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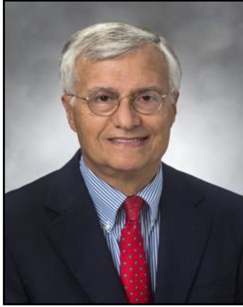

US HOUSEHOLD FINANCES: STRONGEST IN DECADES

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An analysis of Federal Reserve data on household debt leads to a surprising conclusion: In sharp contrast with all previous business expansion cycles, US household sector finances have not deteriorated as the current expansion cycle has matured over the past ten years. The deleveraging of US household balance sheets that began in 2009 has been the most aggressive since the 1930s. The current health of household balance sheets is the strongest in several decades.

Summary and Major Conclusions:

- A close examination of previous business cycles reveals that private sector debt levels and financial risk increase systematically along with aging of the traditional business expansion. Measures of business and household debt have been reliable leading indicators of recession.

- An analysis of official data on household debt leads to a surprising conclusion: In sharp contrast with virtually all previous cycles, US household sector finances have not deteriorated along with the current maturing business expansion. In fact, the health of household balance sheets has improved to its strongest level in the current cycle.

- The deleveraging of US household balance sheets since 2010 has been the most aggressive since the 1930s. From an all-time peak of 135% in 2008, the ratio of household debt to after-tax household income steadily declined to less than 100% last year, the lowest level in nearly two decades.

- The Federal Reserve's financial obligations ratio measures the level of monthly household payments for debt, rent, property insurance, taxes on primary residences, and auto leases as a percentage of monthly income. This ratio is currently at 15%, the lowest level since the inception of the series in 1980.

- Perhaps most striking is the massive improvement in residential mortgage credit quality. Extreme caution by borrowers and unusually tight lending standards of banks have resulted in the best mortgage credit quality in decades.

- Residential mortgage debt has not increased in ten years, an unprecedented development. Currently at a level of $10.3 trillion, mortgage debt outstanding remains *below* the pre-crisis peak of $10.7 trillion in 2008.

- The mortgage loan delinquency rate of 2% is down from the peak of 9% in 2009 and near the lowest on record. New foreclosure filings have declined by more than 80% from their 2009 crisis peak. The foreclosure overhang has been virtually eliminated: At less than 1%, the number of foreclosures as a percentage of total loans has declined to a 25-year low.

- There are two unique circumstances that help to explain the unusual financial health of the household sector: (1) Household borrowing has been extremely moderate; and (2) Lenders have been highly cautious in their lending, maintaining exceptionally tight lending standards since the crisis began in 2009.

- Student loan borrowing is far and away the most serious problem with respect to household sector debt. From 2010 to 2018, student loan debt increased by 125%, a compound annual rate of 8.5%. The vast majority of student debt is government backed, which means that taxpayers — and not private lenders — are at risk.

- The economic implications are favorable: The excellent condition of consumer balance sheets suggests that private consumption should continue to grow at a 2.5% annual rate, roughly in line with trend growth in real disposable personal income.

- The US and world economies are currently held hostage by US trade policy: Economic growth will continue to weaken in a policy framework of escalating trade tensions, while a breakthrough in trade negotiations would be followed by a revival in the global economy.

- Although there is evidence of weakness in most sectors of the domestic economy, the household sector remains strong. Comprising nearly 70% of US GDP, personal consumption expenditures should continue to bolster US economic growth and mitigate the risk of recession.

- In the absence of recession, common stocks should massively outperform bonds over the next year, although the equity market remains vulnerable in the short term until there are concrete signs that trade tensions are easing. Investor sentiment continues to deteriorate.

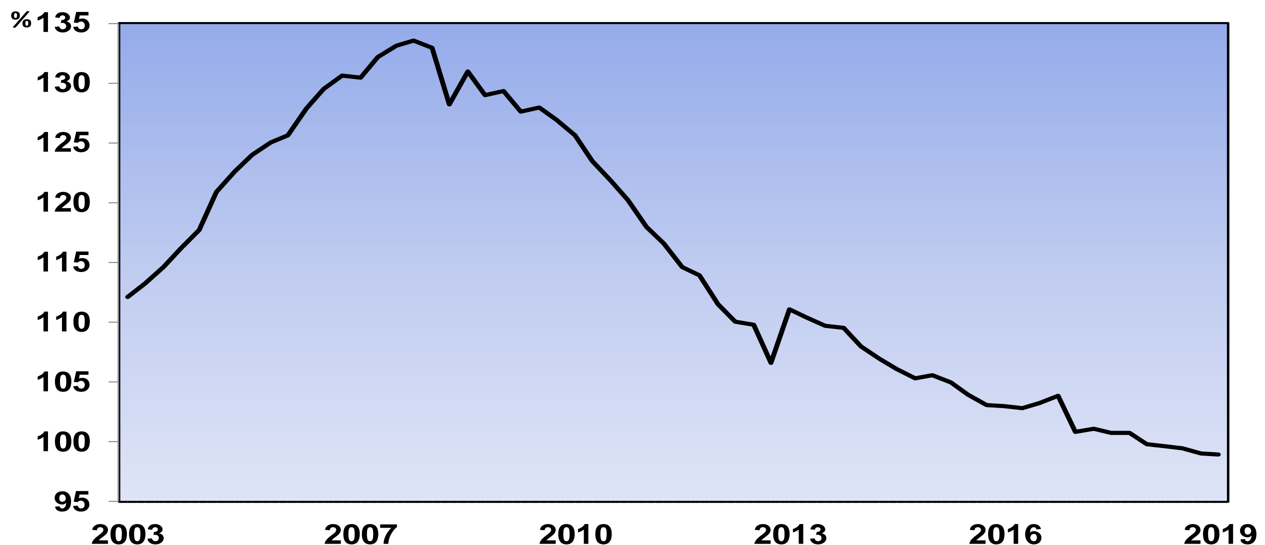
"There has been much hand-wringing about the financial health of American households. A recent Washington Post article on auto lending claiming that seven million borrowers are behind on their loan payments supercharged the concerns. Not to worry. Household credit conditions have arguably never been better.

Household debt is low, and delinquencies and defaults are about as low as they have ever been. There are things to be nervous about in the US economy, but household debt is not one of them. The next recession, if it is any time in the foreseeable future, will not come about because households are overly indebted."

Mark Zandi
Chief Economist
Moody's Analytics
May 2019

An examination of previous business cycles reveals that private sector debt levels and overall credit risk increase systematically along with a maturing business expansion. As such, *measures of business and household indebtedness and debt burdens are reliable leading indicators of recession*.

With the US expansion cycle entering year eleven, it is appropriate to analyze the current condition of household sector balance sheets. This week's *Economic Perspective* provides a statistical analysis of household sector finances along with key implications for the US economy and world financial markets.



Household Deleveraging: An analysis of Federal Reserve data on household debt leads to a surprising conclusion: *In sharp contrast with virtually all previous business expansion cycles, US household sector finances have not deteriorated as the current expansion cycle has matured over the past ten years*. The current health of household balance sheets is the strongest in several decades.

Plunging Real Debt Levels: The deleveraging of US household balance sheets that began in 2009 has been the most aggressive since the 1930s. On a nominal basis, total household debt has risen only modestly since its peak in 2008. *However, after adjustment for inflation and population growth, debt ratios have declined precipitously since the onset of the world financial crisis 12 years ago, and are currently at the lowest level in decades*.

- The ratio of household debt to disposable personal income plunged from an all-time peak of 135% in 2008 to less than 100% in 2018, the lowest level since the 1990s (see chart 1).
- Debt per household and debt as a share of the population is lower today than at its peak in 2008.
- After adjustment for inflation, household debt is 7% ***below*** its crisis peak in 2008.
- The most comprehensive measure of household indebtedness combines these three ratios: ***Inflation-adjusted debt per household is a stunning 15% below its peak in 2008***.
- The key point is that household credit quality is excellent. The delinquency rate on household debt is 2.3%, near the lowest level in 50 years.

Chart 2: Household Debt Burdens at an All-Time Low
Monthly Debt and Lease Obligations
Percentage of Disposable Personal Income
Source: Bloomberg

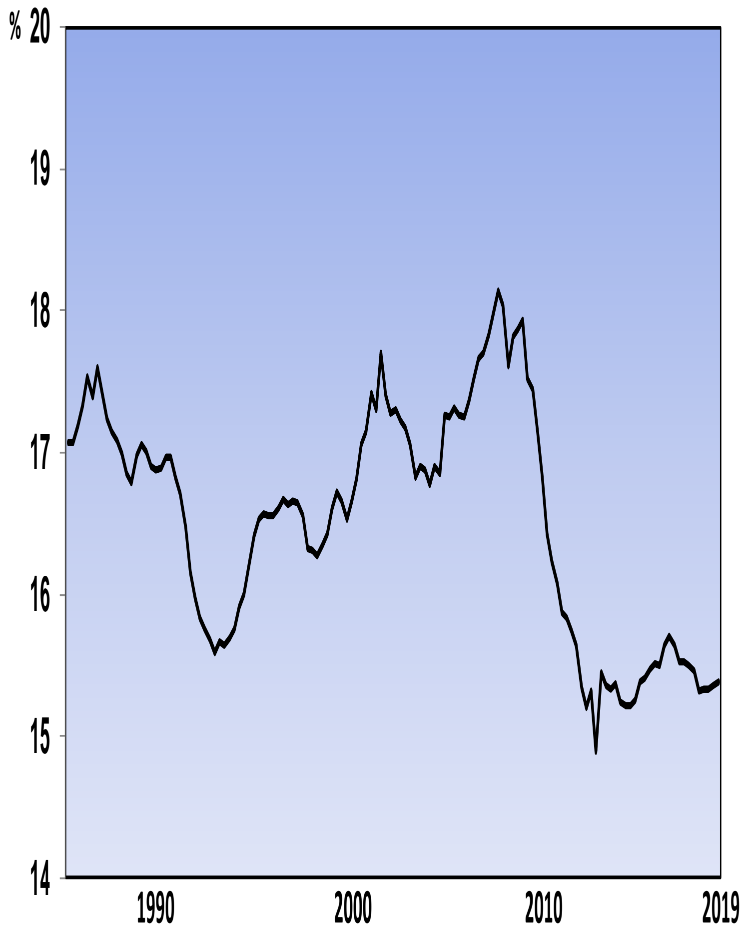


Chart 3: Consumer Confidence at a Two-Decade High
Survey of Consumer Confidence
Source: The Conference Board

Debt Burdens: The combination of low debt-to-income ratios and an unprecedented low level of borrowing rates has pushed household debt service burdens to their lowest level in 40 years. The Federal Reserve's ***financial obligations ratio*** measures the level of monthly household payments for debt, rent, property insurance, and taxes on primary residences, and auto leases as a percentage of monthly income. ***The measure of monthly debt obligations is currently at 15%, the lowest level since the inception of the series in 1980*** (see chart 2).

The bottom line is that comprehensive data on household finances depict a positive picture: Household sector balance sheets are in excellent shape, especially for the eleventh year of a business expansion cycle. The recent surge in consumer confidence is a testimony to the strong financial health of the US household sector, despite the steadily rising level of anxiety associated with the ongoing tariff war (see chart 3).

Chart 4: Unprecedented Weakness in Residential Mortgage Lending
Residential Mortgage Loans Outstanding, $ Billions
Source: Federal Reserve

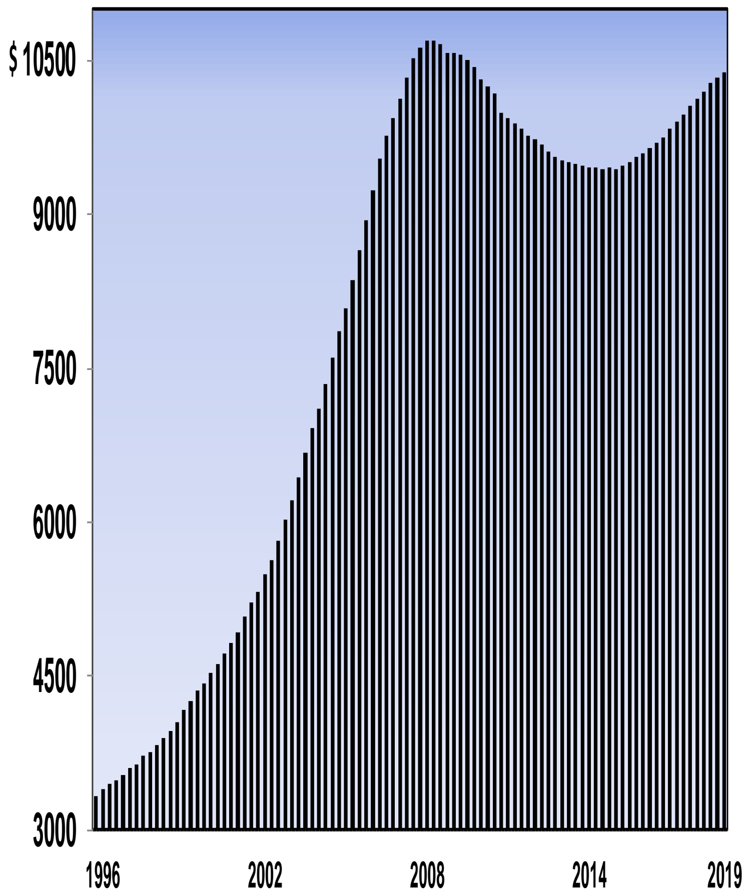
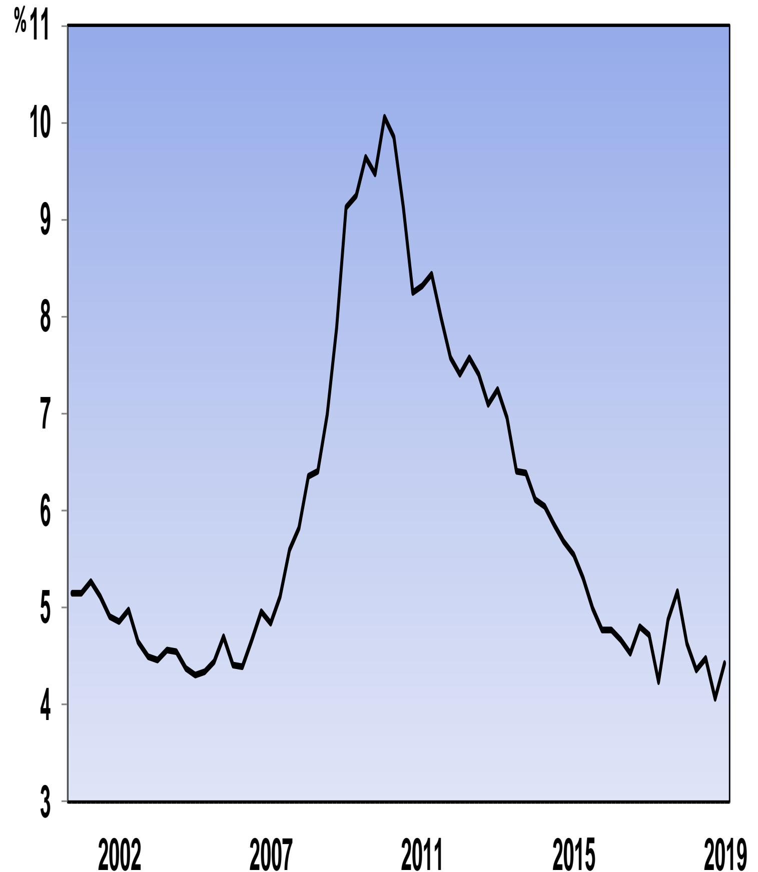


Chart 5: Mortgage Loan Delinquency Rate at a Multi-Year Low
Single-Family Residential Mortgage Delinquencies
Percent of Total Mortgage Loans
Source: Federal Reserve



Residential Mortgages: Perhaps most striking is the massive improvement in residential mortgage credit quality. Extreme caution of borrowers and unusually tight lending standards of banks have resulted in the best mortgage credit quality in decades:

- Mortgage loans outstanding — with the exception of the 1930s — have not increased in ten years, an unprecedented development.
- Currently at a level of $10.4 trillion, mortgage debt outstanding is ***below*** the pre-crisis peak of $10.7 trillion in 2008 (see chart 4).
- The mortgage loan delinquency rate of 4.5% is down from the peak of 10% in 2010 and near the lowest level in many years (see chart 5).
- New foreclosure filings have declined by more than 80% from their crisis peak.
- The foreclosure overhang has been virtually eliminated: At less than 1%, the value of foreclosures as a percentage of total loans outstanding has declined to a 25-year low.

Chart 6: Delinquencies on Credit Card Debt Near All-Time Lows
Credit Card Debt 90+ Days Delinquent, Percent of Total Card Debt
Source: Federal Reserve

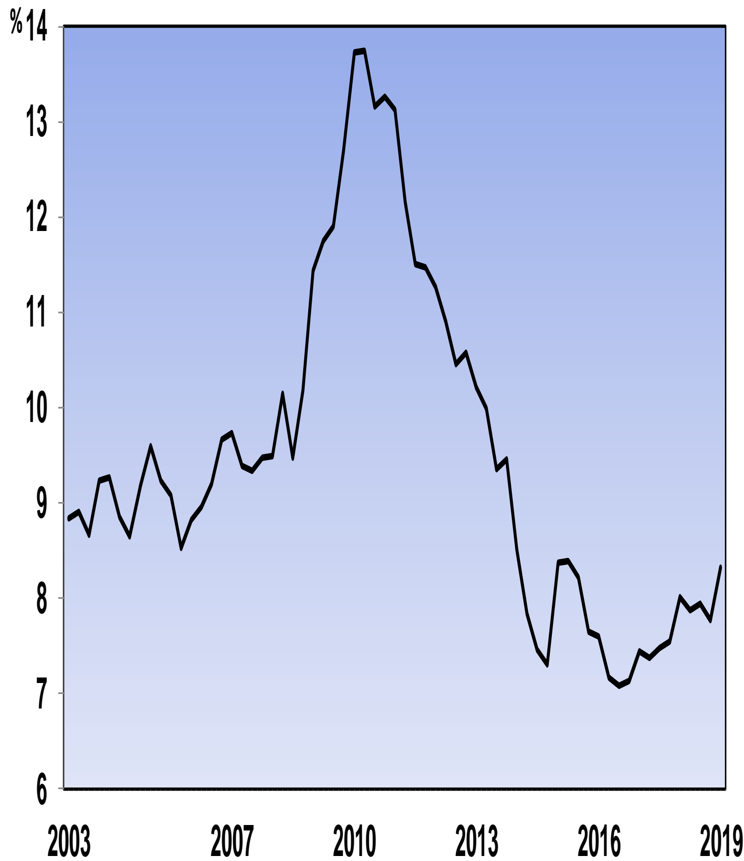
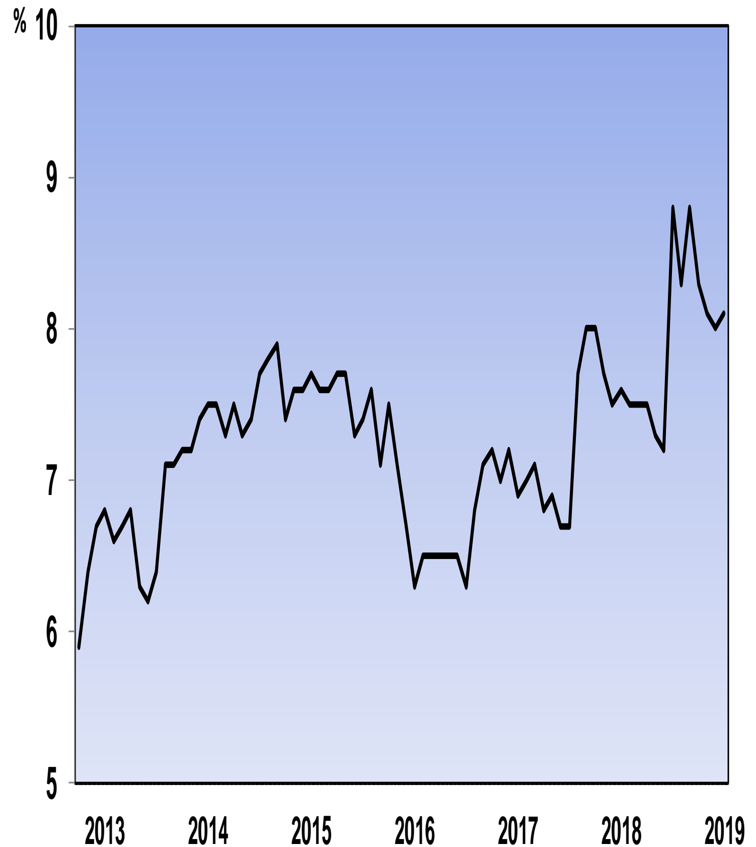


Chart 7: Household Savings Climb to a Multi-Year High
The US Personal Savings Rate
US Personal Savings as a Percent of Disposable Personal Income
Source: Bureau of Economic Analysis



Lenders Respond Quickly: There are two unique circumstances that help to explain the unusually strong financial health of the household sector: (1) Household borrowing has been extremely moderate. With lingering memories of the economic crisis, consumers have been reluctant to take on new debt. (2) Lenders have also been extremely cautious in making new loans, maintaining exceptionally tight lending standards since the crisis. The obvious result has been unprecedented weakness in credit creation.

- **Credit Card Debt**: In 2016, bank and credit card lenders responded quickly to a rising trend in delinquencies by immediately tightening lending standards. Delinquencies on credit card debt stabilized, and are currently 75% below the peaks of the past decade (see chart 6).

Household Savings: Notorious for chronically low savings, US consumers ratcheted up savings in the immediate aftermath of the financial crisis and have maintained the highest level of savings in 25 years. Compared with a rate of 4.2% during the five years preceding the 2008 financial crisis, the US personal savings rate has risen to more than 8% this year. *The 8.5% average savings rate since the end of 2018 is the highest since 1992* (see chart 7).

Student Loans: Student loan borrowing is far and away the most serious problem with respect to household sector debt. From 2010 to 2018, student loan debt increased by 125%, an annual growth rate of 8.5%. There has been a sharp slowdown in borrowing that appears to be temporary, with accelerating growth in balances likely in future years. The vast majority of student debt is ***government backed***, which means that taxpayers, and not private lenders, are at risk, implying much reduced systemic risk compared to banking sector debt.

ECONOMIC IMPLICATIONS

One of the classic signals of an impending recession is a progressive deterioration of household sector finances. Delinquencies and defaults tend to increase sequentially during the period immediately preceding recessions. Spreading credit losses trigger a tightening in lending standards as banks and other lenders move aggressively to protect balance sheets and net income. Tighter lending standards lead to a contraction in consumer spending, followed by knock-on declines in production, employment, and investment.

The excellent condition of consumer balance sheets strongly suggests that private consumption should continue to grow at a 2.5% annual rate over the next year, consistent with underlying growth in real disposable personal income. Continued solid growth in household spending would be inconsistent with a recession in the foreseeable future. Robust spending by consumers would have a favorable domino effect on production, inventory demand, and business capital investment, resulting in a broadening of aggregate demand across more sectors of the economy.

INVESTMENT IMPLICATIONS

As would be expected, market sentiment has turned decisively negative in the wake of the US threat of new tariffs on Chinese imports. *The US and world economies are currently held hostage by US trade policy*. Economic growth will continue to weaken in a policy framework of escalating trade tensions, while a breakthrough in trade negotiations should spark a revival in the global economy.

The odds of a global recession have increased as trade relations between China and the US continue to deteriorate. Although there is evidence of weakness in most sectors of the domestic economy, the household sector remains strong. Comprising nearly 70% of US GDP, personal consumption expenditures should continue to support US economic growth while reducing the risk of recession. In the absence of recession, common stocks should massively outperform bonds over the next year, although the equity market remains vulnerable in the short term until there are concrete signs that trade tensions are easing.

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CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.

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