Fed Flow of Funds: US household balance sheets continue to improve

Continued growth in household wealth thanks to rising equity and real estate prices suggest a bright outlook for consumer spending

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Strengthening balance sheets to support consumer spending

The Fed's flow of funds data provides a comprehensive view of the US economy's balance sheet, showing the aggregate assets and liabilities of households, corporates and the government. This gives a birdseye view of the trends in borrowing and saving, and the aggregate financial health of the US economy.

The Q3 data out last week indicate US households' net wealth increased by $1.74 trillion in the three months to September, mainly from increases in the value of equity and real estate. Household borrowing growth remains moderate at 3.7% (annualised), in line with the average pace in 2016 and 2017. Combined with solid wage growth, this will support continued strong consumer spending in coming quarters.

Corporate borrowing increased by 5.4%, broadly in line with the recent trend. Business investment strengthened in 2017, especially in the energy sector, though strong profitability means many companies can finance investment out of earnings and reserves.

The combination of strong consumption growth and increased business investment is why we think the US economy will continue to grow strongly in 2018.

The Federal government's borrowing increased by 10.3%, a significant increase of 3.6% in Q2 and -2.6% in Q1. Government borrowing tends to be seasonal as tax revenue varies across the year, Quarterly figures are also distorted by the federal debt ceiling, which requires the Treasury to draw down reserves and reduce borrowing as the ceiling limit approaches if Congress doesn't raise the ceiling.

$96.94tr US Household net wealth

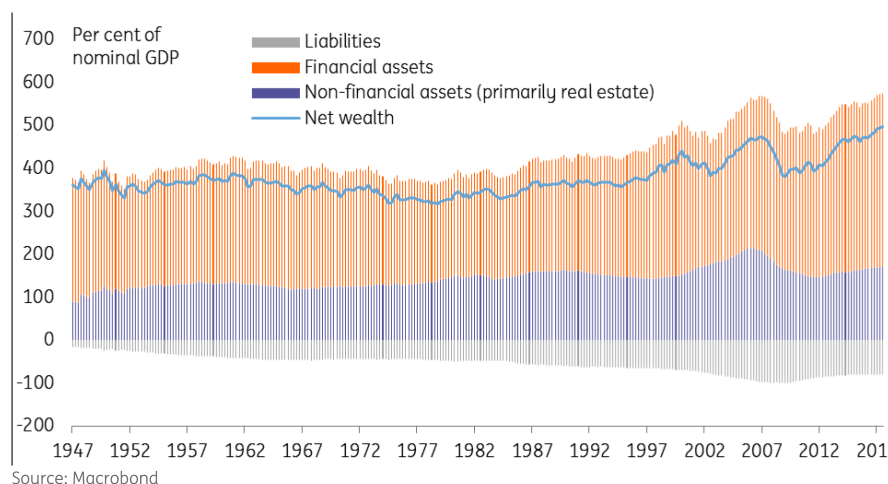
as of 2017 Q3

Tax cuts will boost aggregate household wealth further

Should the tax plan currently under consideration in the US Congress pass, as now seems likely, it will likely reinforce these trends. Although the details are not yet clear, and some households may not see much net benefit from the tax changes, in aggregate US households will have more after-tax income in the near term. That will enable more spending and saving, strengthening balance sheets further. To the extent that the bulk of the benefits of the tax cuts will accrue to wealthy households, who are more likely to save a greater portion of their earnings, the effect will be skewed towards savings rather than spending.

The effect on business investment is less straightforward, as the tax bill makes wide-ranging changes to how businesses are taxed and the details are yet to finalised, but is also likely to be positive.Corporate tax cuts are also likely to boost equities further as much of the tax savings are likely to be used for special dividends and share buy-backs (though much of that effect is probably already priced in), increasing household wealth through holdings of equities.

US household net wealth



Source: Macrobond

Medium term risks are increasing

Taking a step back, US balance sheets suggest a couple of reasons to worry about the medium term:

- The flipside of tax cuts boosting household and corporate balance sheets is a worsening outlook for the federal government. Even before the tax bill, the IMF is projecting a deficit in excess of 3% of GDP in coming years, rising to 5% by the mid-2020s. Tax cuts will add further to the deficit.That means the US fiscal position is weakening at a point in the economic cycle when arguably the government ought to be strengthening its balance sheet rather than providing a fiscal boost to an already solid economy -- the so-called 'fixing the roof while the sun is shining' argument. Current policy will most likely leave less fiscal space to deal with the next recession when it comes along.
- As of Q3, total US household net wealth stands at $96.94trn. That's roughly 500% of US nominal GDP, the highest ratio recorded since the data started in 1945. Previous equity market peaks in 1999 and 2007 saw household net worth reach roughly 440% and 470% of GDP respectively before falling back. That underscores just how stretched market valuations have become. While there are structural changes that explain the higher ratio (e.g. lower interest rates and the fact that profits have increased as a share of GDP), Fed officials have voiced concerns that current valuations are 'somewhat rich' -- suggesting that increasing worries about financial stability risks could start to influence monetary policy more.