# ECONOMIC UPDATE

REGIONS

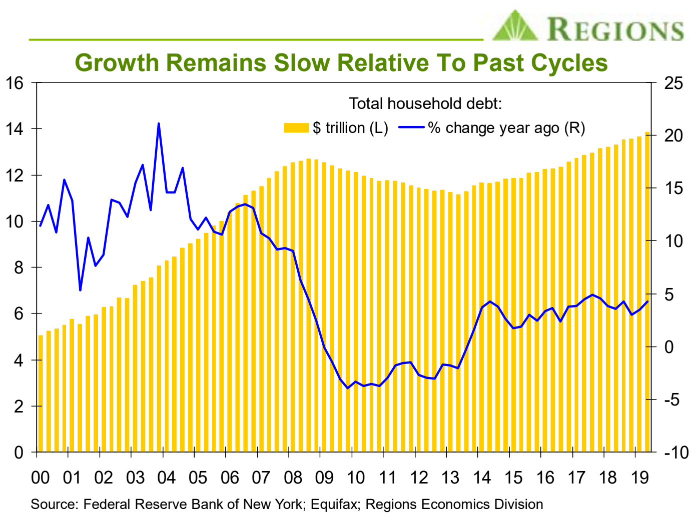
August 14, 2019



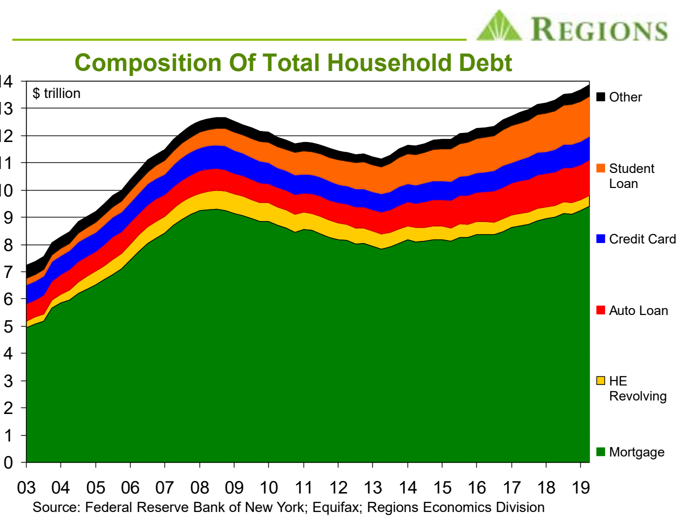

## Q2 2019 Household Debt and Credit: Pockets Of Concern, But Big Picture Looks Solid

- Total household debt rose to $13.860 trillion in Q2 2019, an increase of $192 billion from Q1 2019
- Mortgage balances rose by $162 billion in Q2, accounting for 84 percent of the increase in total debt outstanding
- As of Q2, 4.37 percent of outstanding household debt was in some stage of delinquency, down from 4.56 percent in Q1

The Federal Reserve Bank of New York (New York Fed), in conjunction with Equifax, has released their latest quarterly report on trends in household debt. Total household debt rose to $13.860 trillion in Q2 2019, a $192 billion increase from Q1 2019, marking the 20th consecutive quarterly increase in outstanding household debt. Mortgage debt was the main driver of growth in total household debt in Q2, with the $162 billion increase in outstanding mortgage balances accounting for 84 percent of the increase in total household debt. There were modest increases in outstanding auto loans and credit card debt, with a trivial decrease in outstanding student loan debt and revolving home equity lines continuing their long-running decline. The overall delinquency rate on household debt fell to 4.37 percent in Q2, which is the lowest rate since Q3 2006, and while there are differences in loan performance across loan types, overall performance remains solid. Despite the seemingly obligatory but void of any actual significance ranting about (yet) another new "record high" level of household debt, the reality is that the aggregate debt-to-income ratio is lower than it has been since 2001, not to mention significantly lower than it was at the onset of the 2007-09 recession, while low interest rates continue to hold down monthly debt service obligations. The bottom line is that, while by no means pristine, household balance sheets are in better condition than has been the case for quite some time.



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division



Source: Federal Reserve Bank of New York; Equifax; Regions Economics Division

Though growth in outstanding household debt accelerated a bit in Q2 2019, with a year-on-year increase of 4.27 percent, growth in total household debt over the course of this cycle has been significantly slower than that seen in prior cycles. While this is hinted at in the first chart above, the New York Fed data series has a somewhat limited life, but the *Flow of Funds* data published by the Federal Reserve Board date back to the 1950s and affirm how relatively slow growth in household debt has been during the current cycle. Our view is that this mainly reflects what, in the post-recession years, has been a greater degree of discipline on the part of both borrowers and lenders. What will bear watching is the extent to which this discipline will hold up as we move even further into the current expansion, which recently became the longest U.S. expansion on record. It is, after all, typically in the later stages of a cycle that discipline starts to break down. That said, starting points matter, and that both borrowers and lenders have been somewhat restrained over the course of this expansion should mean that any breakdowns in discipline won't result in excesses as egregious as seen in some past cycles, thus subjecting the financial system and the broader economy to considerably less stress during the next downturn than was the case the last time around. It must be noted, however, that the, for lack of a better term, dynamics of the housing market have acted as a drag on growth in total household debt during the current cycle. What for some time now have been notably low inventories of homes, both new and existing, for sale mean that home sales in the current cycle have lagged behind what would have been seen in more normal market conditions. This has obviously weighed on growth in mortgage debt, and given that mortgage debt is far and away the largest single component of total household debt (as illustrated in the second chart above), this has been a constraint on growth in overall household debt.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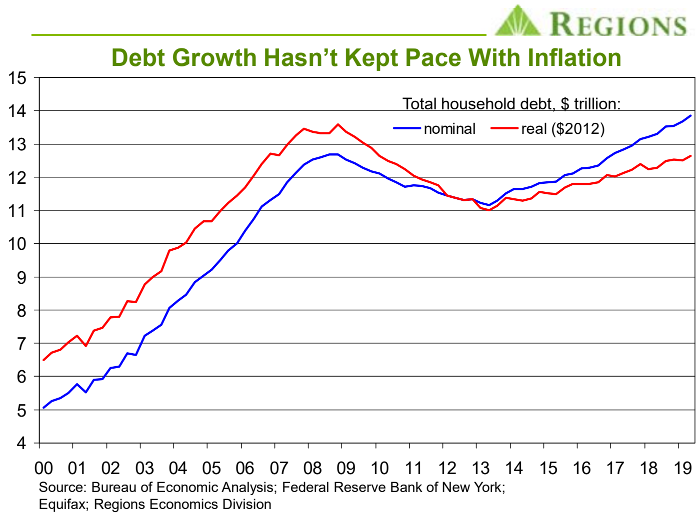
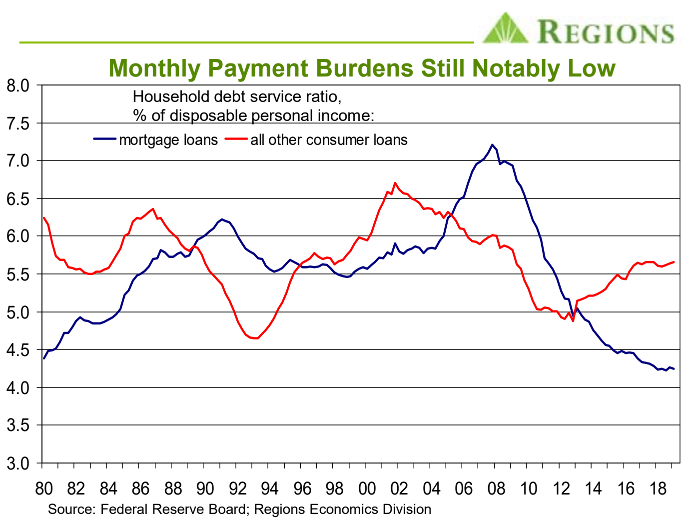


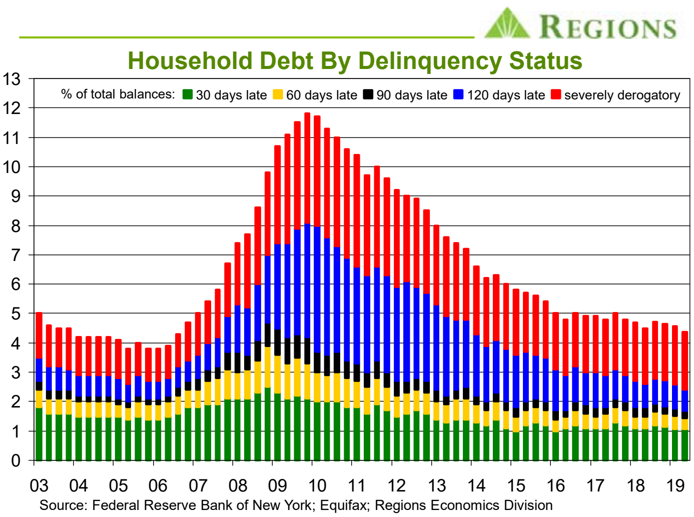

One way to add context to growth in total household debt during this cycle being markedly slower than in past cycles is to look at the level of debt on an inflation-adjusted basis, which we show in the chart to the side. On a nominal basis, the $13.860 trillion in outstanding household debt as of Q2 2019 is 9.35 percent higher than the prior peak – $12.675 trillion as of Q3 2008. At the same time, however, the level of real (or, inflation adjusted) household debt stood at $12.628 trillion as of Q2 2019, which is 7.05 percent below the peak level of $13.586 trillion as of Q4 2008 (we've used the PCE deflator with a base year of 2012, but pick any deflator and any base year you like and the outcome will be the same). We'd say "stop us if you've heard this one before," but, we're fairly sure you haven't, as we very seldom see anyone attempt to put each new "record high" level of household debt into any type of context. Another way to do so is to note that while the level of nominal household debt as of Q2 2019 is 9.35 percent above the prior cyclical peak, the level of disposable personal income excluding transfer payments, which we routinely note is the best measure of the pool of income available for consumer spending and meeting debt service obligations, stood 46.58 percent above its prior cyclical peak as of Q2 2019, hence the significantly lower aggregate debt-to-income ratio.

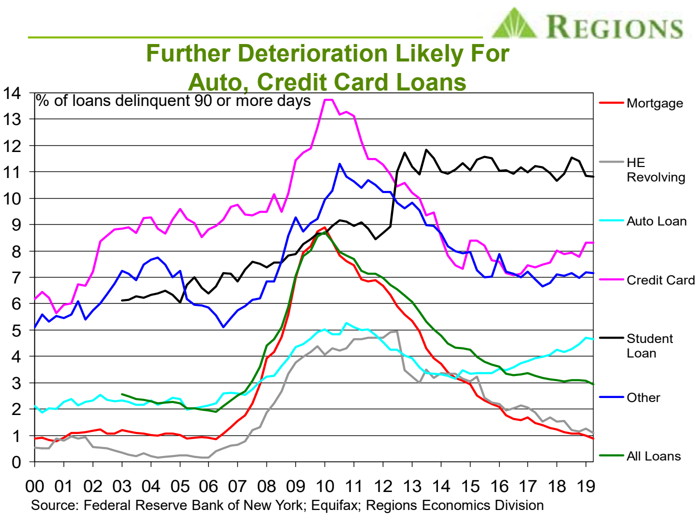



Of even more significance is that monthly debt service burdens (monthly principal and interest payments as a percentage of disposable personal income) have settled around the lowest shares in the four-decade history of this series (note – the Federal Reserve's calculation is based on disposable personal income including transfers, were ex-transfers disposable personal income used as the base, the level of the ratio would be higher but the patterns would be the same). As of Q1 2019 (the latest available data point), monthly debt service obligations accounted for 9.91 percent of disposable personal income, up from 9.89 percent as of Q4 2018 but nonetheless only slightly above the all-time low in this series – 9.85 percent from Q1 2018 through Q3 2018. In the chart to the side we segregate the overall debt service ratio into the two main components, mortgage loans and all other consumer loans. Note that the monthly debt service ratio for mortgage loans is bumping along the historical lows for this series. This notable in light of how much house prices have risen over this time frame, and illustrates the significance of low interest rates in keeping monthly debt service obligations manageable.

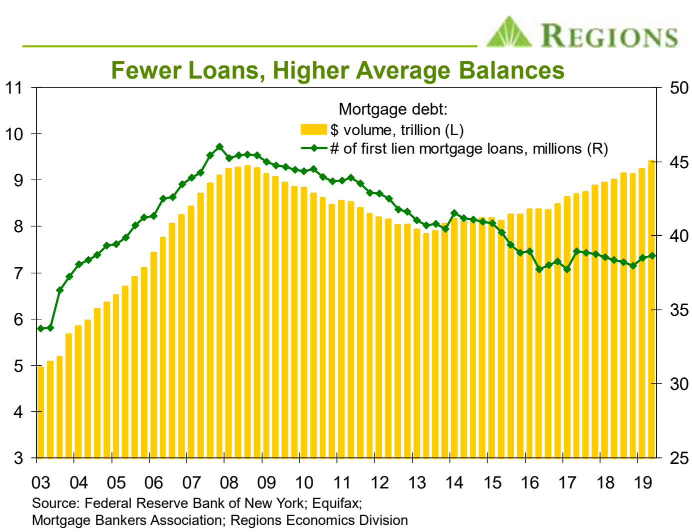
To be sure, just as there are issues around the distribution of household debt and disposable personal income that bias the debt-to-income ratio either higher or lower for any given individual, this is also the case with monthly debt service burdens. The reality, however, is that the aggregate measures are what we have to work with, and there is some signaling value in these aggregate measures, such as the debt service burden climbing rapidly and topping out at 133.8 percent in the years leading up to the 2007-09 recession. While a prolonged period of abnormally low interest rates has contributed to holding the debt service burden down near the all-time low, it does not necessarily follow that higher interest rates will lead to significant increases in monthly debt service burdens. What is a preponderance of fixed-rate debt on household balance sheets will mitigate the effects of rising interest rates on monthly debt service burdens, so that payment shocks triggered by higher interest rates should not be nearly as big of a threat to consumers, and in turn to lenders, in the current cycle than has been the case in past cycles. It is also worth noting that expectations of how high interest rates will go over coming quarters have been scaled back considerably in recent months, the implication being that, even if rates do actually ever go up again, payment resets on what variable rate debt there is won't be as sizeable as had previously seemed likely.

Loan performance improved further in Q2, with 4.37 percent of all outstanding debt in some stage of delinquency, down from 4.56 percent in Q1 and the lowest overall delinquency rate of the current expansion. In terms of dollar volume, there was $604 billion of delinquent household debt as of Q2, the lowest total in the past year. The 30-day delinquency rate stood at 1.07 percent as of Q2, unchanged from Q1 and easily below longer-term norms, which suggests that inflows into later-stage delinquencies will slow over coming quarters. For instance, the 60-day delinquency rate stood at 0.37 percent as of Q2 2019, the lowest rate in the life of this data set. The 90-day delinquency rate has been basically flat over the past seven quarters – 0.25 percent as of Q2 – while the 120-day (or longer) delinquency rate fell to 0.72 percent as of Q2. It is reasonable to expect the 90-day and 120-day delinquency rates to drift lower over coming quarters given the declines in the 30-day and 60-day delinquency rates. There are differences in loan performance across the various components of household debt, with mortgage loans and revolving home equity lines posting the strongest performance. This is not at all surprising given what have been much more stringent mortgage underwriting standards over the life of the current expansion (more on this point later). Newly delinquent balances on credit card loans continue to increase, and though new inflows into delinquency for auto loans slowed in Q2, we won't be surprised to see them turn higher again over coming quarters. Auto and credit card loans are two areas in which subprime lending has played a prominent role over recent years and, as such, pose greater risks during the next downturn while loan performance in the student loan bucket is highly vulnerable to any deterioration in labor market conditions. On the whole, however, that household credit conditions are in better shape than has been the case in many, many years.

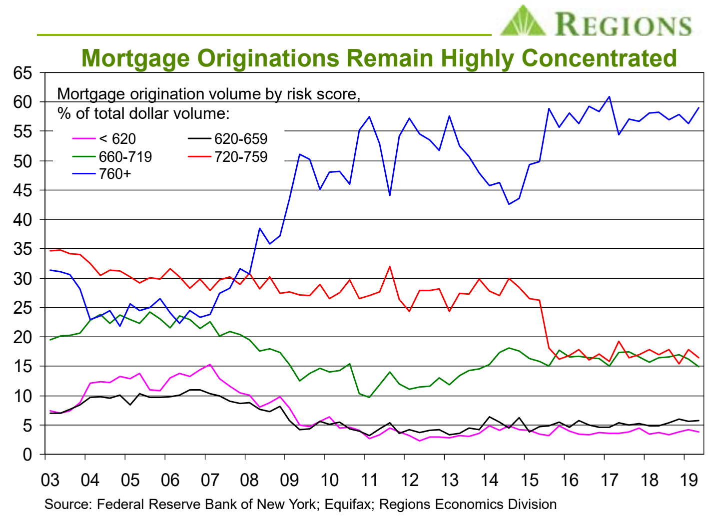



In the "for what it's worth which isn't much" category, at $9.406 trillion as of Q2 2019, the level of outstanding mortgage debt finally surpassed the prior peak of $9.294 trillion seen in Q3 2008. It will surprise no one when we say that, in and of itself, this is not at all significant, and that it took eleven years to surpass the prior peak says just as much about the state of the housing market during the current cycle as it does about the housing market prior to the last recession. As noted earlier, that home sales have been so subdued over the course of the current expansion has weighed on mortgage loan originations and outstanding mortgage debt. Another factor is that cash-out mortgage refinancing activity has been much less prominent during the current cycle than in the years leading up to the 2007-09 recession. For instance, Freddie Mac reports that those borrowers who utilized the cash-out option while refinancing in Q2 withdrew $17.5 billion in equity out of their homes, up only slightly from Q2 2018 but nowhere near the pre-recession peak of $84 billion in Q2 2006. In other words, with significant declines in mortgage interest rates relative to where they stood in Q4 2018, Q2 2019 saw a wave of mortgage refinancing and even coupled with a prolonged period of robust house price appreciation, borrowers were still restrained when it came to extracting equity. To repeat a point made earlier, this restraint suggests there will be far less damage to the financial system and to the broader economy in the next downturn that was the case the last time around.

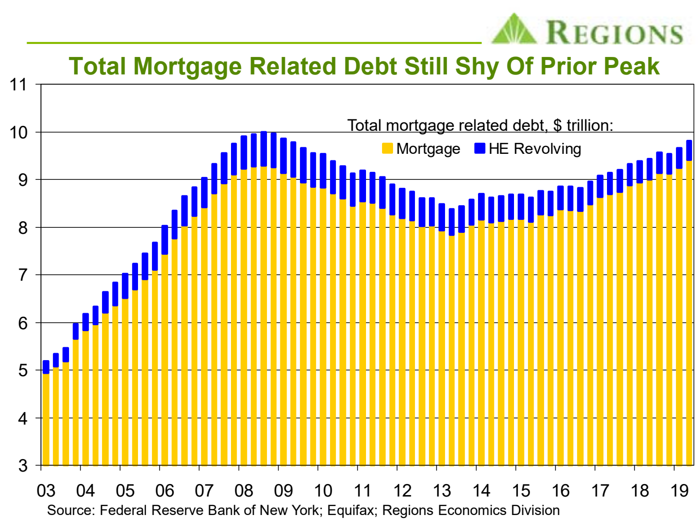


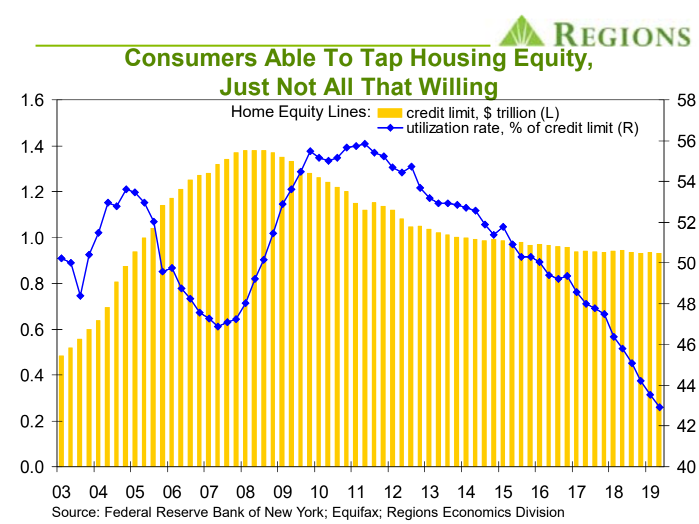

While a new "record high" level of mortgage debt doesn't interest us, we do find it interesting that it has taken significantly fewer borrowers to carry us to this new high than was the case with the prior peak, as illustrated in the chart to the side. Along with the New York Fed data on the dollar volume of outstanding mortgage debt, we show the number of first lien mortgage loans serviced, as reported by the Mortgage Bankers Association (MBA). Right off the bat, we do not use the number of open mortgage accounts reported in the New York Fed data, because this series is simply not plausible, even allowing for the issue of double counting mortgage loans when both members of a couple have their names on the mortgage loan. The New York Fed data suggest a much more pronounced decline in the number of mortgage loans than is seen in the MBA data. Either way, the implication of the data shown in this chart is that average mortgage loan balances have gotten much larger over time, hence the new record high level of mortgage loan debt despite fewer outstanding mortgage loans. To be sure, cash-out refinancing could help push average balances higher but, as noted above, cash-out activity has been relatively subdued over the course of the current cycle relative to the pre-recession years.




Pulling from the Home Mortgage Disclosure Act (HMDA) data base, we can verify that the average dollar volume of newly originated purchase mortgage loans has risen significantly since 2008 – the prior peak in the level of mortgage debt. Though the 2017 vintage is the latest available in the HMDA data, the average dollar volume of purchase mortgage loans rose by 31.37 percent from 2008 to 2017 (the average dollar volume of refinancing loans rose by 23.84 percent over this period). That there has been a significant increase in the average purchase mortgage loan amount is consistent with other data. For instance, from the CoreLogic data we know that house price appreciation has been robust over the past few years even though it has been well short of the pace of price appreciation seen in the pre-recession years (the CoreLogic HPI for the U.S. as a whole stands 8.51 percent above its prior peak as of June 2019). Moreover, significantly higher average loan amounts are consistent with the New York Fed data showing mortgage loan originations have been heavily concentrated amongst those with credit scores above 760, which is illustrated in the chart to the side. Though there is obviously not a perfect mapping between credit score and house price, it is reasonable to assume those borrowers with the highest credit scores are more concentrated in the upper price ranges than in the lower price ranges. To a large extent, the concentration of mortgage loan originations reflects what have been much more stringent mortgage underwriting standards in the post-recession years.

So, while higher average loan amounts at origination have provided some offset from lower transaction volumes (i.e., lower levels of home sales) due to supply constraints, growth in total mortgage debt outstanding has been held down by a much more restrained pace of home sales during the current cycle than has been the case in the past – even removing the distortions of the "housing boom" in the years prior to the 2007-09 recession. As noted earlier, given the predominance of mortgage debt, slower growth in mortgage debt has acted as a material drag on the pace of growth of overall household debt during this cycle. We think it also interesting to note that when one accounts for the long-running decline in outstanding home equity lines, total mortgage-related debt has yet to recapture its prior peak, which we illustrate in the first chart below.




As of Q2 2019, outstanding balances on home equity lines stood at $399 billion, the lowest since Q2 2004. As seen in the second chart above, utilization rates on home equity lines have been trending lower for several years. That utilization rates and balances have continued to decline in recent years is, at least to us, somewhat puzzling. This could in part reflect homeowners scarred by the last cycle and being unwilling to go to/back to the home equity well. To some extent, this could be a rate story, given that interest rates on home equity lines tend to be variable rates tied to a given market interest rate and tend to be well above interest rates on purchase mortgage loans. Still, with the sharp decline in interest rates over recent months, there has been no response from home equity utilization rates. We think the profile of mortgage borrowers in the post-recession years could also be playing a role, at least in light of the data showing mortgage loan originations highly concentrated amongst those with credit scores of better than 760. To the extent these are more affluent borrowers having purchased higher priced homes, they could have less interest in utilizing home equity lines, have less need to do so, or simply have access to alternative forms of credit that carries lower interest rates than those that can be found on home equity lines. We do not know this to be the case, but, instead, this is basically just us thinking out loud in an attempt to solve the puzzle of ongoing declines in outstanding home equity lines.

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