Ameriprise Financial

Economic Views Brief

Russell T. Price, CFA®, Senior Economist
February 20, 2020

CONSUMERS ARE IN GOOD FINANCIAL HEALTH, IN OUR VIEW.

- Consumer debts rose in 2019. So did employment, income, population, personal savings, the stock market, home values, the economy and practically every other fundamental economic measure.
- Recent reports showing a large increase in consumer debt last year have understandably fostered concerns that consumers may once again be outspending their means. In our view, a full analysis of the situation suggests the opposite.
- Debt levels normally rise during periods of economic expansion. While consumer debt increased last year, consumer income grew even more.
- Consumer financial health is critical to economic prospects. Given its importance, we believe it's imperative to examine the situation from multiple angles and in a logical manner before passing judgement. That's our objective with this report, and we believe the evidence shows consumers to be in sound financial health.

Despite some headlines suggesting otherwise, consumer finances are in strong shape, in our view. Recent data from the New York Federal Reserve Bank showed total consumer debt as having risen by $601 billion in 2019, its largest increase since 2007. Such figures can seem worrisome, but they are meaningless unless considered in the proper context; and in the current situation, context matters greatly.

It's perfectly normal for the aggregate dollar value of debt to increase during periods of economic expansion. Over time, growing populations need homes, automobiles and other goods, which naturally lends itself to a higher dollar value of borrowing. Debt doesn't necessary become problematic until it grows faster than household finances can support. But that does not seem to be the current situation. In this short report we look at consumer finances from a variety of angles to get a better sense of the true picture.

The chart at right shows aggregate levels of consumer income (via the Commerce Department) and debt (via the Fed). As seen, in the years prior to the 2008 /2009 recession, debt levels grew much faster than income, with debt eventually matching income levels in 2007. This pattern is typical for economic expansions in the modern era. However, in recent years, consumer debts have grown much more slowly than income.

A variety of factors appear responsible. We believe consumers have been much more conservative with their finances due to the lessons learned from the Great Recession, lenders have been more prudent with their lending, and an aging population has likely reduced loan demand.

Overall, total consumer debt grew by $610 billion in 2019 while consumer income grew by $710 billion.

Consumer income relative to consumer debt.

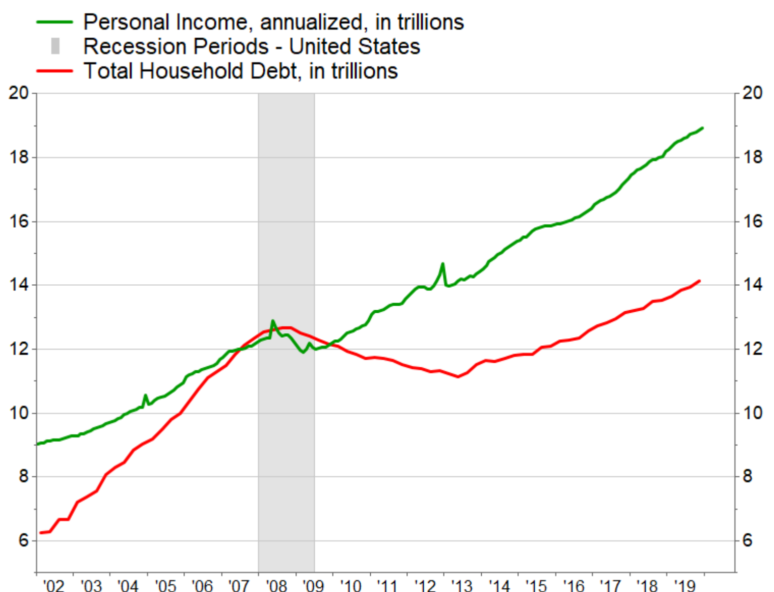

Chart source: FactSet

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Mortgage debt increased at a measured pace: About two-thirds (68%) of the increase in household debt last year was related to housing. New and existing home sales accelerated in the second half of the year and mortgage refinancing surged amid a material drop in interest rates. In the second half of 2019, the 30-year fixed mortgage rate averaged 3.68% nationwide, according to the Mortgage Bankers Association, a full percentage point below its level a year earlier (+4.68%). As a result, housing related debt (mortgages plus a modest decline in home equity line of credit balances) grew by $410 billion. Though this is a huge dollar amount, it represents what we see as a manageable 4.4% yr./yr. increase; a far cry from the 10% to 15% annual increases seen during the "housing bubble" years of 2004 to 2007.

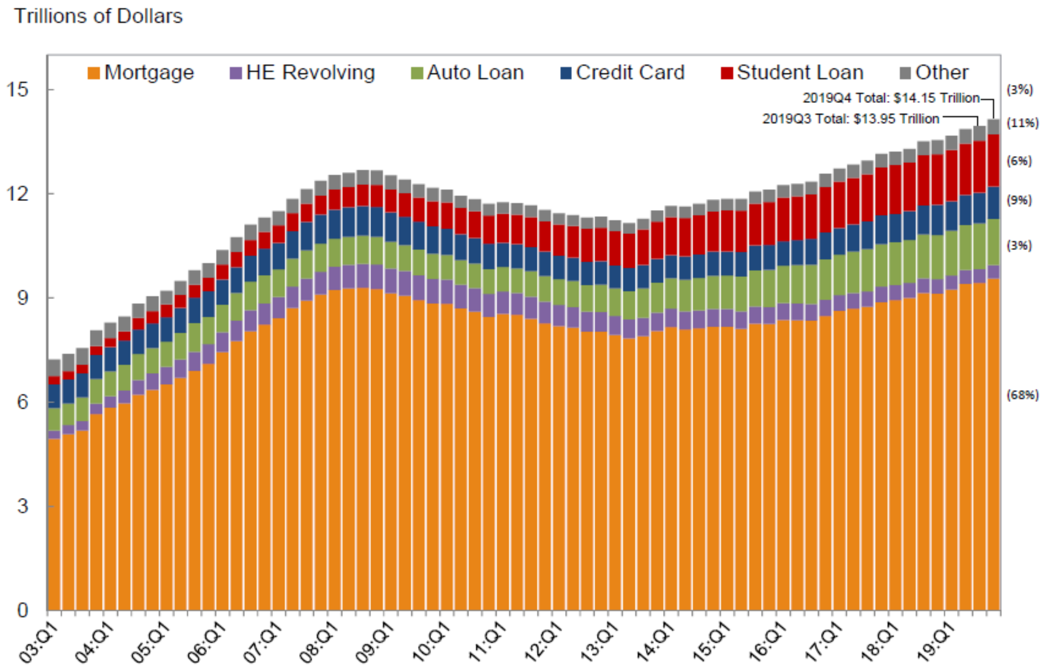

Chart Source: New York Fed Consumer Credit Panel /Equifax

Credit card debt also increased in 2019, but it remains at manageable levels, in our view. Consumers ended 2019 with total credit card debt of $927 billion, according to the New York Fed. This represented a year-over-year increase of $57 billion, or +6.6%. Again, such numbers provide no perspective without the context of affordability.

As seen in the chart at right, credit card debt relative to consumer disposable income (i.e., largely after-tax income) declined precipitously following the Great Recession, and the ratio has maintained these lower percentages since.

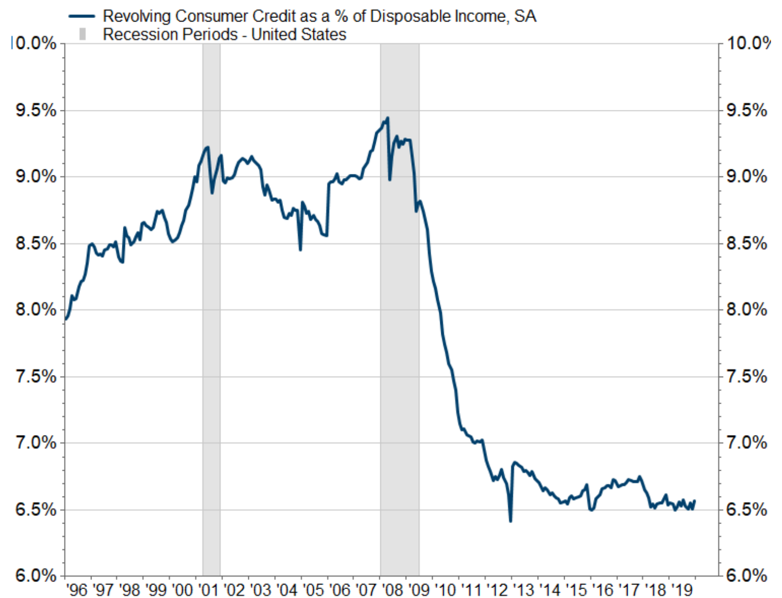

Chart Source: FactSet

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Contrary to historical norms, the personal savings rate has also been rising through most of the current expansion. And consumers in general appear to be doing a good job of keeping up with their payments.

As seen in the chart at left below, the personal savings rate has steadily increased over the last decade. The savings rate, as published by the Commerce Department, simply represents the percentage of disposable income not spent. During prior expansions, the savings rate has typically declined as consumer spending has grown faster than consumer income. For 2019, the personal savings rate was +8.0%, a level not seen on a consistent basis in the U.S. since the early 1990s. It's good that consumers are not over-leveraging themselves, but we wouldn't necessarily like to see this number move much higher as a lack of consumption can bring about economic problems of its own.

Separately, as seen in the chart at right below, consumers are also doing a good job of keeping up with their bills. According to the Federal Reserve, approximately 2.3% of all consumer loans are currently 30-days or more past due. Although the current rate is not as low as it was a few years ago, it's still very low relative to its historic averages, and it remains well below its prior all-time lows as registered in 1994 and 2005. Loan delinquency rates tend to rise later in expansion periods as consumers grow increasingly "stretched." In our view, recent trends show little evidence of that such, at least not to problematic levels.

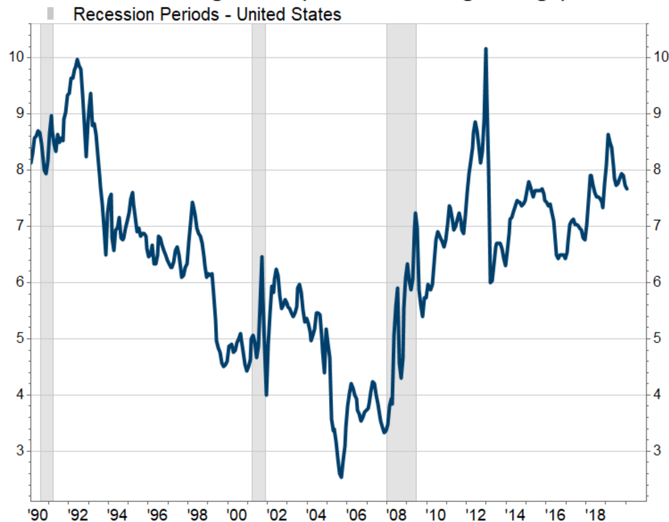

Chart Source: FactSet

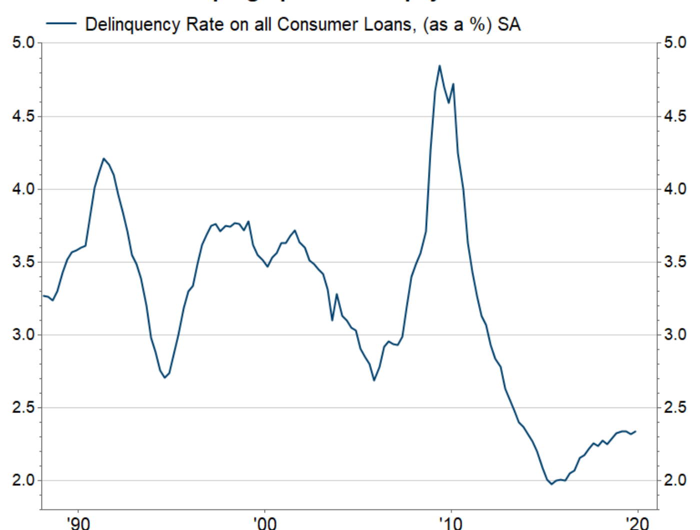

Chart Source: FactSet

Finally, the Federal Reserve's Financial Obligation Ratio (FOR) has long been our favorite measure of overall consumer financial health. Simply and logically, the ratio looks at required payments consumers have to make, relative to their income. In other words, not just the dollar value of debt, but whether consumers can afford the payments required of them (from an aggregate perspective).

Obligations considered in the ratio include mortgage or rent payments, property taxes and property insurance, automobile payments, and required payments on credit cards, student loans and personal loans.

As seen in the chart at right, the ratio currently portrays consumer obligations to be in near-record health.

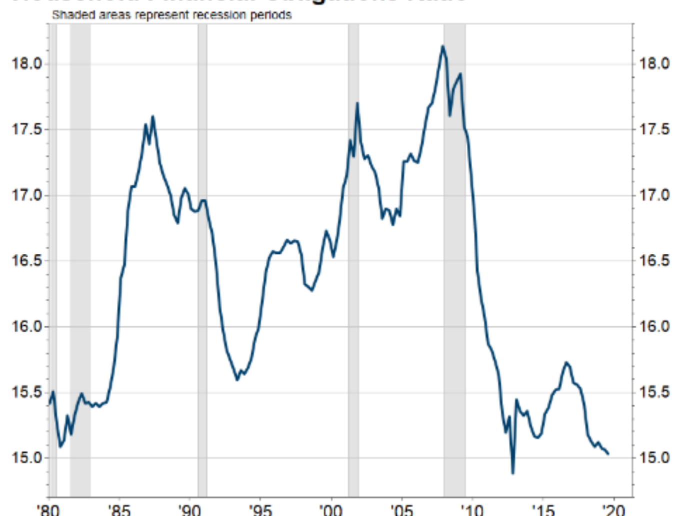

Chart Source: FactSet

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In fact, the ratio has only been lower in one other period in its 40-year history (Q4-2012). We believe it's also telling that the current rate is below that of levels seen in the early 1980's, a time when extraordinarily high interest rates made financing of any sort very expensive and very undesirable. Over the three-year period 1980 through 1982, the rate on a 30-year fixed mortgage averaged 15.5%, based on data from the Mortgage Bankers Association. *Note that the chart on the prior page is through Q3-2019. The ratio for Q4 is scheduled for release in March.*

Summary: No other fundamental factor is more important to intermediate-term economic prospects than consumer financial health. Consumers account for the vast majority of U.S. economic activity, 70% according to the Commerce Department, thus they are typically the primary determinant of its direction.

Historically, the life and death of an economic expansion has usually followed a familiar pattern directly related to consumer leverage. As consumer confidence rises, they spend faster than they earn, resulting in higher and higher debt burdens. Over time, this leads the economy to "overheat" as represented by rising inflation pressures. At this point, the Federal Reserve steps-in to cool things down via higher interest rates. The combination of elevated household financial burdens and rising interest costs eventually leading consumers to pull-back on their spending. Businesses follow the cue of consumers by reducing their spending as well, and a recession is born.

Despite the fact that we are more than 10 years into the current economic expansion and consumer confidence levels reside near historical highs, there's very little evidence of consumer overspending. Inflation pressures have thus remained well contained, leaving little tangible reason for the Federal Reserve to raise interest rates materially. Neither do we see evidence of economically dangerous imbalances growing in the broader economy, at this time.

Fear sells: Aside from the strict economic implications of consumer debt, we also felt a need to produce this report to counter some of the perceptions created by the New York Fed's recent release. Unfortunately, fear sells. As such, even headlines from reputable news sources can sometimes be tinged with a note of danger, beyond that supported by actual underlying circumstances.

Our natural human instinct to be on watch for potential threats has served us well for millennia. But in today's world, financial threats have replaced lions, tigers and bears in the hierarchy of our vulnerabilities. As such, we don't see too many news headlines that read: "Things look O.K." No one buys that newspaper, or in today's terms, clicks on that story. However, at the end of the day, being overly cautious can be as detrimental to achieving your financial objectives as taking on too much risk.

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