Consumer Debt- A 10 year lookback

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Strong consumer confidence and low unemployment rates have propelled US economic growth as we begin the 2nd half of 2018. US Tax Cuts, which took effect in January, are easy to associate with the strengthening economy. This occurs in the midst of rising interest rates as the Fed continues its rate tightening process which began in earnest 18 months ago. Recent Fed actions broadly coincide with the 10 year anniversary of the Global Financial Crisis (GFC).

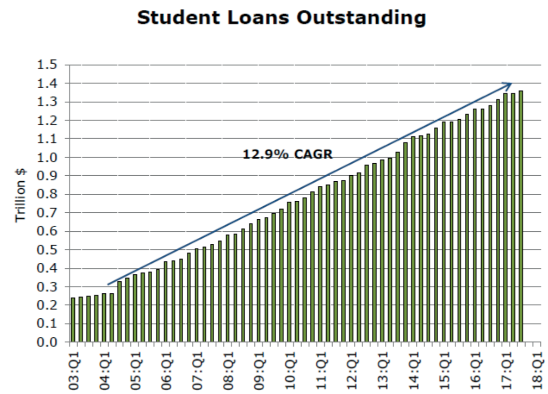
The timing of recent Fed actions, along with the GFC anniversary, poses many questions about the American consumer. Is the consumer beginning to overextend themselves with too much debt? Can the consumer service debt in a rising rate environment? If so, how will the consumer respond to higher interest rates and debt payments? To borrow and slightly modify the campaign line from Ronald Reagan is the American consumer better off today than 10 years ago? The short answer is “Yes” but with a guarded sense of optimism.

At the end of 2017, Americans held $13.1 trillion in consumer debt which is 6% more than on the eve of the GFC. The current consumer profile shows that mortgage debt remains the largest debt obligation but with a slight twist. Although debt levels are higher, the consumer is doing a better job of managing that debt than at the beginning of the GFC. Consumer loan delinquencies are down 53% while delinquent mortgage debt has fallen from 3.7% to just above 1%.[i] As the Bloomberg chart below depicts, unemployment levels are the lowest in the past decade which provides the environment for a healthy credit profile. Long gone are the days of no income verification and interest only mortgages which were prominent in the years leading up to the GFC.

Total Debt Service|Unemployment Rate|12M Libor
2012-2017

Financial Institutions are also bullish on the consumer and don’t view rising interest rates at this juncture as a headwind. In the short term, it’s hard to argue this point as credit metrics remain strong. Slightly higher mortgage rates, which are still considered low by historical standards, have not taken too much wind of the sails of the housing market. The big unknown remains ahead as to how the consumer adjusts to higher interest rates over the next several quarters. A vast majority of consumers that hold mortgages are likely at an advantage as 90%[ii] of loans are issued at fixed rates.

Student Loans



The most telling change over the past 10 years is the composition of the consumer debt profile. Student debt, which has more than doubled over the last 10 years to $1.4 trillion, comprises the 2nd largest piece of consumer debt behind mortgages. More telling is that non students (i.e. parents and grandparents) hold up to 20% of student debt in the form co-signing and taking out loans to fund their loved one's education. This generosity has come at a cost as 40% of "student borrowers" age 65 and above are in default. [iii] We attribute the run up in student default rates as a by-product of the GFC.

At the time of the GFC, the newly graduated workforce struggled to service their existing student debt in light of the rapidly shrinking job market. Although the economy has recovered, today's delinquency rates remain elevated, in the high single digits, after peaking at 11.5% in 2014. Prior to the run up in student debt in the mid 2000's, the student loan delinquency rate was close to 6%. Not to fear, there is a new game show titled "Paid Off™" aimed at helping graduates retire debt. The average graduate now carries $37,000 in debt. If the show is successful, maybe there will be a spinoff for the parents?

Subprime Mortgages

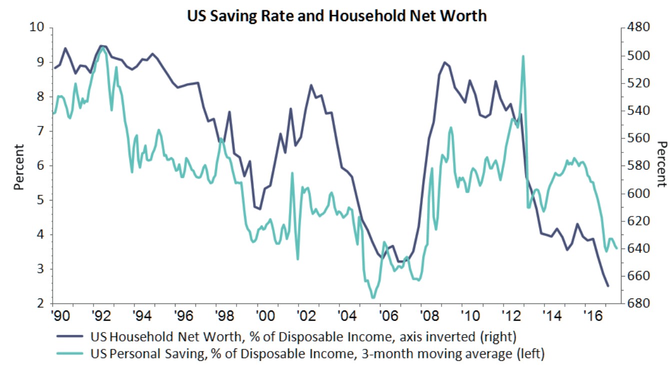
While the household mortgage still remains the largest portion of the consumer debt, the characteristics have changed. The pockets of sub-prime mortgage lending that remain are largely borne by non-financial lenders. These lenders, which also service prime borrowers, now account for close to 45% of the overall mortgage market. How did these lenders obtain their funding? Just look across the street to your bank branch to find the answer. Large global financial institutions like Wells Fargo, Citigroup, and Bank of America are growing their loan books by lending to financial intermediaries at a rapid clip. It's fair to say that these institutions are indirectly exposed to the sub-prime borrower.

Subprime Auto Lending

Auto loan growth has increased since the GFC and pockets of sub-prime lending remain in this sector. Although 25% of auto borrowers are sub-prime, this market is not large enough to take down the financial system. Sub-prime auto loans stand at $280 billion vs $1.3 trillion of sub-prime mortgage debt at the peak of the GFC.[iv] The sub-prime auto loan default rate is actually higher now than during the GFC. Given the ability of lenders to repossess a vehicle much more quickly than a home, the impact is more manageable. This market segment has diversified with non-traditional auto lenders, specifically private equity firms and hedge funds, providing funding to specialized subprime auto lenders.

Growing Concerns?

While the consumer is enjoying the tailwinds of a strong economy, relatively low inflation, and a healthy job market, the chart shows mixed consumer savings rates post crisis. Following the GFC, consumers saved at a higher and more consistent rate as consumer wealth recovered. Since the beginning of 2016, the savings rate dropped as it appears the consumer easily forgot the events of 2007-2009. This does not bode well should the economy slip into recession.



The combination of lack of consumer saving, higher interest rates, and economic euphoria surrounding the recent tax cuts provide a healthy dose of caution. As the saying goes all good things most come to an end. While it's hard to imagine unemployment rates staying at record low levels for the foreseeable future, economic metrics continue to forecast sustainable growth. We know that the cost of servicing debt will continue to rise as the Fed continues to adopt a tighter monetary policy. Will Americans be better two years from now or has the consumer reaped all of the benefits of the current economic cycle? If the answer to the 1st question is no, the financial system is clearly better positioned to absorb the downside of the overextended consumer.

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[i] "Federal Reserve Bank of New York", http://www.newyorkfed.org /microeconomics/databank
[ii] Sean Becketti, "Why America's Homebuyers & Communities Rely on the 30-Year Fixed-Rate Mortgage," http://www.freddiemac.com (April 10, 2017)
[iii] Julia Chang, "Why Student Loans Are a Problem for Older Americans, Too," http://www.northwesternmutual.com (April 16,2018)
[iv] Wolf Richter, "Auto Loan Delinquency rates are worse now than during the financial crisis," http://www.businessinsider.com (April 9, 2018)

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