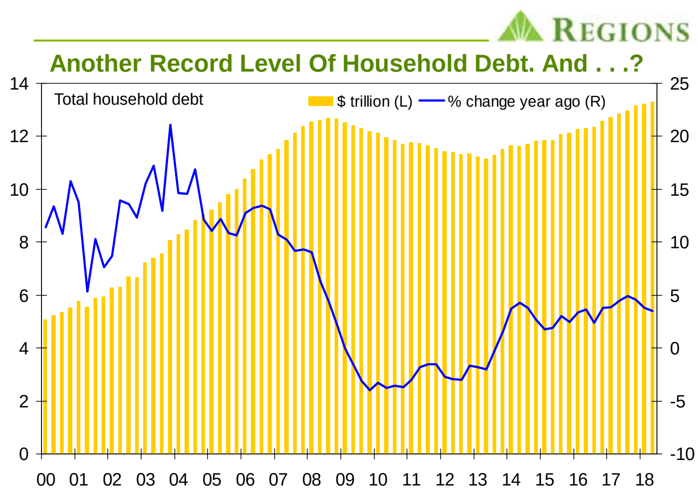
ECONOMIC UPDATE
REGIONS
August 15, 2018

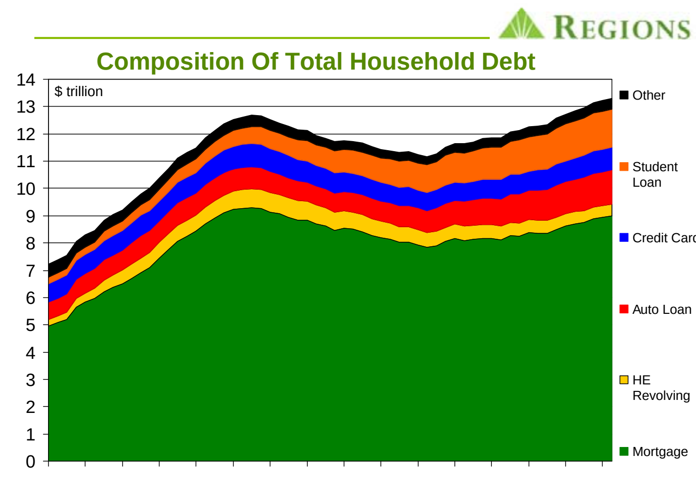
Q2 2018 Household Debt and Credit: Another Record Level Of Household Debt. And . . .?

- Total household debt rose to $13.293 trillion in Q1 2018, an increase of $82 billion from Q1 2018
- Mortgage debt accounted for most of the growth in overall debt in Q2; student loan and HELOC balances declined
- As of Q2, 4.50 percent of outstanding household debt was in some stage of delinquency, the lowest share since Q3 2006

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 $13.293 trillion in Q2 2018, a $82 billion increase from Q1 2018 and, yes, a new record high level of household debt. In our write-up of the Q1 2018 data on household debt, we referred to what was then a new record high level of household debt as "a headline in search of a story," and we feel exactly the same about the new record high set in Q2. We think it of far more relevance to put the level of household debt, new record high or not, in the context of things that matter, such as the level of disposable personal income and households' ability to service their debt. Additionally, we think it interesting to note that the growth of household debt, having never approached growth rates seen during prior cycles, has decelerated in three consecutive quarters. As such, in what follows, we'll comment on a few elements of the New York Fed's latest release. And, as we are in the forecasting game, here's a freebie for you – there will be a new record high level of household debt in Q3 2018. Just thought you'd like to know now.



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division



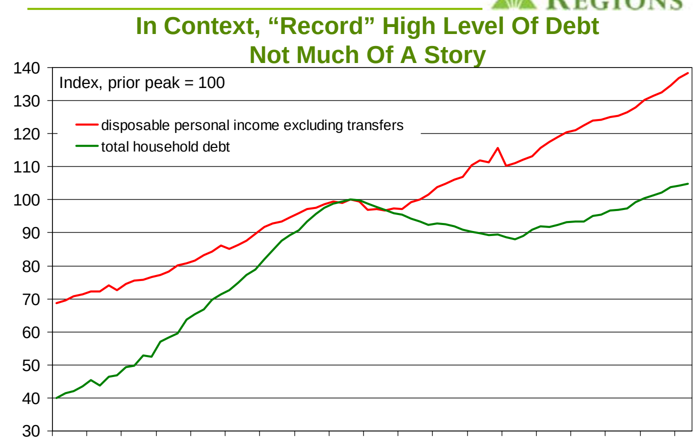
Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division

As always, mortgage debt accounts for far and away the largest share of household debt, 67.7 percent in Q2, matching its Q1 share. In the "for what it's worth" category, the level of mortgage debt as of Q2 – $8.999 trillion – is 3.2 percent below the record high of $9.294 trillion seen in Q3 2008. Mortgage debt accounted for $60 billion of the $82 billion increase in total household debt in Q2, and the 3.54 percent year-on-year increase matched that of total household debt. Credit card debt rose by $14 billion in Q2, good for a year-on-year increase of 5.74 percent, with outstanding auto loans increasing by $9 billion in Q2, leaving them up 4.03 percent year-on-year. The long-running decline in outstanding revolving home equity line balances continued in Q2, with a decline of $4 billion, leaving outstanding balanced down 4.42 percent year-on-year. While student loan balances fell slightly in Q2, this is simply a reflection of typical seasonal patterns that see outstanding balances flat-to-slightly lower in the second quarter of any given year, and even with the decline in Q2 outstanding student loan balances were still up 4.54 percent year-on-year as of Q2 2018.

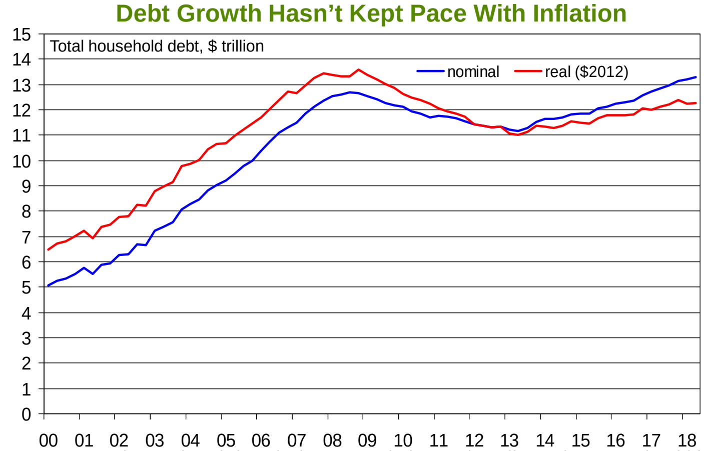
It is striking how many of those who latch on to the "new record high" part of the New York Fed's quarterly reports, whether to scold U.S. consumers, to warn of impending doom, or to simply highlight the "new record high," somehow manage to do so without putting the level of household debt into any sort of meaningful context. For instance, in one account of the Q2 data it was noted that despite growth in total household debt having been fairly modest, the level of debt is nearly 20 percent higher than five years ago. Which is true, with the level of household debt standing 19.1 percent above where it was five years ago, but what was not mentioned is that over this same time period the level of disposable personal income excluding transfer payments increased by 24.5 percent. And, as shown in the first chart below, the disparity between growth in disposable personal income and growth in household debt since the prior cyclical peak in each series has been much more pronounced, with the level of disposable personal income excluding transfer

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

payments having increased by almost 40 percent while the current record level of household debt is 4.9 percent above the prior peak. It is a totally fair point that these aggregate numbers tell us nothing about the distribution of either household debt or personal income, and it could well be that growth in household debt is more heavily concentrated amongst those who have seen less growth in income. We would never dismiss this story line out of hand, but the lack of timely data on the distribution of debt and debt service burdens (i.e., monthly principal and interest payments) makes it hard to assess the degree to which this is the case. What is likely is that growth in different types of debt has been more concentrated amongst specific income groups – for instance, growth in mortgage debt has likely been more concentrated amongst higher income households while growth in credit card debt has likely been more concentrated amongst lower income households.

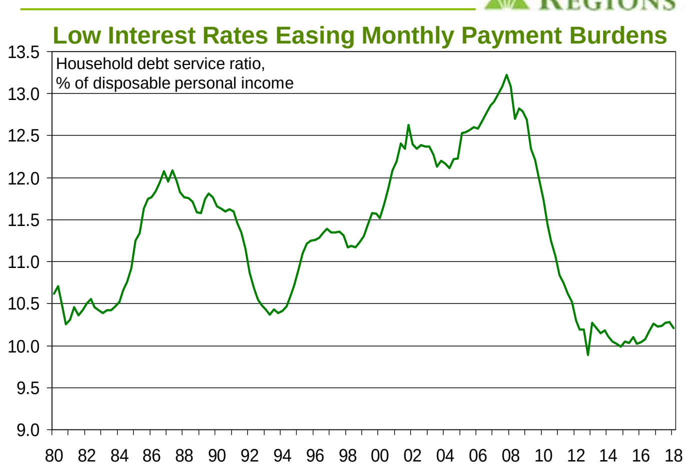


Source: Bureau of Economic Analysis; Federal Reserve Bank of New York; Equifax; Regions Economics Division



Source: Bureau of Economic Analysis; Federal Reserve Bank of New York; Equifax; Regions Economics Division

With all the emphasis on the record level of household debt, we think it worth noting that, when looked at in real (or, inflation adjusted) terms, the level of household debt is not only not at a record high, it's not even close. Indeed, in real terms, the level of household debt stood at $12.279 trillion as of Q2 2018, which makes it only the 19th highest level on record and which leaves real household debt 9.62 percent below the peak of $13.586 trillion seen in Q4 2008. These figures become even more notable when considering how low inflation has been over much of the current expansion, which goes back to our earlier point that growth in nominal debt has not even come close to matching the pace seen in past cycles. That only heightens our interest in the deceleration in the growth of nominal household debt over recent quarters. It could be that, with the bump in disposable personal income thanks to the 2017 tax bill, some households have utilized that extra cash, in lieu of debt, to finance current consumption, though the substitution here would be largely limited to credit card debt as opposed to other forms of debt, and we think any such effect would be very small. We think there are more fundamental factors behind the deceleration in growth of total household debt. For instance, growth in mortgage debt has slowed as the pace of existing home sales has slowed due to inventory constraints, while growth in auto loans has slowed as motor vehicle sales come down from the post-hurricane spike seen late last year and settle back towards their longer-term sustainable pace. Finally, steadily improving labor market conditions are leading to sturdier growth in wage and salary earnings and thus giving consumers greater wherewithal to use income, rather than debt, to finance current consumption – it is aggregate wage and salary earnings that are a main driver of growth in consumer spending, not the more popular but less meaningful average hourly earnings metric.

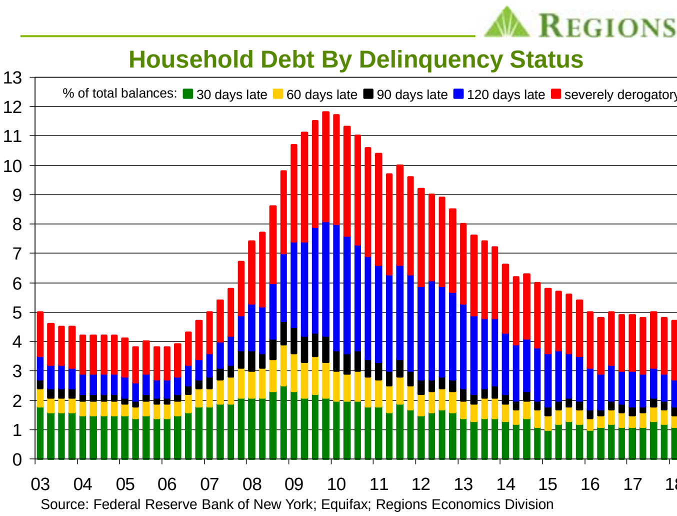


Source: Federal Reserve Board; Regions Economics Division

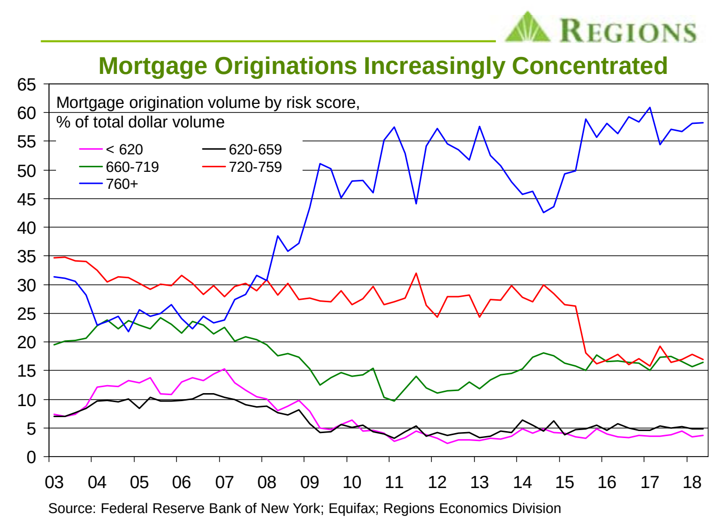
Another way in which to put the level of household debt in proper context is to look at the ability of households to service that debt, i.e., to make monthly principal and interest payments. The chart to the side shows the household debt service ratio, or, monthly debt service payments as a percentage of disposable personal income. While the Q2 data are not yet available, as of Q1 2018 the debt service ratio stood at 10.21 percent – the slight decline in Q1 reflects the effects of the 2017 tax bill, which led to a jump in disposable personal income in Q1 2018 thanks to lower individual income tax rates. As seen in the chart, the debt service ratio is off of its historical low of 9.99 percent, but not by much. Again, this is an aggregate measure and debt service ratios will vary across households, but in general households are able to service their debt fairly easily, record household debt notwithstanding.

One concern is that higher interest rates over coming quarters will make debt service burdens much more cumbersome, but the extent to which this is the case will depend on the relative shares of fixed-rate and variable-rate household debt. Estimates that we've seen put the share of fixed-rate debt between 75 and 80 percent of total household debt – without having access to the source data we are unable to assess these estimates but, given how low interest rates have been and for how long, these estimates certainly seem plausible. The broader point is that a high share of fixed-rate debt means payment shocks triggered by higher interest rates should not be nearly as big of a threat to consumers, and in turn to lenders, in the current cycle than has been the case in past cycles. That said, higher interest rates figure, at least at some point, to curb growth in demand for new debt on the part of households which, as opposed to deterioration in the performance of outstanding loans, may be the biggest impact of higher interest rates over the remaining life of the current expansion.

Loan performance improved further in Q2 2018, with the overall delinquency rate (or, the percentage of total household debt in some stage of delinquency) falling to 4.50 percent, the lowest rate since Q3 2006. Of total outstanding balances across all categories, 1.05 percent were in the 30-days late bucket as of Q2, with 0.42 percent in the 60-days late bucket, 0.25 percent in the 90-days late bucket, 0.84 percent in the 120-days late bucket, and 1.94 classified as "severely derogatory," which are loans on which payments are late (regardless of how late) and for which either a repossession, a charge-off to bad debt, or a foreclosure has been recorded. The share of balances in each bucket declined slightly in Q2.



Inflows into early-stage delinquencies have slowed and are running a bit below what were pre-recession norms. Inflows into "serious" delinquency, i.e., the percentage of balances 90-or-more days late and in the severely derogatory bucket, have been fairly stable, but inflows have picked up over recent quarters for credit card loans, auto loans, and the ever popular "other" consumer loans category. Interestingly enough, inflows into serious delinquency in the student loans category have showed sharply – but still remain well above the overall average – over the past few quarters. This could be a sign that the considerable improvement seen in labor market conditions has reached greater numbers of those transitioning from being in school to being in the workforce, thus enabling more of them to remain current on their student loan obligations.



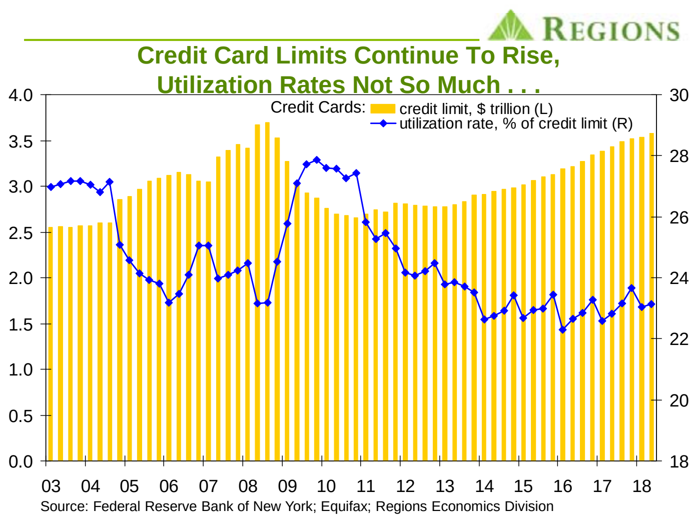
Macroeconomic factors are a key driver of patterns in delinquency rates, but are not the only driver. For instance, while the Federal Reserve's quarterly survey of commercial bank lending conditions shows that banks have been easing lending standards on mortgage loans over the past several quarters, the share of mortgage originations (amongst all lenders, bank and non-bank) remains notably concentrated amongst borrowers with credit scores at or above 760, as seen in the chart to the side. Given that mortgage lending standards have been much more stringent in the aftermath of the 2007-09 recession, even if a bit less so over recent quarters, it follows that mortgage loan performance would have improved amongst more recent vintages.

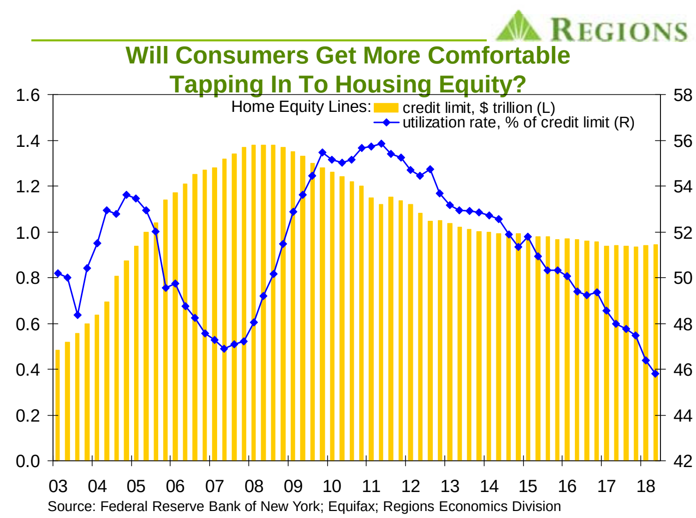
But, we think it worth repeating a point we made in this space in our last write-up of the data on household debt to help account for why mortgage originations remain so highly concentrated amongst borrowers with the highest credit scores even though mortgage lending standards have been easing. The last several quarters have seen notably robust rates of house price appreciation, in part due to extraordinarily lean inventories of existing homes for sale, particularly at lower price points, and in part due to builders of new homes having concentrated on building in the upper price ranges. To the extent many prospective buyers, particularly first-time buyers, have been priced out of the market as greater shares of total home sales take place in the higher price ranges, it would follow that credit scores of borrowers who can afford these higher priced homes would also be higher. So, while there are those who interpret the above chart as an indictment of mortgage loan practices, the reality is that the above chart is more a reflection of underlying conditions in the housing market than it is mortgage lending practices. Along those lines, the monthly home sales data show signs, albeit still early signs, that conditions are beginning to change. Specifically, listings of existing homes for sale have turned higher, which should take some of the edge off of house price appreciation, while lower-priced homes (those selling for less than $300,000) have accounted for a higher share of total new home sales over the past few months. If our interpretation of the concentration of mortgage originations is correct and if home purchases are becoming more accessible to a greater pool of prospective buyers, then coming quarters should see a greater dispersion of mortgage originations across credit score buckets.

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

It is worth noting that after a few quarters of having become more concentrated amongst borrowers with credit scores at or above 760, Q2 saw a decline in the share of auto loan originations amongst this group and a jump in the share of originations amongst borrowers with credit scores of less than 620, or, subprime borrowers. We find this to be of interest – though our usual caveat about not putting too much weight on any single data point applies here – given that much of the deterioration in the performance of auto loans has come from the subprime segment and that commercial banks had been raising lending standards for auto loans. But, with motor vehicle sales trending lower, thus curbing demand for auto loans, it could be that lenders are making another pass at the subprime segment of the market. Again, the Q2 data are but one data point, but this is something we will be watching over coming quarters.

Finally, given all of the attention over each quarter's new record level of household debt, we simply can't resist bringing up utilization rates. After all, the connotation attached to headlines of new record levels of household debt is that of consumers feeling confident enough to "splurge" on purchases of goods and services even if it means taking on debt to do so. The data on utilization rates, however, suggest otherwise, as seen in the following two charts. For instance, while credit card limits continue to increase, even if at a slower pace over the most recent quarters, utilization rates remain low. Sure, a low utilization rate applied to an increasing limit allows for growth in credit card debt, but we think the more relevant point to be that consumers continue to sit on considerable unused capacity to borrow in this manner, which is their choice and not that of lenders. The long-running decline in the utilization rate on home equity lines of credit is striking, particularly with owners' equity in residential real estate above the prior cyclical peak. While recent changes in the tax code by no means account for this trend, less favorable tax treatment on home equity loans and lines means we should not expect a significant reversal in utilization rates in this space any time soon. Whether this reflects greater discipline on the part of homeowners or just flat out fear (i.e., fear of a repeat of the housing market debacle) remains to be seen, and while there's a fine line between discipline and fear, the bottom line is that consumers have ample capacity to utilize debt far more intensively than they have done over the past several years, even if this is at odds with some interpretations of record high levels of household debt.





Clearly, there are elements of the data on household debt that merit attention, such as the deterioration in the performance of the subprime segments of the auto and credit card space. That said, while we love a new record high just as much as everyone else, the reality is that each quarter's new record level of household debt doesn't mean all that much, particularly when put in the context of growth in disposable personal income and what remain notably low monthly debt service burdens. And, in the context of what in general have been more stringent underwriting standards over the life of the current expansion, lenders will on the whole be better positioned when (yes, it's "when" not "if") the next recession comes. It has been income growth, not debt growth, that has been the bigger driver of growth of consumer spending in the post-recession years, even though this point is routinely missed by those who somehow think it a bad thing that growth in consumer spending during this expansion has been slower than in the years leading up to the 2007-09 recession. Sure, the ride has not been as fast this time around, but at the same time it won't feel nearly as bad when the ride comes to an end, as it ultimately will, as it did the last time around. There's something, a lot, actually, to be said for that.

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