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Economics Group

Interest Rate Weekly

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Household Balance Sheets Largely Repaired: Ready for Rates?

In the wake of the Great Recession, households focused on paying down debt to repair their balance sheets. Now that households are in a stronger financial position, they should be able to handle higher interest rates.

Equity at All-Time Highs

Households' balance sheets continued to improve in the first quarter of 2015 according to data from the Federal Reserve. Net worth increased by $1.6 trillion in Q1 to an all-time high of $84.9 trillion. This puts the year-over-year growth rate in household net worth at 5.7 percent (top chart).

As evidenced in the middle chart, the rise in financial assets contributed the most to gains in net worth. This largely mirrors the relatively stable rise in financial markets we have experienced over the past several years. That said, net investment in financial assets by households has been positive since the end of the recession as well, although capital gains have accounted for the majority of the increase. One caveat, however, is that gains have not been evenly distributed.

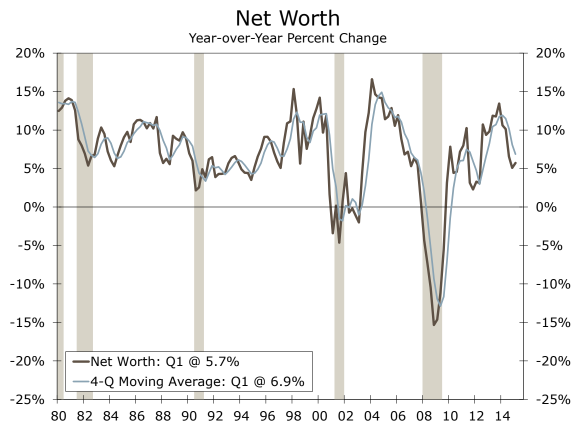
The ratio of financial assets to real estate and other tangible assets for households has risen to near all-time highs since the end of the housing boom and subsequent collapse. The ratio has leveled out recently, which implies that the two components are growing at roughly the same rate.

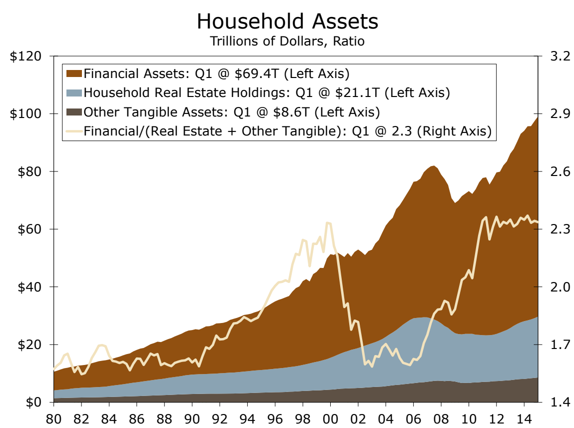
Debt Service Ratio Has Also Improved

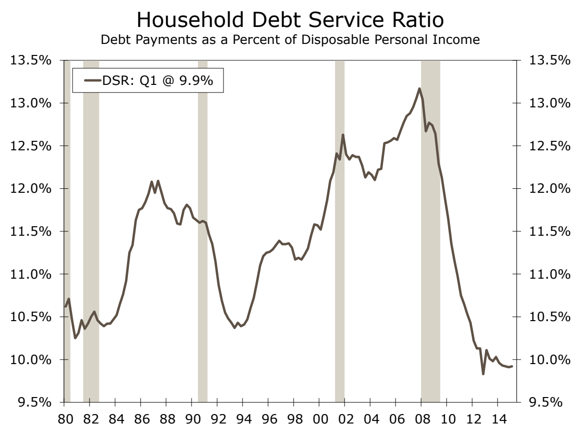
Recently, increases in assets have outpaced the rise in liabilities. This has led to continued household deleveraging. However, over the long run, household leverage has steadily increased. The pace of this increase in leverage accelerated after the dot-com bubble burst in the early 2000s and leading up to the housing bubble, fueled in large part by mortgage debt.

Mortgages are the largest component of household debt, therefore, the mortgage rate is of particular importance. Because the majority of mortgages are fixed rate, an increase in mortgage rates would not affect most of the mortgage debt already outstanding, although the impact on home sales is less certain. The debt service ratio, a measure of households' ability to pay off their outstanding debt, has declined to all-time lows (bottom chart). In addition to deleveraging of household balance sheets, this decline in the debt service ratio also reflects the historical low interest rate environment we have been in for several years now. The low debt service ratio indicates that the average household should have the capability to service debt at a higher interest rate when mortgage rates rise. This supports our belief that an increase in interest rates will not derail the housing market. The varied distributional effects, however, may skew this conclusion to some extent.

In sum, household balance sheets are in a much better position now than the years immediately following the crisis. Households strengthening their financial position contributed to the slow recovery, a typical feature of a balance-sheet recession. Now that households have solidified their personal finances, we expect the economy to continue to expand, despite the modest increase in interest rates we are expecting later this year.







Source: Federal Reserve Board and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual					Forecast						
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	4.05	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.05	0.13	0.55	0.86	1.15	1.43	1.81
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.16	0.27	0.63	0.91	1.22	1.52	1.85
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.25	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.95	3.07	3.15	3.18	3.29	3.53	3.69

Forecast as of: June 19, 2015

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	1.8	2.9	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	0.8	2.0	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: June 19, 2015

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 17, 2015

Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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