

US household finances – adjusting to the new reality

June 2009

- A change in financial circumstances is leading households to save more out of their income than they have done in the past ten years, and to use these savings to pay down debt. This trend is likely to continue for a number of years as households adjust their balance sheets to a new reality. As a result, consumer spending growth will be weak over the next few years (see forthcoming paper).
- Since its peak in Q3 2007, household net worth has fallen by \$13.9 trillion to \$50.4 trillion (Chart 1), a near 20% fall, driven by falling house prices and a declining stock market. With the stock market showing signs of stabilisation, the pace of decline in household wealth is likely to slow. But the decline in wealth experienced so far is already enormous.
- As well as a hit to wealth, US households have also seen their wage income decline. Due to falling employment levels and weak wage growth, total employee compensation fell for a second consecutive quarter in Q1.

Household net worth falling

In the first quarter of this year, household net worth fell by \$1.3 trillion, significantly lower than the \$4.9 trillion fall in Q4, but still an enormous hit to wealth. The value of both households' total assets and total debt is falling (as households repay debt). But the value of assets is falling more quickly than the value of debt – therefore household *net* worth is declining. The fall in household asset values is being driven principally by declining house prices and falling stock markets. At the end of Q1 2009, household real estate assets amounted to \$17.9 trillion and financial assets \$40.3 trillion, compared to \$21.1 trillion and \$50.5 trillion, respectively at the end of Q3 2007.

Decline in wealth likely to continue, but pace may slow

In Q1 2009, declines in house prices averaged over 2% per month on the Case-Shiller 20 index (Chart 2), and the value of household real estate assets fell by \$450 billion. As a result of the fall in house prices experienced so far, Americans now own less of their houses than they ever did. Owners' equity in housing has fallen well below 50% to an all-time low of 41.4%. As recently as Q3 2007, it was above 50%, and the long-term average is 65% (Chart 3).

Though some moderation in the pace of decline is possible, house prices are likely to continue falling the rest of this year. We estimate that if house prices were to decline by another 10% on the Case-Shiller 20 index by the end of 2009 (relative to end Q1 09), household real estate wealth will decline by a further \$1.3 trillion. If house prices were to decline by another 15% on the Case-Shiller 20 index from their levels at the end of Q1, we estimate this would subtract \$2 trillion off household real estate wealth by the end of the year.

Chart 1: Household net worth (\$Bn)

Source: Thomson Datastream

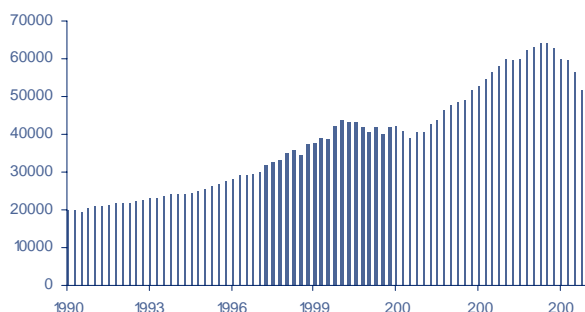
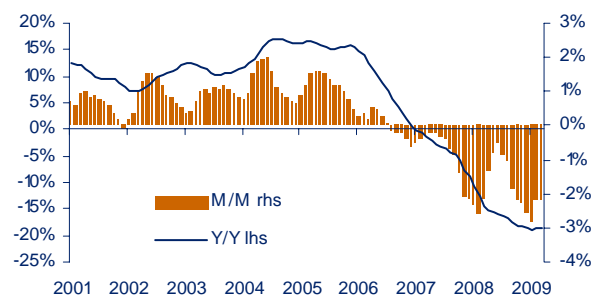


Chart 2: House Prices – Case-Shiller 20 Index

Source: Thomson Datastream



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Worst of equity market impact on wealth may be over

At the end of Q1, household equity assets (including mutual fund holdings) were \$8.5 trillion, down from \$14.8 trillion at their peak in Q2 2007. In Q4 alone, the declining stock market wiped at least \$2.3 trillion off household financial wealth and another \$460bn in Q1. However, stock markets have recovered somewhat in Q2 2009 (Chart 4). The S&P 500 index stands currently around 900, and has risen 32% since it hit a 12-year low of 679 on the 9th March this year. At current levels, we estimate that household equity assets are at least \$1 trillion higher relative to the end of Q1. Therefore, as long as the stock market does not retest its lows, the pace of decline in household wealth could ease even if house prices continue to fall. For example, if house prices decline by a further 10% on the Case-Shiller index by the end of the year, but stock markets remain at current levels, we estimate that total household wealth will ‘only’ decline by a further \$300 billion this year.

Chart 3: Owners equity in housing stock (%)

Source: Thomson Datastream

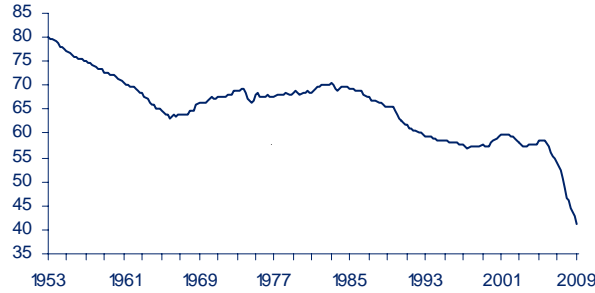


Chart 4: S&P 500 Index

Source: Thomson Datastream



Household income also under pressure

As well as the significant hit to wealth, households are also experiencing a hit to income. More than five million jobs have been lost in the past twelve months (Chart 5), with employment down 4% compared to a year ago (Chart 6). A much weaker labour market is also putting downward pressure on wage growth (chart 7). As a result, total employee compensation in the US economy fell for a second consecutive quarter and is virtually unchanged compared to a year ago (Chart 8).

Chart 5: Monthly change in non-farm payrolls (000s)

Source: Thomson Datastream

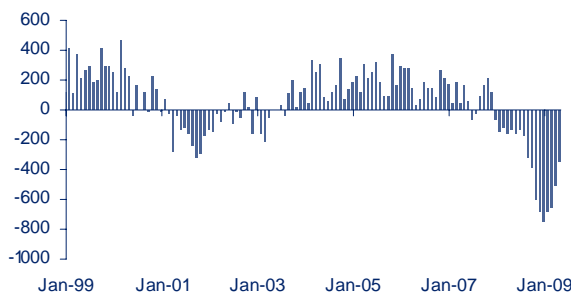


Chart 6: Total employment (% y/y)

Source: Thomson Datastream

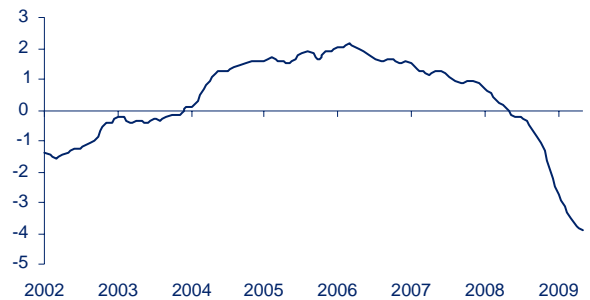


Chart 7: Unemployment and earnings growth

Source: Thomson Datastream

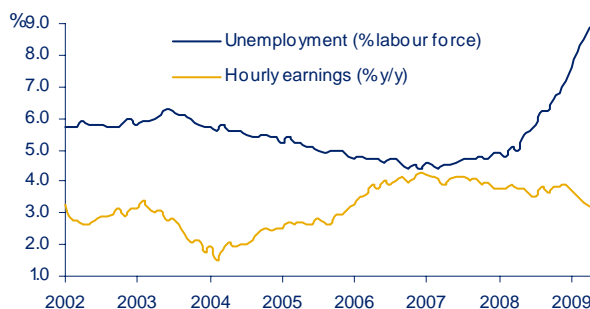
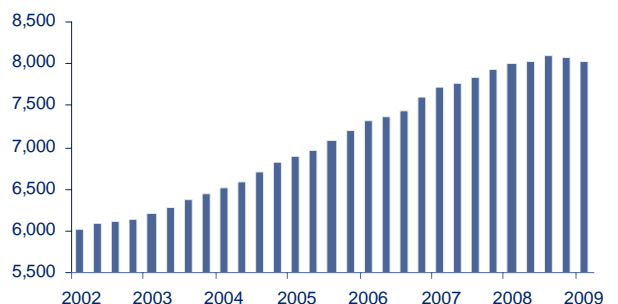


Chart 8: Total employee compensation (quarterly annualised, \$ Bn)

Source: Thomson Datastream



Households saving more and paying down debt

Despite falling income levels, households are saving more than they have done in 10 years, as they pay down debt and seek to replenish their depleting wealth. The savings ratio increased to 4% of disposable income in 2009 Q1, from below 1% between 2005 and 2007 (chart 9). The long-term average for the savings ratio is 6.8% and it is likely to at least head back to that level in the next few quarters.

Households are using part of their increased savings to pay down debt. Outstanding consumer credit debt has fallen by \$75bn (3% of outstanding balances) over the past quarter and outstanding mortgage debt by \$109 bn (1% of outstanding balances) over the past year. As a result, the debt-to-income ratio is falling (chart 10), though it remains well above its long-term average of 100% of income, suggesting households will need to continue saving for a number of years to bring down debt to more sustainable levels. As a result consumer spending growth will weak compared to the earlier part of this decade.

There has only been a small increase in deposits held by households in recent quarters (Chart 11), probably because the majority of saving out of income has been used to pay down debt. However, there has been a ‘flight to quality’ behaviour, with households holding an increasing proportion of treasury securities out of total household financial assets (Chart 12).

Chart 9: Savings ratio (% of disposable income)

Source: Thomson Datastream

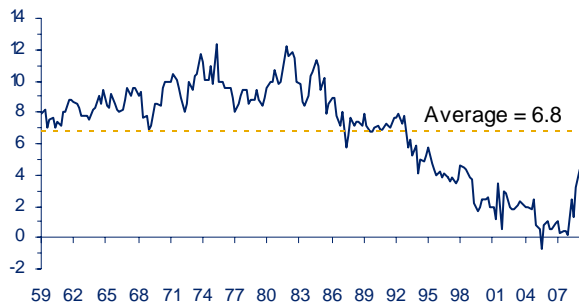


Chart 10: Household debt-to income ratio (%)

Source: Thomson Datastream

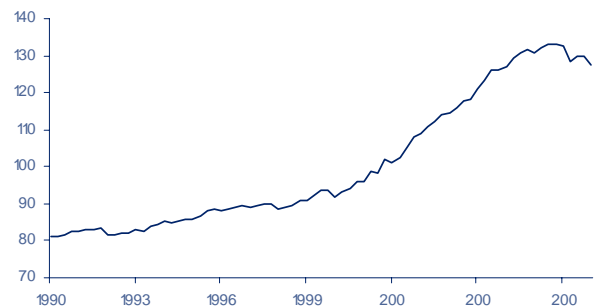


Chart 11: Main household asset values (\$ Bn)

Source: Thomson Datastream

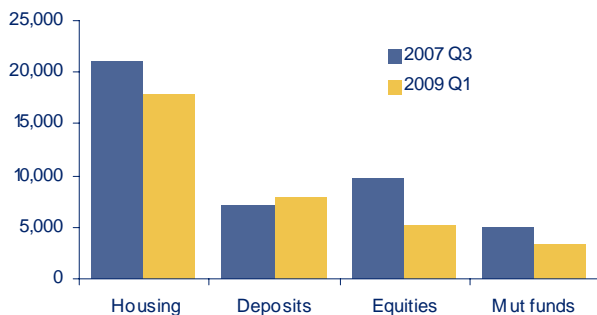


Chart 12: Household treasury holdings as % of total financial assets

Source: Thomson Datastream

