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Downunder Daily

Tightening the Screw

Problems in corporate credit markets are likely to exacerbate the household sector's financial risk. To explain why, you need some background on household-sector finances in the US:

The household sector has an ostensibly solid balance sheet. In fact, the sector's net worth hit a new all-time high in dollar terms in the June quarter, and is almost back at all-time highs relative to income (Exhibit 1).

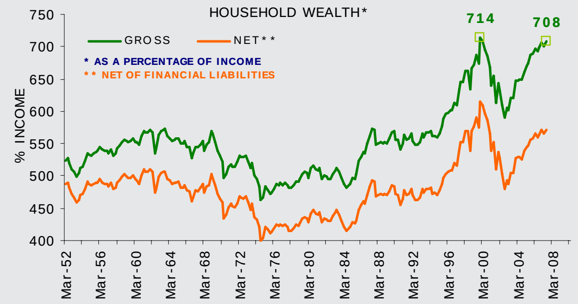
However, balance sheet metrics are typically poor indicators of financial risk, particularly when the assets are valued at market prices. At the top of a boom, asset prices are almost always elevated, providing a false sense of financial solidity. For example, the non-financial corporate sector's debt-equity ratio hit an all-time low in the US in 1999. Historically, debt, or leverage, has been a much better indicator of risk – and it hasn't mattered what assets are on the other side of the ledger. On that measure, American households, with record leverage, are high-risk.

Cash-flow measures are even more worrying, in my view. Exhibit 2 shows the household sector's net financial requirement, which is a net cash flow measure. As I've noted before, the household sector has never, prior to this cycle, run a cash-flow deficit. The deficit was 8¾% of disposable income at its low.

Changes in cash flow are very important for growth. If the cash-flow deficit is widening, that is usually positive for growth, because it suggest that outlays are growing faster than cash income. Conversely, a rising cash-flow balance bodes ill for growth. Exhibit 3 shows the net cash flow for the private non-financial sector. Note that recessions are usually associated with the cash-flow balance rising, and it is a rising cash-flow balance that leads the GDP downturn.

Exhibit 1

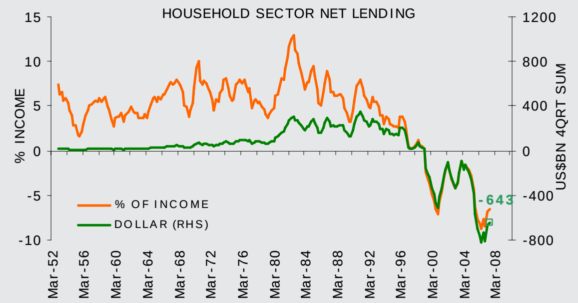
Nice Balance Sheet…



Source: Federal Reserve; Morgan Stanley Research

Exhibit 2

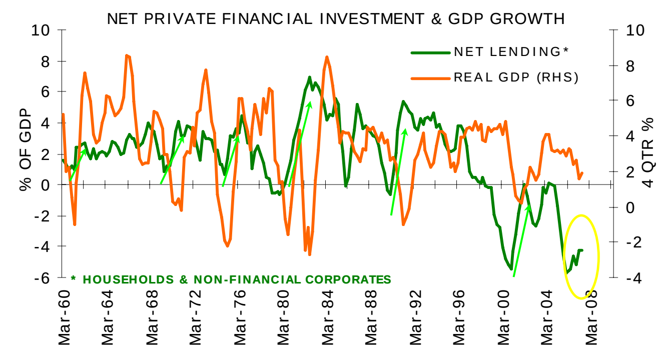
…Shame about the Cash Flow



Source: Federal Reserve; Morgan Stanley Research

The household sector's cash-flow balance has risen gently over the past year, and that has led to GDP growth slowing to below-trend levels. As Exhibit 2 hints, there is potentially a lot more adjustment to come.

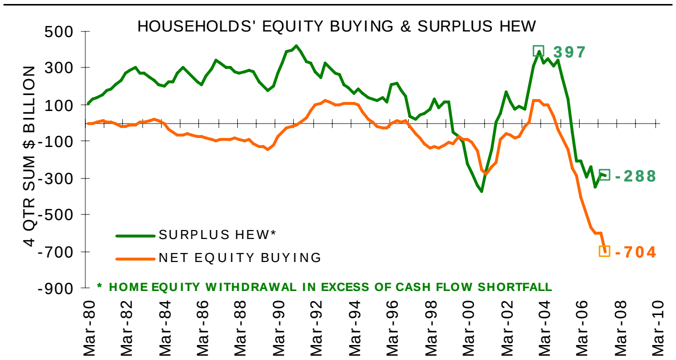
Exhibit 3
Net Lending Adjustments Slow Growth



Source: Federal Reserve; BEA; Morgan Stanley

What are the household sector's options? It has two: Continue to fund the deficit by either increasing debt or selling assets; or reduce the deficit by slowing the growth in outlays relative to the growth in cash income.

Exhibit 4
Households Sold…

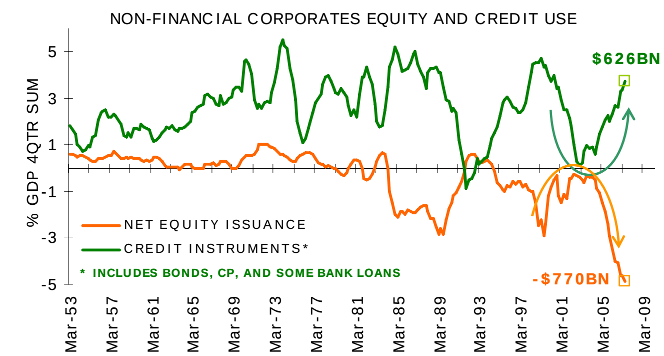


Source: Federal Reserve; Morgan Stanley Research

So far, the household sector has found it relatively easy to finance the cash-flow deficit. For several years, the principal financing tool was borrowing, largely funded against housing – so-called home equity withdrawal (HEW). Over the past 18 months, however, that has become more difficult, but households found an alternative financing source: selling assets, principally equities.

Exhibit 4 shows that funding switch. The 'surplus HEW' series shows the household sector's borrowing requirement net of HEW. In 2003-04, the sector over-funded its deficit, at the peak extracting US$394bn more in HEW than needed to cover the cash-flow deficit. Now, however, HEW is $288bn less than the deficit – a financing hole that needs to be filled. The other series is net equity purchases. Over the four quarters to June, the household sector sold just over $700 billion of equities. (This includes executives selling equity grants given as remuneration.)

Exhibit 5
…What Corporates Bought



Source: Federal Reserve; Morgan Stanley Research

The household sector was able to sell equities because the corporate sector was a willing buyer. Exhibit 5 shows that the corporate sector was a net buyer of $770bn of equities through the year. In other words, over the past three years, there has been a transition from households borrowing to fund their cash-flow deficit to the corporate sector borrowing to buy back stock to fund the household sector's cash-flow deficit.

But here's the rub: The apparent end of the boom in corporate activity will likely lead to a significant fall in net corporate buy-backs in the current half. Although, as colleague Bill Smith has noted, announced stock buy-backs did remain elevated in August, so equity issuance is likely to remain negative.

A fall in household (equity) asset sales will come just as lending conditions have been significantly tightened, courtesy of the sub-prime problems. The risk is that the tightening in financial conditions – debt finance and the reduced scope for equity sales – may cause the household sector, either willingly or unwillingly, to accelerate the pace at which it narrows its cash-flow deficit. That would likely be sufficient to tip the US into recession.

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