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How Do Households Keep Spending More Than They Earn?

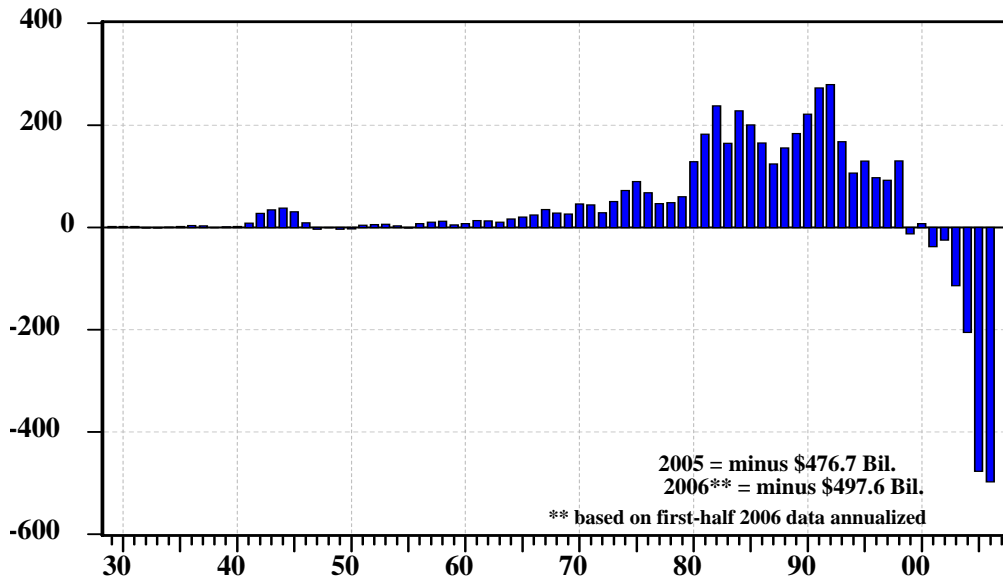
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As Chart 1 shows, total household spending – the sum of GDP line items personal consumption expenditures and residential investment expenditures – has exceeded disposable personal income from 1999 through the first half of 2006, with one small exception in the year 2000. In the first half of this year, the household “deficit” was running at an annual rate of \$497.6 billion or 5.5% of disposable personal income. How do households continue to run up record deficits?

Chart 1
Household Surplus (+) or Deficit (-) *
Bil.\$



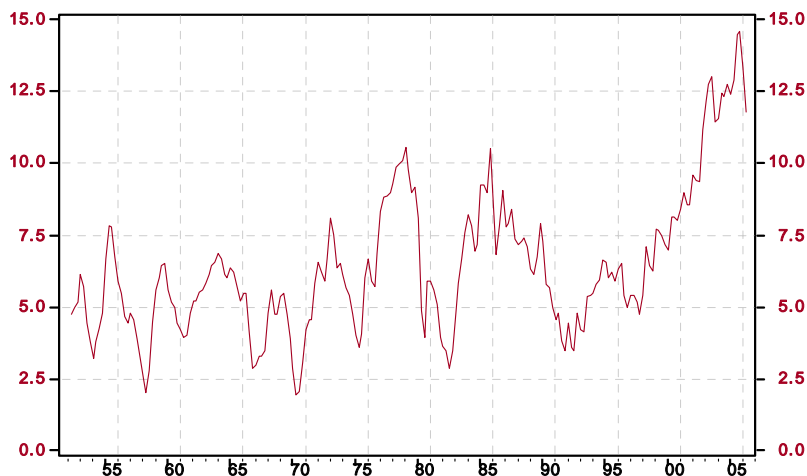
* disposable personal income minus expenditures
on consumer goods/services and residential investment

There are only two ways an entity is able to spend more than it earns – borrow and/or sell assets. And U.S. households are engaging in both. As Chart 2 shows, household borrowing relative to disposable personal income has soared in recent years, although it has recently come off its record high.

Chart 2

Households: Credit Market Borrowing as % of Disp. Personal Income

2-qtr MovingAverage

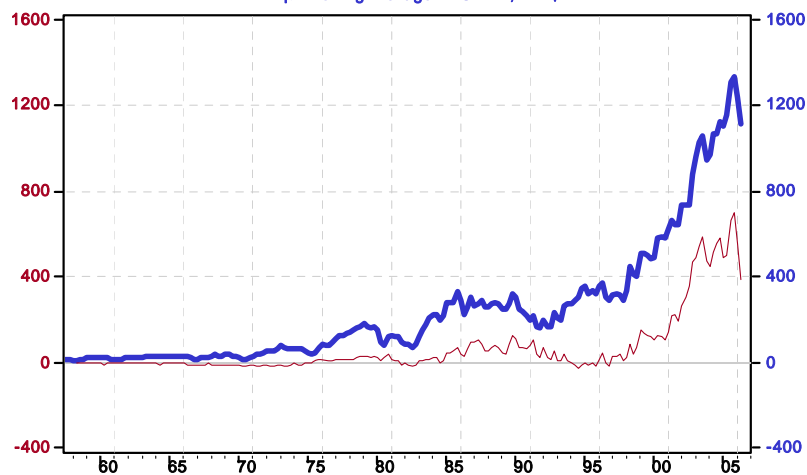


In this cycle, households have tapped the equity in their homes to finance the purchases of goods/services and home improvements like they never have before. The behavior of this mortgage equity withdrawal is plotted in Chart 3 alongside total household borrowing. For all of 2005, mortgage equity withdrawal totaled almost \$600 billion or 6.6% of disposable personal income. As the rate of house-price appreciation has plummeted in recent quarters (see Chart 4) and mortgage/home equity line interest rates have risen, there has been a sharp reversal in mortgage equity withdrawal, with even more likely to come.

Chart 3

< Households: Mortgage Equity Withdrawal
2-qtr MovingAverage saar, \$billions

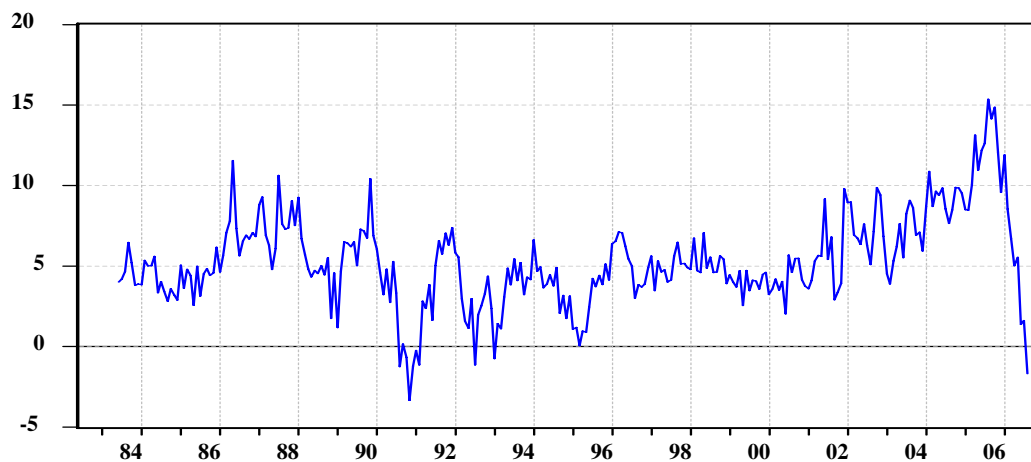
Households: Liabilities: Credit Market Borrowing >
2-qtr MovingAverage SAAR, Bil. \$



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Chart 4

Weighted-Median Single-Family Home Sale Price*
year-over-year percent change

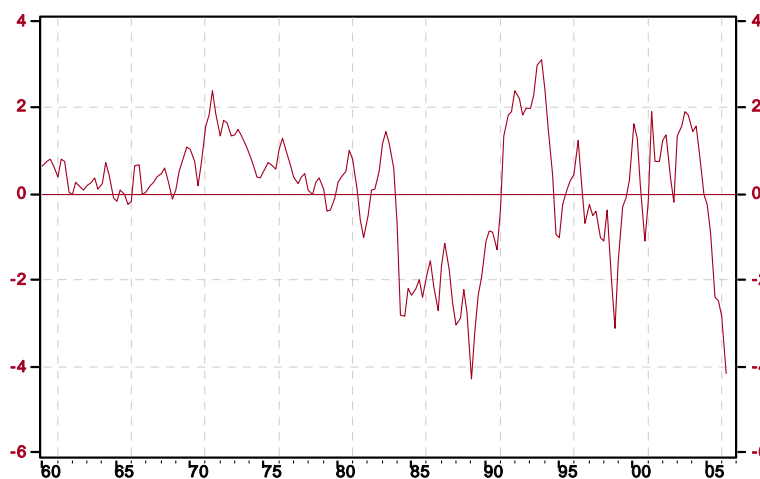


* Weighted by proportions of new and existing homes sold

So, borrowing has been an important way for households to spend more than they earn, although that appears to be slowing. What about asset sales to non-household sectors? Enter corporations. As was the case in the second half of the 1980s and 1990s, corporations have again embarked on a program of massive repurchases of their equity shares. Net purchases of foreign shares by U.S. investors, the “retirement” of corporate equities, ran at a record annualized rate of \$394 billion in the first half of 2006. As shown in Chart 5, this retirement of corporate equity represented 4.2% of disposable personal income.

Chart 5

Net New Corporate Equity Issues as % of Disp. Personal Income
2-qr Moving Average



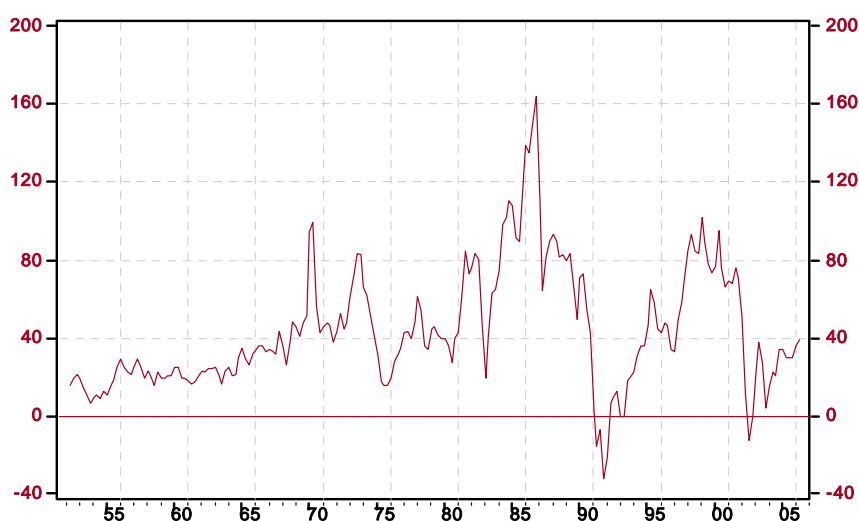
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In contrast to the second half of the 1980s and 1990s, a much larger proportion of the current bout of equity retirement is being funded out of profits as opposed to corporate borrowing. This is implied by Chart 6, which shows nonfinancial corporate credit market borrowing as a percent of profits. In the second half of the 1980s and 1990s, corporate borrowing was around or in excess of 80% of profits. Now, it is only about 40% of profits.

Chart 6

Nonfin. Corps: Credit Mkt. Borrowing as % of Before-Tax Book Profits

2-qr Moving Average



If housing-related borrowing is slowing as a source of financing household deficits, then households will have to depend even more on corporate stock buybacks as a source of funds if they wish to continue spending with abandon. But what if corporate profit growth slows? If corporations are unwilling or unable to lever themselves as they did in the late 1990s, then the pace of stock buybacks would likely moderate. In turn, this would make it more difficult for households to keep spending in excess of their after-tax income.

What is the likelihood of a moderation in corporate profit growth? Chart 7 shows that there is a positive contemporaneous correlation between year-over-year corporate profit growth and year-over-year nominal GDP growth. Our real GDP forecasting model is predicting a moderation in economic growth (Chart 8). With all-items CPI inflation already having peaked, then it is a good bet that *nominal* GDP growth will be slowing over the next several quarters. Thus, it also is a good bet that corporate profit growth will be slowing.

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Chart 7

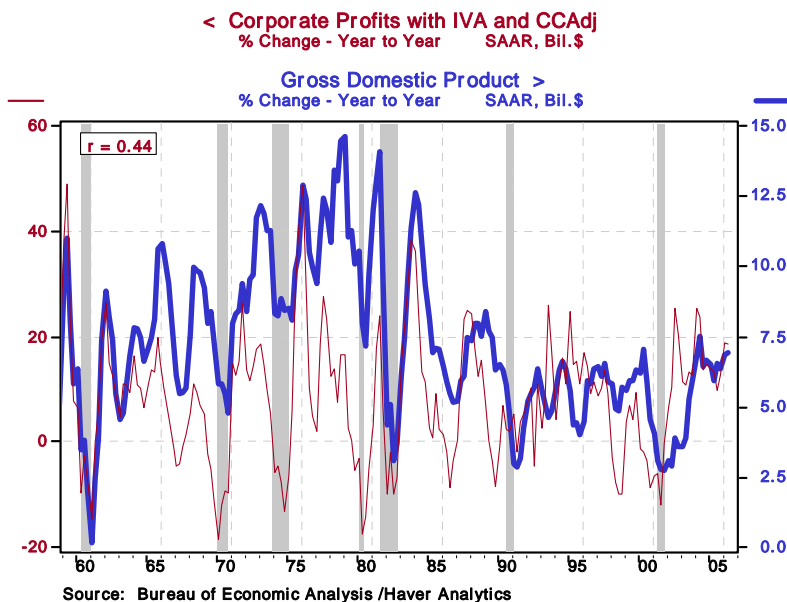
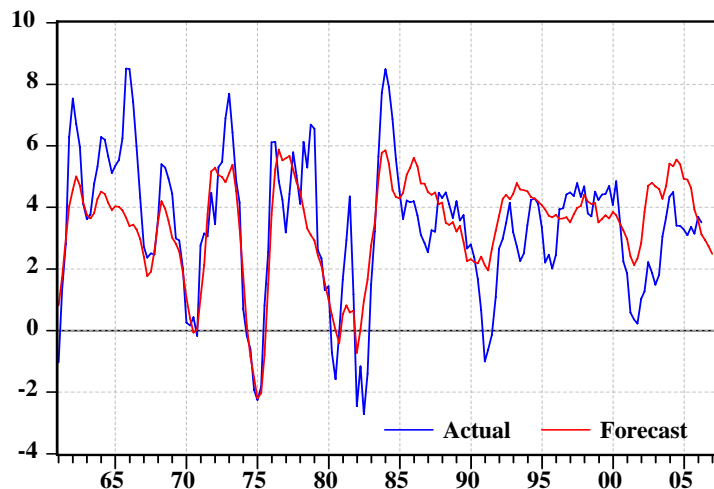


Chart 8

Real GDP: Actual vs. Forecast*
year-over-year percent change, quarterly observations



* Forecast based on lagged values of real M2 money supply, spread between yield on 10-yr. Treasury security and fed funds rate and S&P 500 stock market index.

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Perhaps households could dip into their cash reserves to sustain their deficit spending. Perhaps, but as Chart 9 shows, households already are running a record low liquidity ratio. That is, household deposits, including money market funds, are at a post-war record low in relation to household liabilities. Given that households carrying record leverage (Chart 10) are also enduring a record debt-service burden (Chart 11), it is doubtful they would want to become even less liquid – at least the prudent ones would not want to.

Chart 9

Households: Deposits / Total Liabilities

%

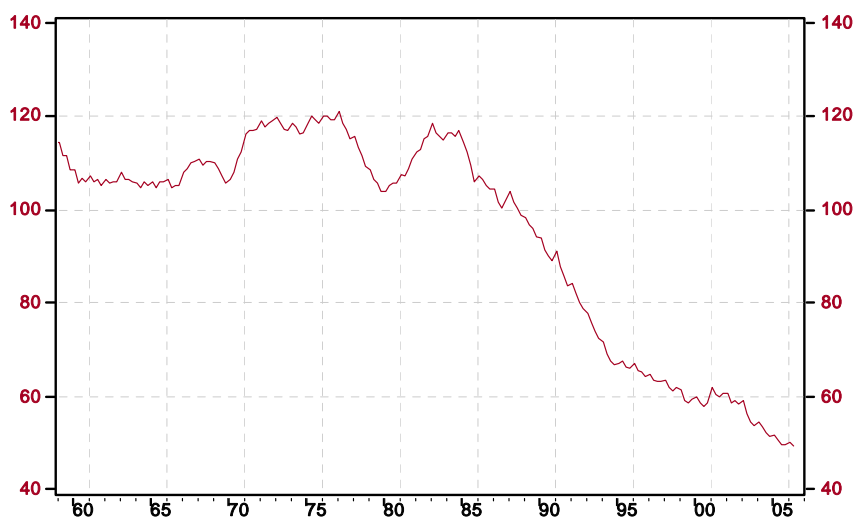
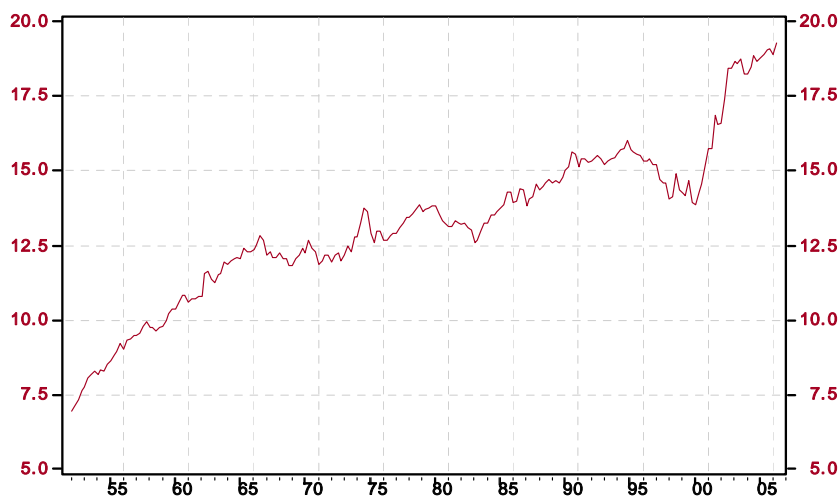


Chart 10

Households: Total Liabilities / Mkt. Value of Total Assets

%



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Chart 11

Household Debt Service Ratio

SA, %



My bet is that those blue bars in Chart 1 will be moving back up toward the zero line in the coming years. That is, households are unlikely to be able to keep running the massive deficits they have been since 1999.

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