during this cycle given the preponderance of fixed rate, as opposed to variable rate, debt on household balance sheets. But, while payment shocks may not be significant in this cycle, that does not mean the level of debt does not matter, and this is where we think

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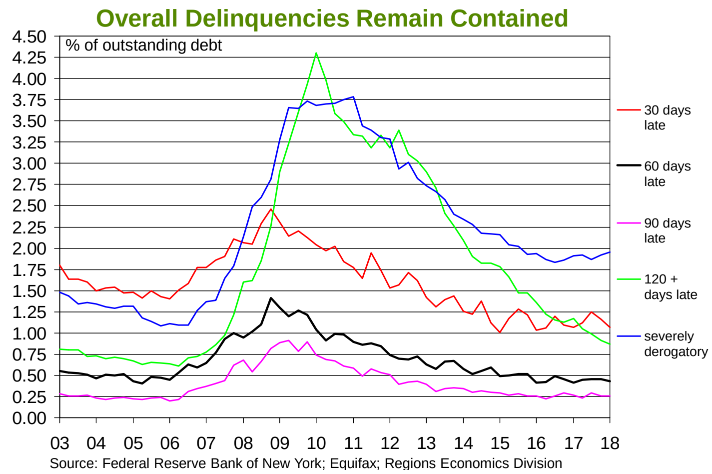
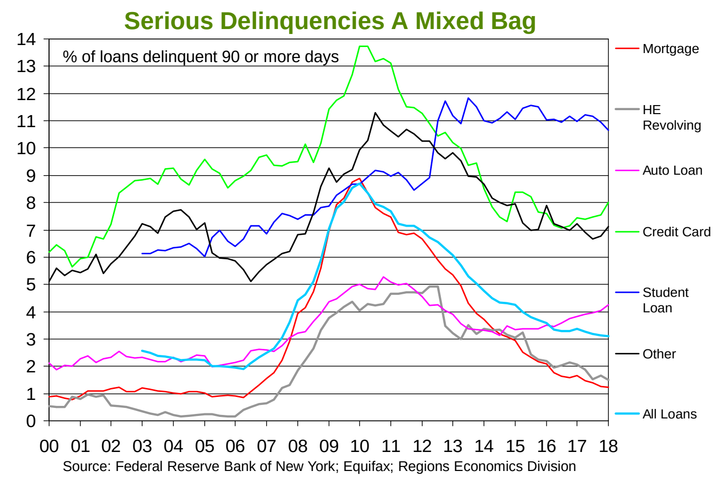
elevated debt-to-income ratios come into play. High debt-to-income levels at some point will act as a constraint on the growth of new debt, such that when the next downturn comes and market interest rates turn lower, that may bring only a muted response in the growth of household debt, hence acting as a drag on the subsequent recovery, particularly if lending standards are meaningfully tighter. These are questions that will be answered in time, and we'll simply note that while it matters little, if at all, whether the level of debt is at a "record high" in any given quarter, the level of debt does matter, but only in proper context, a distinction that is often overlooked.

As for currently outstanding debt, overall delinquencies ticked lower in Q1 2018, with 4.58 percent of total loan balances in some stage of delinquency, which is the lowest overall delinquency rate since Q3 2006. As seen in the chart to the side, delinquency rates in the 30-day, 60-day, and 90-day buckets are either on par with or below pre-recession averages. Though still above its pre-recession norm, the 120-plus day delinquency rate is nonetheless falling steadily from its cyclical high of 4.26 percent. As of Q1, 1.95 percent of all outstanding balances were classified as "severely derogatory," meaning a loan is in some stage of delinquency and there has been a report of repossession, a charge-off to bad debt, or a foreclosure attached to the loan record. The performance of early-stage (i.e., less than 90-day) delinquency rates in the New York Fed data series is consistent with the data on first lien residential mortgages as reported by the Mortgage Bankers Association (MBA). As we noted in our latest quarterly update of the MBA data, early-stage mortgage delinquency rates are not only below rates seen prior to the 2007-09 recession, they are below the historical averages seen over the 1980-2006 period.



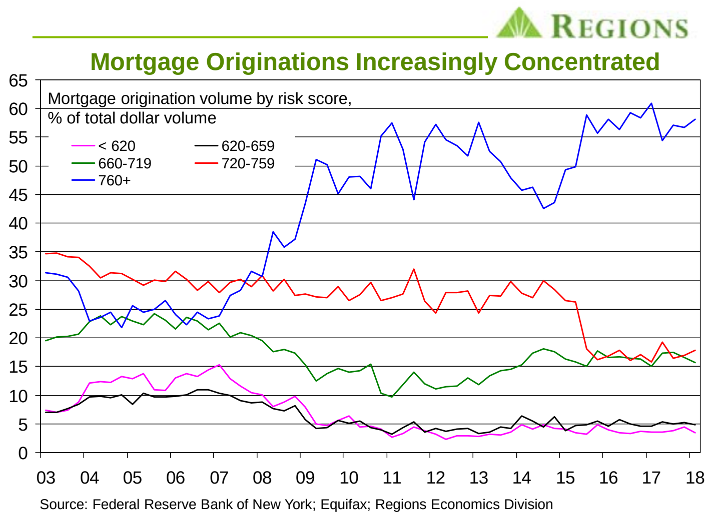
In terms of serious delinquencies, i.e., those loans either 90-or-more days past due or in the severely derogatory bucket, there are clear differences across loan types. At 10.66 percent in Q1, student loans continue to post far and away the highest serious delinquency rate, and the reality is that the reported rate is likely understated. As noted by the New York Fed, with roughly half of all student loans currently in deferment, grace periods, or forbearance and, as such, not in the repayment cycle, delinquency rates for those loans in the repayment cycle are roughly twice as high as the reported rate for the entire universe of student loans. Inflows into the 90-plus day delinquency bucket for credit card loans have risen steadily over the past year and inflows into that same bucket for auto loans have been inching higher over the past few years. At the same time, serious delinquencies amongst mortgage loans and revolving home equity lines continue to drift lower; given the relative size of the mortgage loan segment, this continues to pull the overall serious delinquency rate lower.



In general, the continued downward drift in early-stage delinquencies reflects what has been an improving macroeconomic backdrop, particularly a prolonged period of steadily improving labor market conditions. With wage growth set to accelerate over coming quarters, further gains in wage and salary earnings, far and away the largest single component of personal income, will enable most households to remain current on their debt obligations, even those that have some exposure to rising interest rates. Still, it is more likely that early-stage delinquency rates level off at current low values as opposed to falling further over coming quarters. Whether simply due to "sloppy payers" or unexpected life events, there is a natural floor under delinquencies. That the share of loan balances in the severely derogatory bucket has been fairly flat over the past several quarters suggests this floor has formed in this segment, even if at a higher level than was the case prior to the 2007-09 recession.

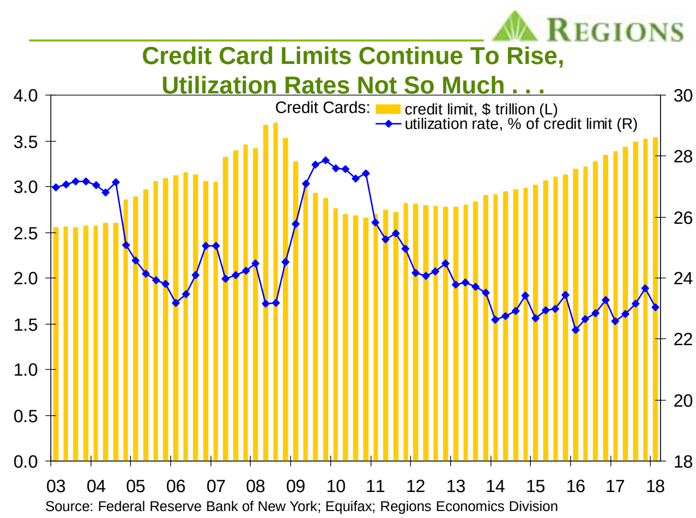
That said, one must be careful to not give too much credit to macroeconomic factors (though one should always give sufficient credit to macroeconomists). One cannot assess loan performance over recent years without accounting for what, in most cases, have been more stringent lending standards in the post-recession years. This is especially the case with mortgage loans. In the post-recession years, mortgage loan originations have been heavily concentrated amongst borrowers with credit scores of 760-or-above while those with credit scores of less than 660 have accounted for a significantly smaller share of all mortgage originations. Given the far more stringent underwriting standards, it is natural that loan performance would be notably better in more recent vintages of originations.

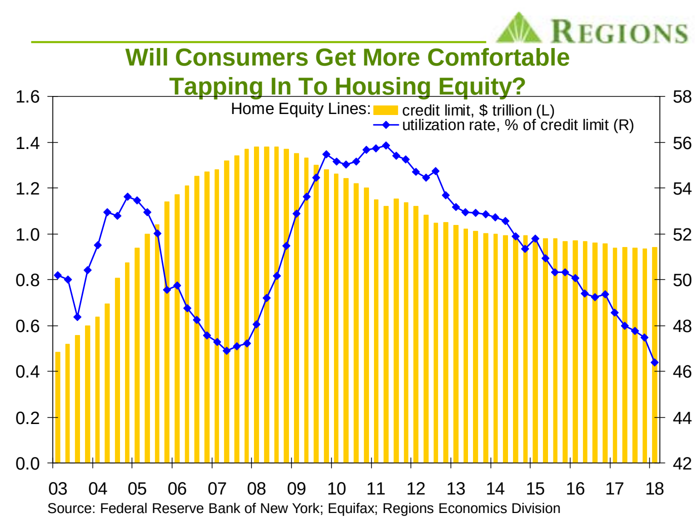
It is worth noting that over the past several quarters the Federal Reserve's quarterly survey of lending conditions shows banks have been easing mortgage lending standards yet, as seen in the following chart, the share of mortgage originations accounted for by those



with credit scores at or above 760 remains elevated. We can point to another factor, perhaps not widely appreciated, which helps account for this seeming contradiction. For the past several quarters the rate of house price appreciation has been notably robust, in part due to extraordinarily lean inventories of existing homes for sale, while for some time now new home sales have been atypically concentrated in the higher price ranges. To the extent many prospective buyers, particularly prospective first-time buyers, have been priced out of the market as greater shares of total home sales take place in the higher price ranges, it would follow that credit scores of those borrowers who can afford these higher priced homes would also be higher. As such, while the chart to the side may seem like an indictment of mortgage lending practices in the post-recession years, digging into the details of the data reveals that market conditions, specifically extraordinarily lean inventories of homes for sale, are helping limit the pool of prospective home buyers.

The past few quarters have seen auto loan originations becoming more and more concentrated – though not nearly to the same extent as with mortgage loan originations – amongst those with credit scores at or above 760. Much of the deterioration in the performance of auto loans, and credit card loans as well, has come in the subprime segment. Many lenders, particularly banks, have responded by tightening lending standards for auto loans, to the point that during Q1 2018, one-third of all auto loan originations were to borrowers with credit scores at or above 760, the highest share since Q1 2011. As with mortgage loans, this should ultimately translate into fewer early stage delinquencies and, in turn, less pass-through into serious delinquency.





Finally, while the barrage of headlines focused on record high levels of household debt may suggest consumers simply can't help themselves, the data tell us otherwise, as indicated in the two charts above. Discounting the typical seasonal patterns – a spike in Q4 of a given year followed by a decline in Q1 of the subsequent year – credit card utilization rates remain persistently low despite steadily increasing credit limits. By the same token, recent quarters have seen aggregate housing equity finally surpass the pre-recession peak, yet utilization rates on revolving home equity lines continue to tumble. Sure, there's a fine line between discipline and fear (i.e., fear of a repeat of the housing market debacle, however unlikely) and it could be the latter more than the former driving the behavior of utilization rates. Either way, however, households have more than ample capacity to utilize debt far more intensively than they have done so to date, headline proclamations notwithstanding.

To be sure, the stubbornly high delinquency rate on student loans and the deterioration, though still fairly modest, in the performance in the subprime segment of auto loans and credit card loans bear watching. They do not, at least in our view, signal a more ominous deterioration in overall performance of household debt, particularly given what on the whole have been more stringent underwriting standards in the post-recession years. While there may be neither no such thing as a good recession nor a good time to have a recession, lenders will on the whole be better positioned when (and it is when, not if) the next recession comes. That income growth, as opposed to debt growth, has been the main fuel for growth in consumer spending during the current expansion, in stark contrast to the years prior to the 2007-09 recession, has meant the ride has not been as fast this time around. At the same time, it also means that it won't feel nearly as bad when the ride comes to an end, as it ultimately will.

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