Topical Study #69: Is A Negative Saving Rate Negative?

OAK ASSOCIATES, *ltd.*

February 11, 2005

Dr. Edward Yardeni

330-668-3326
eyardeni@oakassociates.com

Please visit our websites at
www.yardeni.com &
www.oakassociates.com

I. INTRODUCTION & CONCLUSIONS

In this Topical Study, I assess the financial well-being of American consumers. In brief: I think they are in good shape. From 2000 through the first half of 2004, I recommended overweighting consumer stocks. I figured that falling interest rates along with tax cuts would keep consumer spending growing. Meanwhile, I reckoned that capital spending might be depressed by slow global growth and excess capacity in numerous major industries. Last year, I suggested lightening up on consumer bets during the spring because the latest round of tax cuts would be implemented, with certainly no chance of another round before the presidential election and some risk that taxes might go up if the Democrats win the White House.

President George W. Bush was reelected, and the Republicans gained seats in both houses of Congress. This increases the chances that there won't be a sunset for the tax cuts of 2003, but rather they will be made permanent. The central idea of the "permanent-income hypothesis," proposed by economist Milton Friedman in 1957, is that people base consumption on what they consider their "normal" income. In doing this, they attempt to maintain a fairly constant standard of living even though their incomes may vary considerably from month to month or from year to year.

As a result, increases and decreases in income that people see as temporary have little effect on their consumption spending. Consumers are rational and base their spending decisions not only on their current incomes, but also on their assessment of their future incomes. This suggests that permanent tax cuts, in effect, can have a positive "wealth effect," boosting consumption by more than just the tax cut in the latest paychecks. This makes sense to me and may be one reason why consumers might spend at a faster pace than expected this year, because they believe that Congress will make the 2003 tax cuts permanent during the President's second term.

Of course, on the other side, there are some economists who argue that we Americans have been living well beyond our means for years. They see a day of reckoning coming, maybe even this year. They say that higher interest rates are bound to burst what they say is a housing bubble. That would put an end to cash-out windfalls from mortgage refinancing and to home equity borrowing, which have been propping up consumers' spending sprees, according to these alarmists. It would also cause a negative wealth effect that might be far more democratic and, therefore, much more damaging to consumer spending and the economy than was the Nasdaq debacle earlier this decade.

Among the many concerns of the pessimists is the personal saving rate, which is essentially down to zero now. The personal saving rate jumped from 0.3% in November to 3.4% in December thanks to Microsoft (Figure 1). In December, personal dividend income was boosted by the payment of a $24.8 billion special dividend by the cash-rich corporation. Without this huge payout, the personal saving rate would have been 0.1%, the lowest on record.

The drop in this rate has been precipitous in recent years. Twenty and ten years ago, this rate was 10.6% and 5.2%, respectively (Figure 1). I believe that the personal savings rate could soon turn negative. I can already hear the alarmists ringing the alarms louder than ever. They'll warn that this can't go on, that it can lead only to ruin for our economy and for stock market investors, who foolishly ignore their warnings and remain bullish.

I disagree. The spread between pension and insurance fund benefits and contributions has been widening since the mid-1980s. While benefits provide the retirees with purchasing power, it is contributions and not benefits that are included in personal income (Figure 2). This, more than anything else, explains why the saving rate has been declining in recent years and is likely to turn negative over the next several years. As more Americans retire over the rest of this decade and the coming one, they will be living off their net worth. We aren't living beyond our means; rather, we will increasingly be living on the wealth we have created and accumulated over the past several decades. We Americans have never been wealthier. We are extremely liquid, and our debts are manageable.

We are all getting older, including the Baby Boom generation. During 2003, the number of households headed by a person aged 65 or older rose to a record 23 million, up 5.1 million from 20 years ago (Figure 3). Many of them are retired. Indeed, the labor force participation rate of men over 65 years old is only 19.3%. The 76 million Baby Boomers are currently 41 to 59 years old. Collectively, they earned more than half of aggregate money income during 2003 (Figure 4). Apparently, they haven't been saving much of it, yet they've managed to accumulate a great deal of wealth, as will be shown below. They will start to retire and live off their wealth over the next 10 years. (Of course, there is no reason why the children of the Baby Boomers won't create as much or even more wealth during their working years.)

Societies with much higher personal saving rates than ours are not as wealthy as we are. They tend to have far fewer opportunities to create and accumulate wealth than we do. They also tend to have younger labor forces. There is nothing wrong with these high savers "financing" our federal budget deficit and our current account deficit by purchasing our financial securities and by investing directly in our companies and our real estate. From this perspective, we are providing foreigners with the high-quality, liquid assets that they desire for their savings. Rather than a dangerous imbalance in global trade and finance, this situation is a natural outcome of our wealth and the aspirations of foreigners to become wealthy too!

Finally, I am not worried that the housing market is in a bubble that is about to burst. I have been bullish on the homebuilders and housing-related retailers for the past three years and remain so. The historically low mortgage rates of recent years have made housing more affordable to more households, including immigrants and twenty-something folks who might have rented in the past. These low rates also mean that buyers have been able to afford higher-priced houses. Of course, if mortgage rates rise 200 basis points or more soon, then home prices would mostly likely fall. Then, the bubble prognosticators could rightly say, "We told you so." However, I don't see mortgage rates rising by more than 100 basis points over the next 12 to 36 months. So if housing is in a bubble, the bubble could get larger before it bursts.

In a previous Topical Study titled "Home Equity Loan Bubble?" and dated May 24, 2004, I concluded that we might want to worry more about a bubble in housing finance than in the underlying real estate. I discuss this more fully below.

II. GOING FISHING

Ignore the personal savings rate. It is a very flaky and fluky number. It is calculated as a residual, i.e., the difference between personal consumption expenditures and personal disposable income. In other words, it isn't directly measured. There is an interesting article about this subject in the September 2004 issue of the Survey of Current Business, titled "Alternative Measures of Personal Saving." In the National Income and Product Accounts (NIPA), saving is from income arising from current production and excludes capital gains, so it is not identical to the change in wealth. According to the article, this concept of saving is "best suited to answering questions about the domestic sources of funding for U.S. investment needs." The article also identifies four alternative measures of saving.

Personal income includes employer contributions for employee pension and insurance funds, which totaled $808.9 billion in 2003. Excluded from personal income are benefits paid by such funds, which totaled $1,086.2 billion that year (Figure A and Figure 2). Conceptually and statistically, this categorization makes sense. However, it also suggests that the drop in the personal saving rate may reflect the fact that there are more retirees living longer and spending their benefits than there are consumers increasingly living beyond their means. Obviously, retired workers spend their monthly checks as though they represent their retirement income. No one is in a position to buy goods and services with the contributions made by companies to their pension plans.

Benefits exceeded contributions for the first time during 1984, and the spread has been widening since then. That was also the year after which the personal saving rate started to trend downward (Figures 1 and 2). During 2003, benefits exceeded contributions by $277.3 billion. That year, personal saving totaled $110.6 billion. Adding these two numbers together shows that consumers actually had free cash flow of $387.9 billion, or 3.5 times greater than personal saving. The personal saving rate based on total benefits rather than on contributions would have been 4.6% in 2003 rather than 1.4%, as reported.

Figure A: Employer Contributions For Employee Pension And Insurance Funds And Benefits Paid, 2003 (billion dollars)

Funds	Benefits	Contributions	Difference
Pension & Insurance	1,086.2	808.9	277.3
Pension & Profit Sharing	542.4	312.8	229.6
Private	320.4	190.6	129.8
Defined Benefit	NA	102.8	NA
Defined Contribution	NA	87.8	NA
Publicly Administered	222.0	122.2	99.8
Private Insurance Funds	543.8	496.1	47.7
Group Health	482.3	429.0	53.3
Group Life	18.6	12.6	6.0
Other*	42.9	54.5	-11.6

* Workers' compensation and supplemental unemployment.
Source: Bureau of Economic Analysis, National Income & Product Accounts, Table 6.11D.

During the 1980s and 1990s, contributions to pension and insurance funds rose at a slower pace than during the 1960s and 1970s, because the bull markets in stocks and bonds caused many plans to be overfunded. The bond market continued to provide significant gains during the first half of this decade, though equity portfolios suffered substantial losses from 2000 through 2002. The rebound in stock prices since 2003 helped to alleviate an underfunding problem for several pension plans. As a result of this positive wealth effect, contributions fell below benefits, thus depressing the personal saving rate. In 2003, contributions rose at a faster pace to make up for the underfunding problem that emerged for many plans as a result of the 2001-2002 bear market. However, the impressive rebound in stocks during 2003 and 2004 suggests that contributions likely slowed in 2004 and remained below benefits paid out.

Demographic trends related to the aging of the Baby Boomers suggest that the personal saving rate is likely to remain low and could be negative for quite a long time. It is very likely that benefits will continue to rise faster than contributions. There are more retirees living longer. In about 10 years, the Baby Boomers will start to retire. As noted above, the number of households headed by a person 65 years or older rose to a record high in 2003. Those people are living longer and longer, and their ranks will be swelling as the Baby Boomers retire. In 2003, there were a record 23.1 million households headed by a person 45-54 years old (Figure 3).

This is why the saving rate is probably about to go negative and remain that way for years to come. This doesn't mean that Americans are living beyond their means. Rather, they are living on their retirement benefit incomes obtained from retirement assets that were accumulated over the years for this purpose from employer contributions and from capital gains.

III. THE WEALTH OF OUR NATION

While the personal saving rate measured in NIPA is down to zero, total assets, total net worth, and the liquid assets of households continue to climb to record highs! Here are the latest happy numbers, courtesy of the Fed's quarterly Flow of Funds Accounts:

1) Over the past year, household assets rose a whopping $5.2 trillion to a record $57 trillion during the third quarter of last year. Household debt was at a record high of $10.3 trillion during the third quarter of last year. That's up a mere $873.0 million over the past year. Household net worth rose by an impressive $4.3 trillion to a record $46.7 trillion over the latest four-quarter period (Figures 5, 6, and 7).

2) The jump in assets was led by a $2.3 trillion increase in the value of real estate held by households, to a record $18.0 trillion. Owners' equity in household real estate rose $1.5 trillion to a record $9.3 trillion, exceeding the value of the other asset classes in household balance sheets for the first time since the second half of the 1980s (Figure 8).

3) Americans now have as much of their wealth in their homes as they have in pension fund reserves, which over the past year have rebounded almost back to their previous record high of 2000 (Figure 8). Life insurance and pension fund revenues are up $289 billion over the latest four quarters (Figure 9).

4) Households have a record $6.2 trillion in the equity of their unincorporated businesses and about the same in corporate equities, which is still $3.2 trillion less than they had during 2000 (Figure 8). America is one of the few countries in the world where wealth is so often created without saving. Americans are constantly looking for ways to create wealth. Many are entrepreneurs. Many have their own businesses. I believe that only a tiny fraction of this wealth represents the accumulation of moneys from personal saving. Most of it came from the accumulation of sweat and risk-taking that produced very valuable businesses.

5) Equity and bond mutual funds attracted $236 billion last year (Figures 10, 11, and 12). Last year, households recovered most of what they lost in mutual fund shares, which rose to a record $3.2 trillion (Figure 8).

6) At the end of last year's third quarter, deposits held by U.S. households totaled a record $5.5 trillion, up $333 billion from a year ago (Figures 13 and 14).

7) Mortgages accounted for a record 70.6% of household debts at the end of last year's third quarter (Figure 15). But they've been refinanced numerous times at lower and lower interest rates, thus reducing the burden of this debt. Lower interest rates have allowed many would-be homeowners to buy their first home rather than to continue paying rent.

8) Consumer credit—including personal loans, credit cards, auto loans and leases, and home equity loans—rose to a record 31.7% of personal disposable income during November. On the other hand, savings deposits plus retail money market funds rose to a record $4.2 trillion during November, equivalent to almost a half year's disposable income. From the mid-1980s through the mid-1990s, consumers typically had about a third of a year's income in these liquid assets (Figure 16).

Some interesting implications can be drawn from these uplifting numbers:

First, the balance sheet of American households is in splendid shape. During the third quarter of last year, their net worth was 5.4 times their disposable personal income. This is below the 6.2 times record during the fourth quarter of 1999. However, prior to the equity bubble of the second half of the 1990s, this ratio ranged between 4.0 and 5.0 times (Figure 17).

Second, some of the decline in the personal saving rate since the early 1980s might be attributable to the upward trend since then in the ratio of net worth to disposable income (Figure 18).

Third, if interest rates continue to rise, then households with variable-rate mortgages are likely to get squeezed. On the other hand, consumers sitting on the mountain of cash in liquid assets will receive more interest income. Let's assume that one third of mortgages outstanding are tied to variable rates. That would be $2.3 trillion in variable-rate mortgages. That is a big number, but not as big as the $4.2 trillion in savings deposits and retail money market funds.

IV. BUBBLE, BUBBLE

The Federal Reserve publishes quarterly data on the value of residential real estate and mortgage loans outstanding, including home equity loans. During the third quarter of last year, our homes were valued at $16.6 trillion. We had $7.3 trillion in mortgages and $9.3 trillion in owners' equity in household real estate. In other words, the mortgage bankers own 44% of our homes and we own the remaining 56%, which is near the recent lowest percentage on record and well below the near 70% readings of 20 years ago (Figure 19). Leverage is a wonderful thing when it works in your favor. Last year, it worked for almost all homeowners, as home prices rose by at least 10% (Figure 20).

It is possible to calculate a sort of P/E ratio for household real estate by dividing the Fed's data on the market value of houses by disposable personal income. This ratio soared to a record high of 1.9 at the end of last year's third quarter (Figure 21). On a trend basis, real estate values have been rising faster than incomes since the mid-1970s. Should we be worried? Falling interest rates tend to raise the stock market's P/E. The same is true for real estate. Lower mortgage rates mean that for any given income, people can afford to pay more for a house. Home mortgages as a percent of disposable personal income soared to a record 0.84% at the end of last year's third quarter (Figure 22).

So is there a bubble in real estate that may be about to burst? It all depends on mortgage interest rates. There probably is a bubble. If mortgage rates stay relatively low, as I expect they will this year, then it isn't likely to burst. I do worry that there may be a bubble in the financing of homes and in the increasing use of home equity as a source of credit. Mortgage refinancing activity is down sharply from 2003, and so are home equity cash-outs. Nevertheless, Americans are still tapping their home equity. They are doing it with home equity loans and undoubtedly spending the proceeds. I suspect that more and more Americans may use them to finance a lifestyle they may be unable to support on their incomes alone. Tapping home equity to buy new furniture or to fill up the gasoline tank could set the stage for major financial trouble down the road. On the other hand, it is possible that some borrowers may be using the money to remodel a kitchen or add a bathroom. Such activities would add back to the value of the home and homeowners' equity.

Home equity loans outstanding for all lenders soared to a record $827 billion by the end of the third quarter of 2004, up 27% from a year ago. They are the fastest-growing asset class in commercial bank balance sheets (Figure 23). A home equity loan is really money borrowed from a line of credit secured by the value of the home. Typically, the borrower pays the prime rate. The rate is usually lower when more is borrowed, according to the terms set by the lender. It can be an alternative to a mortgage or a supplemental source of credit. In other words, the actual aggregate line of credit undoubtedly exceeds the amount of home equity loans outstanding. I wouldn't be surprised if the sum of all the lines is twice or even three times as large as total home equity loans. Any way you slice it or dice it, banks already have very large exposure to these loans, and their exposure appears to be heading higher fast.

For now, the extra cash is boosting consumer confidence and spending, as well as the overall economy. Home equity loans increased $177 billion over the past four quarters through the third quarter of last year (Figure 24). The problem is that home equity lines of credit are seductive. In most cases, the more you borrow, the lower the interest rate. If you can't make the payment this month, the bank will take what is due from the credit line. If more households tap more of their home equity—effectively turning their home into a credit card—then such a development could seriously exacerbate the next economic downturn.

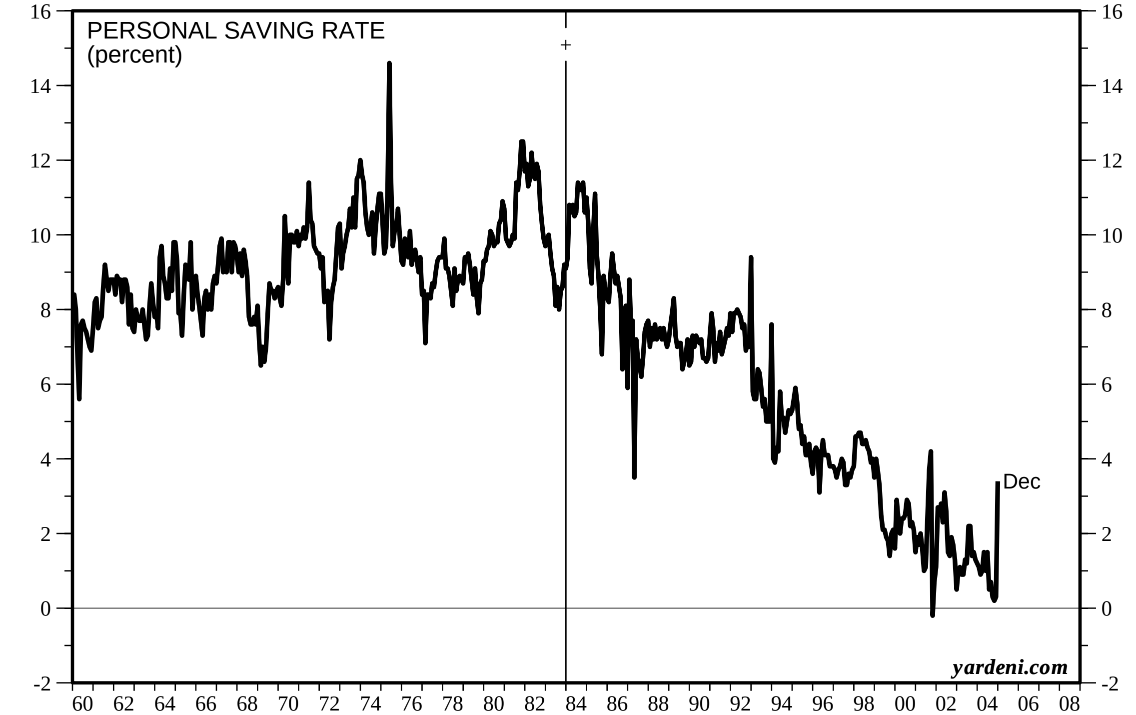
For now, I don't see a housing bubble that is about to cause the next recession during 2005. On the contrary, I see good times ahead for the economy and the stock market. Don't worry about the saving rate.

* * *

- Personal Saving -

The personal saving rate has dropped sharply since the mid-1990s. It is close to zero and could soon turn negative.

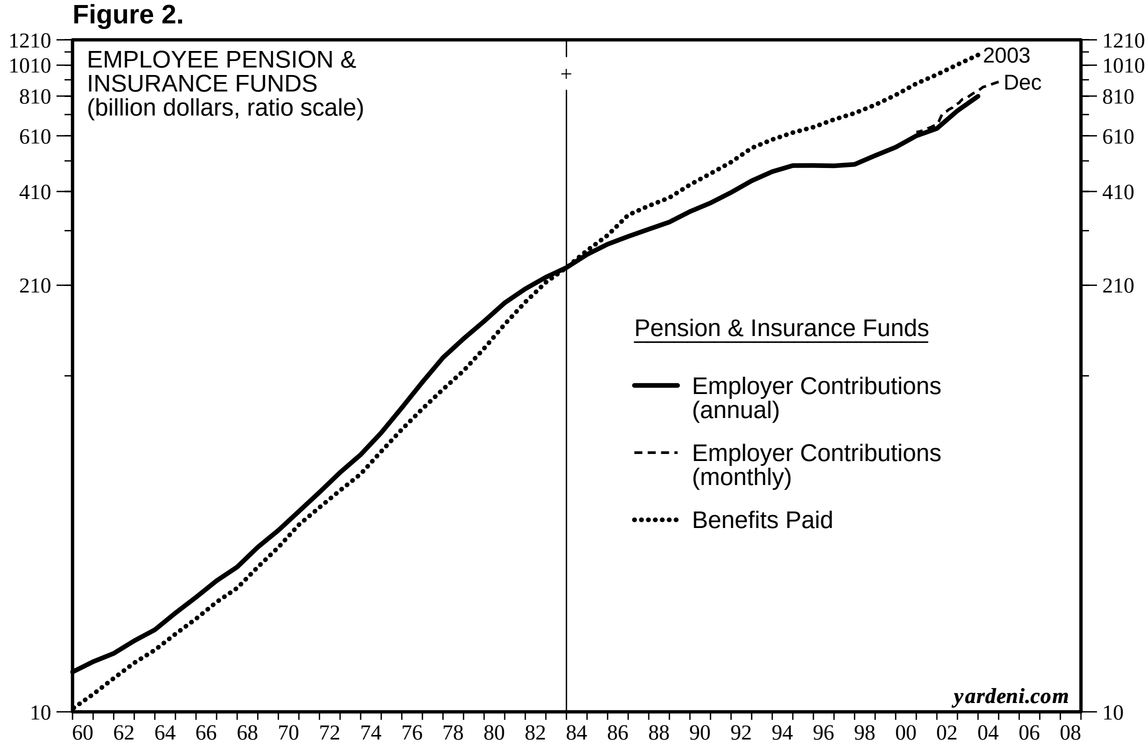
Figure 1.



+ = Benefits paid by pension and insurance funds exceed contributions.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Pension and insurance fund benefits have exceeded contributions since 1984. This explains much of the decline in the personal saving rate.

Figure 2.

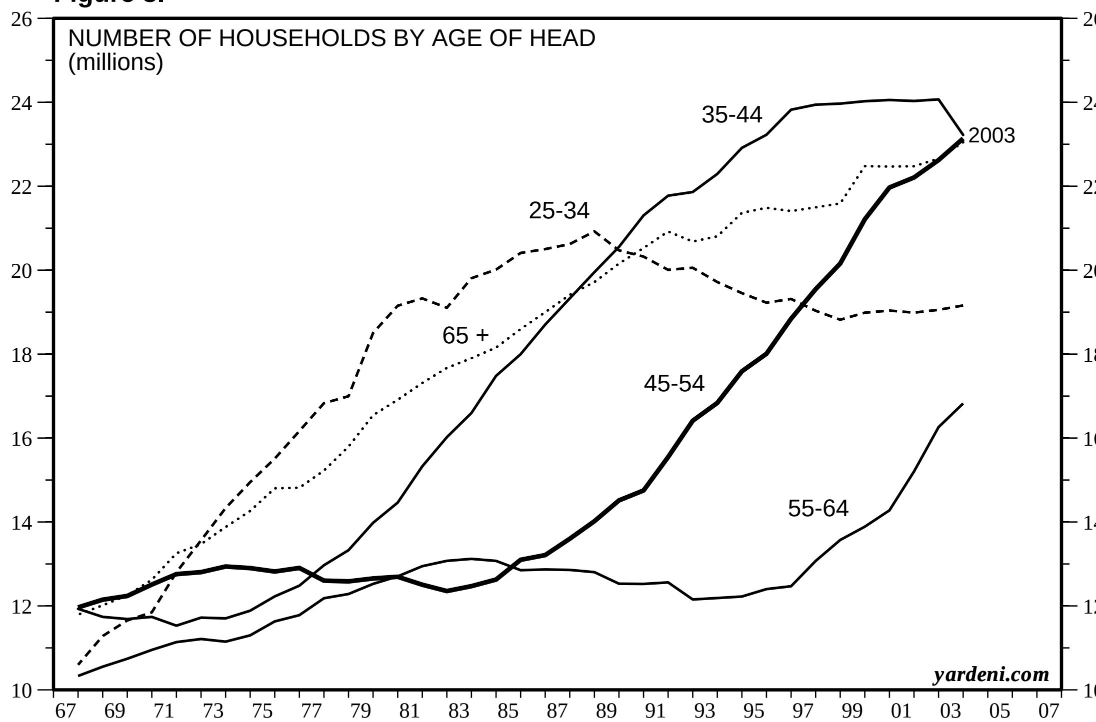


+ = Benefits paid by pension and insurance funds exceed contributions.
Source: U.S. Department of Commerce, Bureau of Economic Analysis.

- Households by Age -

Number of households heading toward retirement age is set to soar over the next 10 years.

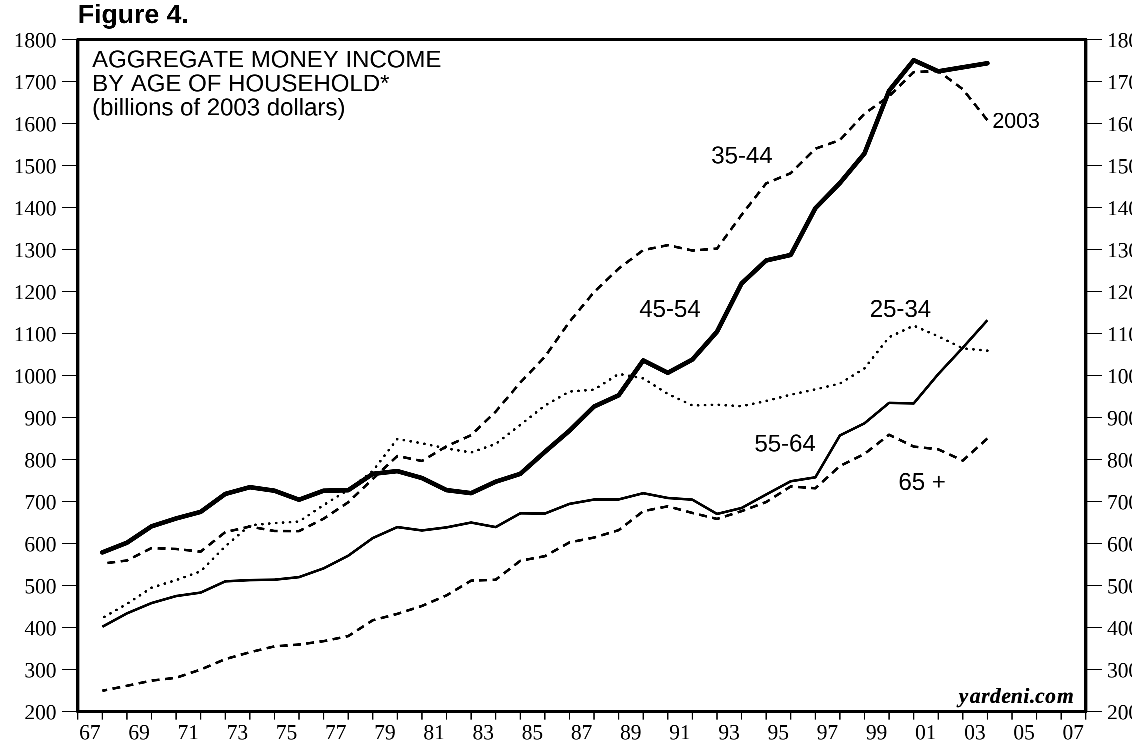
Figure 3.



Source: Bureau of the Census, Income Statistics Branch (unpublished data).

Currently, 45 to 54 year-olds have the largest share of total personal income.

Figure 4.

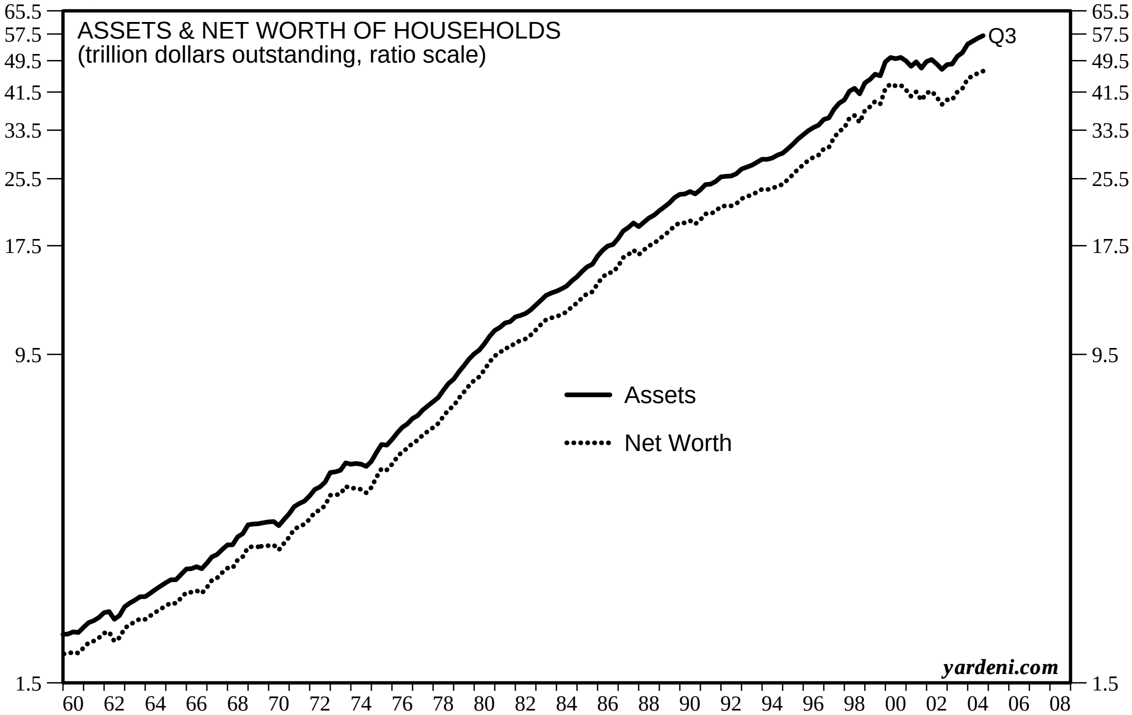


* Mean income times number of households.
Source: Bureau of the Census, Income Statistics Branch (unpublished data).

- Household Assets -

Household assets and net worth are at record highs.

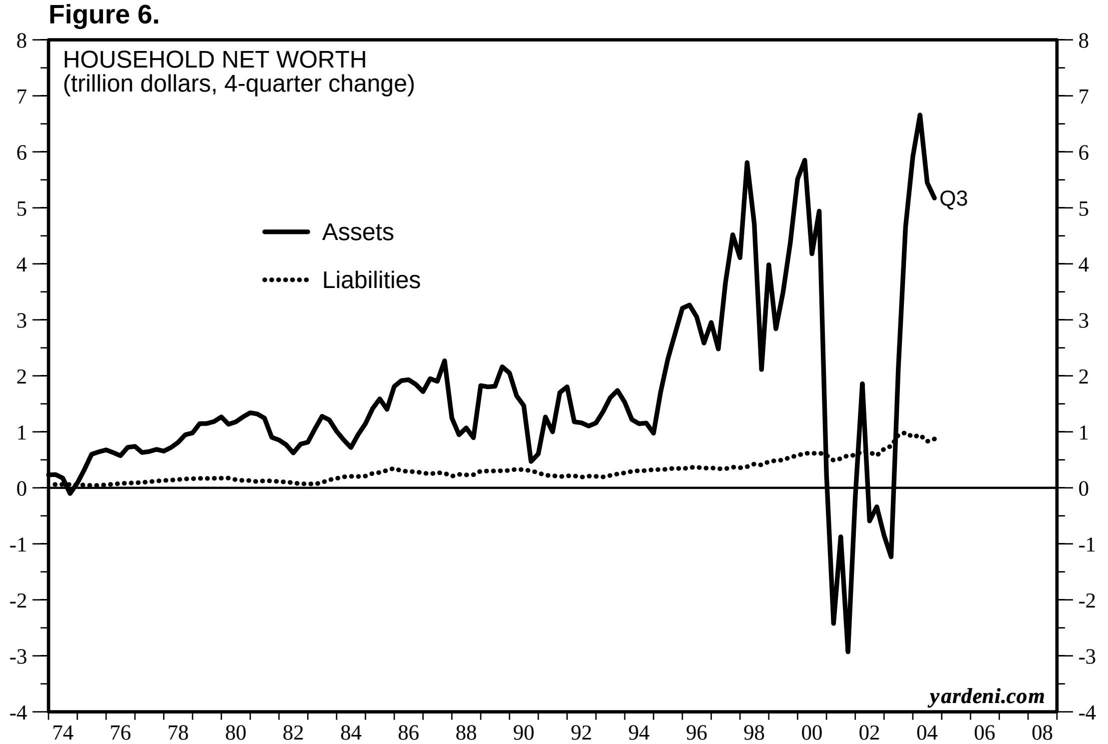
Figure 5.



Source: Federal Reserve Board Flow of Funds Accounts.

Household assets are rising much faster than liabilities.

Figure 6.

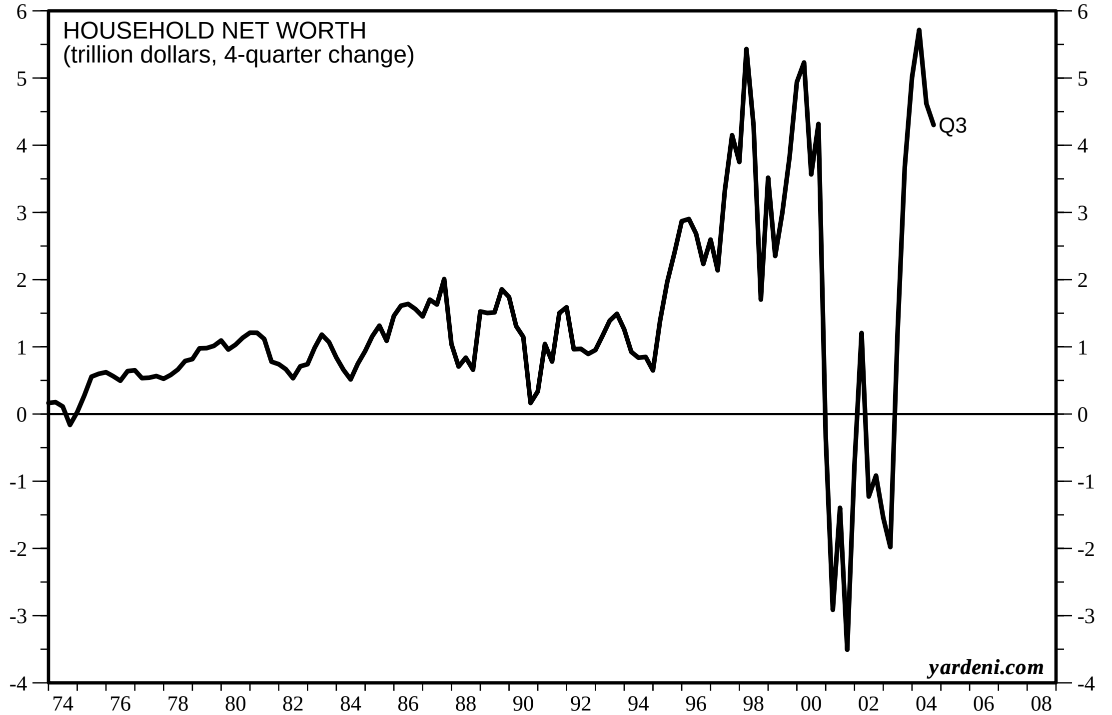


Source: Federal Reserve Board Flow of Funds Accounts.

- Household Assets -

Household net worth is rising rapidly again.

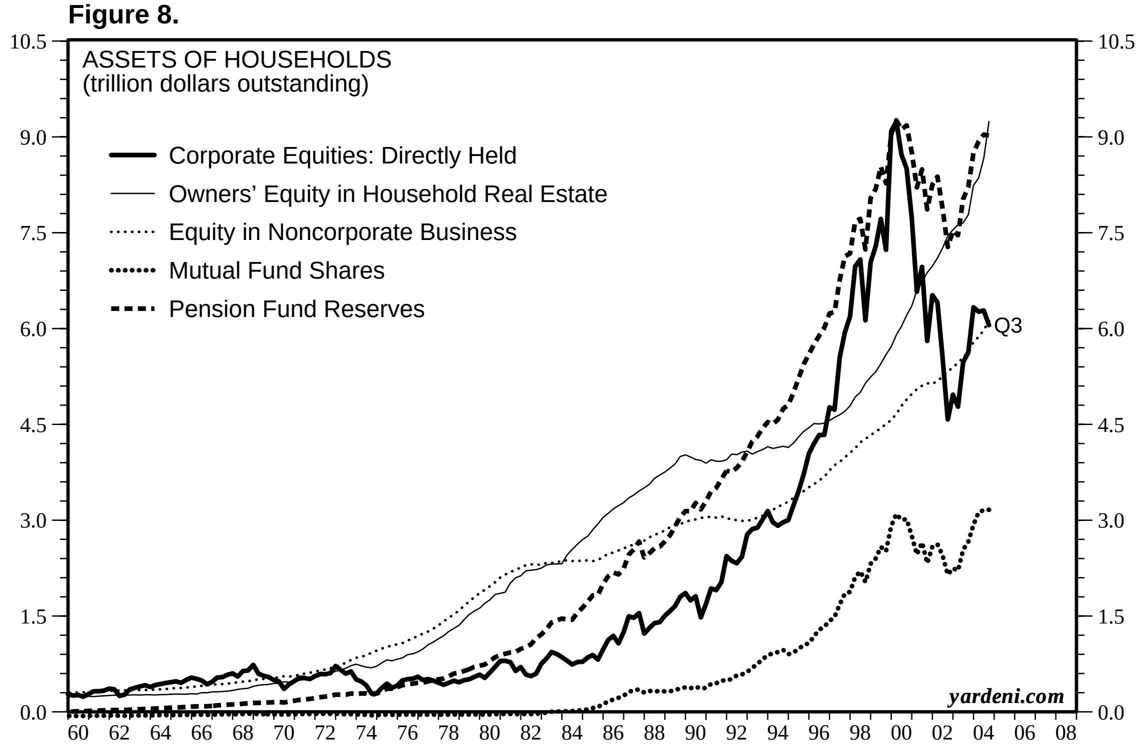
Figure 7.



Source: Federal Reserve Board Flow of Funds Accounts.

Households have a diversified portfolio of assets.

Figure 8.

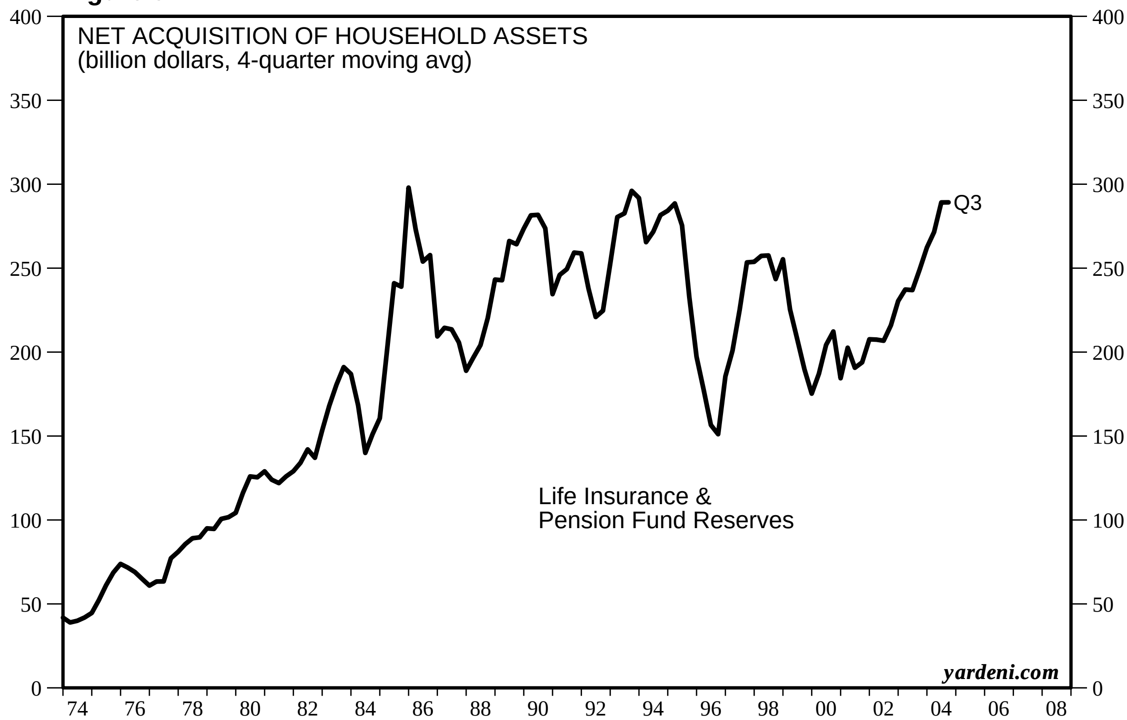


Source: Federal Reserve Board Flow of Funds Accounts.

- Household Assets -

Households' life insurance and pension fund reserves are growing rapidly.

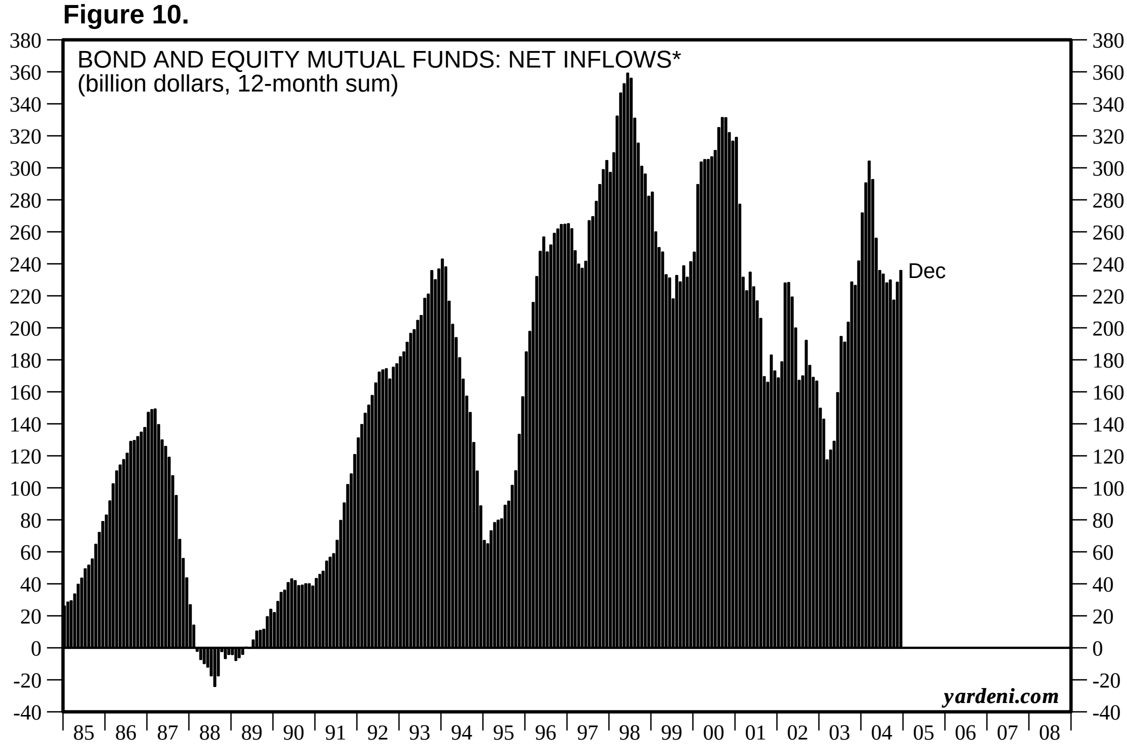
Figure 9.



Source: Federal Reserve Board Flow of Funds Accounts.

Net inflows into equity and bond mutual funds totaled $236 billion last year.

Figure 10.

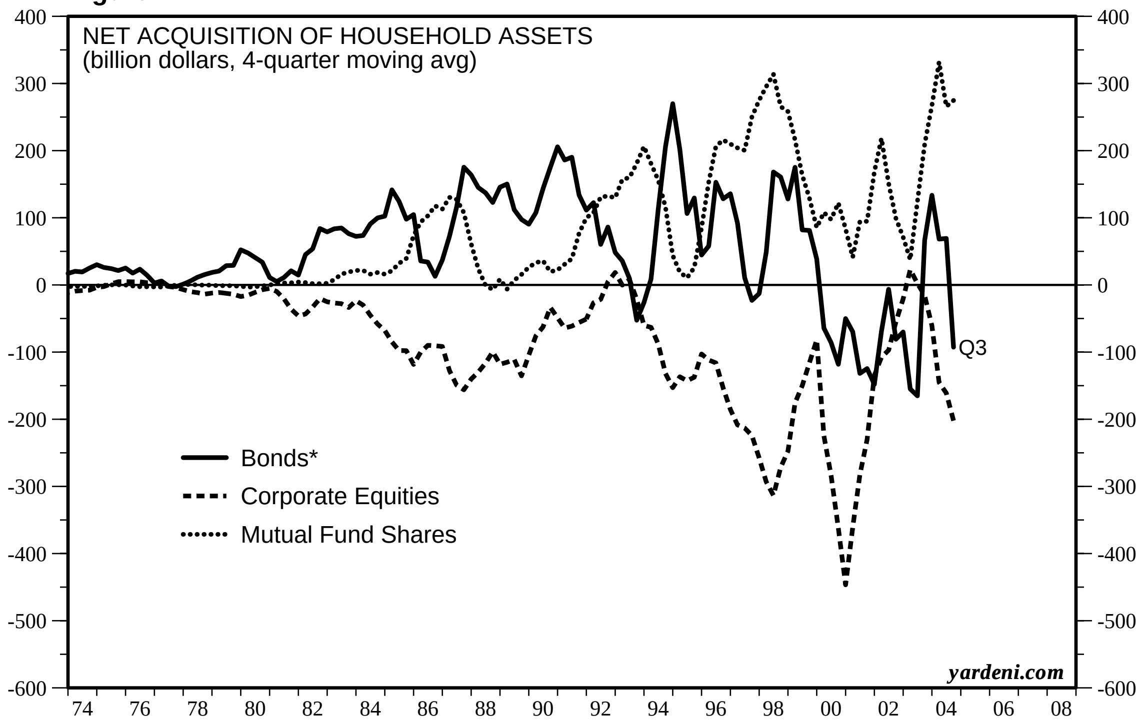


* Figures reflect sales less redemptions, plus the net result of fund switches, plus reinvested dividends.
Source: Investment Company Institute.

- Household Assets -

Net acquisitions of bonds and equities (directly held) were in negative territory.

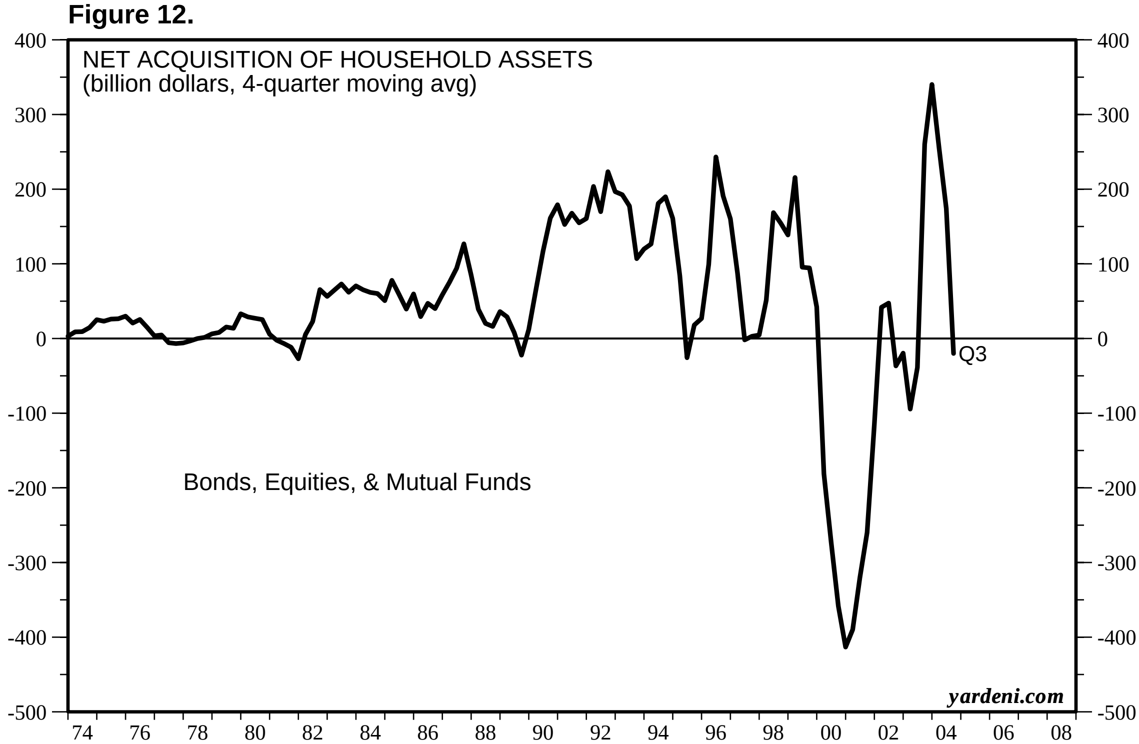
Figure 11.



* Includes Treasury, Agency, corporate and foreign, and municipal.
Source: Federal Reserve Board Flow of Funds Accounts.

Households' direct and indirect inflows to bond and stock markets netted to zero last year.

Figure 12.

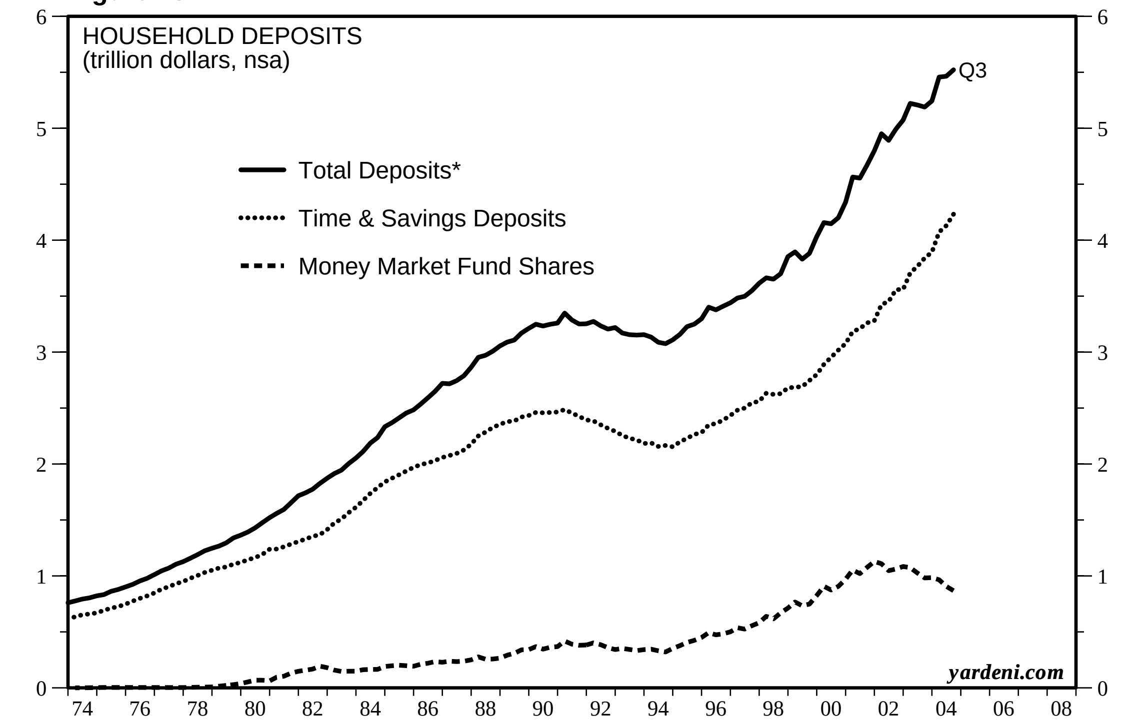


Source: Federal Reserve Board Flow of Funds Accounts.

- Household Assets -

Households are holding a record $5.5 trillion in deposits.

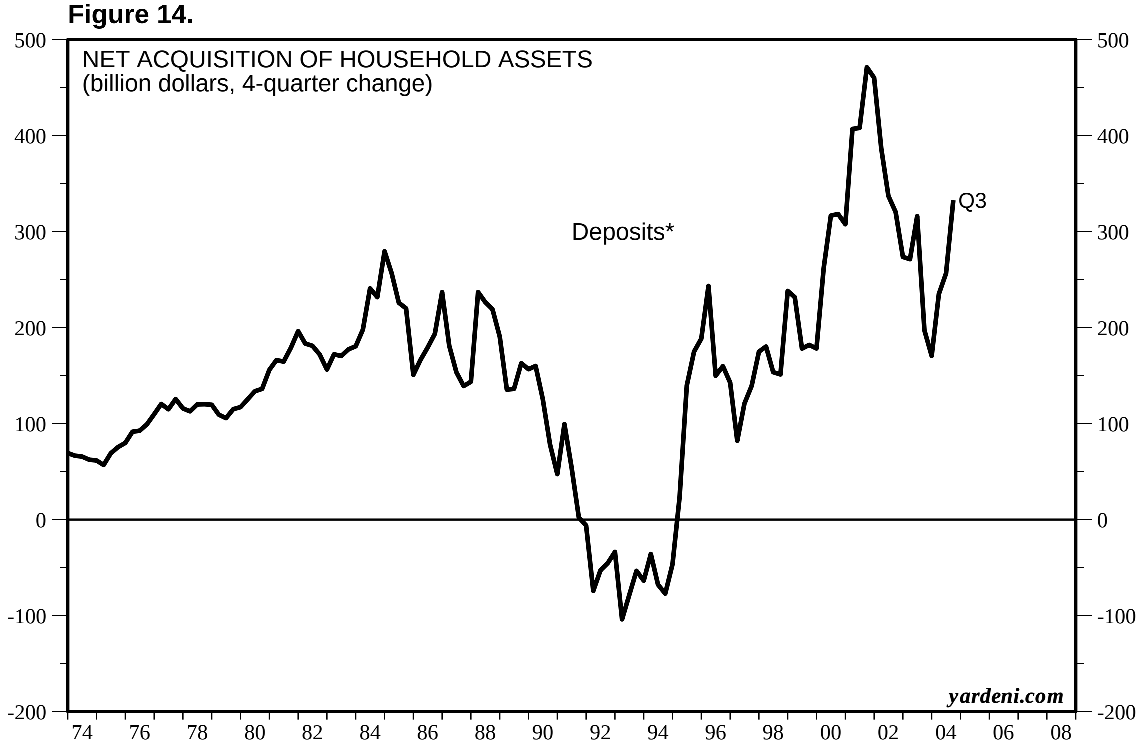
Figure 13.



* Includes foreign deposits, checkable deposits and currency, time and savings deposits, and money market fund shares.
Source: Federal Reserve Board Flow of Funds Accounts.

Households have been acquiring liquid assets at a rapid pace since the mid-1990s.

Figure 14.

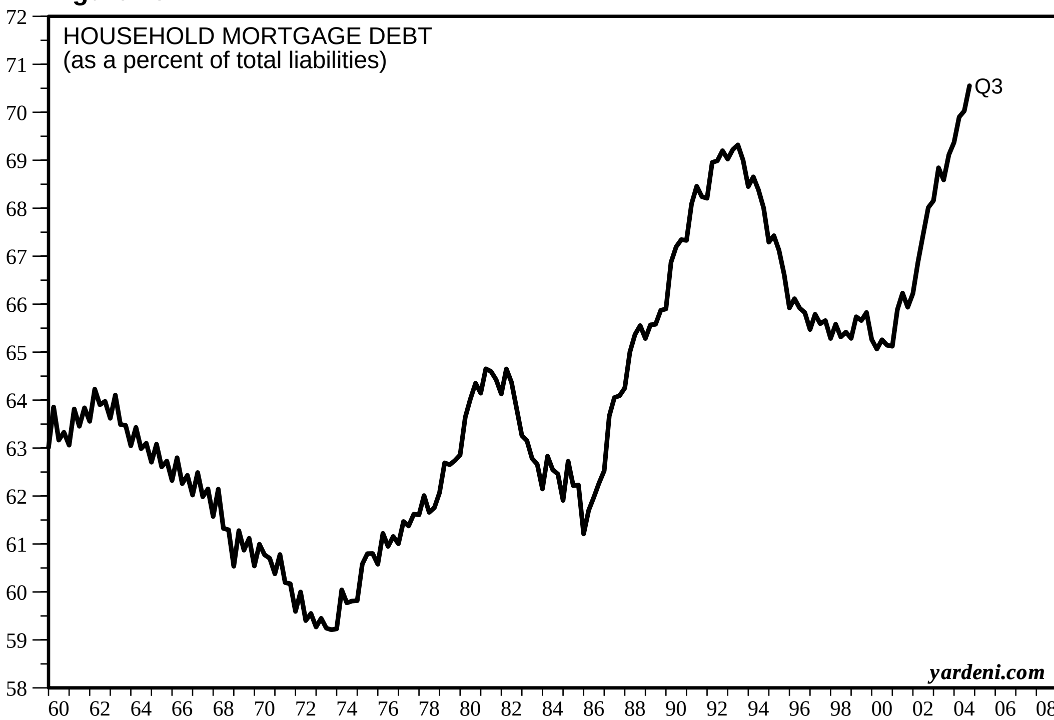


* Includes foreign deposits, checkable deposits and currency, time and savings deposits, and money market fund shares.
Source: Federal Reserve Board Flow of Funds Accounts.

- Household Liabilities -

Percentage of household liabilities in mortgage debt is at a record high. Low interest rates allow households to carry more debt and also to buy homes when they are young rather than continue to rent.

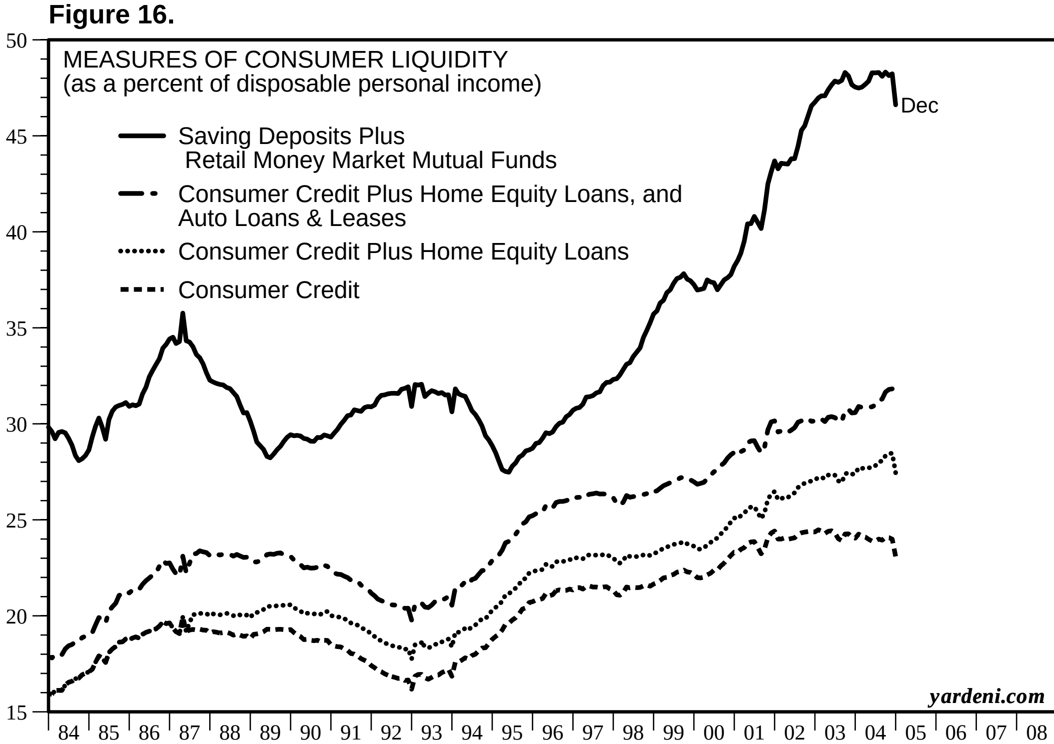
Figure 15.



Source: Federal Reserve Board Flow of Funds Accounts.

Consumer debt is at a record high of disposable income, but so are liquid assets.

Figure 16.

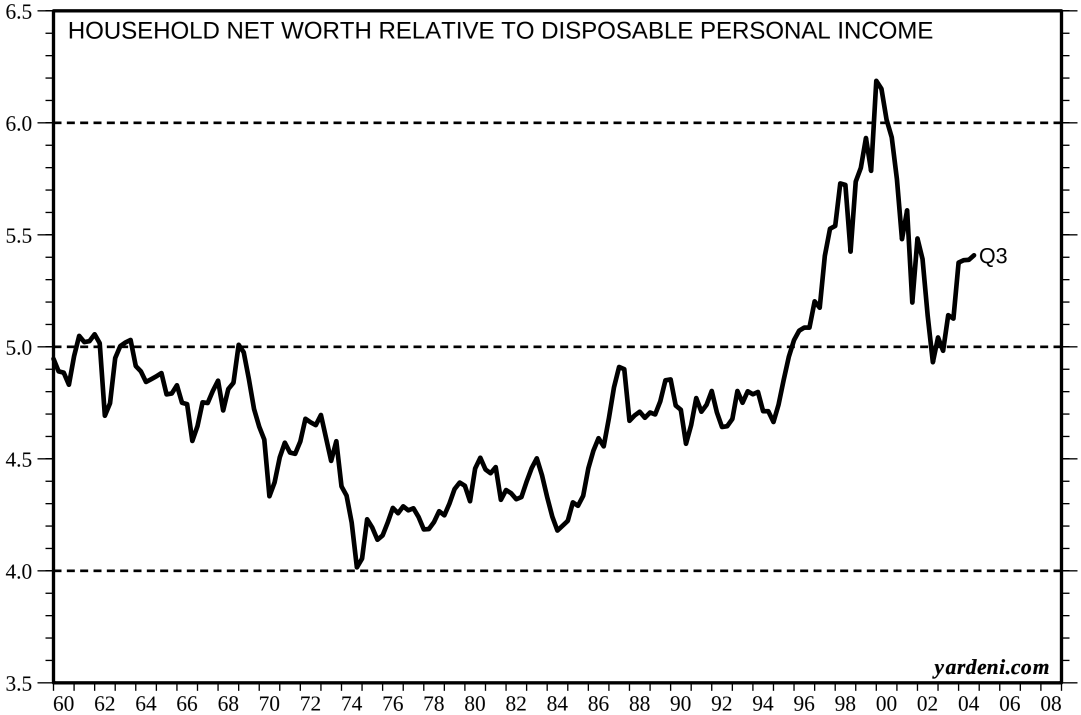


Source: Board of Governors of the Federal Reserve System.

- Household Net Worth -

At 5.4, the ratio of household net worth to disposable personal income is down from a 6.2 peak, but is well above levels prior to the mid-1990s.

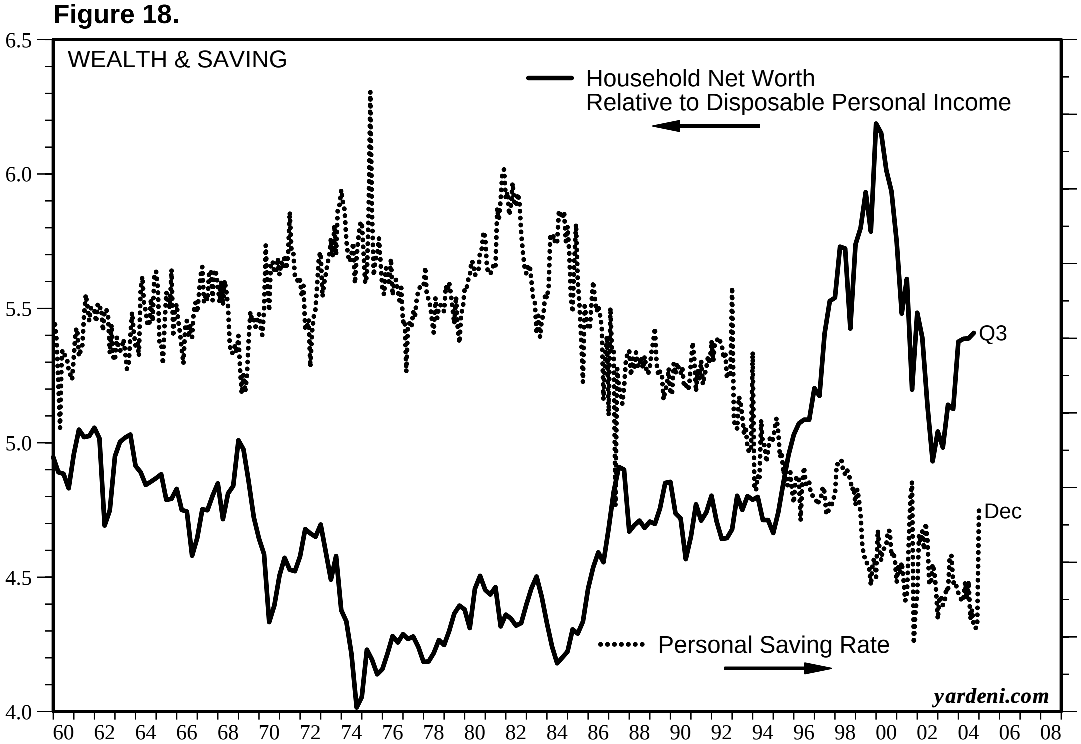
Figure 17.



Source: Federal Reserve Board Flow of Funds Accounts.

Fed officials have noted the inverse relationship between the saving rate and the wealth-to-income ratio.

Figure 18.

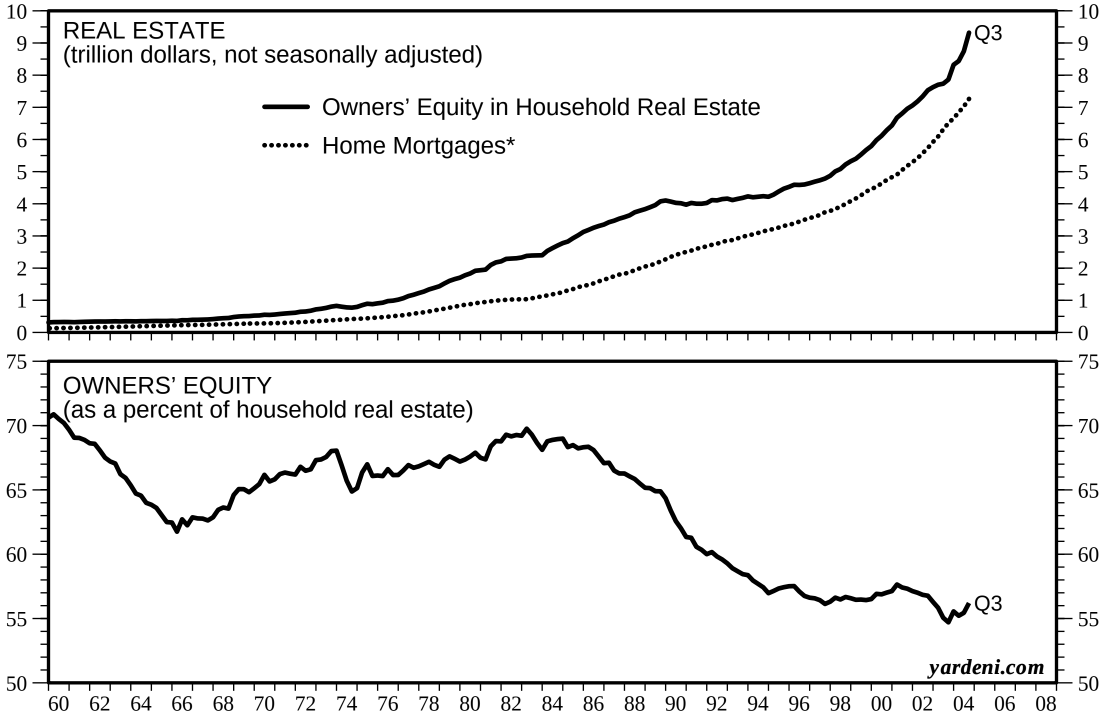


Source: Federal Reserve Board Flow of Funds Accounts and U.S. Department of Commerce, Bureau of Economic Analysis.

- Real Estate -

Owners' equity in household real estate soared to a record $9.3 trillion last year.

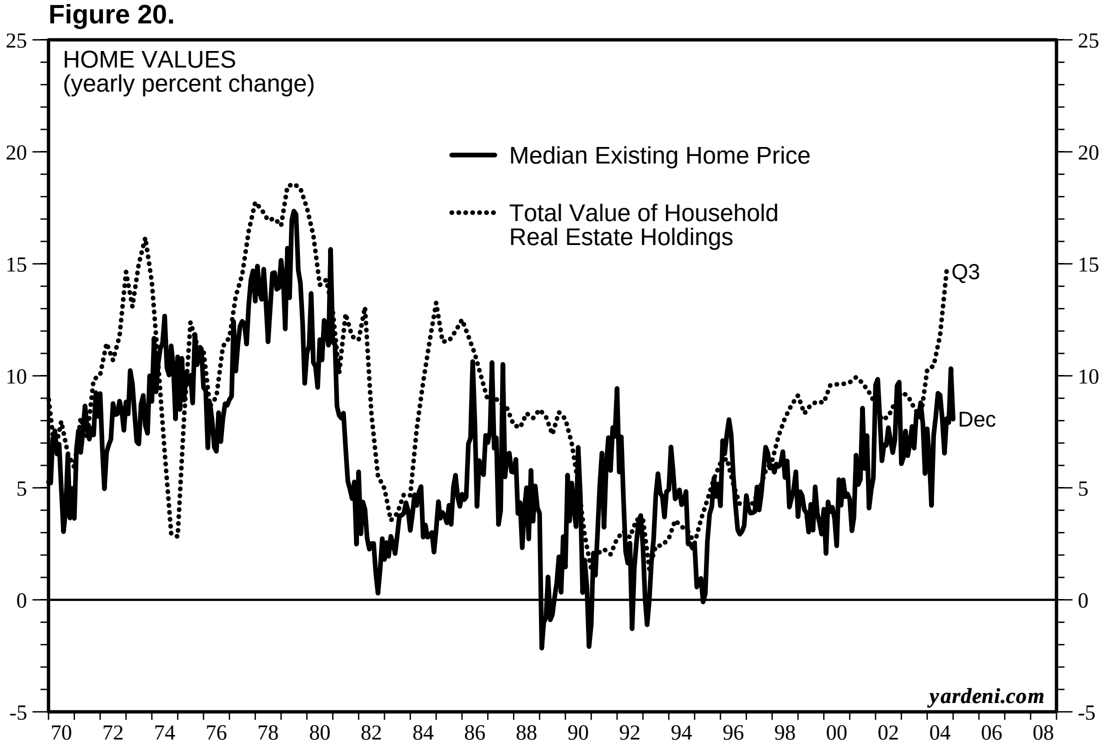
Figure 19.



* Includes home equity loans and second mortgages.
Source: Federal Reserve Board Flow of Funds Accounts.

Home values are rising at an annual rate of 10% to 15%.

Figure 20.

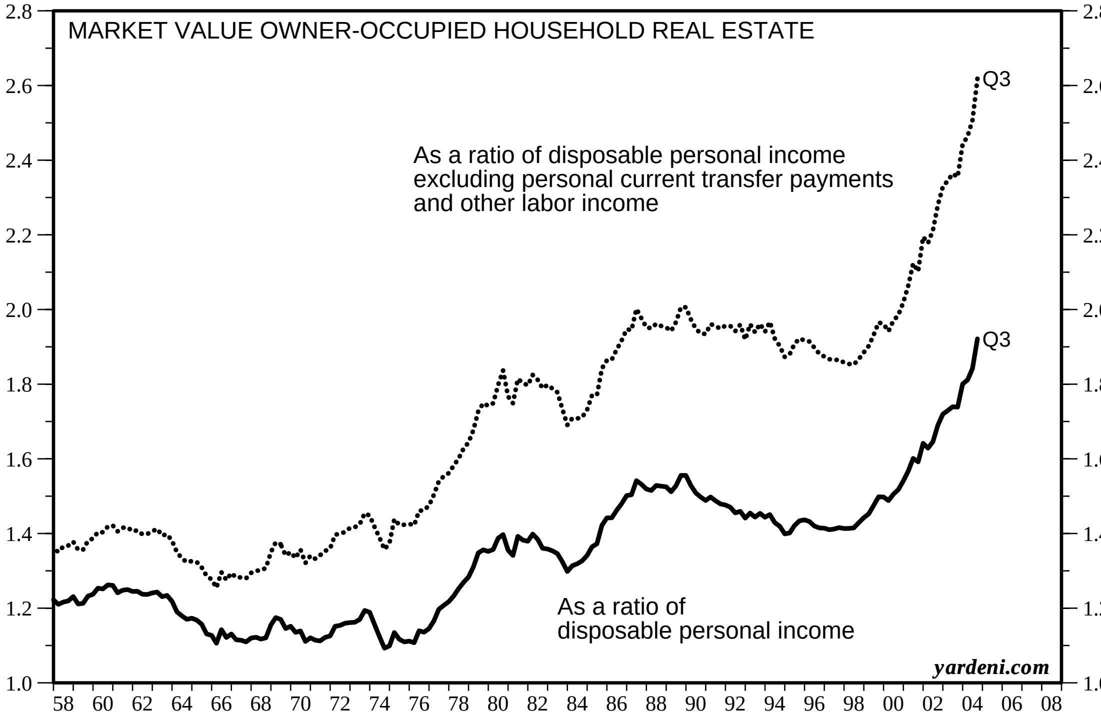


Source: Federal Reserve Board Flow of Funds Accounts and National Association of Realtors.

- Real Estate P/Es -

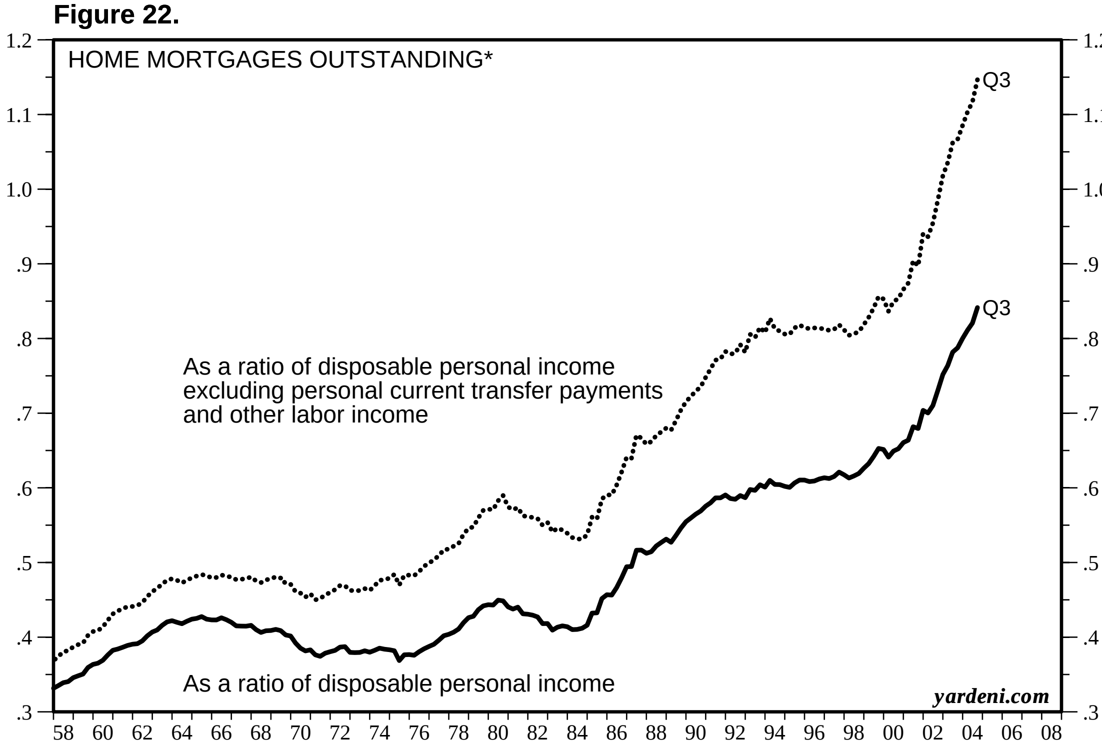
The housing market's P/E is soaring. The market value of homes is at a record 1.9 times disposable personal income. Mortgage debt is also at a record relative to incomes. This could be a dangerous development supporting fears of a housing bubble. On the other hand, low mortgage rates have made mortgage debt more affordable and allowed more people to borrow.

Figure 21.



Source: Federal Reserve Board Flow of Funds Accounts and U.S. Department of Commerce, Bureau of Economic Analysis.

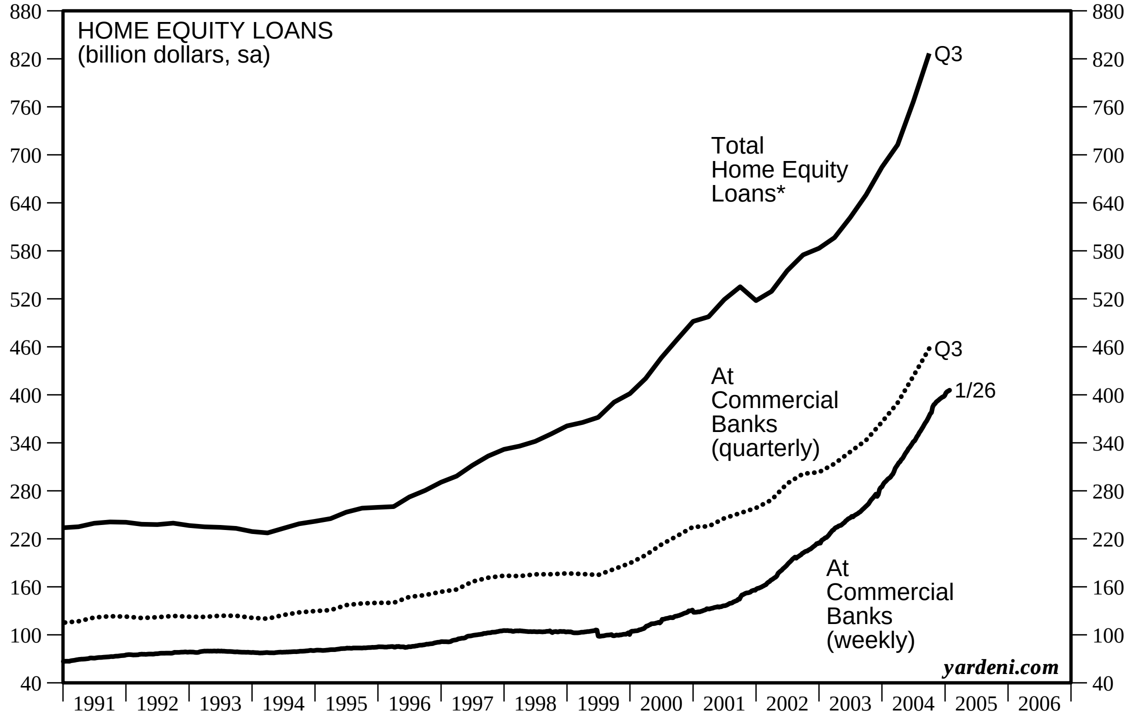
Figure 22.



* Includes home equity loans and second mortgages.
Source: Federal Reserve Board Flow of Funds Accounts and U.S. Department of Commerce, Bureau of Economic Analysis.

- Home Equity Loans -

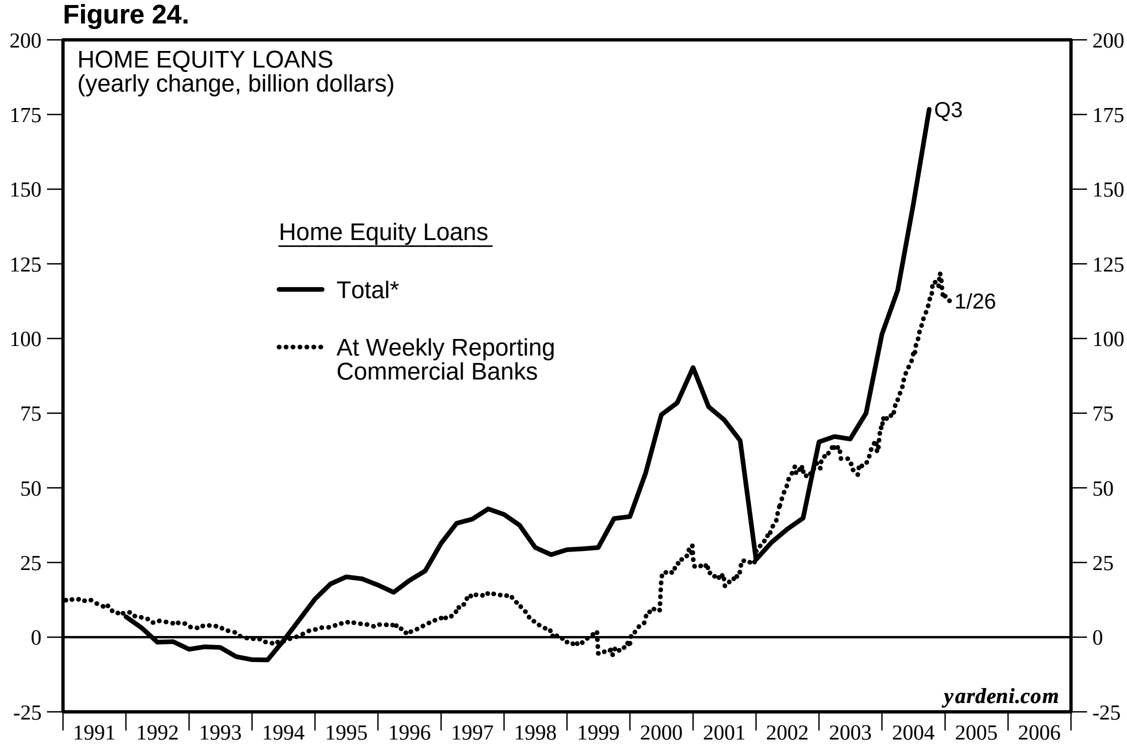
Figure 23.



* Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.
Source: Board of Governors of the Federal Reserve System.

Home equity loans are soaring.

Figure 24.



* Loans made under home equity lines of credit and home equity loans secured by junior liens. Excludes home equity loans held by mortgage companies and individuals.
Source: Board of Governors of the Federal Reserve System.

Additional Information Available on Request.