

ECONOMIC UPDATE



REGIONS

March 2015

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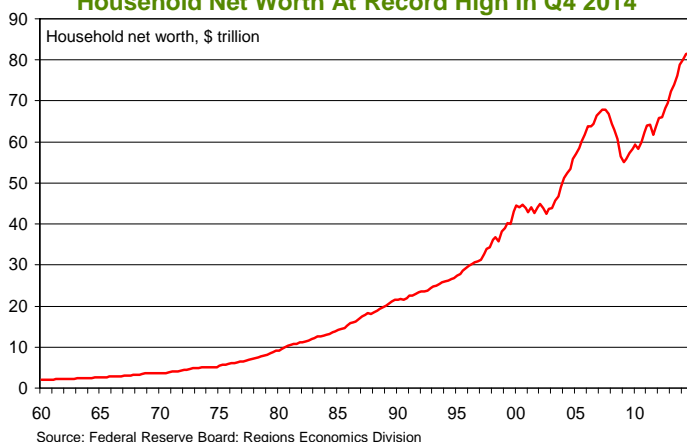
Q4 2014 Flow Of Funds: Cautious Households; Cash (And Debt) Heavy Corporations

Each quarter the Federal Reserve produces its "Z1" statistical release *Financial Accounts of the United States* or, as it is also known, the *Flow of Funds Accounts*. The Z1 release provides a detailed look at the levels of assets and liabilities, with an emphasis on financial instruments, held in the various sectors of the economy and the flows of these financial instruments between the various sectors. The broader Integrated Macroeconomic Accounts relate gross domestic product (GDP) to lending, borrowing and investment amongst the public and private sectors, the latter broken down into the corporate and household sectors. In short, the Z1 release is the most comprehensive mapping of financial flows through the economy and provides much useful detail, for instance, detail on household net worth and its underlying components.

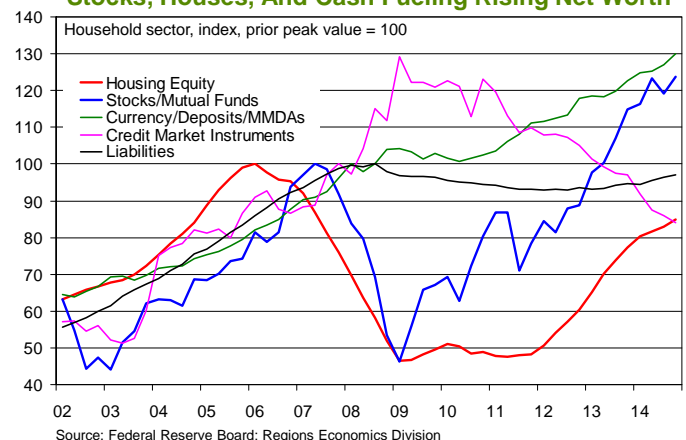
The data come with a lag and the Federal Reserve only recently released the Q4 2014 data; what follows is a summary of some of the most relevant findings for the household, business, and government sectors of the U.S. economy. In short, the Q4 data show the household and corporate sectors sitting on significant levels of both cash and debt – with "cash" used as a broad heading that includes currency, demand and time deposits, money market accounts and other cash equivalents. The data for the household sector don't so much lead to any new conclusions about household spending/saving decisions as much as they offer more detail and hence help further explain underlying trends in household financial behavior. For instance, our March *Monthly Economic Outlook* explored recent consumer spending patterns and discussed why even though we expect faster growth in consumer spending this year we nonetheless do not expect growth in consumer spending to settle back into the trend rate of growth that prevailed from the 1970s through the start of the 2007-09 recession. Our main concern is still-high household debt levels. On the afternoon that document went out the Q4 2014 Z1 data were released (who says timing is everything?) and, while nothing in the Z1 data would change any of the conclusions we had arrived at, the Z1 data do shed more light on the current state of household balance sheets. The bottom line, however, is the same – anyone waiting for growth in consumer spending to settle in to that pre-recession pace has a long wait ahead of them.



Household Net Worth At Record High In Q4 2014



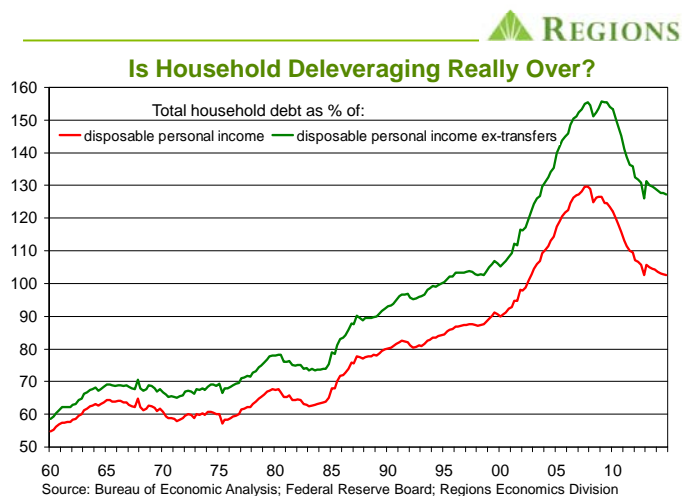
Stocks, Houses, And Cash Fueling Rising Net Worth



If there is one data point from the Z1 release most people hear discussed each quarter it would be the level of household net worth. As shown in the first chart above, household net worth has recaptured the losses seen during the depths of the 2007-09 recession and then some, standing at a record level of \$82.9 trillion as of Q4 2014 (though the ratio of net worth to GDP is still shy of the record reached ahead of the 2007-09 recession). On the asset side of household balance sheets, financial assets account for roughly 70 percent of total assets, with corporate equities representing the largest single block of financial assets. The second chart above shows an index of values of selected assets and total household liabilities relative to their pre-recession peaks. Note as of Q4 2014 aggregate

household liabilities are still shy of their pre-recession peak, reflecting significant write-offs of bad debt during the downturn and subsequent deleveraging in the household sector in more recent quarters. By, at least in the aggregate, doing pretty much nothing, the liability side of household balance sheets has effectively contributed to rising net worth in the household sector in recent years.

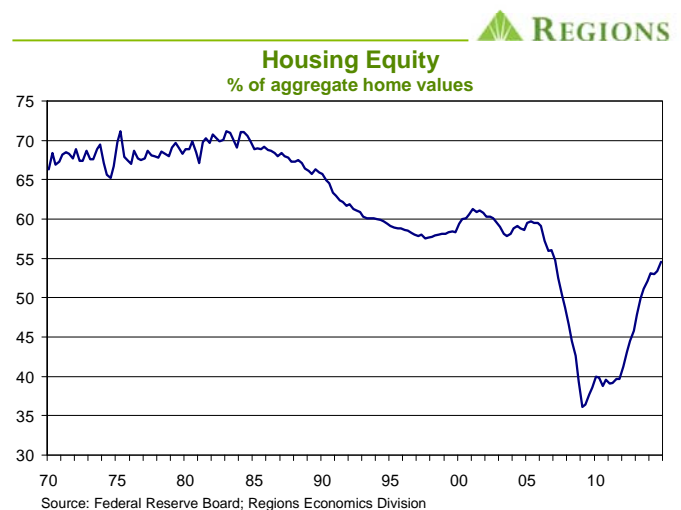
Clearly, though, rising share prices have been the primary catalyst behind the recovery in household net worth since the end of the recession, but since 2012 rising house prices have fueled rising housing equity and thus contributed to growth in net worth. What may be surprising in this chart is the steady increase in cash (broadly defined, as noted above) holdings in the household sector. To be sure, during the downturn increased cash holdings were perfectly consistent with the precautionary demand for savings, but what is less immediately obvious is the motive behind the ongoing build in cash holdings since the end of the downturn, especially in light of what for years has been little to no real return on these holdings thanks to artificially depressed short-term interest rates. Note also the steady decline in household holdings of credit market instruments (mainly debt securities) since early 2009.



One may be tempted, upon hearing the words “record household net worth,” to wonder why all this wealth does not seem to have done much to light a fire under consumer spending, particularly in conjunction with what over the past several months has been an accelerating pace of job and income growth. One likely factor is distributional effects, i.e., while aggregate stock values have blown past the pre-recession peak the gains from rising stock values are somewhat concentrated amongst a subset of the household sector as opposed to being broadly distributed – recall the incidence of direct stock ownership is considerably below the incidence of homeownership, even with the recent sharp decline in the latter. This is one reason we have consistently tried to temper expectations that rising stock values will unleash wealth effects that will, in turn, foster a faster pace of consumer spending growth.

Another reason why record net worth (or, for that matter, steadily rising net worth over recent years) doesn't seem to have sparked more robust consumer spending is, at least in our view, the still elevated household debt-to-income ratio. Given we discussed this in detail in our March *Outlook* we won't repeat that here, though we do repeat the above chart, other than to again make the point that while household debt loads have come down considerably via a mix of write-offs of bad debt and genuine deleveraging, we simply do not buy the argument the latter of these has run its course. Yes, household liabilities have ticked higher of late, as seen in the chart on the prior page, but they have done so at a rate slower than the rate of income growth, thus allowing the debt-to-income ratio to fall.

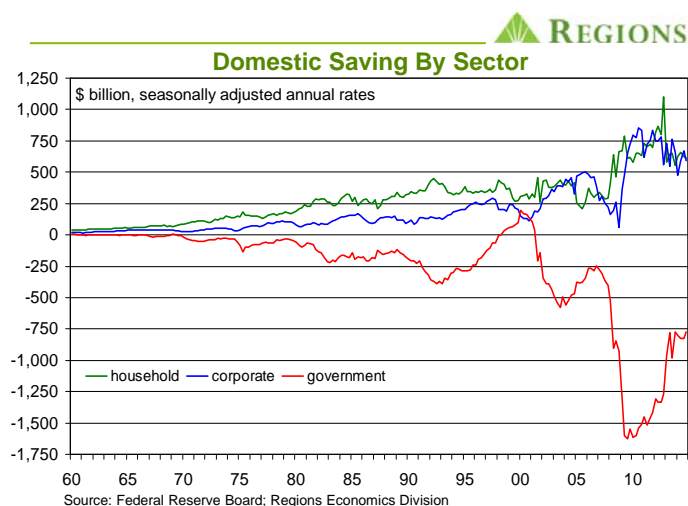
Recall from the chart on the prior page that housing equity has risen steadily since 2012 but yet remains well below the pre-recession peak. There is, however, nothing magic about the pre-recession peak – for many, “evil” may be a more accurate description given that peak was an artificial construct stemming from cheap and readily available mortgage credit. So, by no means are we saying we can, should, or will see housing equity return to that level, but using that as a basis of comparison is still helpful to put not only the data but also certain elements of household (and lender) behavior in context. What is perhaps a better way to look at housing equity is the chart to the side showing aggregate housing equity (i.e., net of mortgage liability) as a share of aggregate housing values. As of Q4 2014, housing equity in the aggregate stood at 54.5 percent of the aggregate value of housing, up from the historical low of 36.1 percent in Q1 2009 but still short of any level that would be considered “normal.” Truth be told, the 54.5 percent figure overstates the case for those households with mortgage debt. According to the Census Bureau's 2013 *American Community Survey* (the latest available), 35.7 percent of owner occupied households had no



mortgage debt (the annual ACS numbers can jump around but a reasonable longer-term average is around 33 percent) meaning, for those households with mortgage debt, net housing equity is considerably below the 54.5 percent aggregate average.

We think this significant for the following reason. As noted above, direct stock ownership is more concentrated than is homeownership and, for many households, the home is their single most valuable asset, and with market values still below prior peaks across much (most) of the U.S. and equity shares still substantially depressed, many householders likely feel considerably less wealthy than some of the aggregate numbers would imply. To the extent this is the case, it is natural to assume such households are still intent on paring down debt and building up liquid assets as opposed to increasing spending, particularly if doing so means they have to take on new debt. This would be a far bigger constraint on spending growth than rising stock prices would be a boost to spending growth.

Housing equity as a percent of housing value hovered around 70 percent from the mid-1950s through the mid-1980s and it was the advent of home equity lending that began to push this ratio lower even before the artificial run-up in house prices in the years leading up to the 2007-09 recession. In essence, home equity loans/lines of credit allow consumers to extract equity from their homes in order to facilitate spending and this was a considerable boost to consumer spending in the pre-recession years, as at its peak equity extracted from housing was equivalent to roughly 10 percent of disposable personal income. More generally, this was part of a broader pattern in which the increased availability of credit (in various forms, not just home equity lending) and rising household net worth (thanks to increased homeownership rates/rising house prices along with a rising incidence of direct stock ownership) displaced traditional saving – not fully but close to it – in the household sector, corresponding with a secular decline in the personal saving rate. (This a topic on which we have done considerable empirical work, summarized in our November 2012 *Monthly Economic Outlook*.)



Recent years, however, have seen significant increases in both the level of household savings and the saving rate (note that during the years in which the saving rate was falling the level of savings was fairly stable but steadily rising income drove down the saving rate). The chart to the side shows domestic saving in the household, corporate and consolidated (i.e., combined local, state, and federal) government sectors. That household savings remain elevated, albeit down from the peak seen in Q4 2012, could suggest a reversal of the pattern that prevailed from the mid-1980s until the start of the 2007-09 recession – instead of letting rising asset values substitute for savings, households are now resorting to, you know, actual saving, i.e., spending less than their current disposable incomes. What is less clear is, to the extent this is the case, how long it will be the case, but there is nothing in the data suggesting a reversal is at hand any time soon. We suspect when growth of labor income accelerates to a sufficient degree, consumers will begin

to feel more confident in spending more and saving less, but again we will note our view that the level of household debt will act as a constraint on the rate of growth of consumer spending, particularly when interest rates do begin to rise, leading to meaningfully higher debt service burdens. As such, the household saving rate could rise further still over coming quarters.

The above chart reflects what in recent years has been a shrinking federal government budget deficit though, in the aggregate, the government sector is still a significant source of dissaving in the U.S. economy. The one comment we will make here is the above chart illustrates what those who over the years have repeatedly warned government budget deficits lead to higher interest rates have always missed, and that is it is the total level of saving in an economy that matters, not the level of saving (or, in this case, dissaving) in an individual sector. In other words, there is scant empirical evidence to show a causal relationship between budget deficits and U.S. interest rates (and, this goes back well before quantitative easing was a concept let alone an actual policy), nor should there be when one considers the total pool of saving available to finance government deficits. Moreover, in an open economy the pool of domestic saving can be augmented by foreign savings, as in the case of the U.S. when foreign capital helps finance U.S. deficits. To be sure, the risk is there could be a significant decline in the pool of saving, foreign and domestic, at a time when net government borrowing needs remain elevated, which would trigger an increase in interest rates, even if over time increases/decreases in private/government saving have tended to offset each other. But, if there is one thing all of us should have learned from the past few years is don't think it won't happen just because it hasn't happened yet, to borrow a line from Jackson Browne, so the lack of a causal relationship between deficits and interest rates in the historical data does not ensure there never will be such a link.

Finally, as for the corporate sector of the U.S. economy, the above chart shows a significant increase in net saving in the corporate sector over recent years, matching the build-up of saving in the household sector. This is consistent with the widely discussed build-up of cash (again, broadly defined) on corporate balance sheets. But, what has been a corresponding increase in the aggregate level of debt on the other side of corporate ledgers, as seen in the chart to the side, has not gotten nearly as much attention as it deserves. Over the past several years corporations have taken advantage of low interest rates to either increase total debt levels or refinance existing debt at more attractive interest rates. In and of itself, of course, the increase in corporate debt need not be seen as a negative but what is, at least to those not on the receiving end, worrisome is the extent to which this debt has been used to facilitate share buybacks or finance increased dividend payouts as opposed to funding capital spending that would support faster long-term economic growth. It is much the same argument many, including us, make regarding government borrowing – if the borrowed funds are being used to finance investment that expands the economy's long-run productive capacity, debt can be viewed as productive. Perhaps more significant, however, is the potential risk inherent in the run-up in corporate debt. Should corporate profits fall and/or interest rates rise significantly, defaults on corporate debt could jump, posing risks to the credit markets and the broader economy.

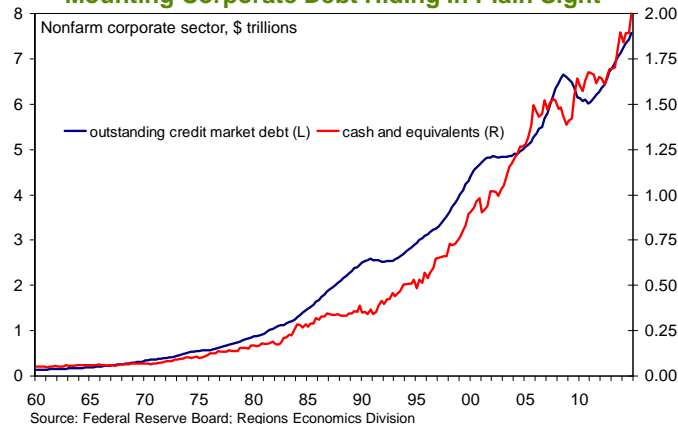
Still, there is some evidence to suggest at least part of the debt being taken on by firms has gone to finance investment. From the Z1 release we can construct the corporate “financing gap” which basically is the difference between the change in internal cash flows and the change in capital spending in a given quarter, or, a gauge of the extent to which firms must rely on external financing for their capital outlays in a given quarter. Again, this is an aggregate figure, but recent quarters have seen a positive financing gap, i.e., firms need external financing to fund capital outlays. The financing gap had been negative in 19 of the 20 quarters prior to 2014, suggesting that in the aggregate firms could self-fund capital outlays, which was consistent with our argument that firms were underinvesting in the capital stock, which in turn we believe to be a culprit behind what is a meager trend rate of worker productivity growth. Moreover, the financing gap was negative in an extended period of rapid growth in corporate debt, raising the question as to whether or not that debt was being used for productive means. During the second and third quarters of 2014 capital spending on equipment and machinery rose at a double-digit pace before slowing sharply in Q4 2014. In that sense, the positive financing gap seen in each of the four quarters of 2014 was encouraging. But, going forward, a key marker to watch in 2015 is whether or not the growth in business investment spending

picks back up from the slow pace seen in Q4 2014. We expect this to be the case but with a somewhat soft global growth environment and what will be a significant paring back of investment outlays in energy and related sectors in 2015, the outlook for overall growth in business capital spending is somewhat uncertain at this point in time.

On the whole, the *Flow of Funds* data provide a great deal of detail on the underlying financial flows through the economy, even if this comes with a lag. As we work through the myriad of data releases each month, the “what” is of course readily visible in the headline numbers, but the more significant “why” is not always immediately obvious. For instance, while a still-restrained rate of growth in consumer spending may seem puzzling, the detail provided in the *Flow of Funds* data help explain why it is not, or should not be. At the same time, the *Flow of Funds* data can help highlight risks that are developing though not necessarily being seen. One could argue this is the case with the significant build-up in corporate debt that has seemed to fly under the radar, particularly relative to the endless discussion of the level of cash on corporate balance sheets. All in all, while not typically garnering a great deal of attention, the Flow of Funds data are nonetheless useful, as we hope to have illustrated with this discussion.



Mounting Corporate Debt Hiding In Plain Sight



Corporate Financing Gap

