



The Northern Trust Company
Economic Research Department
Positive Economic Commentary

"The economics of what is, rather than what you might like it to be."

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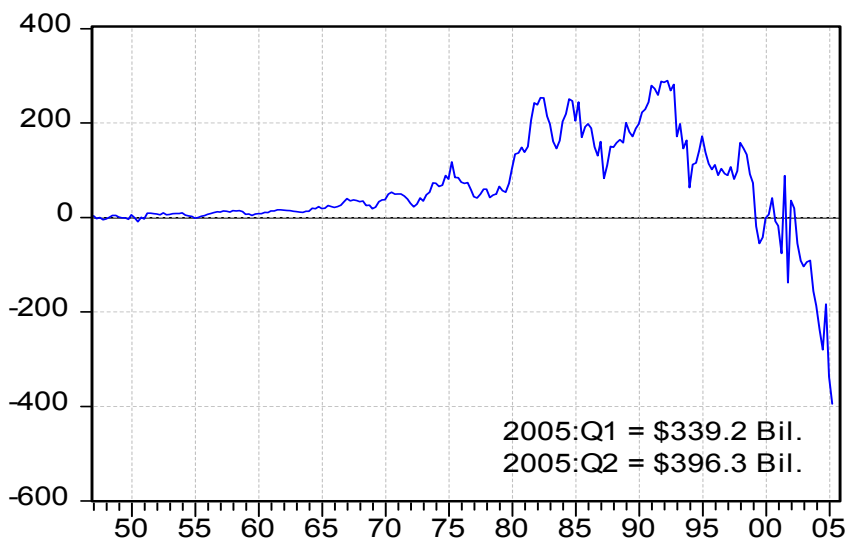
INXS

This is an oddz and endz piece about excesses I perceive in the U.S. economy. The first such excess has to do with household spending. Throughout most of the post-WWII era, U.S. households' expenditures have been less than their after tax income. In other words, households tended to run surpluses. The implication of a household surplus is that households are net *suppliers* of funds to the rest of the economy. The government, at least the federal government, tends to run a deficit as does the nonfinancial corporate sector. So, households historically have been net suppliers of funds to these two sectors. But starting in the late 1990s, households began to run deficits. That is, household expenditures on consumer goods/services and residential investment (new houses, renovations to existing houses and real estate brokerage fees) began to exceed disposable personal income. Households, therefore, are now net *demanders* of funds. Households have changed places with nonfinancial corporations, which now uncharacteristically have become net suppliers of funds. Of course, the government sector continues to run deficits.

Chart 1 shows the post-WWII history of household surpluses and deficits. The advance GDP data imply that households ran a record \$396 billion (saar) deficit in the second quarter of this year. It is likely that the household deficit for 2005 will exceed the federal government deficit. The "twin deficits" are really the household deficit and the government deficit, which, in turn, contribute to the current account deficit. Foreign funders of our twin deficits have to be wondering how McMansions and subsidized prescription benefits for seniors will enable U.S. residents to produce enough goods and services in the future to pay the interest on the foreign debt. Because practically all of the U.S. liabilities owed to foreign investors are denominated in U.S. dollars, do not foreign investors fear that political pressure could be put on the Fed to "print" more U.S. dollars with which to discharge our foreign financial obligations? Evidently not yet or else the greenback would have entered a free fall.

Chart 1

Household Surplus (+) or Deficit (-)*
\$ Bil. SAAR

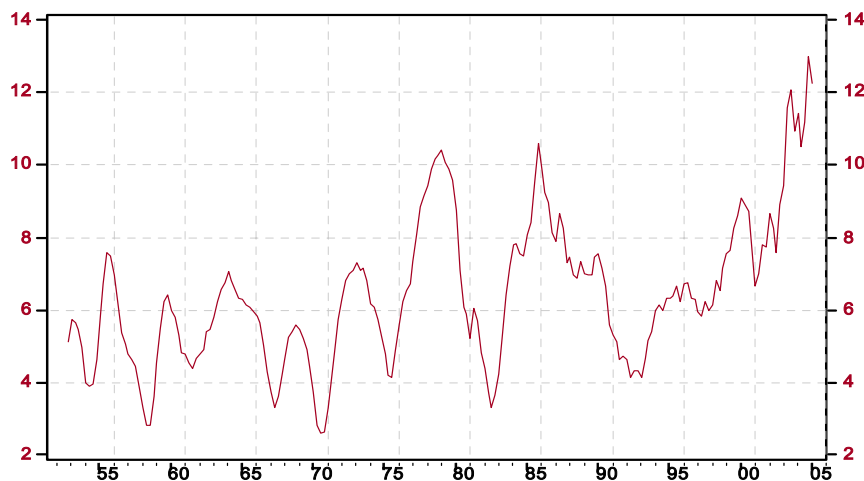


* disposable personal income minus expenditures on consumer goods/services and residential investment

Unlike corporations, households cannot finance deficits by issuing equity in themselves. They either have to sell off assets or increase debt to fund their deficits. Households have certainly taken on a lot of debt in recent years. Chart 2 shows that the increase in their liabilities has moved up to over 12 percent of their after-tax income – a post-WWII record high.

Chart 2

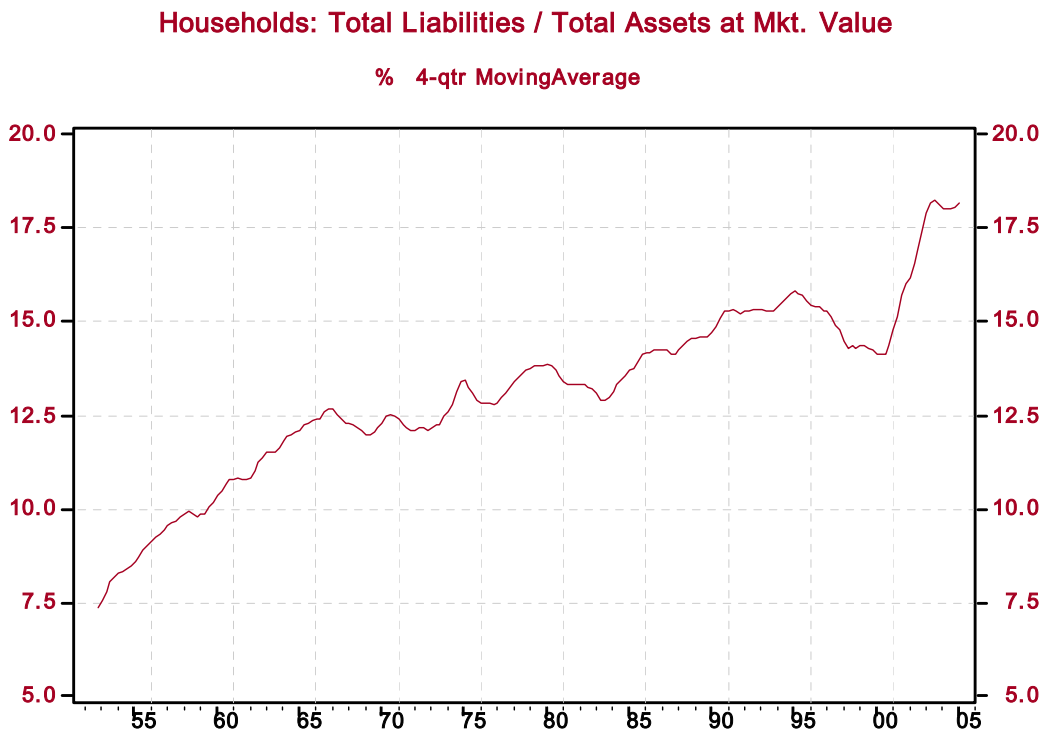
Households: Increase in Liabilities / Disp. Pers. Income
% SAAR 4-qtr MovingAverage



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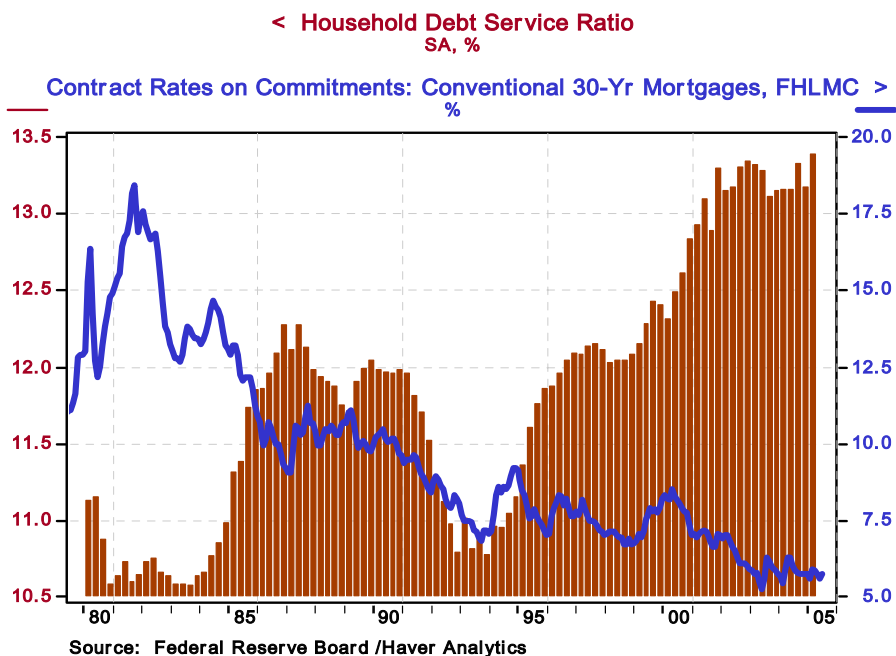
Now, it is often said that the increase in household borrowing is nothing to be concerned about because the value of household assets also has increased significantly in recent years. Yet, if one compares the value of household debt to the market value of household assets – both tangible and financial – one finds that debt has been increasing in value faster than assets. Hence, as is shown in Chart 3, total household liabilities as a percent of total household assets is now at a post-WWII high of over 18 percent.

Chart 3



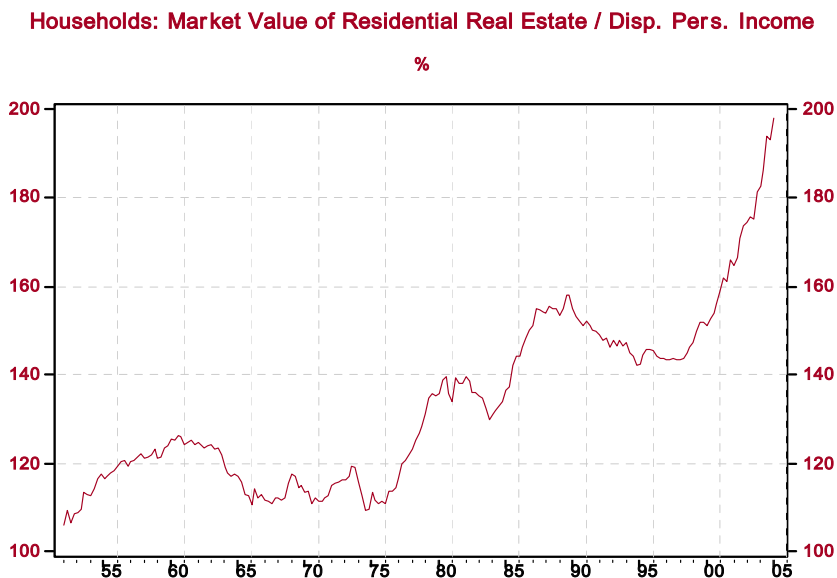
Still others say that all of this accumulated household debt is nothing to be concerned about because servicing it is not a problem given the low level of interest rates. But Chart 4 shows that households' required principal and interest payments as a percent of after-tax income is at a record high 13.4 percent despite the lowest long-term fixed mortgage interest rates in 40 years. In other words, households have been "making it up on volume." With the Fed continuing to push up short-term interest rates and *with credit card issuers being pressured by their regulators to increase minimum monthly payment requirements by borrowers*, households are unlikely to be able to continue their borrow-and-spend activities to the degree they have.

Chart 4



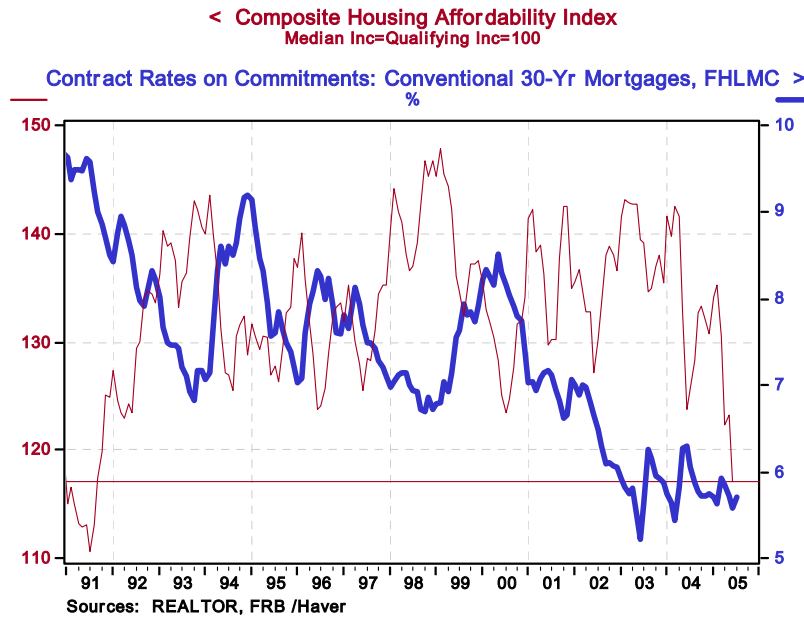
One of the important contributors to recent household deficits is the housing market boom. Let's look at some metrics of excess in this sector. Chart 5 shows that the total market "cap" of residential real estate "owned" by households is a record 198 percent of household after-tax income. The sharp rise in the relative value of residential real estate explains why housing affordability has plunged to 14-year depths despite low mortgage rates (see Chart 6).

Chart 5



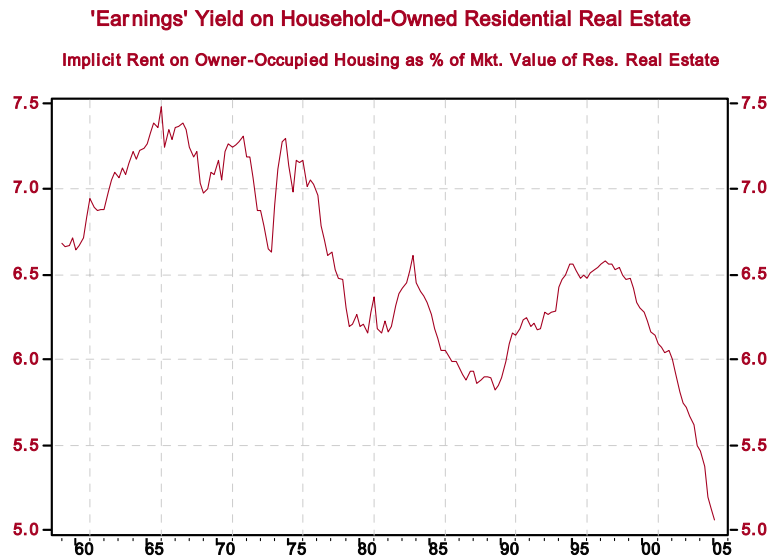
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Chart 6



Residential real estate is taking on a characteristic of dot.com stocks back in the late 1990s – high in price relative to its visible earnings. An “earnings” yield can be calculated for household-owned residential real estate by dividing the Commerce Department’s estimate of the implicit rent on owner-occupied stationary housing (i.e., excluding mobile homes) by the market value of that housing. The history of this housing earnings yield is shown in Chart 7. The earnings yield has fallen to a record low 5.1%. Back in 1965, when Treasury bond yields were at levels comparable to today, the earnings yield on residential real estate was about 7.4%.

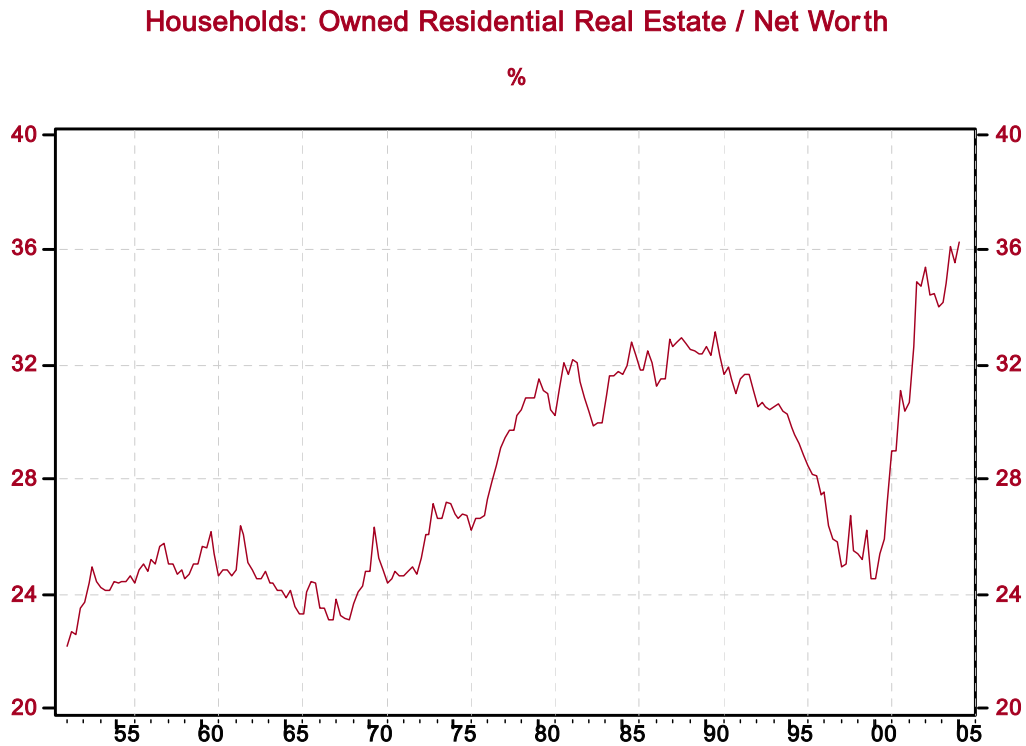
Chart 7



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Housing is similar to the dot.coms of the late 1990s in another respect. Households are making a big bet on housing to fund their retirements just as they bet on the NASDAQ to do for them a few years ago. Chart 8 shows that residential real estate accounts for a record high 36 percent of households' net worth. To whom will Boomers sell when they retire? Their children? I see Boomers becoming strong advocates for the liberalization of our immigration restrictions! I also see a boom in *reverse* mortgage originations in a few years. Kids, don't count on a big inheritance.

Chart 8



Although not a post-WWII high, at 6 percent, nominal residential investment expenditures in relation to nominal GDP is the highest since the 1950s (see Chart 9). Residential investment expenditures include actual value-added construction along with real estate brokers' commissions. What is not included are legal services connected with the purchase and sale of residential real estate, mortgage brokers' commissions and Wall Street's commissions connected with securitization and sales of mortgages to investors. Given that mortgages now represent almost 45% of total domestic nonfinancial debt (see Chart 10) – the largest constituent of nonfinancial debt – adding in the commissions associated with the origination and sales of mortgages might put housing related "value-added" at a record percentage of GDP today.

Chart 9

Nominal Residential Investment Expenditures / Nominal GDP

%

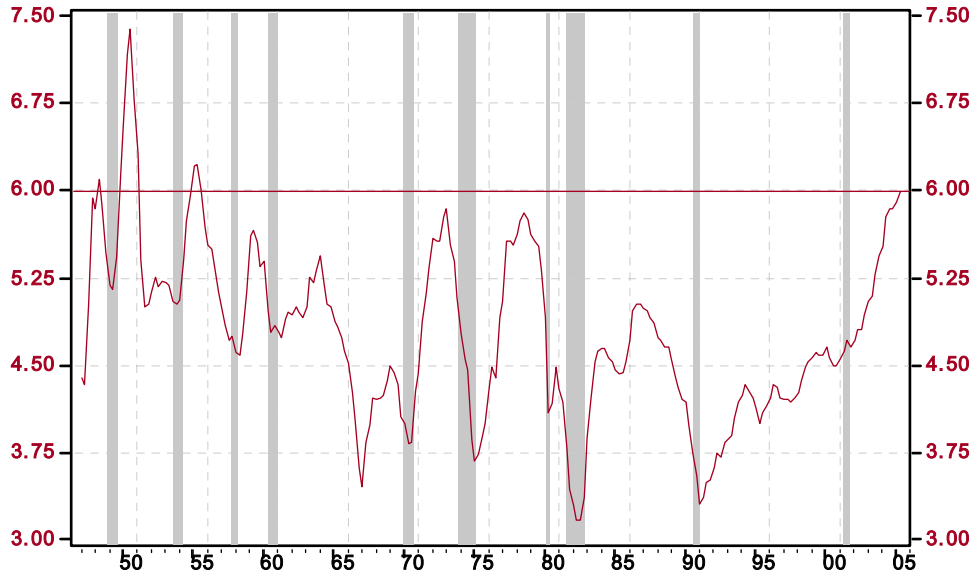
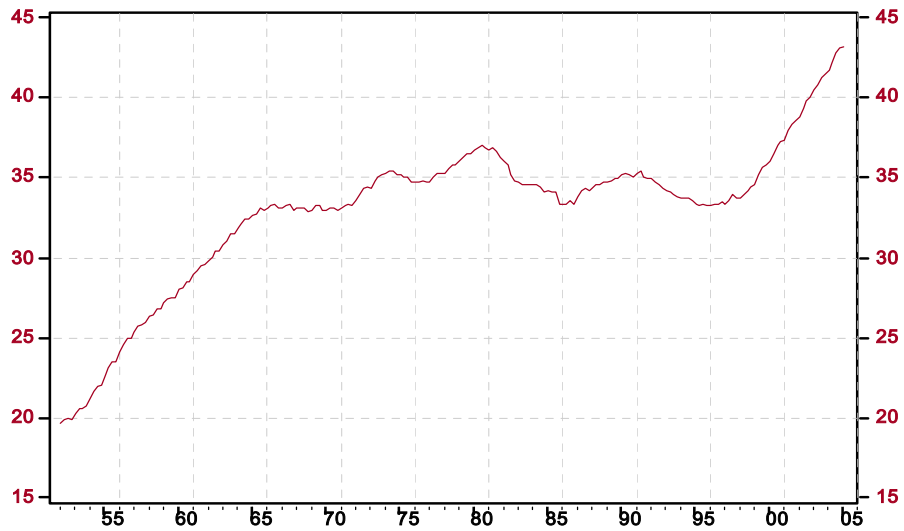


Chart 10

Mortgages / Total Domestic Nonfinancial Debt

%

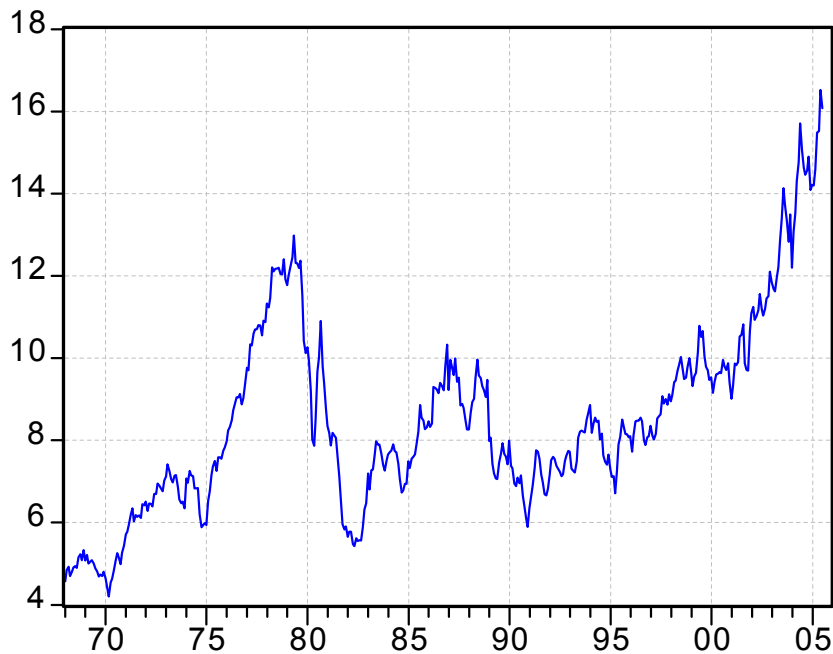


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Another metric illustrating how large residential real estate is to the U.S. economy is the dollar volume of single-family existing home sales. In July, this dollar volume was approximately \$1.7 *trillion* or 16% of estimated nominal Personal Income (see Chart 11). And this does not include the dollar volume of used condos! Again, reminiscent of the NASDAQ bubble.

Chart 11

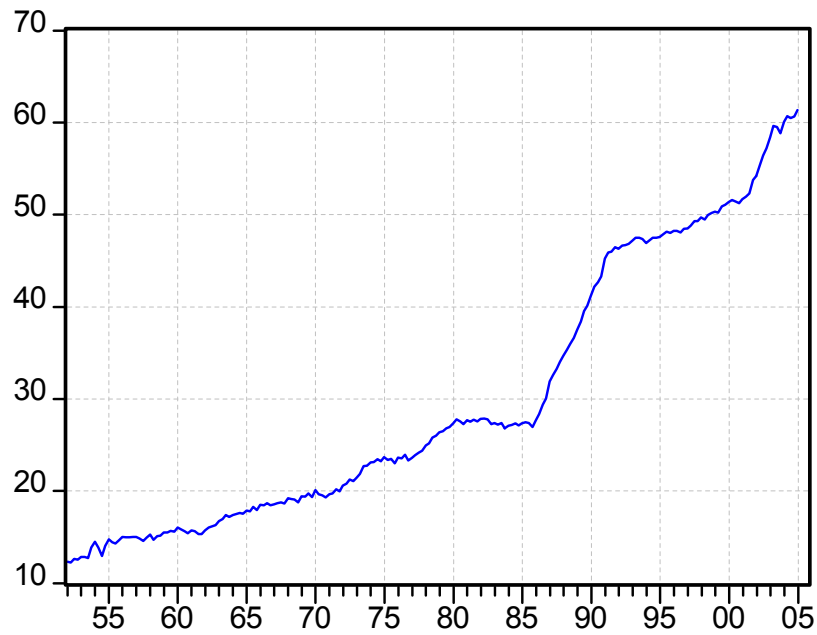
Dollar Volume of Existing Single-Family Home Sales / Personal Income
%



Lastly, perhaps the most ominous housing-related excess is exhibited in Chart 12 – U.S. commercial banks' exposure to the mortgage/housing market. A record 61 percent of total bank credit is mortgage-related. If the excesses in the housing market result in large mortgage defaults, then the U.S. banking *system* (not every bank) is likely to suffer significant losses. History suggests that when an economy's banking system is impaired, economic activity is impaired, too. Witness the Japanese economic stagnation of the 1990s. The reason for this is that the banking system is the transmission mechanism between the central bank and the private economy. When the banking system is crippled, central bank interest rate cuts are much less effective in reviving economic activity.

Chart 12

U.S. Chartered Commercial Banks: Mortgage-Related Assets* / Total Bank Credit
%



* Sum of mortgages, mortgage-backed securities and liabilities of GSEs.

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