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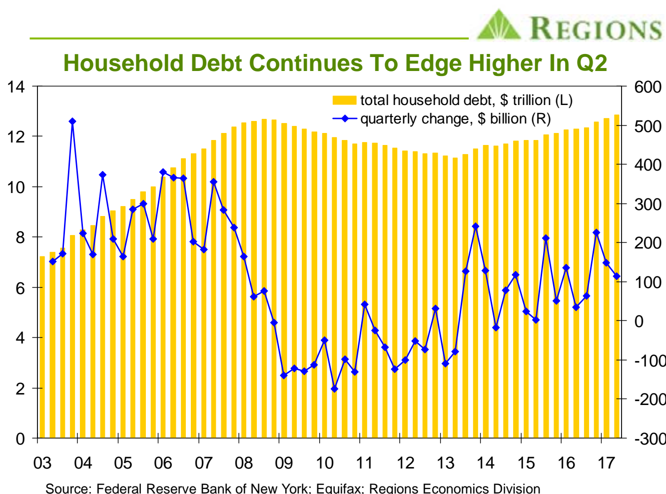
Q2 2017 Household Debt and Credit: Household Debt Continues To Edge Higher

- Total household debt rose to $12.839 trillion in Q2 2017, an increase of $114 billion from Q1 2017.
- Mortgage debt, auto loans, and credit cards accounted for most of the growth in overall debt in Q2; HELOC balances declined.
- As of Q2, 4.77 percent of outstanding household debt was in some stage of delinquency.

The Federal Reserve Bank of New York (New York Fed), in conjunction with Equifax, has released their latest quarterly report on trends in household debt. Total household debt rose to $12.839 trillion in Q2 2017, an increase of $114 billion from Q1 and the 12th consecutive quarterly increase in total household debt. And, sure, the $12.839 trillion of household debt is a new record high, which seems to be the main point of interest in most accounts of the New York Fed's report, although we don't know why. Total household debt grew 4.49 percent, year-on-year, in Q2, easily ahead of the 3.86 percent pace in Q1 and the fastest year-on-year growth since Q2 2008. The main contributors to growth in household debt in Q2 were mortgage debt, up by $64 billion, auto loans, up by $23 billion, and credit card debt, up by $20 billion after having declined in Q1. "Other" forms of household debt rose by $11 billion, student loan balances were unchanged, and balances on home equity lines of credit fell by $4 billion, leaving them at their lowest level since Q3 2004.



As noted above, much has been made about the fact that Q2 saw a new record high in the level of total household debt. There are a number of ways to interpret that. Some have taken the new record high as a sign of distress amongst U.S. consumers, in that they are having to resort to credit to facilitate current consumption. Others take it as a sign of growing confidence amongst U.S. consumers, in that they feel more confident about their jobs and incomes and, as such, are willing to take on more debt to enhance current consumption. In and of itself, however, the level of outstanding debt actually tells us very little and has to be put into some sort of context in order to interpret its meaning.

The most obvious point to make is that, as can be seen in the details of the quarterly New York Fed reports, there is considerable variation in the behavior of the individual components of household debt, thus making it difficult to draw broad conclusions by simply looking at the headline number. For instance, growth in outstanding credit card debt has accelerated sharply over the past few quarters, with year-on-year growth of 7.54 percent in Q2. Whether this is a sign of distress or confidence, however, is open for debate, though we'd be more inclined to go with the latter. At the same time, growth in auto loans has steadily decelerated over the past few quarters but nonetheless remains faster than growth in total household debt. The deceleration in growth in auto loans is consistent with patterns in unit motor vehicle sales, which are receding from their cyclical peak, which in our view simply reflects a good portion of the pent-up demand that existed earlier in the cycle having been sated. Meanwhile, outstanding mortgage debt ambles along at a fairly slow pace, which is consistent with patterns in sales of new and existing homes, though higher home prices, as opposed to more home sales, are clearly helping fuel growth in aggregate mortgage debt. The point here is that each component of household debt tells us a specific story about a specific segment of the economy. In contrast, simply looking at the aggregate level of household debt tells us very little about any specific segment of the economy, and it's hard to know whether a new record is cause for celebration or concern.

As to context, we think it useful to put the growth of household debt in the context of growth in income, which helps assess to what extent households: a) have the ability to service current debt levels; and b) have the capacity to take on additional debt. Though most discussion along these lines focuses on disposable personal income, i.e., what households have left after meeting tax obligations, we think this to be too broad of a measure of income. Instead, we believe the proper measure of income to be disposable personal income excluding transfer payments. There are two reasons for this. First, even though they are booked as personal income, not all forms of transfer payments reflect actual cash payments to individuals. For instance, Medicaid and Medicare payments are booked as personal income in the form of transfer payments but do not reflect cash available to spend or from which to service debt. Second, many of the forms of transfer payments that are cash payments, such as Social Security or Unemployment Insurance benefits, are typically spent in their entirely, and mostly on necessities, meaning they provide recipients with few, if any, funds out of which to service debt. As such, disposable personal income excluding transfer payments more properly measures the pool of funds out of which debt service payments will be made.

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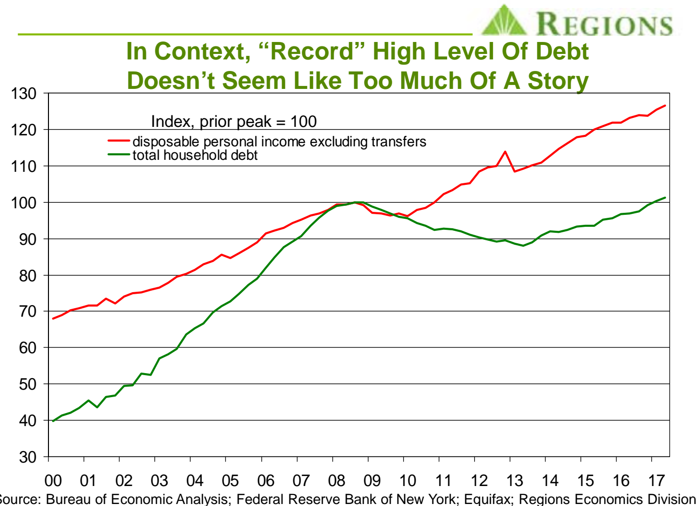
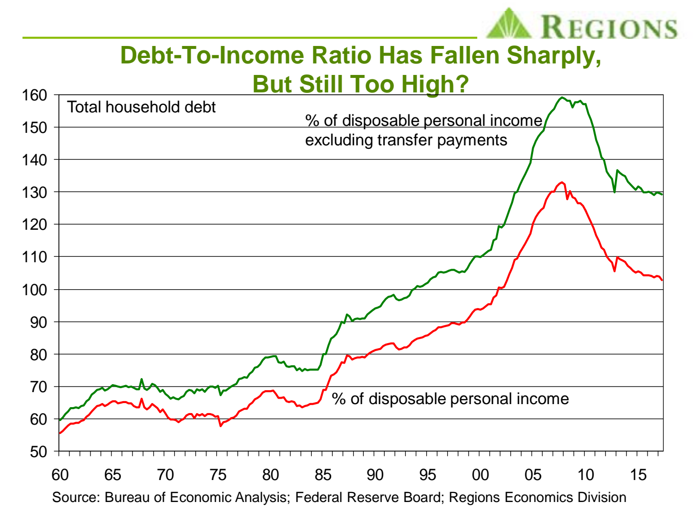
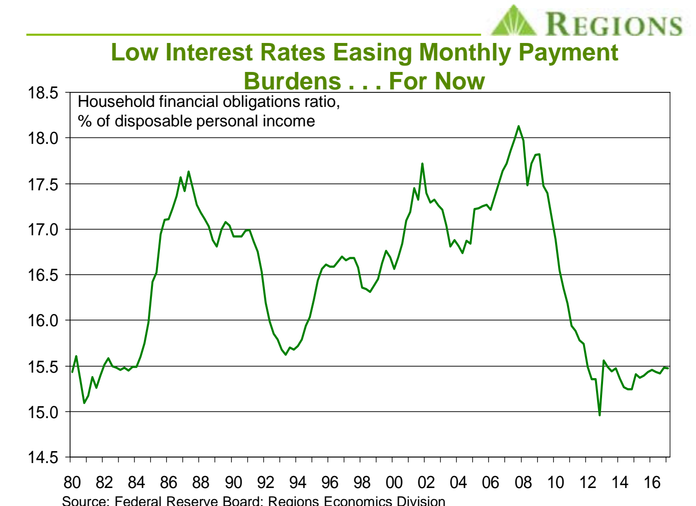
The chart to the side shows the paths of disposable personal income excluding transfer payments and aggregate household debt, in the form of indexes for which the prior cyclical peak is set at 100. As seen in the chart, while the aggregate level of household debt reached a new record high in Q2, it stands just 1.29 percent above the Q3 2008 peak. Oh well, a record is a record, one supposes. In contrast, however, the level of disposable personal income ex-transfers stands 26.60 percent above its prior peak. Another way to think about it is that the debt-to-income ratio (whether total or ex-transfer income is the base) in the household sector is much lower today than at its peak.



During and after the 2007-09 recession, households went through a prolonged period of deleveraging (to be sure, in the early phases this mostly reflected lenders writing off bad debt); while household debt has been growing again for several quarters now, the rate of growth has not come close to the rate seen prior to the recession nor do we expect it to do so any time soon. For context, between Q1 2000 and Q4 2007 year-on-year growth in household debt averaged 12.46 percent. After peaking at just over 159 percent in Q4 2007, the ratio of household debt to disposable personal income ex-transfers has fallen steadily and stood at just over 129 percent as of Q2 2017. It is, however, valid to ask whether the debt-to-income ratio is still too high. Many analysts argue the level of debt, and in turn the debt-to-income ratio, does not matter as long as households are able to service their debt. We simply can't, however, get comfortable with debt-to-income ratios being as high as they are, no matter how hard we try to do so.

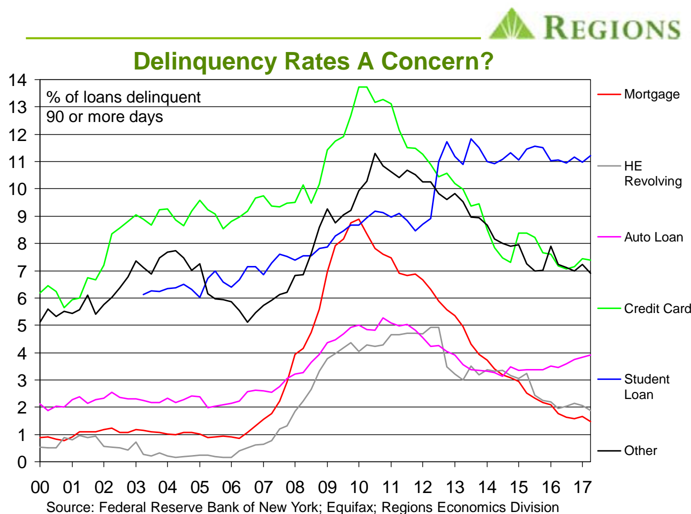


It is true that a prolonged period of low interest rates has meant that monthly debt service obligations and the broader measure of overall financial obligations have been hovering near historical lows for some time now, as seen in the bottom chart (as a side note, the ratio hit an all-time low in Q4 2012 which simply reflected a spike in income as many individuals pulled income forward into Q4 2012 ahead of an increase in personal income tax rates on January 1, 2013). This, however, is where our concerns arise, in that consumers are vulnerable to an increase in interest rates of any significance that would result in higher monthly payment obligations. And, even to the extent consumers have opted to take on more fixed rate, as opposed to variable rate, debt, higher interest rates coupled with still-high debt-to-income ratios would materially limit consumers' capacity to take on additional debt, let alone the willingness of lenders to extend additional debt. So, in other words, our view is that the level of debt does not matter, until it actually does.



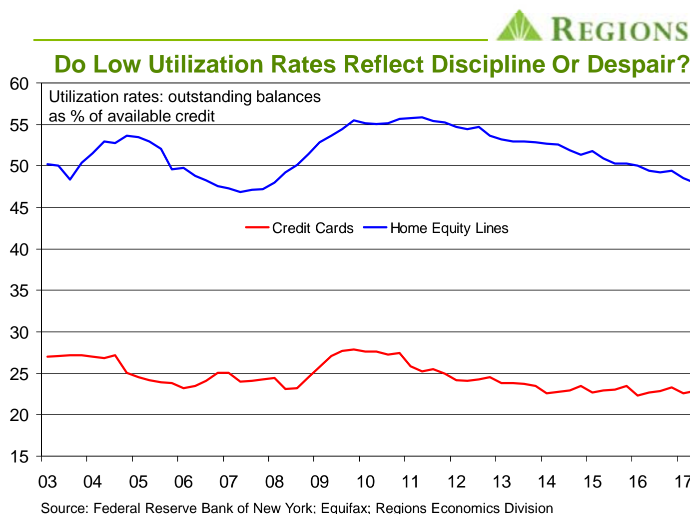
While the broader trends remain favorable, delinquency rates point to specific instances of financial stress even absent higher interest rates. As of Q2 2017, 4.77 percent of total household debt was in some stage of delinquency, down trivially from 4.83 percent in Q1 and the lowest percentage since Q4 2006. "Serious" delinquencies, i.e., delinquent for 90 or more days, slipped to 3.20 percent of total household debt in Q2, down from 3.35 percent in Q1 and the lowest rate since Q3 2007. Still, the serious delinquency rate remains easily above the pre-recession average of 2.25 percent. A recent trend that has garnered considerable attention is that credit card debt has accounted for a growing share of inflows into delinquency over the past few quarters, though still remaining below auto loans and student loans in terms of newly delinquent balances as a share of outstanding balances. Unfortunately, the publicly available data from Equifax do not allow us to answer the question of whether the main factor behind rising credit card and auto loan delinquencies is a higher incidence of consumer distress or looser underwriting standards, though anecdotal evidence points to the latter. We do know

from the Equifax data that since 2012 over 20 percent of all new auto loans have been originated to borrowers with credit scores below 620, which is a higher share than loans originated to those in the 660-719 and 720-759 score buckets.



More broadly, the serious delinquency rate on student loans ticked higher in Q2 and now stands at 11.22 percent, while the serious delinquency rate on auto loans rose to 3.92 percent and that on credit card loans slipped to 7.38 percent. Serious delinquency rates on HELOCs and mortgage loans continued to drift lower in Q2, with the former standing at 1.88 percent and the latter at 1.47 percent. It is worth noting that, contrary to auto loans and credit card loans, new mortgage originations remain highly concentrated amongst borrowers with credit scores of 760 or higher, as has been the case in the post-recession years. Though our view is that to this point increases in auto and credit card delinquencies have mainly been driven by borrowers on the lower end of the credit score spectrum, we'll reiterate our earlier point that a material increase in interest rates could easily lead to rising defaults across a wider range of borrowers given that debt-to-income ratios remain elevated, even if they are down sharply from their cyclical highs.

Finally, we think it worth reiterating that despite the considerable fanfare around the fact that the level of household debt hit a new record high in Q2, growth in overall household debt remains considerably below historical norms. While, as in the case of mortgage loans, that is to some extent a function of lenders being more selective, don't lose sight of the fact that consumers have a say in this as well. For instance, utilization rates (or, outstanding balances as a percentage of credit limits) remain notably low on credit card loans and HELOCs, in the case of credit cards the utilization rate is not only below the peak seen in the aftermath of the 2007-09 recession but is also below the pre-recession average. This begs the question of whether the low utilization rate reflects discipline or despair on the part of card holders. For instance, is it that consumers still scarred by the severe downturn and having before been burned by high levels of debt are now more disciplined, or are they simply lacking confidence in future job and income prospects and, as such, unwilling to dip too deeply into the pool of available credit? We think it more the former than the latter, but new inflows into credit card delinquencies have ticked higher over recent quarters, which could suggest that those most intensively utilizing credit card debt are doing so more out of necessity than choice.



As for HELOCs, outstanding balances have declined in 30 of the past 33 quarters, which was understandable earlier in the expansion but less so over the past several quarters in which the rate of house price appreciation has been much stronger. The HELOC utilization rate stood at 47.98 percent in Q2, the lowest since Q4 2007. Still, it is worth pointing out that house price appreciation has been quite uneven across individual metro areas, meaning that improved equity positions have to some degree been concentrated amongst a smaller group of larger metro areas, which will have limited the pool of homeowners with the ability to tap into higher housing equity.

Contrary to many accounts of the New York Fed's latest report on household debt, we don't see the fact that Q2 2017 saw a new record high level of household debt as meriting all that much attention. After all, as noted above, the new record is only marginally higher than the old record set back in Q3 2008, but almost everything else is much different. The size and relative health of the economy, the income pool out of which debt is serviced, the level of interest rates, and the composition of the stock of debt are all vastly different today than was the case in 2008. Despite these differences, many have leapt to the conclusion that because the old record level of debt was set as the economy was tumbling into the most severe downturn since the Great Depression, hitting a new record must mean we are in for a similar fate this time around. While this is, well, curious is about the most polite term we can use to describe this line of thinking, we nonetheless harbor some concerns. For instance, the level of and stubbornly high delinquency rate on student loan debt and the deterioration, though still modest, in the performance of auto loans and credit card debt bear watching, and we see more downside risk from higher interest rates than do many other analysts. That said, given that income growth, as opposed to debt growth, has been the main fuel for growth in consumer spending during the current cycle, the ride may not be as fast this time around, but it won't feel nearly as bad when it comes to an end, as it ultimately will.

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