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Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
Director of
Economic Research
312.444.4145
312.557.2675 fax
plk1@ntrs.com

I Have a Lot of Problems with You People!

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Well, as Festivus is nearly upon us (December 23), it is time for the airing of grievances with the economy. So here goes.

Households, you are carrying a record amount of debt and other liabilities relative to the market value of your assets (Chart 1). What's more, this record levered state has come at a time of relatively rapid increases in the market value of your assets (Chart 2). What will happen to your leverage ratio if, perchance, the market value of your assets should fall?

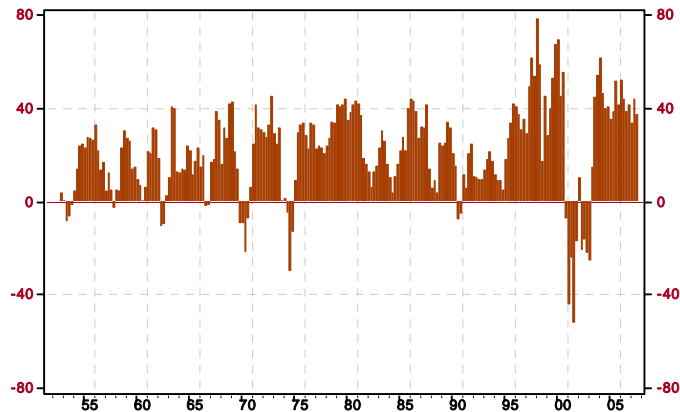
Chart 1

Households: Total Liabilities as % of Market Value of Total Assets



Chart 2

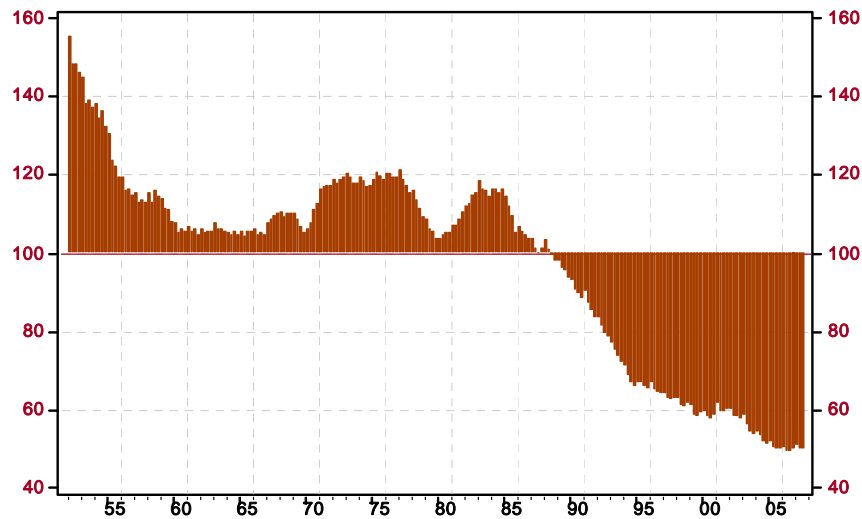
Households: 4-Qtr. Moving Total of Holding Gains on Assets / Disp. Pers. Inc. %



Households, you are at near record levels of *illiquidity* (Chart 3). Don't tell me you needn't be as liquid today as your parents were because you have access to more credit. As shown in Chart 1, you *already* have record high leverage. You also *already* have borrowed a record amount relative to the value of your house, just shy of 50% (Chart 4). Moreover, the equity you have in your house is now falling (Chart 5) and with over 2 million *empty* houses and condominiums for sale (Chart 6), the value of your house is likely to fall further. And your bank is a lot less willing to lend to you now (Chart 7).

Chart 3

Households: Deposits plus Money Funds as % of Total Liabilities



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Chart 4

Residential Mortgage Debt / Market Value of Owner-Occupied Real Estate

%



Chart 5

Households and Nonprofit Orgs: Owners Equity in Real Estate

% Change - Year to Year Bil \$

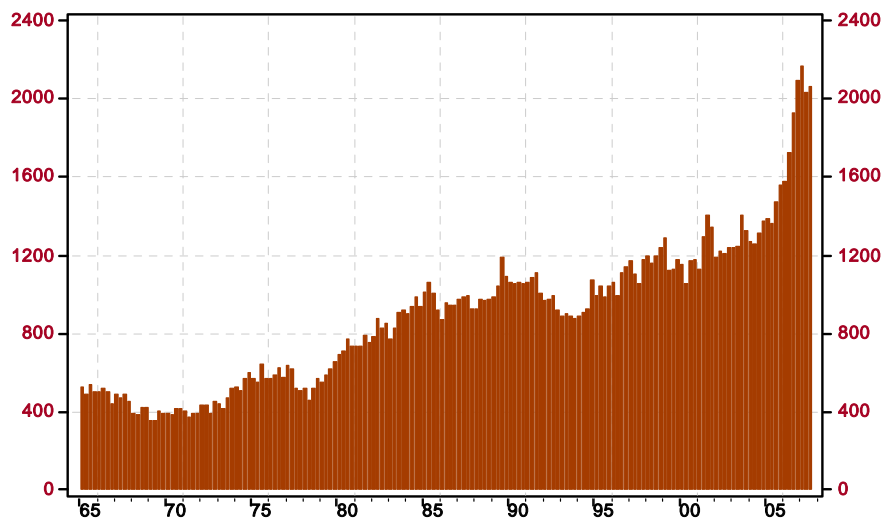


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Chart 6

Total Vacant Housing Units: United States: Year-round For Sale Only

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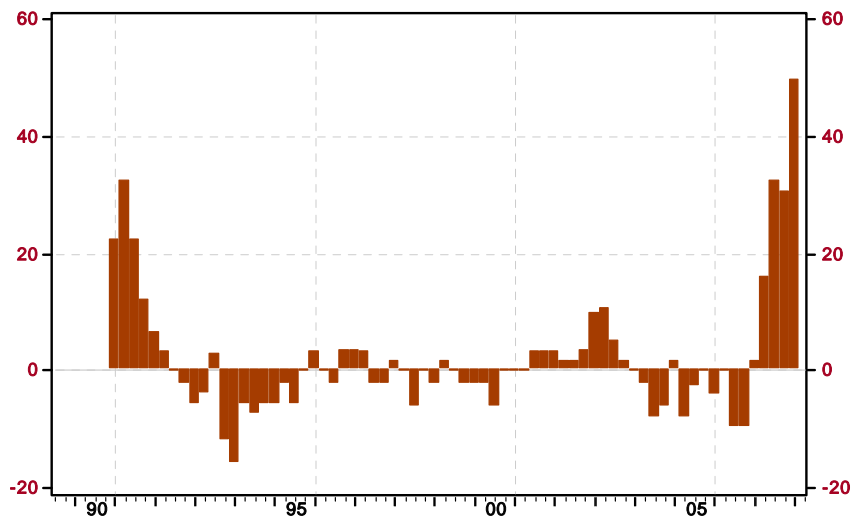


Source: Bureau of the Census /Haver Analytics

Chart 7

FRB Sr Loan Survey: Res Mortgages: Net Share, Banks Tightening

Haver Est, %

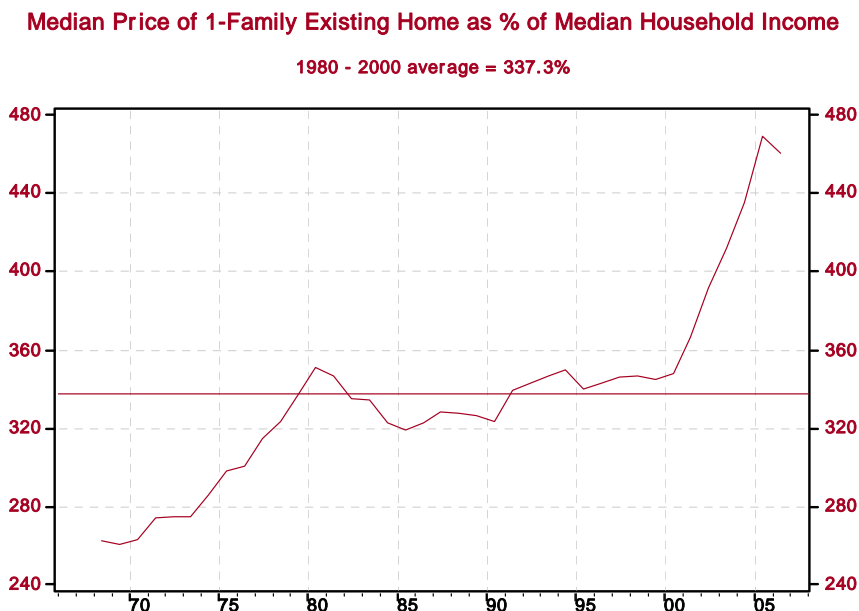


Source: Federal Reserve Board /Haver Analytics

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To get some idea how much the price of your house might fall, consider the implications of how much the price of your house has risen relative to your income (Chart 8). Between 1980 and 2000, the price of your house averaged about 337% of your income. Then, according to former Fed Chairman Greenspan, came the delayed effect of the fall of the Berlin Wall, and the price of your house soared to 469% of your income – a record high for the 1968 through 2006 period. Assuming, *optimistically*, that your income increases by 4.05% in 2007 and 2008, the rate at which your income increased in 2006, by what percentage would the price of your house have to *fall* from its 2006 level to get the price/income ratio back to 337% average in 2008? **The answer is 21.7%**. From 1968 through 2006, the median price of an existing home *never* fell on a year-to-year basis. So, we are in uncharted waters here.

Chart 8



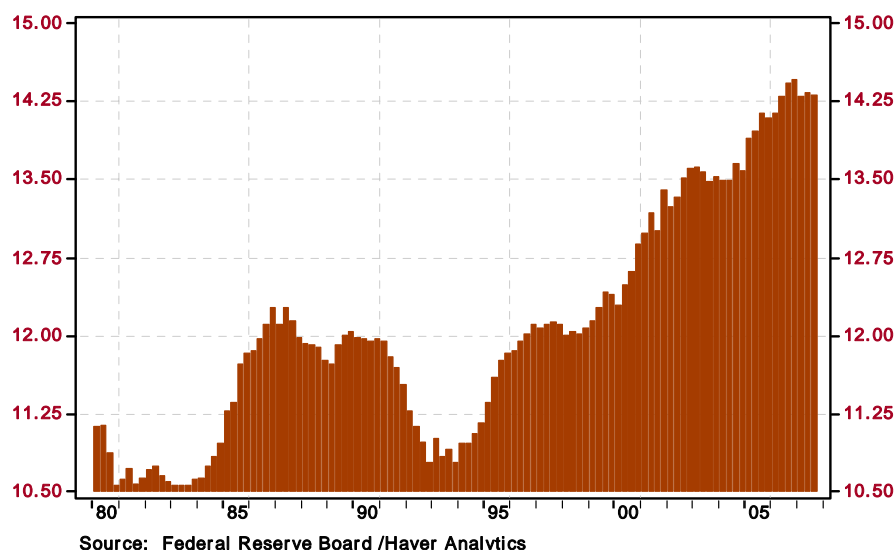
Lastly, you *already* are devoting a near record high percentage of your take-home pay to your creditors in order to keep the collection agencies from calling you at all hours of the day (Chart 9). With employment growth slowing and your mortgage rate resetting, you will likely have even less left over next year after paying your monthly P&I.

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Chart 9

Household Debt Service Ratio

SA, %



Households, your net worth has increased for the 20th consecutive quarter, but notice that relative to your take-home pay (disposable personal income), it is leveling off (Chart 10). Now there are two ways that you can increase your net worth – spend less than you earn or be fortunate enough to have a Northern Trust investment advisor, i.e., experience holding gains on your assets. In a “normal” year, approximately 61% of a household’s change in net worth derives from holding gains on previously acquired assets – tangible and financial. Households, in the past four years you have experienced above-normal holding gains on assets (Chart 11). But notice that in the third quarter of 2007, holding gains contributed the smallest percentage to your increase in net worth, only 68%, in the past four years, primarily because of the slowdown in the appreciation of residential real estate, but also because of weaker gains in the stock market. The odds are that residential real estate will not be generating large holding gains over the next year – in fact, probably losses as discussed above. Unless the stock market shows extraordinary gains, and we will talk about why this is unlikely later when we air some grievances with Corporate America, you may have to start spending less than you earn if you want to keep increasing your net worth. Horrors! And although one quarter does not a trend make, it looks as though households are rediscovering thrift as means of increasing their net worth. In the third quarter of this year, households ran a financial surplus – i.e., acquired more financial assets than they acquired liabilities -- for the first time since the fourth quarter of 2003 (Chart 12). (As to why a household financial surplus implies that households are spending less than they earn, see [Gene Epstein's Great American Savings \(sic\) Myth](#)). This household financial surplus was 5.7% of after-tax income, the highest surplus percentage since the second quarter of 1998. Perhaps this is why consumer discretionary retailing stocks have fallen on hard times and why they are likely to be under-performers for some time.

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Chart 10

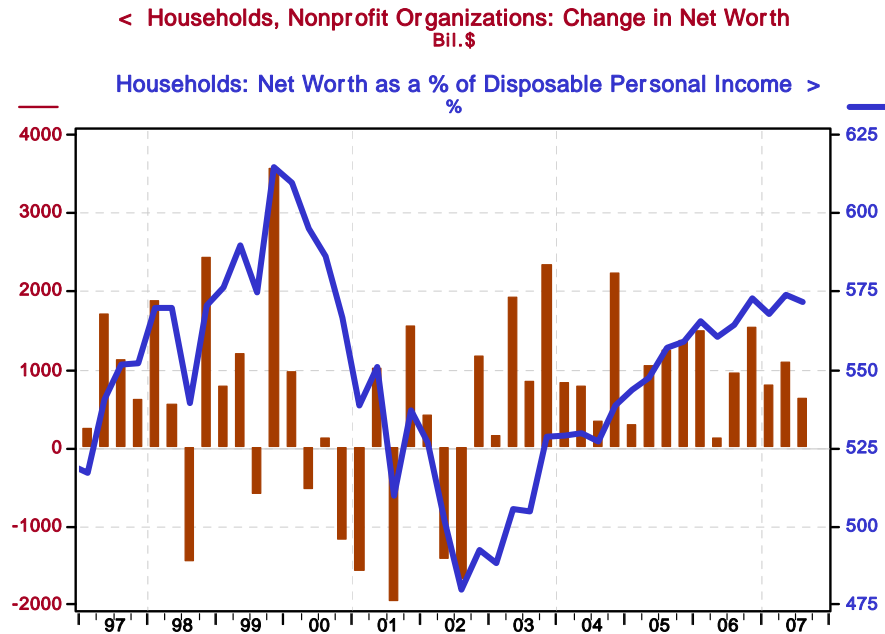
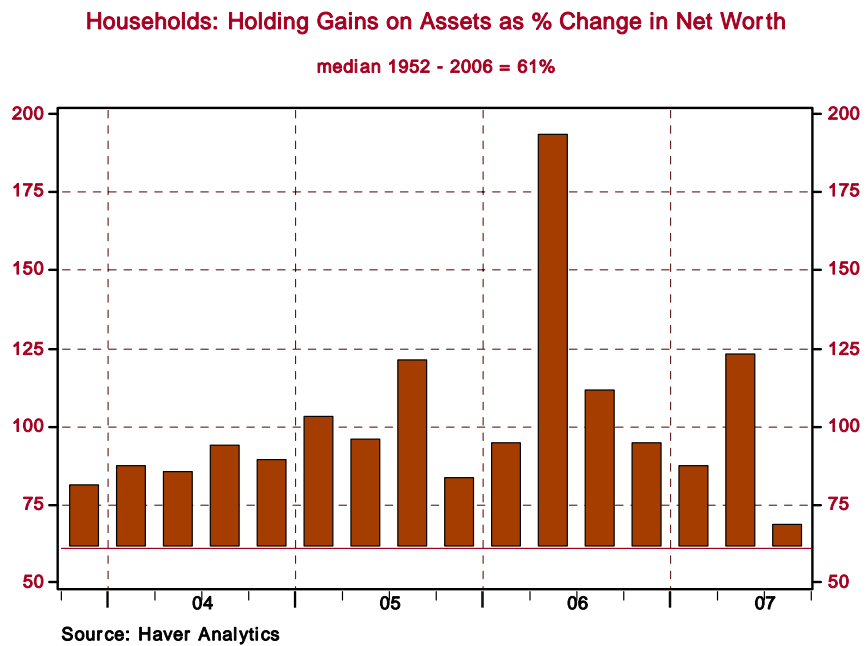
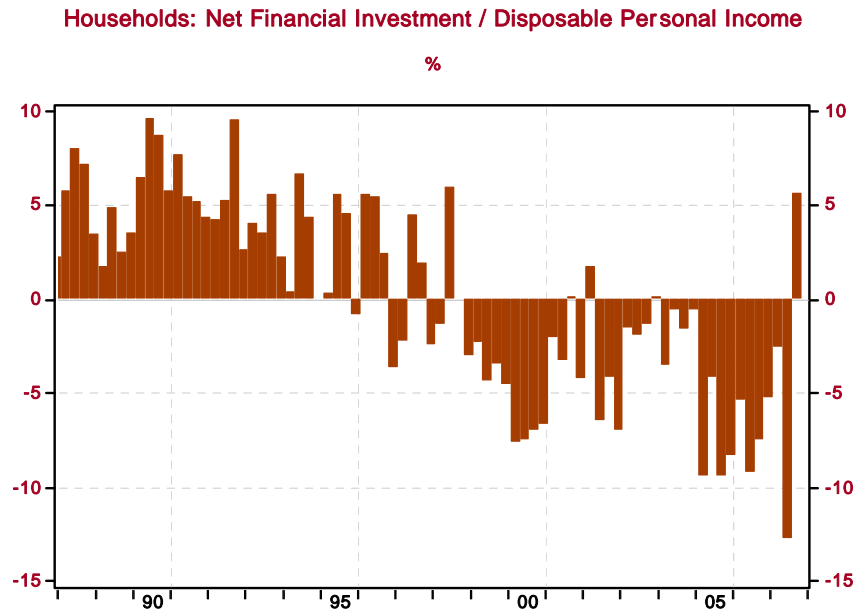


Chart 11



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Chart 12



Now it's your turn, Corporate America. For starters, the growth in your "operating" profits has slowed to a crawl – just 1.9% year-over-year in the third quarter (Chart 13). Moreover, if it were not for your earnings from overseas operations, which are inflated when translated into depreciating greenbacks, your profits would be *contracting* (Chart 14.) As Merrill Lynch's chief North American economist, David Rosenberg, has reminded us, corporate hiring of U.S. domestic residents and capital spending in the U.S. depend on corporate profits *generated in the U.S.*, not corporate profits generated in Germany or China. And while we still are on the subject of domestically-generated profits, note that profits from the nonfinancial sector have contracted four quarters in a row and the growth of profits from the financial sector have slowed significantly (Chart 15). With the mortgage cash-cow having run dry, do you think that financial sector profits will rebound soon?

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Chart 13

Corporate Profits with IVA and CCAAdj

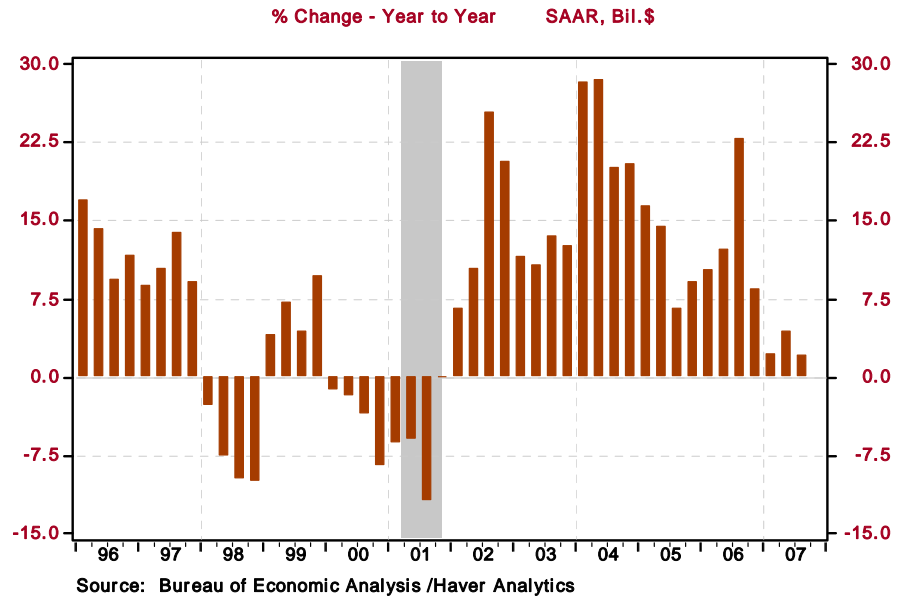
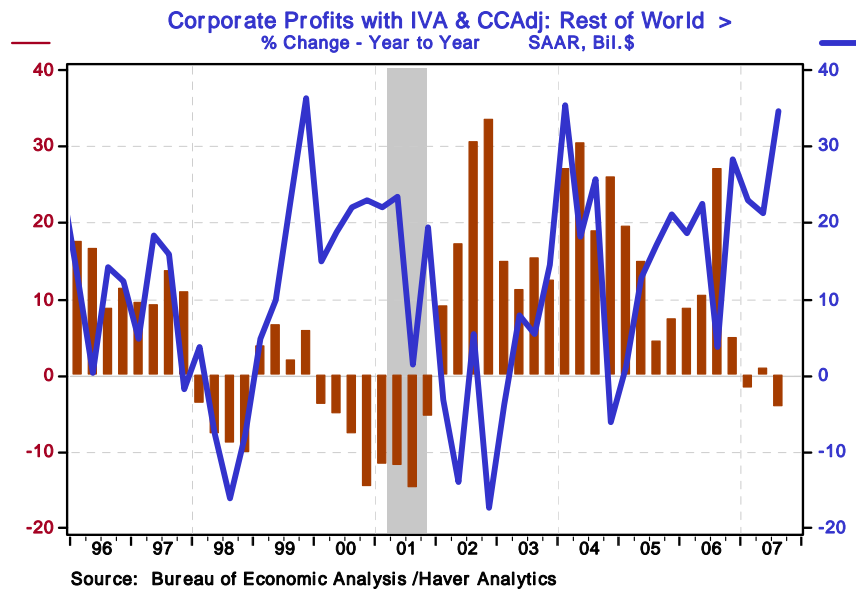


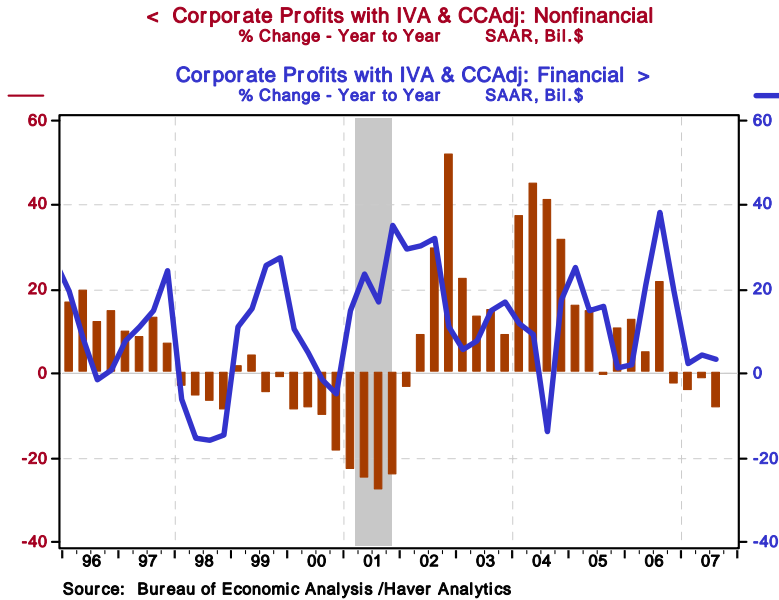
Chart 14

< Corporate Profits with IVA & CCAAdj: Domestic Industries



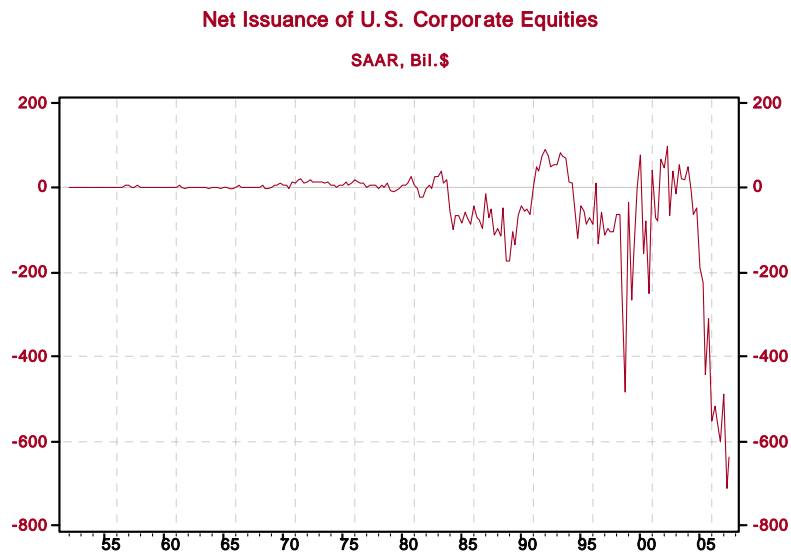
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Chart 15



Despite this relatively poor corporate profit performance, the prices of corporate equities are up on the year. We wonder if it has something to do with the record amount of corporate equities that have been “retired” via share buyback programs and leveraged buyouts of late (Chart 16).

Chart 16



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Nonfinancial corporations have stepped up their credit market borrowing of late, both in absolute terms and relative to their cash flows from operations (Chart 17). Have nonfinancial corporations increased their borrowing to fund capital outlays? Apparently not, inasmuch as the ratio of their borrowing to their capital outlays is rising and now is just a shade below where it was in the first quarter of 1999 (Chart 18). So, as corporate profit growth is slowing, it appears that corporate treasurers are tapping the credit markets more to fund their share repurchases. With corporate borrowing costs rising absolutely and relative to the U.S. Treasury's borrowing costs, how much longer will corporations be able to levitate the value of their shares via leveraging the corporation itself (Chart 19)?

Chart 17

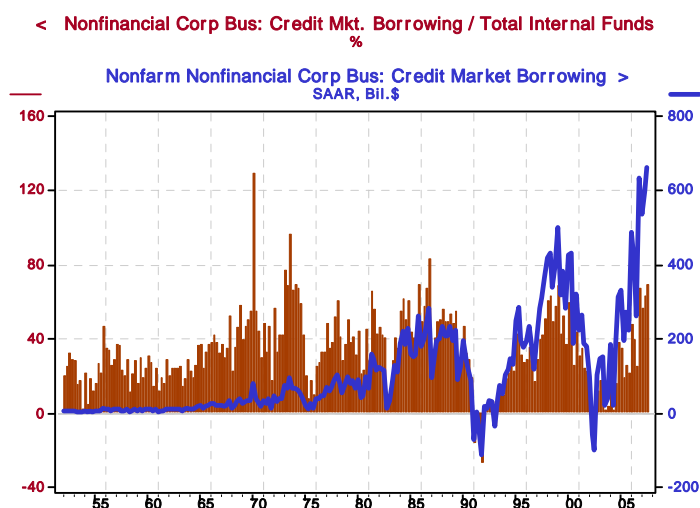
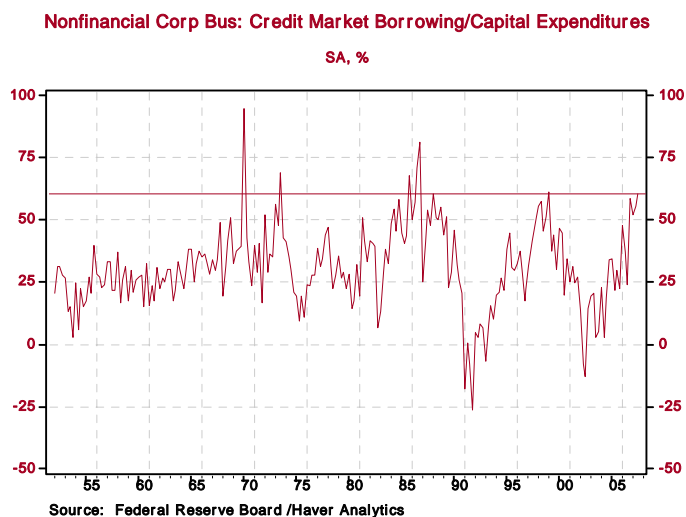


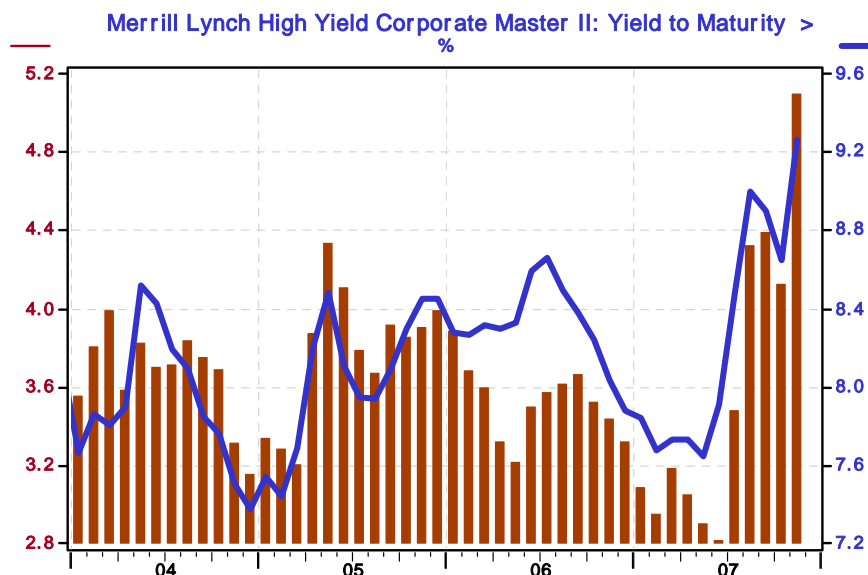
Chart 18



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Chart 19

< Yield Spread: M-L High Yld. Corporate Master II minus Treasury 10-Yr. percentage points



And lastly, I have some problems with you, commercial banks. You gave the impression that you were primarily operating as an originator-distributor during this credit cycle. That is, you originated credit and then sold it to some other investor. Well, you must have been retaining some of the credit you originated and were financing the purchases of the buyers of credit you sold because growth in your loans and investments (bank credit) since the last recession has generally been above the median growth rate of 7.6% from the first quarter of 1975 through the third quarter of 2007 (Chart 20). Moreover, you cashed in on the mortgage boom by increasing mortgages and private-label mortgage-backed securities from 33.7% of your total earning assets in the first quarter of 1991 to 47.9% in the third quarter of 2007 (Chart 21). So you have some mortgage credit “challenges,” too. Moreover, you have some *indirect* mortgage challenges as a result of the loans you made to other purchasers of the “toxic waste” originated during this credit cycle. And your credit challenges will not be restricted to residential mortgages, but commercial mortgages and consumer credit card debt, too, as delinquency rates on these loan categories are rising (Chart 22).

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Chart 20

US-Chartered Commercial Banks: Assets: Total Bank Credit

% Change - Year to Year median Q1:1975 - Q3:2007 = 7.6%

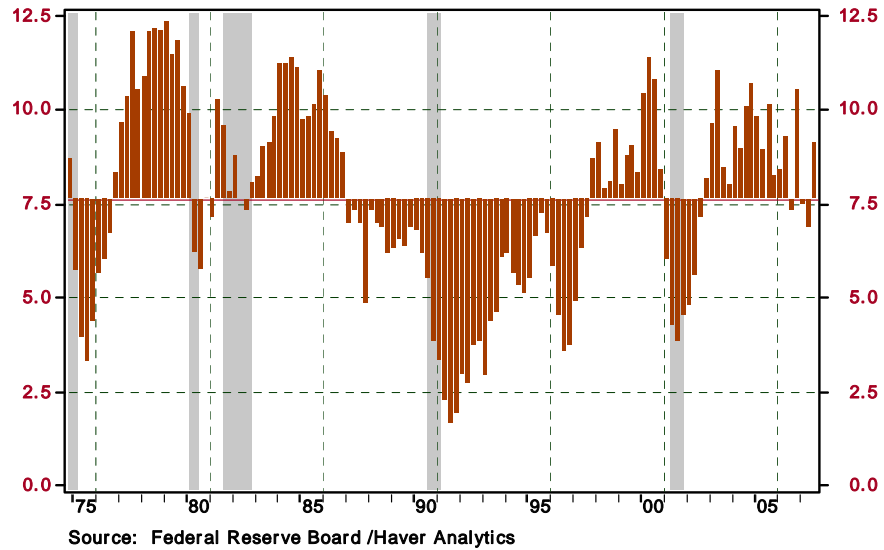
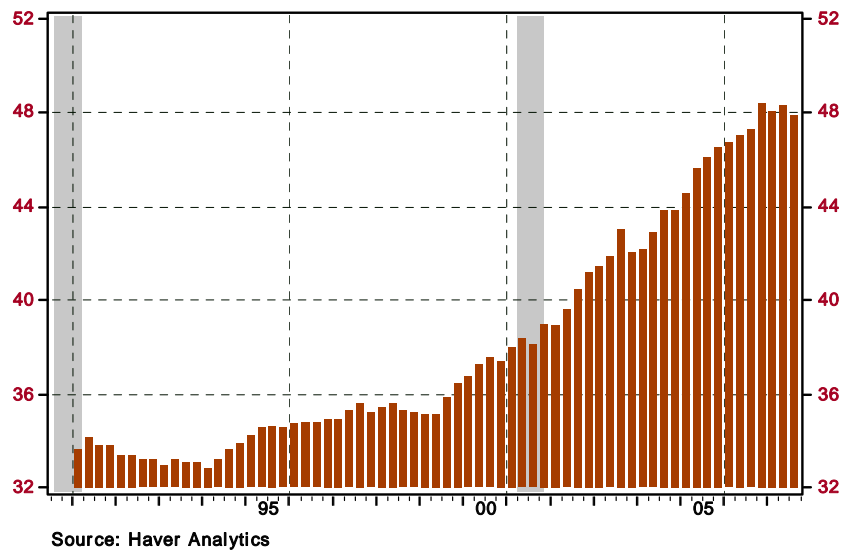


Chart 21

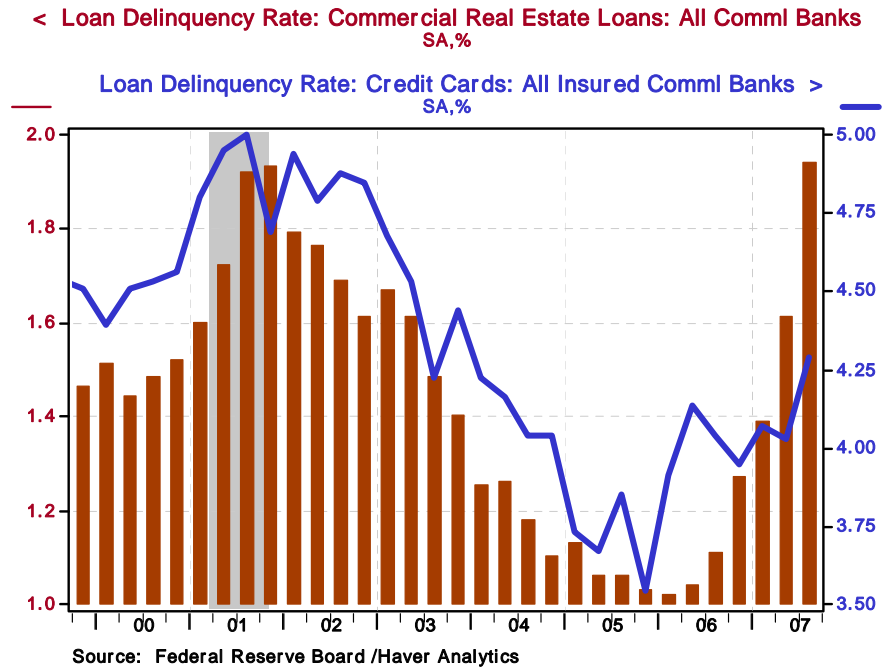
US Comm. Bks.: Mrtgs plus Prvt.-Issued Mrtg-Bkd Sec. / Total Bk. Credit

%



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Chart 22



Remember, Festivus is not over until the economic Pollyannas pin me.

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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