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# Light at the end of the tunnel

## Getting ready for the return of the U.S. consumer

J.P.Morgan

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# 1. Light at the end of the tunnel

Decision-makers have focused on the high and persistent unemployment in the U.S. and material losses related to the housing crisis which have significantly dampened U.S. consumer spirits. There is, however, good news on the horizon. Notably, U.S. consumer balance sheets have improved to levels we have not seen in many years, suggesting that the **U.S. consumers' health is not as bad as many assume**. This trend could lay the foundation for a recovery in consumer sentiment.

Despite fortress balance sheets, **many firms are not investing in ways that would take advantage of a potential consumer recovery.** The U.S. consumer represents over $10 trillion and even small changes in U.S. consumer demand would send shockwaves through the global economy. We recommend that senior decision makers put in place a roadmap to prepare their firm for a turn in consumer sentiment.

# 2. The second largest economy in the world

Executives of global firms should care about the health of the U.S. consumer. U.S. household consumption accounts for 71% of the U.S. economy, which in turn represents 24% of world GDP. Together this makes the **U.S. consumer, at $10 trillion, the second largest economy in the world** (just ahead of China in world rankings and larger than the combined economies of India, Brazil, Russia, Mexico and South Africa; see Figure 1).

**Figure 1**

**The largest economies in the world ($tn)**

| Country | GDP (PPP) | GDP (USD) |
|---|---|---|
| United States | $ 14.5 | $ 14.5 |
| **U.S. consumer** | **$ 10.2** | **$ 10.2** |
| China | $ 10.1 | $ 5.9 |
| Japan | $ 4.3 | $ 5.5 |
| India | $ 4.1 | $ 1.6 |
| Germany | $ 2.9 | $ 3.3 |
| Russia | $ 2.2 | $ 1.5 |
| United Kingdom | $ 2.2 | $ 2.3 |
| Brazil | $ 2.2 | $ 2.1 |
| France | $ 2.1 | $ 2.6 |

Source: 2010 IMF data

In previous reports, we have contrasted the historic strength of U.S. and global firms with the weakness of sovereign entities.[1] Indeed, U.S. firms are less levered and more cash rich than they have been for many years, and the strongest firms have access to debt at record low yields. They are not, however, ready to invest and take advantage of their historic financial flexibility. In 2010, capex and R&D of non-financial S&P 500 firms was less than 50% of operating cash flow (down from 67% in 2007 and over 80% at the end of the previous decade).

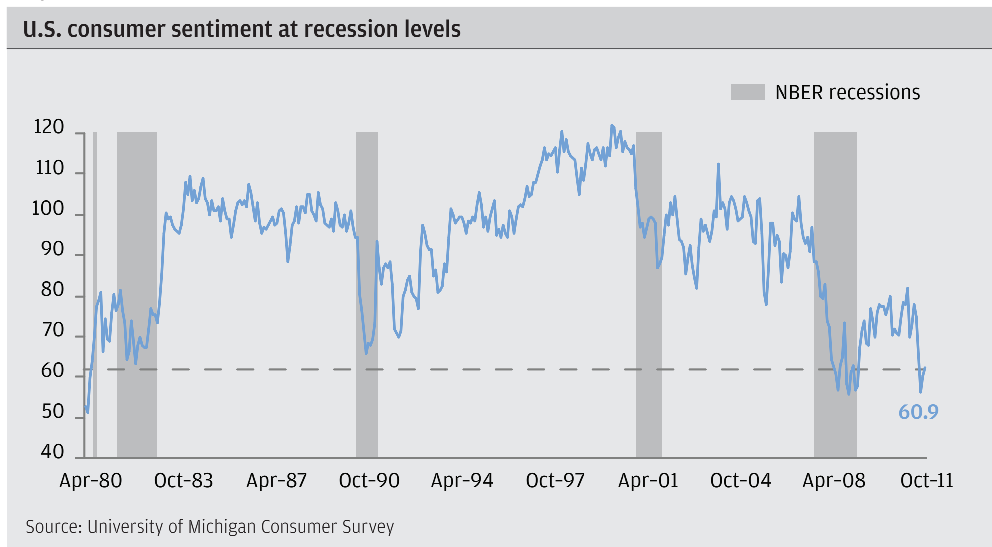
[1] "It's déjà vu all over again: How to be ready when the cheap capital environment ends" https://mm.jpmorgan.com/PubServlet?action=open&doc=GPS-614595-0.pdf; "The new face of M&A: How a trillion dollars will change the strategic landscape" https://mm.jpmorgan.com/PubServlet?action=open&doc=GPS-587671-0.pdf.

Given how large a role the **U.S. consumer plays in the global economy, he/she could serve as a catalyst for growth** by generating increased demand. In turn, this demand pick up would lead to increased investments from firms and, ultimately, to stronger sovereign balance sheets. The key to sparking this virtuous chain of events is higher consumer confidence and, subsequently, an increase in personal expenditures.

Unfortunately, U.S. consumers are not in high spirits. As Figure 2 illustrates, **U.S. consumer sentiment is close to the lows** of the early 1980s. In the past, we experienced such lows in consumer sentiment only during recessions, but now, more than two years after the end of the financial crisis, we are finding ourselves still mired in severely low consumer sentiment. Is this the sign of a more worrisome structural shift in consumer sentiment? Or is this the precursor for the rebound that we have seen following previous lows in consumer sentiment?

**Figure 2**

**U.S. consumer sentiment at recession levels**




Source: University of Michigan Consumer Survey

## 3. The bad news everybody is focused on

Consumers naturally feel more confident when they are financially secure or when they expect to become so in the near future. In the U.S., the primary drivers of financial wealth and security are real estate values and job opportunities.

**Real estate** prices have fallen dramatically. From 2Q2007 to 2Q2011, household real estate assets dropped by approximately 30%, leading to a significant negative impact on the overall wealth of the consumer. Today, home values are about $8 trillion below their 2006 peak. By virtue of the $16 trillion of leverage on U.S. homes, the drop in homeowners' equity has been more dramatic. Consumer home equity peaked at $13.5 trillion in early 2006 and is currently around $6.2 trillion, below its nominal value in 1Q2000 and a decline of more than 50% from the peak.[2] Real estate values have continued to decline since 1Q2009 (to the tune of an additional $1 trillion in losses), in contrast to financial assets, which rebounded in 2010.

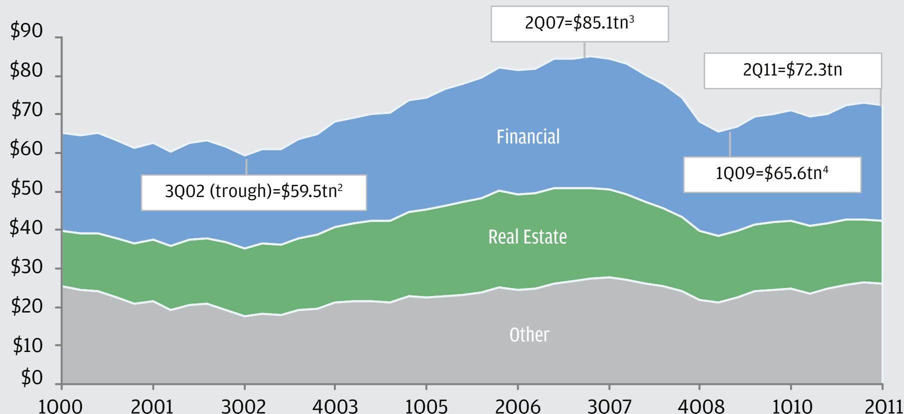
[2] Federal Reserve Flow of Funds.

Unlike real estate, **financial assets have staged a substantial recovery** since the depths of the financial crisis. Aggregate value of household financial assets at the end of 2Q2011 was around $26 trillion, which was almost back to the 2Q2007 level. Financial assets are, however, held disproportionately by more affluent households, thus potentially limiting the benefit of recovery to certain households. Overall, the aggregate assets of households are higher than they were six to ten years ago, but the fact that they are still below 2Q2007 levels may be a continuing source of pessimism among consumers.

**Figure 3**

**Financial assets have recovered since 1Q2009; housing remains depressed**

U.S. consumer assets ($tn, 2011 dollars)[1]




Change in household asset values ($tn, 2011 dollars)

| | | | | | Δ% | | |
|---|---|---|---|---|---|---|---|
| **Asset** | **3Q02** | **2Q07** | **1Q09** | **2Q11** | **3Q02-2Q07** | **2Q07-1Q09** | **1Q09-2Q11** |
| Financial | $ 17 | $ 27 | $ 21 | $ 26 | 56% | (22)% | 23% |
| Real estate | 19 | 26 | 19 | 18 | 34% | (26)% | (6)% |
| Other | 22 | 31 | 25 | 27 | 41% | (21)% | 12% |
| **Total** | **$ 59** | **$ 85** | **$ 65** | **$ 72** | **43%** | **(23)%** | **10%** |

Source: Federal Reserve Flow of Funds, Bureau of Economic Analysis

[1] "Financial assets" includes mutual funds, directly held stocks, bonds, retirement accounts and other managed assets and deposits/MMMF; "Other" includes investments in non-corporate businesses, life insurance reserves and pension reserves.

[2] Nominal amount = $48.6tn

[3] Nominal amount = $79.8tn

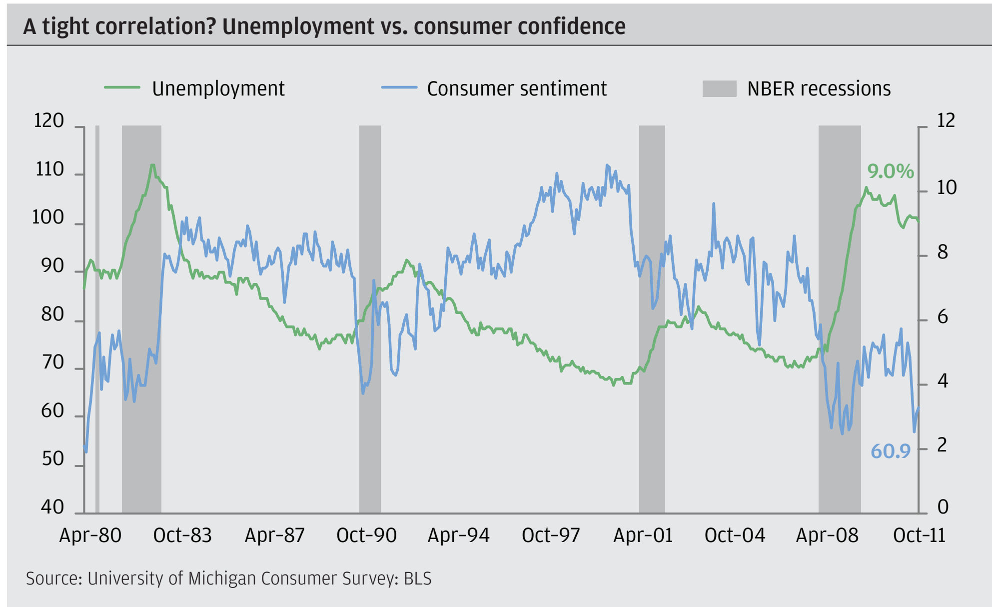
[4] Nominal amount = $63.7tn

The other source of continuing consumer pessimism is the state of the labor market. A **weak labor market** impacts not only the unemployed, but also the employed in terms of slower income growth and greater fear about financial insecurity. Figure 4 demonstrates the close relationship between U.S. consumer sentiment and unemployment levels.[3]

[3] While consumer sentiment has historically been closely tied to personal consumption, consumer sentiment may not be an accurate predictor of personal expenditures. Over the last several years, for example, personal expenditures have increased while consumer sentiment has declined. As of October 2011, personal expenditures increased 1.6% year-over-year while consumer sentiment was down 11%. Bureau of Economic Analysis "U.S. Personal Consumption Expenditure Core Price Index" and University of Michigan Survey of Consumer Confidence Sentiment.

Figure 4

**A tight correlation? Unemployment vs. consumer confidence**




Source: University of Michigan Consumer Survey: BLS

The persistence in U.S. unemployment has been much publicized. The most popular measure of unemployment (U-3, as defined by the Bureau of Labor Statistics) continues to remain above 9%, while a broader measure of unemployment that includes marginally attached and part-time workers is at a staggering 16.5%.[4] Further, the labor participation rate has fallen 3.1 percentage points from its 2000 peak and is at levels not seen since the 1980s.[5]

The depressed state of the housing market also limits the potential recovery in the labor market. Historically, the U.S. labor market has benefited from significant workforce mobility relative to that of other countries. Today, this mobility is hampered by low housing values and a significant percentage of mortgages that are underwater (i.e. mortgages with a loan-to-value ratio higher than 100%). Globalization of the economy may also have hampered domestic job prospects. Whereas employees may have been willing to move from the Midwest to Texas for improved job prospects, when jobs move from the Midwest to China, mobility becomes more challenging.

On a positive note, job openings actually increased 23% in September, a post recession high. Good job openings data could signal the beginning of a recovery in the labor market.[6]

## 4. The good news that may re-energize the U.S. consumer

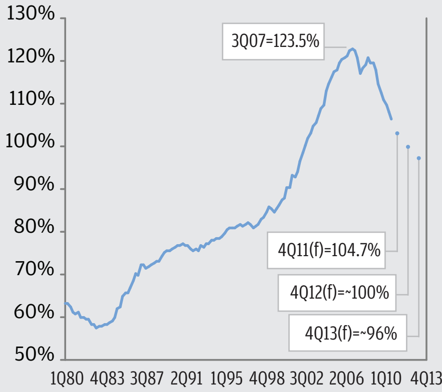
Since the crisis, households have delevered significantly. Total consumer debt has decreased by $800 billion from its 2008 peak through charge-offs and pay-downs. In Figure 5, we show how household liabilities as a percent of disposable personal income (Debt-to-Income or **"DTI"**) have declined from 123% in 3Q2007 to 107% today. If current trends continue, this ratio is expected to be around 100% by the end of 2012.

[4] As of September 2011.
[5] Labor force participation was 67.3% as of 01/31/00 and 64.2% as of 09/30/11.
[6] JOLTS report.

**Figure 5**

**Consumer debt and debt service ratios have improved dramatically**

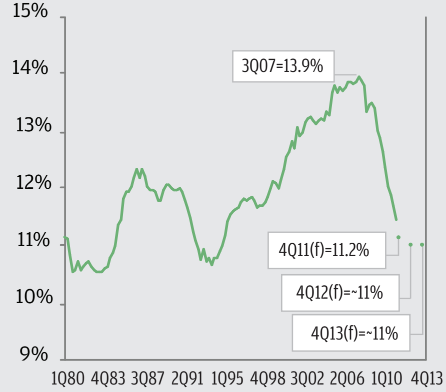
Household liabilities[1] as a % of disposable personal income (1980–2013)




Source: Federal Reserve; Bureau of Economic Analysis; J.P. Morgan

[1] HH home mortgage and consumer credit liabilities only (excludes: other miscellaneous debt, often from non-profits; home mortgage loans to non-corporate businesses —primarily residential construction loans).

Household Debt Service Ratio (% of disposable income, 1980–2013)




Source: Federal Reserve; J.P. Morgan

The ability of firms and households to service their debt is much greater today than at the start of the financial crisis. The household debt servicing ratio (“DSR”), measured as a percent of disposable income in Figure 5, is at a 15-year low and is projected to improve further. The current low levels of interest rates have contributed to this phenomenon.

The household leverage position could actually improve further through foreclosures. Currently, about $800 billion of mortgage debt outstanding are 90+ days past due, suggesting that they should not be included in households’ current debt burden. Excluding these balances DTI would decline from 107% to 100%, and DSR would decline from 11.5% to 11.0%.[7]

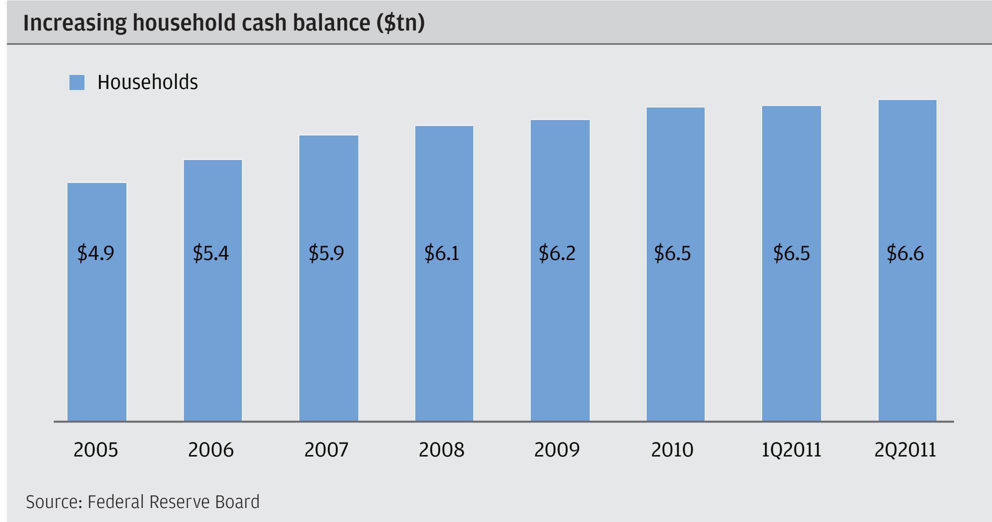
## Increasing consumer cash balances

Since the end of 2006, household savings have increased by 23% (see Figure 6). This substantial household liquidity, together with the historically high corporate and bank cash balances, represents a significant shift from the liquidity crisis of 2008. Along with the deleveraging of balance sheets, the increase in liquidity means consumers are better able to absorb downside shocks to the economy.

[7] NYFRB, FRB, Mortgage Bankers Association, J.P. Morgan.

Figure 6

**Increasing household cash balance ($tn)**




Source: Federal Reserve Board

## 5. Catalysts that could awaken the U.S. consumer

With consumer balance sheets improving dramatically, what combination of factors could serve as a catalyst to re-energize the U.S. consumer?

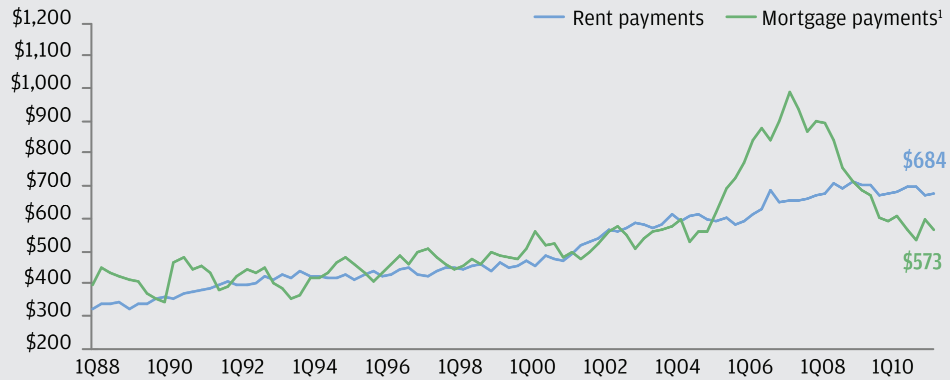
**The end of the European sovereign debt crisis and U.S. government retrenchment**
High sovereign debt levels have led to a sovereign debt crisis in Europe and retrenchment by the U.S. government. Recently, the markets have been focused on Europe with volatile reactions to news of changes in the European situation. Policy solutions to the growing sovereign debt problem have consisted of repeated rescue packages, which have not been embraced by the markets as providing for a sustainable and long-term solution. Realistic and pragmatic long-term solutions to European debt crisis, even if painful, could reduce market volatility and re-energize the consumer.

**Increasing housing prices**
Declining home prices have impacted households' willingness to consume. When home prices increase, household wealth increases and consumers feel more comfortable making purchases. In contrast, when home prices decline, household wealth declines and consumers become more conservative with their expenditures. Several factors could turn the housing market around and, in turn, provide the impetus for a broader consumer-led recovery.

1) **High rents:** Consumers view renting as a substitute for buying homes. As rent prices increase, consumers find homeownership to be a more attractive option, thereby bolstering home sales. For the first time since 2005, median rental prices are above mortgage payments (mortgage payments are now at a 16% discount to rental payments)

Figure 7

**Rental payments are higher than mortgage payments**




Source: U.S. Census Bureau, J.P. Morgan

[1] Effective mortgage payment calculated by applying effective mortgage rate to a hypothetical 80% LTV mortgage on the median asking sales price for the period.

2) **Affordability relative to income:** Homes are at their most affordable levels since before the crisis. The National Association of Realtors' Housing Affordability Index, which measures the ability of the average family to pay its mortgage after a 20% down-payment, has increased 69% from 4Q2007 to 1Q2011

3) **Low mortgage rates:** Mortgage rates for home purchases are at their lowest level since the mid-1990s. The average 30-year effective rate was 4.3% in 2Q2011, down from nearly 7% in 2008, and has continued to decline[8]

4) **Low housing starts:** Housing starts are at record lows, and a large portion of housing sold in foreclosures is being converted to rental housing, reducing the housing stock on the home sales market. After hitting a 20-year high in 2006 (2.3 million units), annual housing starts in September declined to 658K, nearing their 2009 lows. Low housing inventory could result in increased construction—a leading indicator of economic growth

## Emerging economies

From 2006 to 2010, real GDP in the U.S. grew at an average of 1.0%, while growth rates in the BRIC (Brazil, Russia, India and China) economies ranged from 4% to 11%. BRIC countries are now expected to account for over 50% of global growth. 2010 household consumption in the BRIC counties was $5.5 trillion. Historically, U.S. consumption has stimulated emerging market economies through job creation overseas. We may now experience a reversal in this trend. The strength and growth potential of consumers overseas may led to an increase in domestic revenue and U.S. job creation.

## The generational wealth transfer

The U.S. population is getting older. Households aged 55 or older now account for 38% of the population, up from 35% of the population in 1980. A consequence of the aging population is the continued shift of wealth to older households. Households aged 55 or

[8] Mortgage Bankers 30-Year Effective Rate from Mortgage Bankers Association.

older have increased their portion of total net wealth from 55% in 2001 to 60% in 2007. These households now control over $40 trillion of net worth, a portion of which is expected to be transferred to younger generations. Assuming these younger generations have higher consumption rates, this wealth transfer may have a stimulating impact on the economy. The timing and the extent of this impact remain uncertain.

### Rising shareholder distributions

Shareholder distributions have been on the rise over the last 18 months. They could continue to increase significantly from current levels, as U.S. corporate cash balances are at historic highs, dividend payout ratios are at historic lows and, despite worries about a double dip, earnings expectations continue to be strong.[9] There is also increasing pressure on firms and lawmakers alike to find a way to put the cash that is trapped offshore (likely more than half of the U.S. corporate cash) to work. Distributing this cash to shareholders would amount to about 6% of disposable income and represent $100-$200 billion more than S&P 500 firms spent on distributions in 2010. Incremental dividend income and higher stock values could serve as an impetus for healthier consumer sentiment.

## Executive takeaways

1) The U.S. consumer alone constitutes the second largest economy in the world
2) Most decision-makers are focused on the significant and real headwinds facing the consumer
3) As a result, firms have spent the last three years fortifying balance sheets and preparing for worse macro trends
4) There are, however, many catalysts on the horizon that could break the downward trend of consumer sentiment
5) Decision-makers should consider putting in place a roadmap to quickly change direction if and when a change in consumer sentiment creates a surge in demand
6) **When this turnaround happens, investors will likely shift their focus to growth and a firm's preparedness to capitalize on this "new growth" environment**

[9] "Q1 2011 Distributions: Facts & Trends, Resurgence in shareholder distributions" http://csas.ny.jpmorgan.com/files/J.P.Morgan_Corporate_Finance_Advisory_Q1_2011_Distributions_report.pdf.

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