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Rising Household Debt—Canary in the Coal Mine?

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Key takeaways

» *The level of consumer credit outstanding in the U.S. recently has surpassed its post-financial-crisis high, and some investors have asked whether this may be the first sign of a downturn in the economy.*

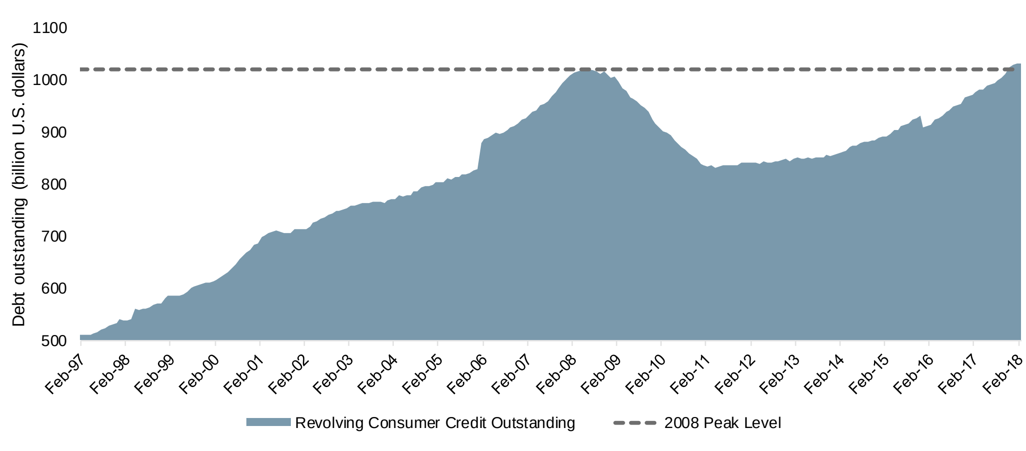
» *While absolute indicators of debt levels are instructive, we believe that a household's ability to pay back its obligations (currently at reasonable levels) is a better measure of financial stress.*

What it may mean for investors

» *We continue to believe that the U.S. economy is in the final third of its expansion, but we do not expect a recession this year. Therefore, we believe that a positive outlook on the economy, coupled with improving earnings fundamentals, remains supportive of our favorable view on U.S. stocks.*

Federal Reserve (Fed) data shows that the total amount of revolving consumer debt outstanding (including credit cards) in the U.S. recently reached its highest level since before the height of the global financial crisis in 2008. Could this be signaling an imminent downturn in the U.S. economy? While higher debt levels are notable, we believe that no one indicator can accurately predict turning points in economic cycles. Further, when viewed in context, the latest data suggest that debt levels appear manageable—and are not indicative of overstretched economic conditions in the U.S.

Chart 1. U.S. revolving consumer debt is on the rise

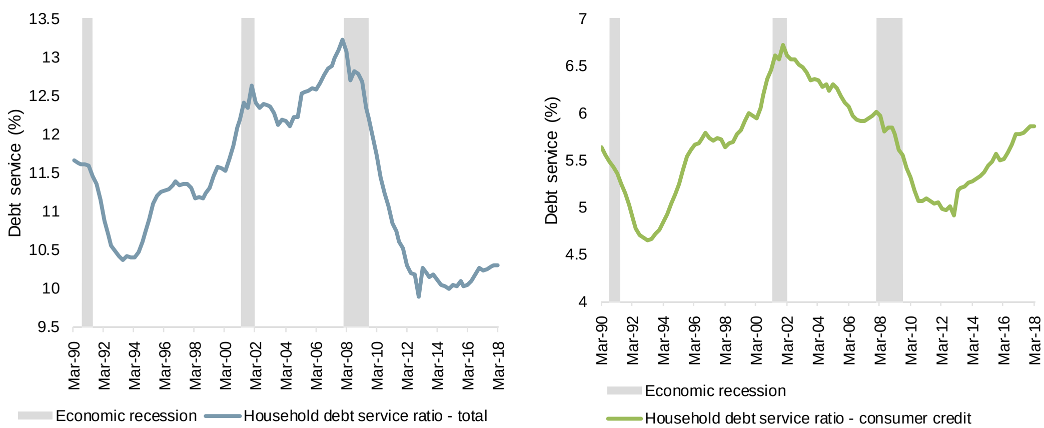


Sources: Wells Fargo Investment Institute; Bloomberg; April 9, 2018.

Rising debt—put it in context

Given that we do not believe that a recession is likely this year, then how concerned should investors be about rising consumer debt levels in the U.S.? We believe that higher levels of revolving debt are simply more evidence of a maturing economic recovery. This tells us little about whether households are experiencing financial stress as a result of that higher debt. To this point, we believe that: 1) the ability to service debt, and 2) total debt outstanding relative to income earned are two important indicators to consider when measuring credit-related household financial stress. So far, these indicators are not suggesting overstretched conditions in household borrowing.

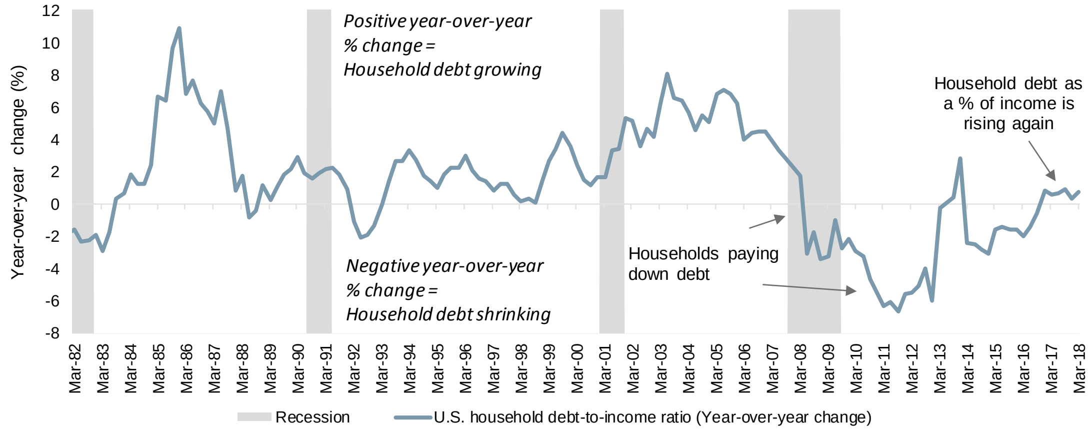
Chart 2. Households' ability to repay debt more manageable today than in years past



Sources: Wells Fargo Investment Institute, Bloomberg; April 9, 2018. Note: Debt service is a measure of how much of a household's disposable income goes to making payments on loan obligations.

For example, data in Chart 2 reflect U.S. personal debt service ratios over the past few recessions. More specifically, the data measure how much of a household's disposable income is used to make payments on loan obligations. The total debt measure (including mortgages and other consumer debt) in the left panel of Chart 2 shows that households are using a smaller fraction of their incomes to pay back loans (relative to pre-crisis levels). In the right panel of Chart 2, we isolate consumer credit, which includes obligations like credit cards. While the chart shows that debt utilization has been on the rise, this rate remains below its previous peak level. Indeed, lower levels of overall debt service (as illustrated in the left panel of Chart 2) are likely offsetting the recent increase in consumer credit—which suggests to us that household financial conditions are not stretched.

Chart 3. Households have de-levered since the height of the global financial crisis



Sources: Wells Fargo Investment Institute, Bloomberg; April 9, 2018.

Investment implications

If we believe that current levels of consumer debt outstanding are consistent with a maturing economy and not a recession, then when should we be concerned about higher debt contributing to an economic downturn? Fortunately, Chart 3 illustrates that households have been paying down debt at a rate faster than incomes have been rising (as opposed accumulating debt faster than incomes were rising as in prior expansionary periods between recessions). When combined with the data in Chart 2, this view suggests that household debt appears manageable (viewed in a historical context). We would grow more concerned about rising household debt if we witnessed accelerating debt-to-income ratios, but we are not there yet.

While rising levels of absolute household debt are important to monitor, we believe that the ability of consumers to service their debt burdens is a better indicator of financial stress. Today, these measures of household financial stress, while having risen to their pre-crisis peak, remain below levels associated with the past two recessions. To this point, we do not believe that the rising nominal level of household debt is a "canary in the coal mine" pointing to an imminent downturn in the U.S. economy.

Indeed, while market volatility has been disconcerting to some investors, we still expect the U.S. economy to expand at a rate of 2.9% in 2018 and believe that the U.S. economy recently has entered the late and final stage of its expansion. At this juncture, we expect investors to look for evidence of an economic downturn—and for bond market participants in particular—to watch for the flattening (and eventually inversion) of the Treasury yield curve that often is cited as a precursor to a recession as short-term rates overtake longer-term yields.

Fortunately, our work shows that today's trends in Fed policy and inflation are not yet consistent with factors that have led to an inverted yield curve in the past. This view should continue to provide a constructive environment for bond market participants. We believe that investors are likely to find favorable opportunities in high quality credit on the shorter end of the yield curve. For equity investors, gradual rate increases by the Fed and positive economic growth should support the corporate earnings environment, underpinning our favorable view of U.S. stocks and cyclical sectors like Financials, Consumer Discretionary, Industrials, and Real Estate.

Economic Calendar

Date	Report	Estimate	Previous
4/24/2018	FHFA House Price Index MoM	0.60%	0.80%
4/24/2018	S&P CoreLogic CS 20-City NSA Index	--	205.1
4/24/2018	S&P CoreLogic CS 20-City MoM SA	0.63%	0.75%
4/24/2018	S&P CoreLogic CS 20-City YoY NSA	6.40%	6.40%
4/24/2018	S&P CoreLogic CS US HPI NSA Index	--	196.31
4/24/2018	S&P CoreLogic CS US HPI YoY NSA	--	6.18%
4/24/2018	New Home Sales	630k	618k
4/24/2018	New Home Sales MoM	1.90%	-0.60%
4/24/2018	Richmond Fed Manufact. Index	16	15
4/24/2018	Conf. Board Consumer Confidence	126	127.7
4/24/2018	Conf. Board Present Situation	--	159.9
4/24/2018	Conf. Board Expectations	--	106.2
4/25/2018	MBA Mortgage Applications	--	4.90%
4/26/2018	Initial Jobless Claims	231k	232k
4/26/2018	Continuing Claims	1854k	1863k
4/26/2018	Advance Goods Trade Balance	-$74.7b	-$75.4b
4/26/2018	Retail Inventories MoM	--	0.40%
4/26/2018	Wholesale Inventories MoM	--	1.00%
4/26/2018	Durable Goods Orders	1.20%	3.00%
4/26/2018	Durables Ex Transportation	0.40%	1.00%
4/26/2018	Cap Goods Orders Nondef Ex Air	0.60%	1.40%
4/26/2018	Cap Goods Ship Nondef Ex Air	0.20%	1.40%
4/26/2018	Bloomberg Consumer Comfort	--	58.1
4/26/2018	Kansas City Fed Manf. Activity	--	17
4/27/2018	Employment Cost Index	0.70%	0.60%
4/27/2018	GDP Annualized QoQ	2.00%	2.90%
4/27/2018	Personal Consumption	1.20%	4.00%
4/27/2018	GDP Price Index	2.20%	2.30%
4/27/2018	Core PCE QoQ	2.60%	1.90%
4/27/2018	U. of Mich. Sentiment	98	97.8
4/27/2018	U. of Mich. Current Conditions	--	115
4/27/2018	U. of Mich. Expectations	--	86.8
4/27/2018	U. of Mich. 1 Yr Inflation	--	2.70%
4/27/2018	U. of Mich. 5-10 Yr Inflation	--	2.40%
4/30/2018	PCE Core YoY	--	1.60%
4/30/2018	Personal Income	0.40%	0.40%
4/30/2018	Personal Spending	0.40%	0.20%
4/30/2018	Real Personal Spending	--	0.00%
4/30/2018	PCE Deflator MoM	--	0.20%
4/30/2018	PCE Deflator YoY	--	1.80%
4/30/2018	PCE Core MoM	0.20%	0.20%
4/30/2018	Chicago Purchasing Manager	58.5	57.4
4/30/2018	Pending Home Sales MoM	--	3.10%
4/30/2018	Pending Home Sales NSA YoY	--	-4.40%
4/30/2018	Dallas Fed Manf. Activity	--	21.4

Source: Bloomberg, as of April 20, 2018.

Risk Considerations

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