

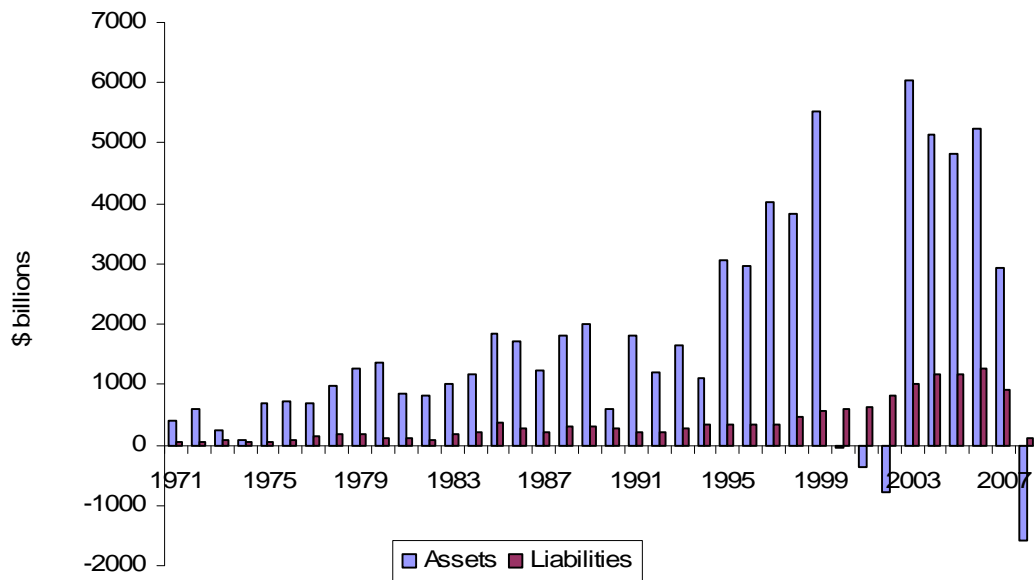
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Is U.S. Household Savings Rate Dangerously Low?

The front page of Sunday's New York Times highlighted the heavy household debt burden (an average \$117,951 per household), comparing it to the low personal savings rate ("\$392 savings each year"). Two full pages inside the A section elaborated on exhausted household finances. American Express's weak earnings contribute to the view that even upper-end American households have run out of money. The implication is that even harder times are ahead, with the July 22 UK Telegraph likening conditions to the breaking point in 1931.

- Instead, we think the U.S. is in gradual recovery after a sharp two-quarter slowdown, with consumer resilience more likely than the decades-old expectation of a consumer slump. Fed data shows clearly that household savings of all types – liquid, financial and tangible -- are still close to the record levels set in September. IMF data (discussed below) shows U.S. households holding more financial savings than the rest of the world combined. Consumption has repeatedly outperformed expectations in recent quarters and years.
- The New York Times presentation is misleading because it compares the stock of debt from Federal Reserve data to an artificially low measure of annual savings from the Commerce Department. In the five years through March, Fed data shows that U.S. households added \$1.8 trillion per year to net financial savings, an average \$14,800 annually per household.
- We think people should save more and federal policy should be less biased against savings. But the macro-economic issue is whether aggregate household savings is low enough to impede current growth. We think not.
- The Times article ignores the Fed's data showing a much higher level of household assets than liabilities (an average \$573,379 of assets per household versus \$117,951 in liabilities). The table of household assets and liabilities is at the end of this piece. Both assets and liabilities are skewed, rising with income levels, with median levels in most states well below these averages. Assets include the cash value of life insurance, 401k plans marked to market, and, in California, a median house price of \$500,000 or more. Liabilities include mortgages (with California materially pulling up the average), credit card balances, and auto loans.
- In dollar terms, assets (blue bars below) have been growing much faster than debt (red bars); in percentage terms, at about the same rate. Even after factoring in recent declines in stocks and house prices, U.S. household assets are nearly five times larger than household liabilities.

Annual Changes in Household Assets and Liabilities (last obs one-qr chg Q1 2008)

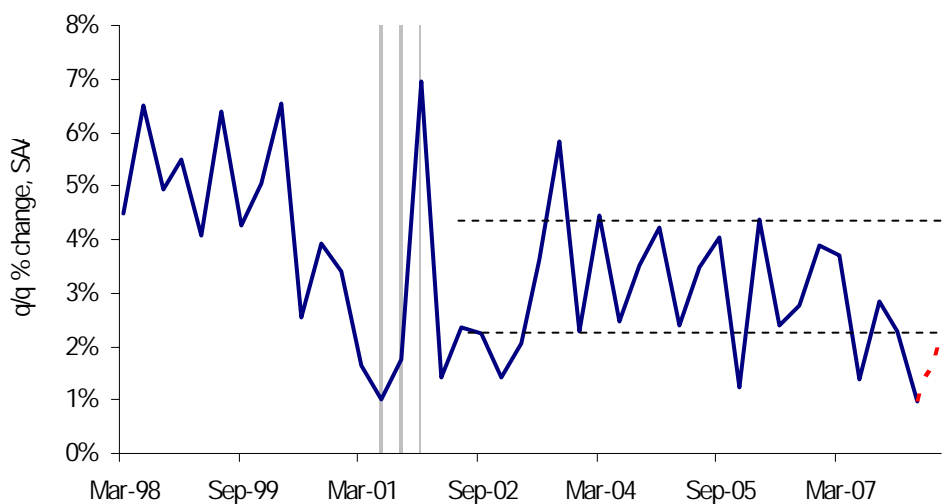


Source: Haver; Encima Global

A key variable in the U.S. outlook is whether consumers are tapped out and will be forced to reduce consumption. We think not. We expect changes in consumption patterns (away from gasoline, for example), but continued growth in overall consumption.

- Rather than responding to changes in wealth, consumption generally tracks lifetime earnings expectations. They remain fairly good based on the unemployment rate and immigration restrictions. **We expect consumer resilience even after the rebate checks are used up.** The negative wealth effect from housing, the reduction in mortgage equity withdrawals and the low personal savings rate all started in 2006, yet consumption growth remained solid through the third quarter of 2007, and was only markedly weak in the first quarter.

Quarterly Growth of Real Consumer Spending (last obs Q1 2008, Q2f)



Source: Haver; Encima Global

- Consumption growth slowed some beginning in the fourth quarter, though it has been consistently above our September 5, 2007 forecast. That forecast of a sharp consumption slowdown was based largely on an expected deterioration in the employment situation, not wealth or debt.

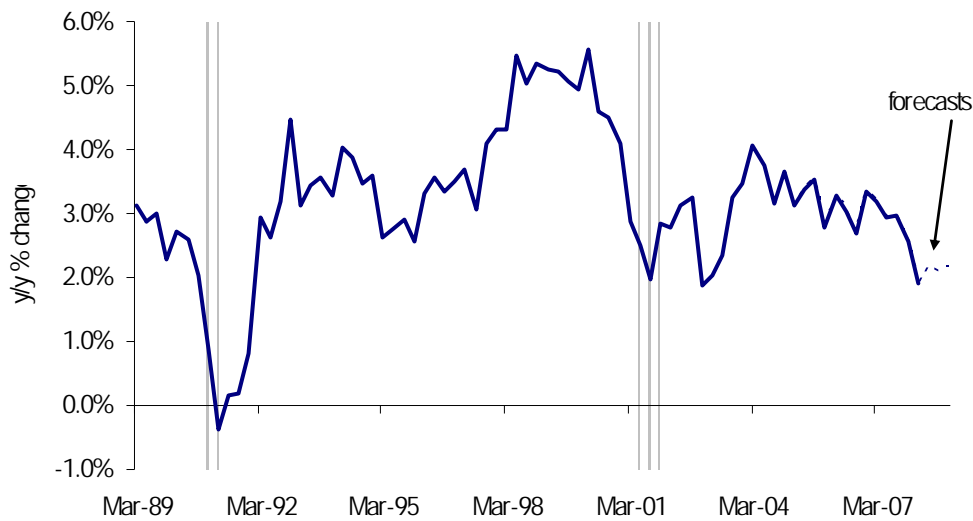
Personal Consumption Expenditure (Historical and Current Forecasts)

	Quarter/ Quarter Change SAAR				
	4Q 07	1Q 08	2Q 08(f)	3Q 08(f)	4Q 08(f)
Personal Consumption Expenditure	2.3%	1.1%	2.0%	2.5%	2.5%
4/6/08 forecast			2.0%	2.5%	2.5%
9/5/07 forecast	1.6%	1.0%	2.0%	2.2%	2.5%

Source: Haver; Encima Global

- On a year-over-year basis, consumption growth has slowed slightly more than in the 2001 recession, but much less than the 1990 recession despite many predictions that the consumer impact of the credit crunch would be as bad as 1990 (or even the 1930s).

YOY Growth of Real Personal Consumption (last obs Q108, forecasts Q2-Q4)



Source: Haver; Encima Global

- Going forward, we think jobless claims and the unemployment rate will continue to be more important in anticipating consumer trends than wealth or credit.

Measuring the Savings Rate

The reported “personal savings rate” is lower in the U.S. than in other countries, but this calculation is unrelated to actual savings. **The reported U.S. personal savings rate compares apples to oranges—using a very narrow definition of income (which excludes accumulated gains) and a very broad measure of expenditures. It’s a meaningless comparison, like comparing an income statement account to a cash flow account on a corporate financial statement. It gives no indication of actual additions to or increases in household savings, nor does it claim to.**

- The footnotes for the July 20 New York Times article state that “annual savings includes employee and employer 401(k) contributions and I.R.A’s paid for by current income.” This is true. However, the footnotes omit that annual savings under the personal savings rate do not include gains from previous contributions to private retirement plans.
- For example, a contribution to a pension plan made thirty years earlier was included in that year’s savings, but the thirty year compounding of capital gains within the pension are excluded from U.S. household savings. **This makes the personal savings rate increasingly distorted to the low side.** Retirees who spend some of their pension and add the rest to their savings are scored as big dis-savers because the cash from the pension is excluded from income while the expenditures are included in outlays.

Sample calculation of the reported personal savings rate. In April, disposable income – a narrow measure of the cash flow to households, which excludes gains – rose 0.4% from March to \$10.574 trillion annual rate. Personal outlays – a broad measure of personal consumption – rose 0.5% to \$10.534 trillion. As a result, official personal savings (simply income minus outlays) was \$39.7 billion at an annual rate. Dividing by disposable income, the personal savings rate (excluding gains) was 0.4% in April. (The May data is shown on the graph, with personal savings distorted upward to 5% by the rebate checks.)

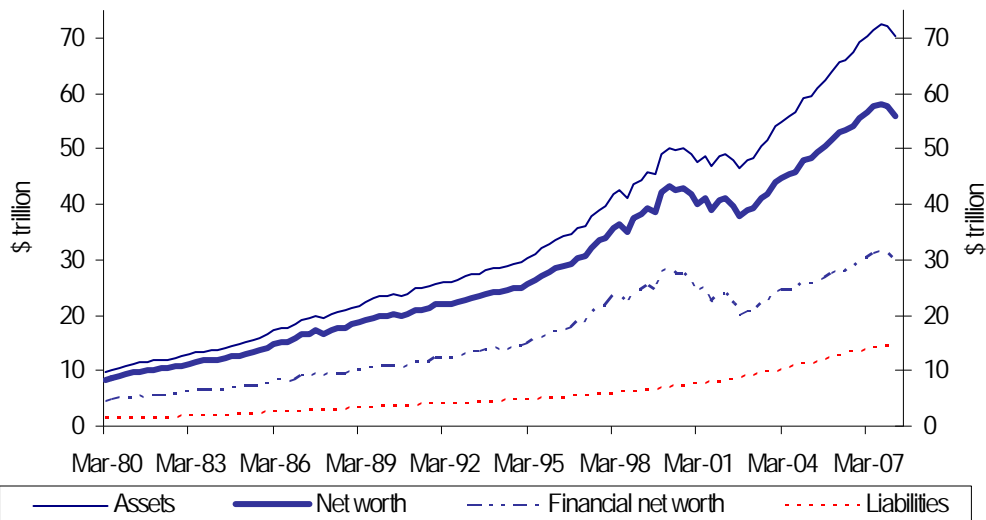
U.S. Personal Savings Rate (last obs. May 2008)



Source: Haver; Bear, Stearns & Co. Inc.

- Is the actual household savings rate low? No. The U.S. household sector has been saving a lot, as shown by the huge growth in financial net worth over the decades. Until the fourth quarter, the household sector has been adding rapidly to both financial assets and housing, and getting appreciation from them over time. Only the Commerce Department's "personal savings rate" is low. It uses a narrow measure of income and a broad measure of consumption, so it doesn't present a meaningful view of savings. Many people need even more liquid savings to prepare for retirement, economic downturns and asset price declines, but the immediate issue in the outlook is whether low savings will constrain consumption – we think not.

Household Balance Sheet (last obs Q1 2008)



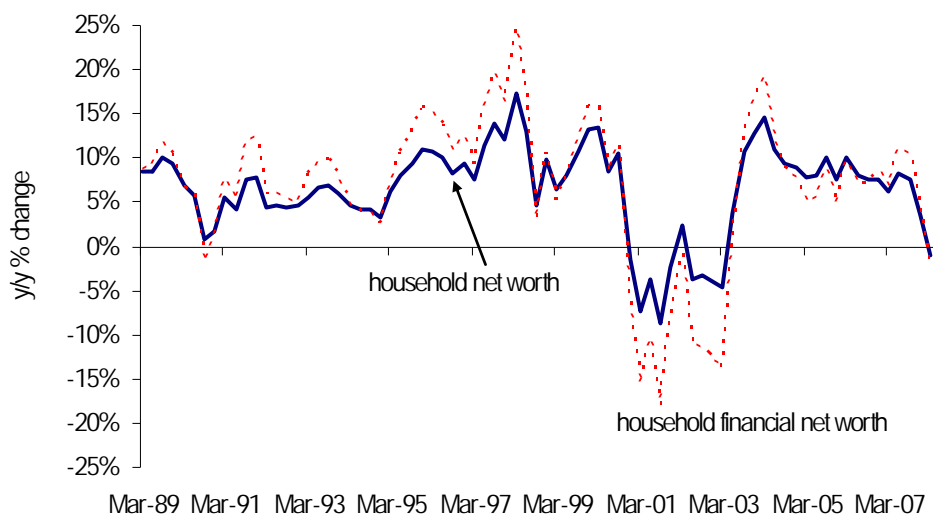
Source: Haver; Encima Global

How else can savings be measured? Conceptually, it would be useful to think in terms of "risk-adjusted savings." This would give value to the security of savings, not just the magnitude. For example, houses and stocks are less secure in the short term than a bank account, so they could be discounted somewhat. Also, floating rate debt is more risky than fixed rate debt, so it would subtract more from risk-adjusted savings. We don't have a measure reflecting this concept.

- The Fed shows \$736 billion net acquisitions of financial assets in the four quarters through March, one measure of the flow of new savings. This indicates a four-quarter savings rate of 7.1% of disposable income. In contrast, "personal savings" (simply disposable income minus outlays) was \$38.8 billion in the same period, 0.4% of disposable income (low because it doesn't measure additions to savings or the amount of savings, but instead arbitrarily subtracts two unconnected numbers – personal income not counting gains and a broad measure of personal outlays.)
- Two other measures of savings are now showing declines, reflecting the weakness in equities and house prices. However, unless the economic downturn is unusually long and deep, we expect the high levels of U.S. household savings to remain a sturdy, not fragile, factor in the economic outlook. Household net worth stood at \$56 trillion in March, down 1% from March 2007. Financial net worth (financial assets minus all liabilities) slipped to \$29.6 trillion in March from its \$31.5 trillion record in September, down 2.2% from March 2007. **This still leaves the U.S. with more net household financial savings than the rest of the world combined.** By this IMF measure of savings, Japan had \$9.4 trillion (2007 Q3),

the UK \$5.1T (2007 Q3), Germany \$3.8T (end 2006), and France \$3.1T (end 2006). A broader measure of household savings that included tangible assets (e.g. houses and autos) would be even more favorable to the U.S.

Y/Y Percent Change in Household Savings/Net Worth (last obs. Q1 2008)



Source: Haver; Bear, Stearns & Co. Inc.

Whatever the savings rate is, hasn't it gone down? It's generally stayed high and steady, though it savings declined in the last two quarters. Since the reported personal savings rate is low now and was higher in the past, it gives the impression that the U.S. savings rate has gone down a lot. However, the official personal savings rate is being pushed down by the gains taking place in the economy, which are not counted in personal income or GDP. As more of the economy is oriented toward producing longer-term gains rather than current output, the wedge between the personal savings rate and actual savings increases.

Will the reported personal savings rate go back up in the long run? Probably not, at least not sustained at previous levels. An increasing portion of U.S. economic energy is aimed at producing gains (which are excluded from the savings rate) rather than ordinary income. This is a logical and probably permanent shift as society becomes more affluent and more dependent on education, ideas, innovation, small businesses and entrepreneurial activity, none of which is fully counted in savings. In addition, demographics (and low interest rates) are likely to hold down the personal savings rate as people invest for the long run – for capital gains (not counted in savings) rather than current income – in preparation for retirement. These negative factors in the official savings rate will probably outweigh the factors which may tend to increase the personal savings rate: higher interest rates will cause some increase (people are being paid more to save rather than consume); a recession or consumer retrenchment might slow consumption more than income for a while, pushing up the savings rate. But as long as the U.S. is a confident society investing for future growth, the **“personal savings rate” as currently presented will probably remain low or negative even as actual savings grows to new records.**

Most Recent Fed Data

The first quarter flow of funds data from the Federal Reserve (released in June) showed a decline in household savings both in terms of financial net worth and total net worth.

- In the first quarter of 2008, U.S. household net worth slipped to \$56.0T from \$57.7T in the third quarter. Household liabilities rose to \$14.5T.
- Household liquid assets (deposits, credit market instruments, equities, mutual funds) totaled \$21.1T, near the record \$22.2T in the third quarter.

Selected Components of U.S. Household Balance Sheet

	2008 Q1 (\$ trill)	2007 Q4 (\$ trill)	Yr/Yr % chg 2008 Q1	Yr/Yr % chg 2007 Q1	Yr/Yr % chg 2006 Q1
Total assets	\$70.5	\$72.1	0.4%	6.8%	10.3%
Tangible assets	\$26.4	\$26.7	0.4%	5.6%	10.4%
Real Estate	\$22.1	\$22.4	-0.4%	5.9%	11.7%
Other tangible assets	\$4.3	\$4.3	4.3%	4.0%	4.4%
Financial assets	\$44.1	\$45.4	0.5%	7.6%	10.3%
Checkable deposits & money funds	\$1.6	\$1.5	17.5%	13.0%	-2.1%
Time and savings deposits	\$6.0	\$5.9	7.3%	9.9%	10.8%
Credit market instruments	\$3.9	\$4.1	4.7%	3.8%	13.2%
Equities (direct)	\$4.9	\$5.5	-18.5%	0.7%	4.6%
Mutual funds	\$4.7	\$5.1	-0.4%	14.3%	19.3%
Pension reserves/life insurance	\$13.3	\$14.0	-1.7%	6.6%	10.2%
Equity in unincorporated business	\$7.9	\$7.9	5.7%	10.0%	11.6%
Other financial assets	\$1.7	\$1.6	25.4%	11.0%	7.3%
Total Liabilities	\$14.5	\$14.4	6.4%	9.0%	11.4%
Mortgages	\$10.6	\$10.5	5.5%	9.6%	13.9%
Credit card	\$1.0	\$0.9	7.8%	7.0%	3.2%
Nonrevolving consumer credit	\$1.6	\$1.6	4.9%	3.9%	3.9%
Other	\$1.4	\$1.3	14.7%	12.1%	7.4%
Net worth	\$56.0	\$57.7	-1.0%	6.3%	10.1%
Financial net worth (financial assets minus total liabilities)	\$29.6	\$31.0	-2.2%	6.9%	9.8%

Source: Haver, Bear, Stearns & Co. Inc.

Notes

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