Market Insight

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Banking on the Consumer: Spending More, Saving Less

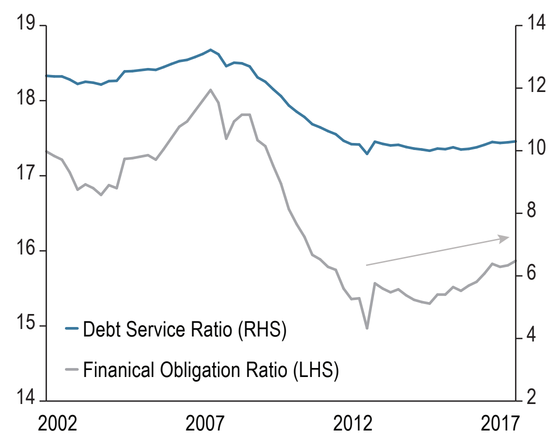
Introduction

As the current economic cycle continues to extend and markets start to exhibit higher volatility , it is important to periodically check the state of the consumers and the health of consumer balance sheets — since consumer spending accounts for ~70% of U.S. GDP. In a previous Market Insight, “How Bankable is the U.S. Consumer?” (August 2016), we argued that consumer balance sheets had greatly improved since the financial crisis of 2008. We noted the crisis era had induced a behavioral shift among consumers, who despite the recovery remained cautious towards borrowing and spending. The Insight argued that consumer caution might restrict the pace, but quite likely would extend the length of the economic cycle. We also argued that the observed greater willingness to use revolving credit suggested spending might eventually increase, resulting in a faster pace of expansion.

Currently, we are in the ninth consecutive year of economic expansion; 2017 posted a strong pick up in year-over-year growth, and consensus expectation is for this trend to continue in 2018. Consumption is increasing and savings are declining, due to higher household wealth and, to a lesser extent, increasing short-term borrowing. Low interest rates have eased mortgage and auto debt burdens for many consumers. Deferrals and income-based repayment plans have lessened the sting of student loans. By contrast, a spike in apartment rents has created a divide: renter financial obligation burdens are near record highs, whereas homeowner burdens are near record lows. Additionally, low interest rates have boosted asset valuations for wealthy households.

Overall debt to income levels are stable and the total household debt service ratio remains low (Figure 1). The short-term debt-service ratio, past due loans and lending standards are worsening, but current levels or pace of decline do not present a systemic risk such as was observed in the last upswing a decade ago. Despite recent tax reform, however, most financial executives expect credit card and auto loan delinquencies and losses to rise over the next 12 months, which is surprising given the strength of the economy. What’s more, rising volatility in financial markets can dampen confidence, which can cause consumers to cut back spending, which in turn could lead to a slowdown in growth.

Figure 1. Broad Levels of Consumer Indebtedness Remain Low



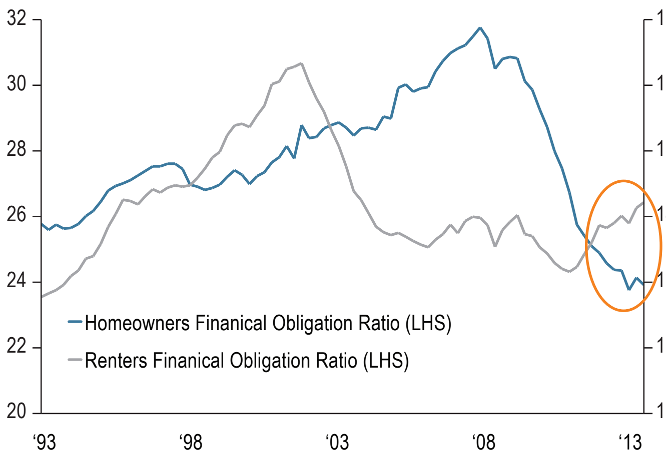
Source: Federal Reserve.
Note: financial obligations ratio includes rent payments on tenant-occupied property, auto lease payments, homeowners’ insurance and property tax payments as a percentage of disposable income. Debt service ratio is the ratio of total household debt payments as a percentage of total disposable income.

Why the Disconnect?

Most analyses of consumer financial vulnerability are overly reliant on aggregate data. Most consumer metrics, e.g., debt-to-income and debt-service-to-income ratios, are effectively income-weighted shares of the U.S. population. Growing income inequality has skewed aggregates, so that they mainly represent higher income households. Aggregates understate the risks to lower income consumers, who are more likely to default. Even if these lower income debtors represent a smaller portion of the U.S. credit market, their losses can create broad problems through tighter lending standards and slower economic activity, which can migrate up to higher-quality borrowers and reduce confidence.

A large portion of lower income consumers rent rather than own homes, and a surge in rental prices is the main driver of worsening financial obligation ratios. The median financial obligation ratio for renters recently stood at a 15-year high of 26%. Driving up this ratio were increased rental demand due to tighter mortgage lending standards, lack of residential investment in low-priced starter homes and a surge in urban home prices. By contrast, the financial obligation ratio for homeowners markedly improved to 13%, due to smaller debt loads and falling mortgage rates (Figure 2).

Figure 2. Homeowner and Renter Financial Obligations Are Diverging



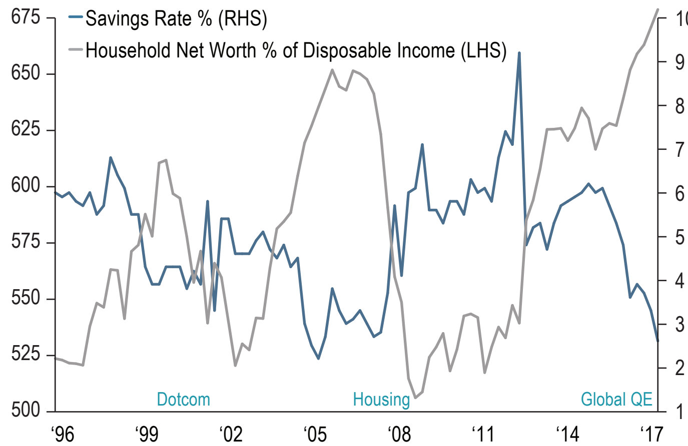
Source: Federal Reserve

Strong Consumption and Low Saving Ratio

Consumer income and expenditure figures showed strong real consumption in the fourth quarter of 2017 — up by 3.8% from the previous quarter and by 2.8% from the previous year. This fourth quarter strength was in part a bounce-back from a devastating hurricane season. Real income growth was weaker — up by 1.6% from the previous quarter and by 2.1% from the previous year. A decline in the savings ratio can explain the gap between strong consumption and somewhat softer income growth. The savings ratio fell to a 12-year low of 2.4% in the fourth quarter of 2017, compared with 3.0% at the end of the third quarter of 2017, 3.9% at the end of the first quarter of 2017, and over 6% in 2015 (Figure 3). The tax reform bill passed in late 2017 started to increase consumers' paychecks in February 2018. A study by UBS estimates that the average annual tax cut for median non-stressed households will be $3,000 in 2019, or $250 per month—about 1.5% of income. For stressed households these numbers are significantly lower: $311 for the year or $26 per month—about 0.8% of income.

Figure 3. U.S. Household Savings are Declining as Net Worth Increases

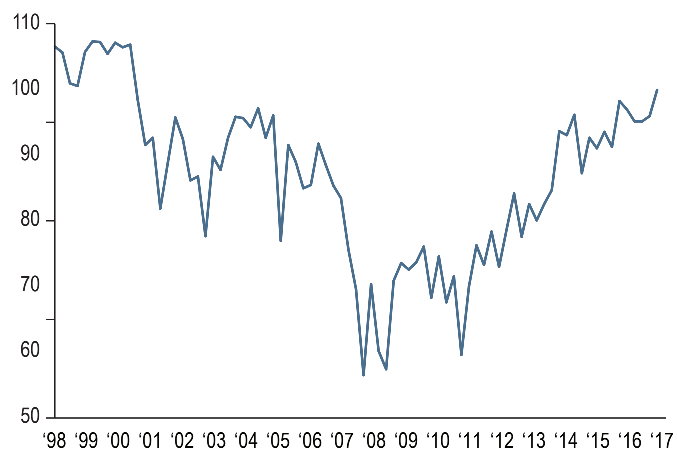
U.S. Household Savings and Net Worth



Source: Federal Reserve

Figure 4. University of Michigan Consumer Sentiment Index

U. of MI Consumer Sentiment



Source: Bloomberg

Is History Repeating Itself?

One factor behind the last two recessions was a correction (increase) in the savings ratio after a period of sharp decline. Is history repeating itself? There are certainly echoes of the past, when rising wealth in relation to income seemed to contribute to a lower savings ratio. The ratio of net wealth to household disposable incomes rose from 617% of personal income in the third quarter of 2015 to 673% in the third quarter of 2017, suggesting that consumers are feeling more comfortable about their finances and choosing to save less. The University of Michigan Consumer

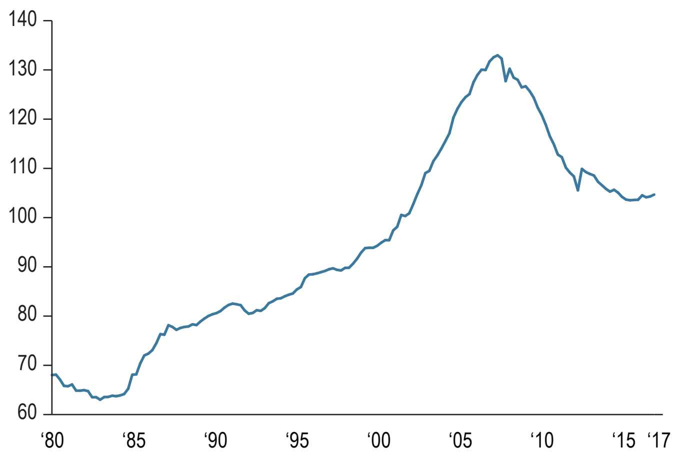
Sentiment Index, a predictor of household spending, has been hitting post-crisis records due to consumers' continued optimism about the state of the U.S. economy. The index is currently at its highest level since 2000 (Figure 4).

Debt Has Been Rising Only at the Same Pace as Income

In general, household debt in relation to disposable income fell after the Great Recession due to higher savings ratios, reduced credit availability, and household debt write-downs. It declined from 132% of disposable income in the fourth quarter of 2007 to 103% in the fourth quarter of 2015 (Figure 5). According to the Federal Reserve, the ratio was still only 104% in the third quarter of 2017, showing that debt has only been rising at the same pace as income in recent years.

Figure 5. Household Debt has fallen since the Great Recession

Household Debt to Disposable Income %

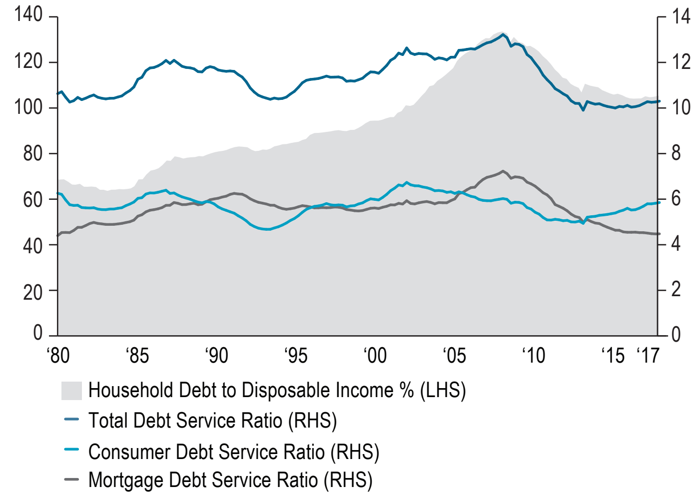


Source: Bloomberg

No Big Change in Debt Service Ratio

Aggregate debt service ratios have begun to rise in recent years. The increase is due to greater shorter-term consumer credit. Shorter-term consumer credit approached its peak levels in the mid-2000s (Figure 6). The latest total debt ratio of 10.3% is lower than the peak of 13.4% in the fourth quarter of 2007. Consumer debt-service ratio, currently at 5.8%, is close to the 6.0% pre-crisis level in the fourth quarter of 2007. However, its lowest value was around 5% in 2012. Therefore, there was not a meaningful change over the years.

Figure 6. U.S. Household Debt Service Ratios



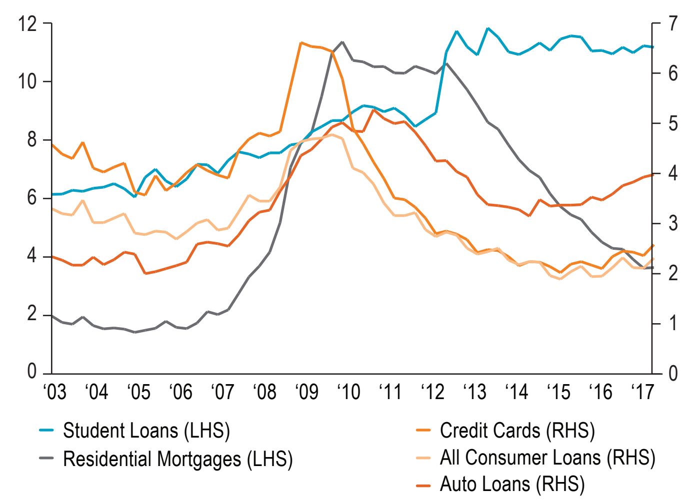
Source: Federal Reserve

The Consumer Credit Delinquency Rate is Normalizing

The numbers of auto and credit card loans that are past due is rising. The peak delinquency rate for credit cards was 6.8% in the second quarter of 2009 (Figure 6). Delinquencies hit a trough of 2.1% in the second quarter of 2015 and subsequently climbed to 2.5% as of the third quarter of 2017. This is not only below the previous peak but also below the trough in the mid-2000s. The relatively higher level of delinquent student debt is worsening slightly, but not dramatically. Due to worsening credit experiences, the Senior Loan Officers Report (SLO) shows a tightening of credit standards, particularly for auto loans (Figure 7).

Figure 7. Delinquency Rates Are Rising for Auto Loans and Credit Cards, Declining for Mortgages

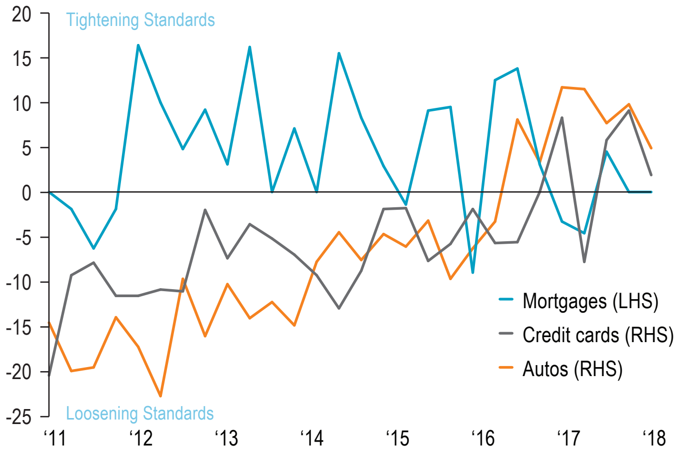
Delinquency Rates %



Source: Bloomberg

Figure 8. Credit Standards Have Been Tightening

Senior Loan Officers' Report



Source: Federal Reserve

Consumer Credit Will Continue to Expand

While credit card debt has been rising quickly (Figure 9), resulting in higher delinquencies and charge-offs, the increase has been modest. Concerns that credit could adversely affect the consumer in the near term may be premature because unsecured credit card debt problems have mild implications for housing demand, house prices, and owners' equity compared with mortgage debt before and during the Great Recession. With strong consumer confidence, reduced unemployment, and faster growth in wages, consumer credit will likely continue to expand at a good clip, while the increase in wealth may continue to result in a decrease in the savings ratio.

Figure 9. Credit Card Debt per Household

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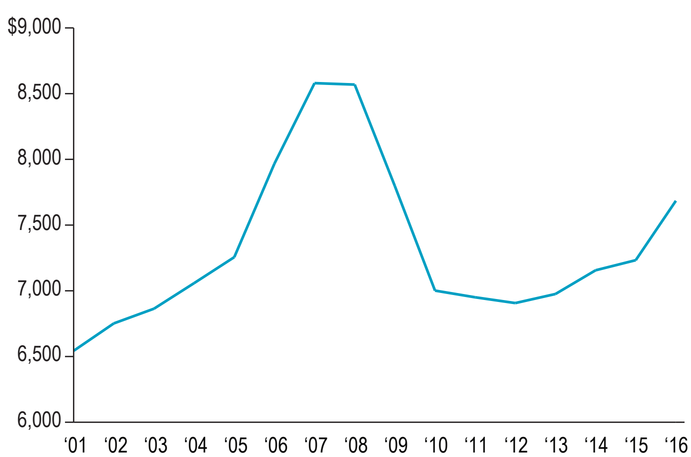
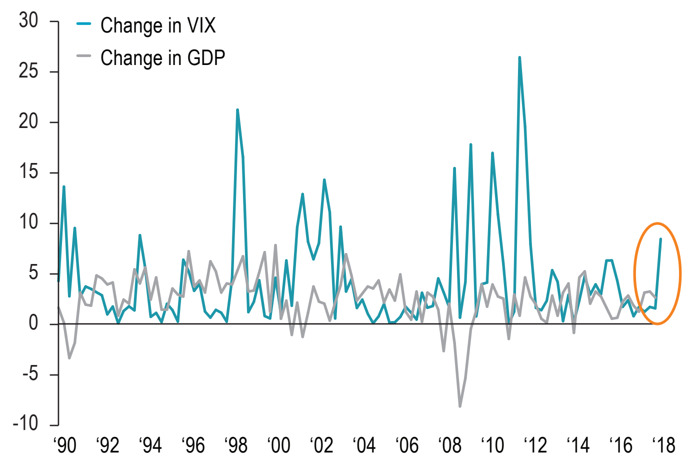


Source: Bloomberg

However, at some point when asset prices correct materially for a sustained period, the wealth effect could go into reverse gear, and if employment falls, consumer credit burdens could become too large for some, particularly lower income households. The volatility shocks in 1998, 2008 and 2011 foreshadowed slower growth, or even contraction, about one or two quarters later. Rising volatility in financial markets (Figure 10) can affect confidence, causing companies to delay expansion or other plans and prompting consumers to cut back on spending. After all, if markets are going haywire it is hard to know whether the funding you need to pay for such things will be available and at what cost.

Figure 10. Market Volatility

VIX Shocks and GDP



Source: Bloomberg

Even after the recent market correction, this does not appear to be an immediate prospect, but when the sustained correction comes, significantly weaker consumer spending likely will be a key feature of the evolution of the economy. For now, though, overall consumer dynamics remain robust. In this environment, observers are closely watching central bank actions; how the market interprets those actions will be of paramount importance for the evolution of the cycle going forward.

Investment Implications

Assets geared to strong household balance sheets are safer in the near term. This includes companies exposed to high income or high credit score consumers and lenders with high-quality loan books. Investors should be more cautious of companies and assets exposed to low-income or low-credit score consumers, where stress could first emerge. Subprime consumers, auto lenders and private-label credit card issuers also may be at risk.

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