ECONOMIC OUTLOOK
REGIONS
November 2012

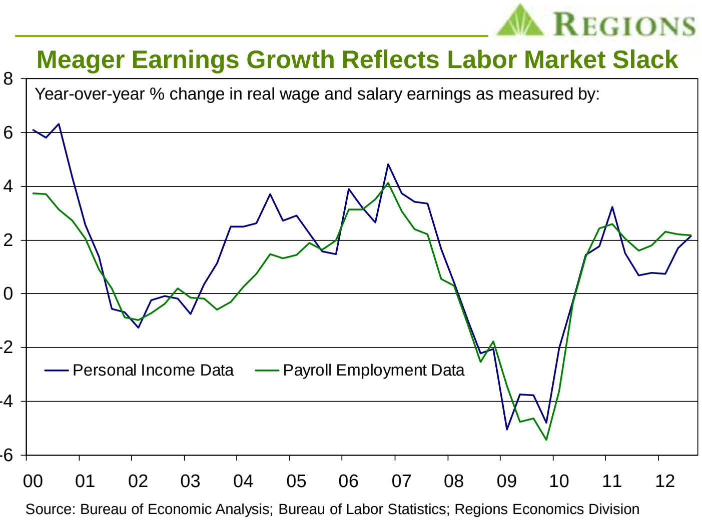
Will Consumers Pick Up The Pace?

After a few years of relative restraint, some voluntary, some not so much, U.S. consumers have had more spring in their step of late. Rising house prices and a lower unemployment rate have fed into improving consumer confidence, and retail sales rose sharply during 2012's third quarter – even after accounting for the impact of higher food and gasoline prices. Particularly noteworthy has been the stepped up pace of vehicle sales, where a high degree of pent-up demand and readily available financing have translated rising consumer confidence into solid sales growth. To be sure, the levels of vehicle sales, real (i.e., inflation adjusted) retail sales, and consumer confidence all remain below pre-recession levels, but the improvement of late is encouraging.

As measured by the Bureau of Economic Analysis, consumer spending accounts for roughly 70 percent of real GDP. Thus, to some extent, what has been a lackluster and uneven recovery in the broader economy has simply reflected the patterns seen in consumer spending since the end of the recession. Improved consumer sentiment and spending of late has stirred hopes that this improvement will be not only sustained but strengthened in 2013 which would, in turn, lead to a faster pace of real GDP growth. While we do agree with the basic premise, we do not expect growth in consumer spending to accelerate as sharply as many other analysts seem to.

Household balance sheets are in better condition than was the case at the end of the Great Recession, but it is also true that there is further to go before they can be considered healthy. Moreover, growth in real disposable personal income remains middling and, at its current rate, is simply not supportive of a meaningful and sustained increase in the rate of growth of consumer spending. To this point, the personal saving rate fell sharply during Q3, ending the quarter at 3.3 percent compared to 4.4 percent at the end of Q2. Clearly, the pick-up in retail sales during Q3 was financed in part by consumers dipping into savings, which is not a sustainable dynamic over a longer time period.

While other analysts point to improving household net worth and low monthly debt service/financial obligations ratios, in our view it is the rate of growth of disposable personal income that is, and over the near term will remain, the key driver of the growth of consumer spending. This is the main reason why, despite expecting some improvement, we see meaningful acceleration in consumer spending growth as still a way off. The main factor holding down growth in disposable personal income is the high degree of labor market slack, which is acting as a drag on growth in aggregate wage and salary earnings. The chart below illustrates this point, and the meager pace of earnings growth is apparent in data from numerous sources. In addition to the monthly employment reports and the monthly personal income reports, growth in earnings as measured in the productivity data and the Employment Cost Index affirm the trends shown here.



Despite the unemployment rate having fallen below 8.0 percent, as of October, there remains little upward pressure on wage growth. Another factor in that plays into the lack of significant upward pressure on aggregate earnings is the mix of jobs added during the current recovery, which is a topic we discussed at length in the October *Economic Outlook*. In short, job gains during the current recovery have been heavily concentrated amongst industry groups in which hours worked and hourly earnings are below average, resulting in a slower pace of growth of aggregate earnings.

Given that wage and salary earnings are easily the largest single component of total personal income, it is not surprising that growth in real disposable personal income remains weak. Moreover, that growth is likely to get weaker still over the near term, as we fully expect that on January 1, 2013 Social Security Withholding rates will revert back to the normal 6.2 percent from the current rate of 4.2 percent that has been in place as part of the efforts to stimulate the economy. This will represent a significant hit to disposable income for lower to middle income households, which will be reflected in slower growth in consumer spending in early 2013.

On top of what remains sluggish growth in real disposable personal income, households remain engaged in the process of repairing their balance sheets. Part of that process is in the form of household deleveraging, i.e., paring down debt from what proved to be unsustainably high levels. The chart below

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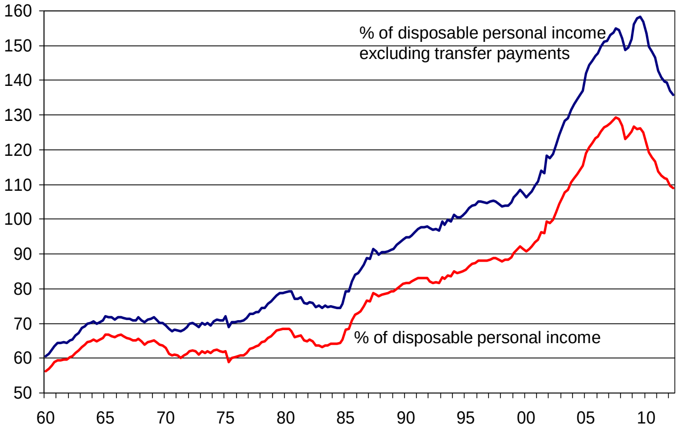
shows the ratio of total household debt to both total disposable personal income and disposable personal income excluding transfer payments, which is our preferred measure of the income stream available for servicing debt and engaging in discretionary spending. By either measure of income, it would seem that while there has been progress made, there remains further to go in the deleveraging process. Our estimations show that the ratio of household debt to personal income will not return to a sustainable trend until early 2014.

Total Household Debt



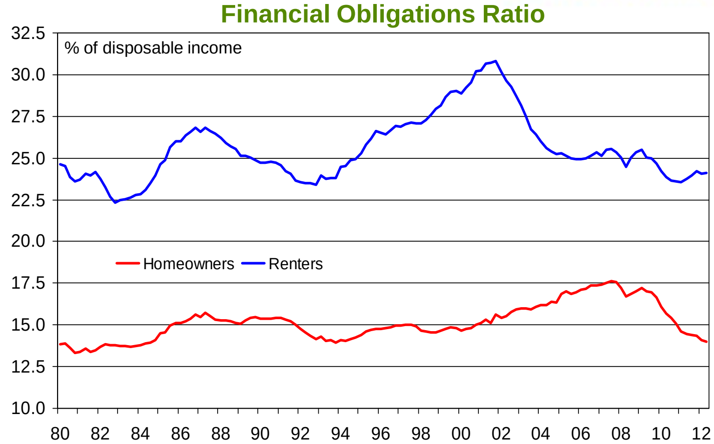
Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

It should be noted that the initial decline in the household debt to income ratio was mainly a function of lenders writing off bad debt. Over time, however, charge-offs have diminished and the decline in the debt to income ratio increasingly reflects debt reduction rather than the elimination of bad debt. Interestingly enough, many mortgage refinancings are now taking the form of "cash in" refinancings, through which borrowers reduce the amount of mortgage debt being financed. This is vastly at odds with the "cash out" refinancing that contributed to the run up in household debt in the years prior to the recession, and suggests this time around mortgage refinancing will be less supportive of growth in consumer spending.

There are, however, those analysts who argue that the level of debt is not relevant, and what matters instead is the debt service ratio, i.e., the ratio of monthly principal and interest payments on mortgage debt and consumer credit to disposable income. An alternative measure is the Federal Reserve's financial obligations ratio, which encompasses a broader range of monthly financial obligations such as leases, rents, and property taxes, and both measures are now at exceptionally low levels. It is on this basis some analysts argue households have the capacity to take on additional debt despite the debt to income ratio still being well above what we would consider a sustainable longer term level. On this basis, not only is the household deleveraging process already complete, but the capacity of households to take on more debt suggests growth in debt can facilitate a faster pace of growth in consumer spending and, in turn, faster overall economic growth.

The chart below shows the behavior of the financial obligations ratio for both homeowners and renters. We think it meaningful to make this distinction, particularly given that historically median household income of renter households has been just over half that of owner households, which is one factor behind the disparity in financial obligations ratios. With more and more households opting to rent, whether this choice is voluntary or imposed, the income gap narrowed somewhat over recent quarters but nonetheless remains considerable.

Financial Obligations Ratio



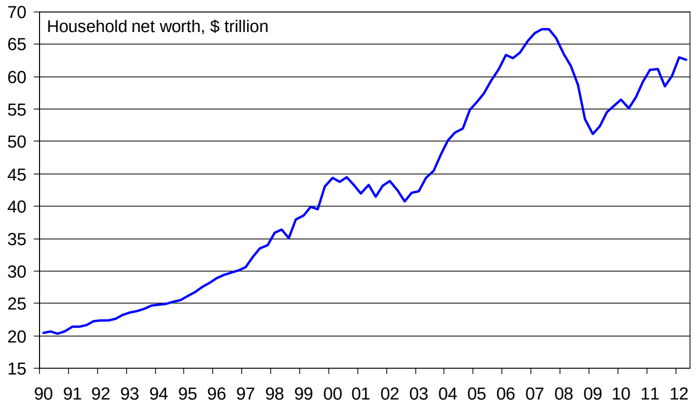
Source: Federal Reserve Board

The decline in the financial obligations ratio for homeowners reflects the exceptionally low level of mortgage interest rates. Another factor behind the low ratio for homeowners is property taxes which in many markets across the U.S. areas are lower than in previous years thanks to sharp declines in house prices. Those who argue monthly debt payments are what matter, as opposed to the level of debt, point out that the "equilibrium" financial obligations ratio is just over 15.0 percent, and thus the current ratio (13.97 percent) leaves owner households room to take on additional debt and still comfortably meet monthly payment obligations.

Renter households, however, have little, if any, such capacity for taking on new debt. With considerably lower levels of household income, renter households are far more sensitive to changes in market rents which, at present, are rising at rapid rates in most markets across the U.S. At 24.09 percent, the financial obligations ratio for renter households is below its long-term average (around 25.50 percent) but has been rising over recent quarters even as interest rates on consumer debt have fallen, reflecting higher rents. If, as is expected to be the case, market rents continue rising over coming quarters, this will offset lower interest rates and push the financial obligations ratio for renter households higher, thus limiting their capacity to take on additional debt.

Unlike dueling analysts who focus on either the level of debt relative to income or the monthly payments on that debt relative to income, most real live actual consumers likely focus on their ability to meet monthly debt service/financial obligations as well as the overall level of their debt relative to the value of their assets. While the former relationship is neatly summarized by the financial obligations ratio, the latter can best be expressed by household net worth. The chart below shows that household net worth took a considerable hit during the Great Recession, with a peak-to-trough decline of $16.2 trillion. Since bottoming in Q1 2009, household net worth has recovered much of this decline and now stands $4.7 trillion below the previous peak.

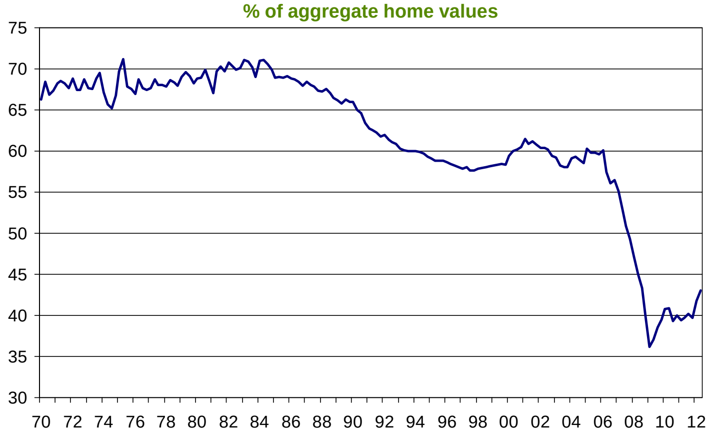
Household Net Worth On The Mend



Source: Federal Reserve Board

Looking at total net worth, however, masks what remains a stark divide amongst the components of household wealth, and this distinction is indeed relevant in understanding patterns in household debt. The rebound in household net worth seen since the cyclical trough is almost solely a function of rising stock prices, with the value of household holdings of equities and mutual funds very close to the peak seen in Q3 2007 (as reported in the *Flow of Funds* accounts). In contrast, the value of owners' equity in residential real estate logged a peak-to-trough decline of $7.3 trillion as house prices plunged, apparently not having been told that house prices "never" decline. Since hitting bottom in Q1 2009, housing equity has fluctuated and stands $6.2 trillion below the peak, though house prices have recently embarked on what we expect to be a gradual recovery. As seen below, the value of owners' equity translates into just 43.1 percent of the value of residential real estate as measured in the *Flow of Funds* accounts.

Housing Equity
% of aggregate home values



Source: Federal Reserve Board

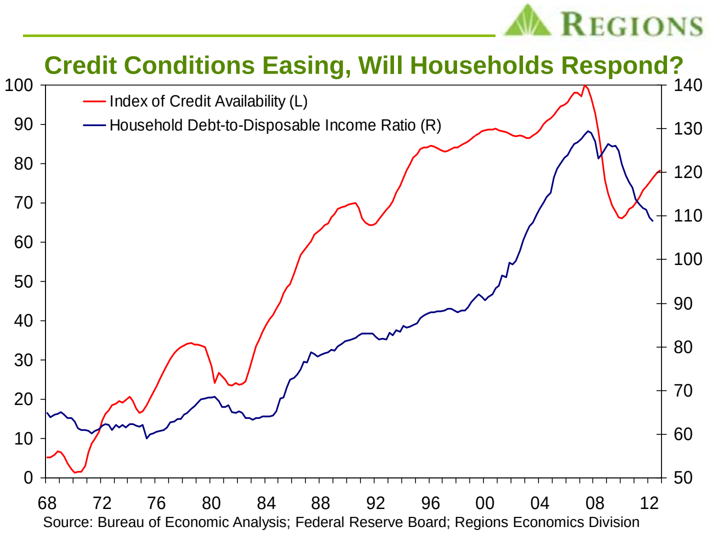
Clearly, the path of house prices was a key driver of changes in household debt in the years leading up to the recession, and we expect this will remain the case. For instance, the sharp decline in aggregate housing equity means the average homeowner has lost a sizeable amount of equity over the past several years as most, if not all, of the debt incurred in the purchase of the home remains. This serves as a meaningful constraint on the ability to borrow against any remaining equity for those homeowners willing to do so. Those who own their homes free and clear and, as such, have equity to extract are not likely to be as willing to do so as would have been the case before house prices tumbled.

In short, given this significant decline in the value of an asset that for many owner households represents the largest single source of wealth, it is unlikely that homeowners will be willing to incur additional debt unless and until they see a more meaningful recovery in housing equity. Those households who are "underwater" on their mortgage loans are effectively precluded from doing so. Once house values are more aligned with corresponding mortgage/home equity debt, we could see a greater willingness to take on additional debt, but it will remain to be seen whether or not the experiences of recent years result in households preferring less leverage, both absolutely and in relation to asset values, than they had been comfortable with before the recession.

Lenders Have A Say In This As Well

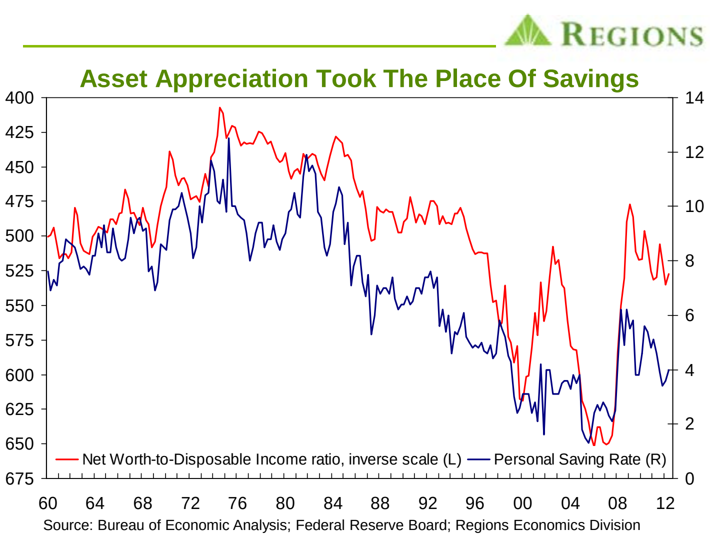
As is always the case, there are two sides to the household debt story. After all, the long-term rise in the household debt to income ratio would not have been possible without lenders providing new means through which households could take on debt. From the 1950s, when the credit card as we know (and love?) it today came to be; through the 1980s when second mortgages morphed into home equity loans; the 1990s when access to mortgage loans was expanded; and into the 2000s when subprime mortgages and various "exotic" mortgage products spread across the financial landscape, a series of financial innovations have made credit increasingly accessible to a broader range of households. This expanded access was coupled with a steady decline in the cost of credit in the form of lower interest rates which helped make households willing to take on increased debt levels, as reflected in the household debt to income ratio.

The chart below shows the household debt to income ratio along with a measure of credit availability. This measure is an updated version of the credit availability index introduced by Muellbauer ("Housing, Credit, and Consumer Expenditure" in *Housing, Housing Finance, and Monetary Policy* at the 2007 Jackson Hole symposium sponsored by the Federal Reserve Bank of Kansas City) which attempts to gauge changes in the availability of credit over time. The index is based on data from the Federal Reserve's quarterly survey of senior loan officers regarding changes in the willingness of commercial banks to make consumer loans and changes in mortgage lending standards, and is scaled to have a value of 100 at the peak, i.e., when credit availability was at its greatest.



While there is some cyclical sensitivity apparent in the credit availability index, the increase over time is consistent with the increase in the household debt to income ratio. The credit availability index peaked during the second quarter of 2007, one quarter ahead of the peak in the debt to income ratio. Also note that, according to this measure, credit availability bottomed in Q1 2010 and the subsequent increase mainly reflects what has been a steady increase in the willingness of banks to make consumer loans, as mortgage lending standards have yet to be meaningfully relaxed.

Note the steady increase in the credit availability index dates back to the early 1980s, followed shortly thereafter by the steady increase in the debt to income ratio. This also marks the starting point of the secular decline in the personal saving rate, a decline that culminated with the saving rate hitting an all-time low of 1.3 percent in Q3 2005. What ties these occurrences together is the acceleration in growth of household net worth, fueled by long running increases in stock and house prices. As seen in the chart below, the falling saving rate was to a large extent simply the mirror of a rising household net worth to disposable income ratio.



In essence, rising asset values displaced "traditional" savings for many households and helped both lenders and borrowers become more comfortable with debt. Rather than socking cash away under the mattress or in a savings account, households used rising asset values as their means of saving. Whether to contend with a "rainy day" or to merely satisfy the desire to spend, more liberal credit availability meant households could simply take on more debt, liquidate assets, or borrow against asset values, with lenders willing to accommodate them.

It was in this manner that the path of consumer spending became increasingly intertwined with the growth of household debt. There was of course nothing inherently wrong with this relationship, it was more a matter of it getting out of hand when rising household debt not only contributed to rising asset values, in the form of house prices, but was also used to extract that asset price appreciation. As it turns out, house prices can, and do, fall, and it was the precipitous fall in house prices that began in earnest in 2006 that left many borrowers and lenders in deep holes from which they have yet to fully emerge.

It is interesting to see how over the course of the Great Recession the saving rate rose as household net worth plunged, but over the course of the recovery these patterns have reversed. In other words, despite wild swings in asset prices as well as household income over recent years, rebounding net worth and increasing credit availability again seem to have lessened the appetite for traditional savings. Of course, what we do not know at this point is whether the recent decline in the saving rate is by choice or by necessity. With income growth still fairly weak and prices for gasoline and, to a lesser degree, food rising, it could be that many households are utilizing savings to finance current spending rather than resorting to credit. Still, regression analysis shows the credit availability index and the net worth to income ratio together explain over 90 percent of the variance in the saving rate since the mid-1960s, so it will be interesting to see whether this remains the case going forward.

What Does It All Mean?

As the above discussion illustrates, there is far more to the household financial picture than can be conveyed by a simple ratio, be it the debt to income ratio or the financial obligations ratio. Either way, we maintain households are not yet at the point where they will begin to take on new debt at a rapid rate, nor are lenders at the point where they will accommodate such behavior. Still, there are several points that should be made which will have a bearing on the rate of growth of consumer spending we expect to see over coming quarters.

- First and foremost, a stable debt to income ratio does not mean there is no growth in the level of debt, but instead means the growth in debt is in line with the growth of disposable income. Nor does saying the deleveraging process is not yet over mean there can be no growth in household debt; again, the relative rates of growth in debt and income are what matter. Over time, as the pace of income growth picks up, that allows for faster growth in the level of debt, and it has been our view for some time now that we will see growth – job growth, income growth, and real GDP growth – pick up as we navigate the fiscal cliff and move into the latter half of 2013 and into 2014. Until then, however, we expect households to remain judicious in taking on new debt.

- As noted above, one area in which credit is being put to use is vehicle purchases. When purchasing a vehicle the relevant constraint is meeting the monthly payment obligation, with relatively little concern for the level of debt taken on. Exceptionally low interest rates have helped keep monthly payments fairly stable, with data from Equifax/Moody's Analytics showing average monthly auto loan payments having fallen on an over-the-year basis for the past several months despite rising average loan balances.

- In contrast, we have yet to see meaningful growth in credit card usage. The number of open credit card accounts is almost five million lower at present than was the case in mid-2008. Of course, much of this decline reflects lenders having written off bad debts or actively paring down accounts, but consumers are also exhibiting some restraint. Utilization rates (i.e., outstanding balances as a percentage of credit limits) on bank cards are down sharply from rates seen at the peak in 2010 and are consistent with rates seen over the 2005-2008 period. The patterns are very similar when looking at the entire credit card universe and the key point is that consumers have shown restraint when it comes to credit card usage, particularly in an environment in which income growth has remained so sluggish.

- We expect this to remain the case going forward; again, stressing that growth in overall debt will be more in line with growth in disposable income. For now, the degree of slack that remains in the labor market is such that gains on the order of 162,000 new payroll jobs per month – the average seen over the past twelve months – have not been sufficient to generate meaningful earnings growth. While house prices have begun to rise, owners' equity remains far below anything that could be considered a "normal" level, which will weigh on any growth in home equity debt. Until we see more significant easing of mortgage lending standards, home sales will increase, thus generating new mortgage debt, but at a relatively restrained pace. Over time, however, a strengthening economy and an improved pace of income growth will allow for a rate of growth in household debt that is faster but, again, more closely aligned with income growth, meaning we do not look for another spike in the debt to income ratio.

- Still, it is likely that at some point we will see some form of financial "innovation" that makes debt more accessible to households. What we do not know at this point is how households will respond. For all of the talk about households now having a more sober outlook on debt, we simply do not know if this will remain the case when we see better economic times.

- It is, however, likely that any such financial innovation will originate with nonbank lenders instead of within the banking sector. More stringent capital requirements and vigorous regulation in the banking sector would seem to suggest that banks will take a back seat to nonbank lenders in terms of any further financial innovation.

- Either way, those who argue household deleveraging has already run its course and, in turn, households can take on more debt are at least implicitly suggesting a debt to income ratio of over 100 percent is sustainable. That is, after all, our starting point given the current value of the debt to income ratio. While improved income growth will put downward pressure on that ratio, further growth in debt will mitigate any downward movement in the debt to income ratio. We may be proven wrong on this point, but until then we simply will have a hard time seeing that as a viable scenario.

- The increase in the value of household holdings of equities and mutual funds will be supportive of growth in consumer spending. This support, however, will be somewhat limited, at least in part because the rate of direct stock ownership is well below the homeownership rate. Rising equity values may induce households to save less and thus spend more out of current income, but given that households do not typically borrow against equity holdings, the impact of rising equity values will be seen in the behavior of the saving rate as opposed to debt to income ratios.

- As to the saving rate, there has been much discussion of where the saving rate will ultimately settle given the experiences of the past several years. Some analysts argue that a new found financial discipline will lead households to increase their savings and, as a result, the saving rate will settle somewhere on the order of six to eight percent. It could be, however, that the saving rate could settle much lower, perhaps around three percent. As housing equity becomes more fully restored, households may go back to viewing a home as a means of saving, a not uncommon view before houses turned into ATMs. If this turns out to be the case rising home values, which made up a considerable portion of the increase in household net worth that began in the 1980s could, for many households, become the primary means of saving as opposed to "traditional" savings. This is consistent with our view, and suggests an equilibrium saving rate lower than many analysts now expect.

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