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USA Spend-tacular: Wealthy Hands on the Wheel?

American households have amassed significant wealth since the onset of the COVID-19 pandemic, fuelled by soaring stock prices, rising home values, and increased liquid assets. In this report from our partner, Northcape Capital, the team examines the overall health of the US consumer and the potential implications for inflation, interest rate settings and the US economic outlook.

US consumer spending has been resilient

In the initial shock of COVID-19 in early 2020, the U.S. economy experienced a sharp contraction, leading to a brief recession. However, the subsequent recovery has been characterized by strong GDP growth and a resilient job market. Despite fluctuations and challenges, including inflation and supply chain issues, the U.S. economy has not officially entered a recession since that initial COVID downturn. This resilience has surprised some market spectators and the key question for investors going forward is how long could this continue?

A key driver of economic resilience to date, has been the health of the US consumer whose spending at aggregate levels has been strong. Consumer spending is the biggest component of GDP, accounting for around two-thirds of this metric. As such the continued health of the US consumer is key to economic outlook. Compositionally this spending is skewed to high income households noting the top 40% of households account for around 65% of total consumer spending.

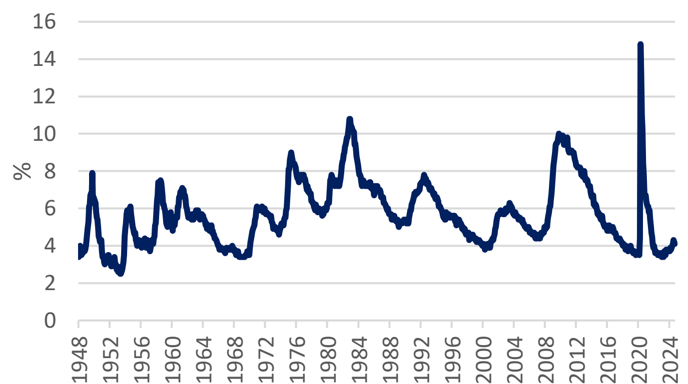
US consumer spending

Source: TradingEconomic.com, US Bureau of Statistics

Employment and spending in the U.S. are closely interconnected in a cyclical manner. When employment rises, people have more income, which typically leads to increased consumer spending. This heightened demand for goods and services can encourage businesses to hire more workers, thus reducing unemployment further.

The US unemployment rate currently remains close to decade lows at 4.1%. If one compares today's labour outcomes with what the Congressional Budget Office (CBO) expected pre-pandemic, employment in latter half of 2023 came in at 2 million jobs higher than expectation. Had unemployment figures came in more in line with those expectations, then the unemployment rate would be more around 5.5%.

US unemployment rate



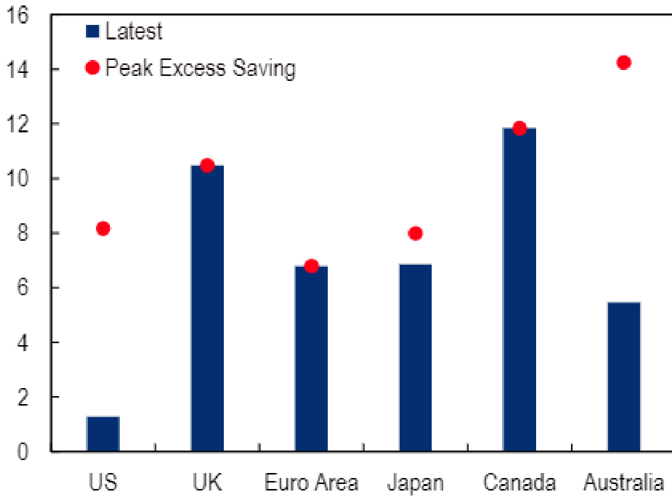
Source: Federal Reserve Bank of St Louis

But pandemic-era excess savings now depleted

Household liquid wealth comprises cash, checking and savings deposits and money market funds. From the onset of the pandemic, consumers built a pile of excess cash savings. With social distancing and business closures they spent less. But also, households were given substantial pandemic related financial support which helped prop up their liquid wealth.

Households built up excess savings 18 months into the pandemic but started depleting these savings in late 2021. The rate of excess savings depletion has been faster in the U.S. compared to other developed markets.

Stock of excess saving as % of GDP by market

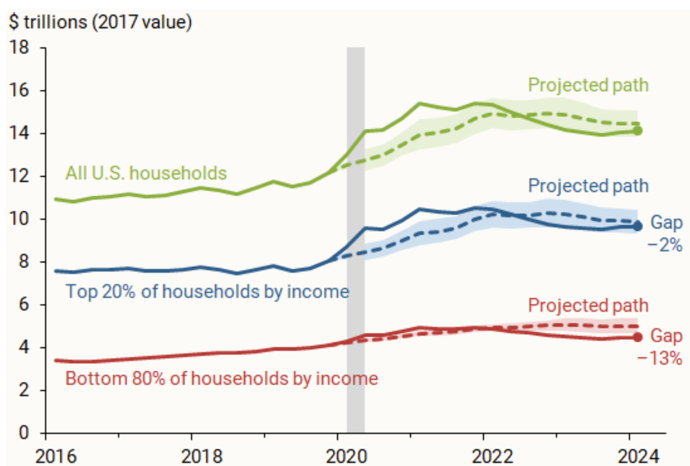


Source: Citigroup

A study by the Federal Reserve Bank of San Francisco examined the evolution of US household excess savings across different income levels. It estimated that the highest-income households (the top 20%) accumulated four times the excess savings compared to other households during the pandemic.

Further, any savings that lower income households did gather were spent at a faster rate than higher income households.

Trajectory of US household liquid wealth vs "no-pandemic" estimates



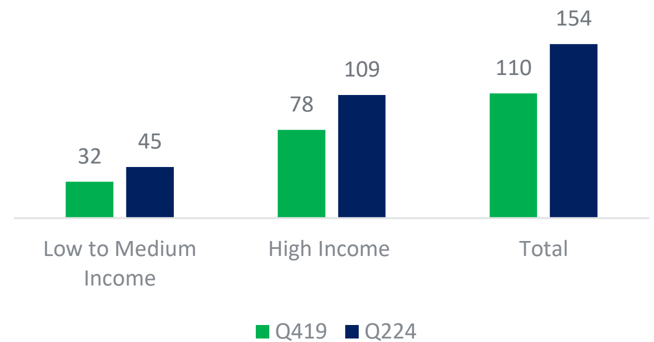
Source: Federal Reserve Bank of San Francisco. Pandemic-Era Liquid Wealth is Running Dry FRBSF Economic Letter 2024-21, August 12, 2024.

In line with the above findings, the lowest 40% of income households have been observed to be spending beyond their liquid wealth in recent quarters.

US household net wealth remains 40% higher than pre-COVID levels

Despite the spending patterns observed among households, the net asset value of U.S. households (the value of household assets minus liabilities) remains 40% higher than pre-COVID levels in aggregate.

Total household net wealth (pre- & post COVID) $tn



Source: Distributional Financial Accounts, Federal Reserve. Low to medium income = 0-80 percentile, High Income = 80-100 percentile.

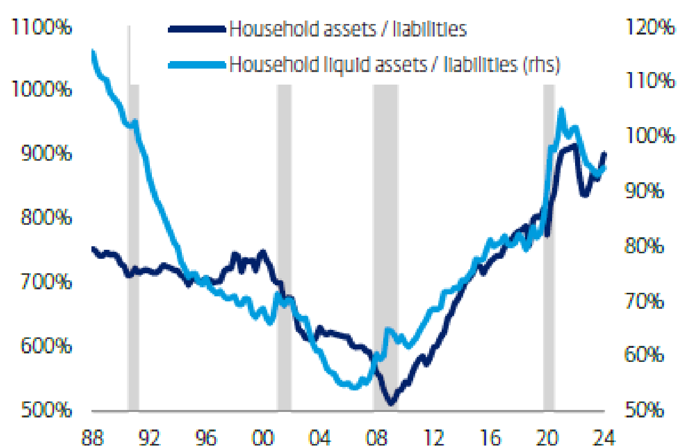
High income households (the top 20% of income), who held a larger portion of share and housing assets to begin with, accounts for the majority (70%) of this overall household net asset growth.

Growth in household wealth is observed across generations pre- and post-COVID with baby boomers continuing to dominate wealth at around 50% share.

Interestingly, millennials (and younger) have grown wealth almost threefold post COVID aided by both financial cautiousness (consistently battling with incomes lower than cost of living) and curiosity (with technology enabling a faster path to financial literacy than prior generations). They were also early adopters of cryptocurrencies (with 5x higher adoption rate than boomers), where Bitcoin and Ethereum have provided substantial returns.

In sharp contrast to GFC levels, household net worth to income is currently high. Further, the current ratio of household assets to liabilities is well above pre-COVID levels. Going into the global financial crisis, this ratio was at 50%, almost half today's levels. It follows that if the labour market or house prices were to deteriorate today, deleveraging pressure on households would be materially lower.

Ratio of total household assets and liquid assets to total liabilities

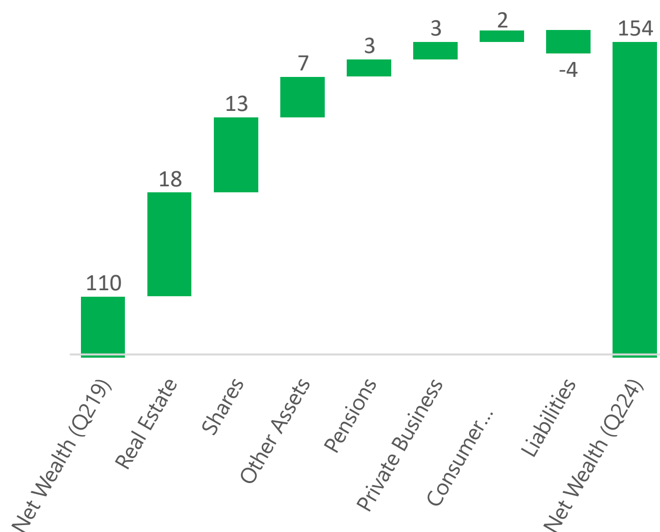


Source: BofA Global Research, Federal Reserve Board

Drivers of the rise in household net wealth

For households in aggregate, net wealth growth post pandemic has been around $44trn. House prices have risen around 50% based on Case-Shiller National Home Price Index. Share market gains have been around 70% (based on the S&P 500 Index). Interestingly, "other assets" (a portion of which would relate to liquid funds) remains about $7tn higher than pre-covid levels. This suggests, there is still some portion of liquid assets in the system. Some market commentators have estimated there to be some $2tn additional liquid funds in US households at present which could support further spending.

Change in household wealth (pre/post COVID) - $tn



Source: Distributional Financial Accounts, Federal Reserve.

Importantly, housing price gains have been more evenly distributed across income brackets compared to other gains. From 4Q19 and 2Q24, real estate gains for all households totalled $18.4 trillion, accounting for 41% of the increase in household net wealth since the pandemic. Notably, 45% of this increase was attributed to low- to moderate-income households.

Meanwhile, the net increase in share assets was 30% lower than that of housing and was much more concentrated among high-income households, with only 12% of the gains attributed to low- to medium-income households. Additionally, other assets, including some liquid assets, are similarly skewed toward high-income households.

Can consumers continue to capitalise on wealth generated?

The significant increase in household wealth since COVID has been accompanied by a marked rise in the wealth effect, which measures changes in consumption based on changes in wealth. According to analysis from Visa Business and Economic Insights, the wealth effect typically ranged from 4% to 15% pre-COVID, meaning consumers spent 4 to 15 cents of every dollar of newly acquired wealth.

In 2022, this effect nearly quadrupled to an estimated 34%. This likely reflects a higher portion of spending from pandemic era excess cash savings. It also reflects a substantial rise in spending from both house price gains and share market gains.

Wealth effect (cents spent per dollar change in household worth)

Wealth Effect Category	2017	2022
Overall wealth effect	9 cents	34 cents
Housing Stock effect	4 cents	20 cents
Stock/Bond wealth effect	9 cents	24 cents

Source: Visa Business and Economic Insights and Federal Reserve Board

Typically, and as observed post pandemic, the spending response is higher for stock and bond gains vs wealth held in owner occupied housing. At a basic level this comes down to the relative ease with which one can dispose of shares compared to a home. At a more complex level, most of the recent wealth created in US housing has been derived from locking in fixed rate loans significantly below market interest rates, creating a strong disincentive to sell, otherwise known as the "lock-in effect".

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In the US, over 96% of borrowers have a fixed-rate mortgage (commonly fixed for 30 years) and 57% of those borrowers had a rate below 4% as at 2Q24 (vs ~7% current loan rates). Those borrowers were, on average able to capitalize on record low interest rates at start of the pandemic while also buying into the market at lower prices.

Given the rise in house prices, tappable equity, or the share available to withdraw while maintaining a 20% equity cushion, hit an all-time high in June 2024 at $11.5 trillion (up 9.2% YoY). Most mortgage holders (90%) have some degree of tappable equity currently. Three out of five U.S. mortgage holders have at least $100K in tappable equity, with 4.6 million mortgage holders now having at least $500K and nearly 1.2 million having accrued $1m or more.

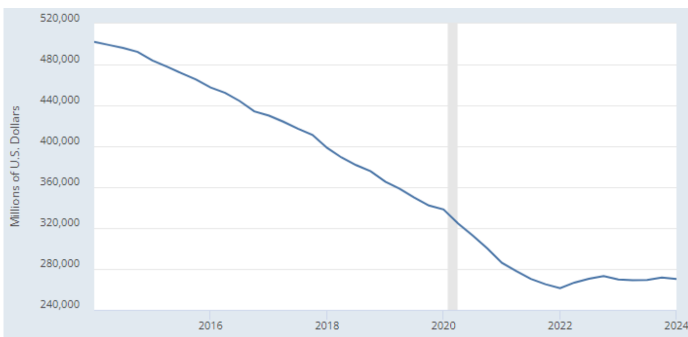
So how does a borrower tap into their home equity? The traditional choice, when accessing funds is to refinance a mortgage and release equity. Refinance originations rose as high as $700bn per quarter in 2021 but this pace has dropped to below $100bn since 2023, amid rising rates.

The outcome of this is that in 2Q22, more than 60% of outstanding mortgage balances had been originated during the previous two-year window. Today this is <30% as homeowners are, rationally, hanging on to pre-pandemic era mortgages. Mortgage refinancing is near record lows currently.

Home equity lines of credit (HELOC) provide an alternative to refinancing. These are revolving loans capped at a maximum amount but with flexibility for the customer to borrow smaller amounts as required, often at a variable interest rate. Such loans have been rising since 2021 but remain well below GFC levels.

HELOC loans are unlikely to reach GFC levels again due to tighter lending standards, with most new credit lines now going to borrowers with FICO scores above 760 (classified as "Very Good" to "Excellent"). This is likely skewed to higher income households.

Home equity lines have been flat



Source: Federal Deposit Insurance Corporation, fred.stlouisfed.org

Notably, because of the rise in overall household wealth pre and post pandemic, a significant portion of share market gains was skewed to the top income earners. It follows from the above that the low to medium earner's incremental wealth is currently largely driven by a rise in the value of their housing assets. Further, in the absence of lower rates, this cohort's ability to tap into these gains is likely constrained.

Rising Delinquencies: The Canary in the Coal Mine?

The Federal Reserve publication cited earlier makes the point that at precisely the time at which COVID excess savings were depleted (on an inflation adjusted basis), credit card delinquencies began to rise. For low to mid income households, delinquency rates are now well above pre-COVID levels.

Supporting the above is Federal Reserve data on delinquency rates on credit card loans outside the top 100 banks (which typically have a higher proportion of lower quality borrowers). Interestingly, this rate is currently at an all-time high.

Credit card delinquencies for banks outside top-100

Source: Federal Reserve Board

Meanwhile, credit card delinquency rates for banks inside the top 100 largest banks (which typically have a higher proportion of prime borrowers) are still below GFC levels, but now above pre-COVID levels. There is also a skew of delinquencies to younger age groups.

Do consumers still have propensity to spend?

Despite solid household balance sheets and employment conditions being stable, consumer confidence has dropped in September and is below pre-COVID levels. Unsurprisingly, the steepest drop in confidence was for consumers aged 35 to 54 and those earning less than $50k (average salary in US is $59K).

A large determinant of consumer spending is optimism around economic prospects. At a personal level this is tied to security around employment and the prospect of future earnings covering a household's cost base.

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A higher % of Gen Xers are long term unemployed or have been unemployed for more than 27 weeks which makes them more pessimistic than those in younger generations. This could explain some of the decline in consumer sentiment.

Conclusion

US household balance sheet health is strong. The top income quintile (top 20%) accounts for 70% of net household wealth creation since COVID. As income growth slows, there is upside risk to consumer spending if wealthier consumers continue to utilise their strong balance sheets.

COVID era excess liquid wealth has diminished, and lower income households have limited means to tap into any home equity wealth as their loans have been locked in at rates well below current rates making refinancing or a line of credit unattractive. Credit card delinquencies for this cohort have risen materially indicating strain.

The bottom-up view from companies under coverage is that there are signs of a "tenuous" consumer. One that is hesitant to spend on non-essentials. This consumer is also delaying big ticket items which are often partially funded by loans. Labour market forward indicators, though, are sound with real income rising. This will support essential spending and may facilitate a soft landing or better.

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