Under Pressure: U.S. Household Wealth Steps Down from Recent Highs

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Highlights

- The recent release of second quarter household balance sheet accounts revealed a record drop in U.S. household net wealth, led by a decline in the market value of financial assets, partially offset by growth in non-financial assets.
- With losses since extending to home valuations, net wealth in the third quarter may take another step down.
- Meanwhile, high inflation will force households to continue piling on more debt, despite the rising cost of borrowing.
- By applying a traditional rule of thumb, the pull-back in net wealth so far this year will translate into a drag on real spending of up to two percentage points.

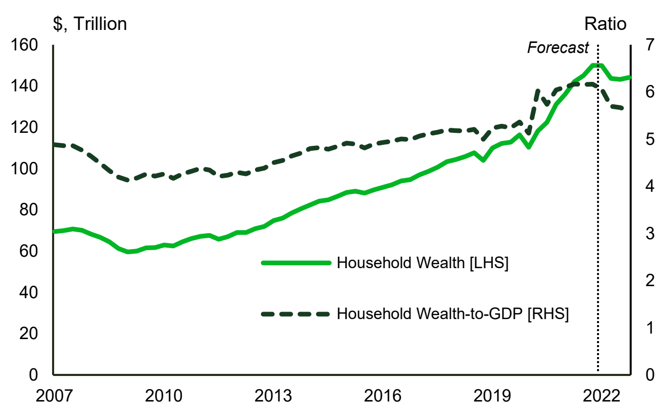
American households have been feeling the pinch from soaring inflation and interest rates. However, there has been less focus on the third of a trifecta of financial headwinds – declining net wealth. Last month's release of second quarter household balance sheet accounts revealed a record $6.1 trillion decline in U.S. household net wealth, which followed a $147 billion drop in the first quarter. The gap between household assets and liabilities remained relatively high, but another large drop set for the third quarter is likely to further erode that cushion (Chart 1). As a share of GDP, household wealth should remain below the pre-pandemic trend for the rest of the year.

Stock Market Drove Wealth Down

The net drop in wealth in the second quarter was led by a $7.3 trillion decline in the market value of financial assets as investors priced in the Fed's aggressive response to overheating inflation with a series of interest rate hikes (Chart 2). Roughly 90 percent of the drop was in directly held corporate equities and mutual fund shares with the rest stripped from the valuation of pension and insurance funds.

What gives more comfort is the signs that households remained level-headed during the sell-off, actively rebalancing their investment portfolios towards bonds as higher interest rates made these assets more attractive. Wealth held in debt securities rose by $557 billion, extending the first quarter growth to a combined increase of $944 billion since the beginning of the year (despite the two-quarter market loss of roughly $330 billion). Some of these gains were partially funded by the decline in time-saving deposits and money market funds as their collective value declined by $430 billion since December 2019.

Chart 1: Household Wealth Steps Down From Recent Highs



Source: Federal Reserve Board, Bureau of Economic Analysis, TD Economics.

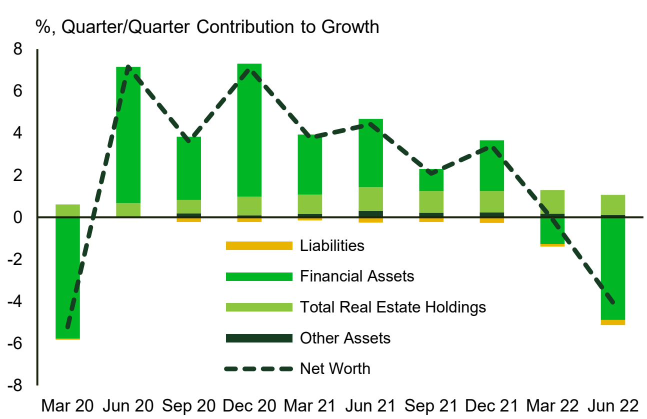
The rest likely came from the sale of equity investments. Of the $6.8 trillion drop in overall equity holdings in the first half of 2022, roughly $1.3 trillion (or 20 percent) were equity redemptions, with paper losses making up the residual (Chart 3). In contrast, during the Global Financial Crisis, the cumulative redemptions accounted for over 90 percent of the total market losses. This suggests that households didn't sell rashly into the falling market this time.

Tightening financial conditions combined with worries about the outlook for growth and corporate profits continued to put stock prices under pressure in the third quarter of 2022. Since the beginning of the third quarter to the time of writing, S&P declined by another two percent and is expected to finish the year 25 percent below the value reported in December 2021, setting up annual growth for the first decline since 2018.

Real Estate Values Held Up

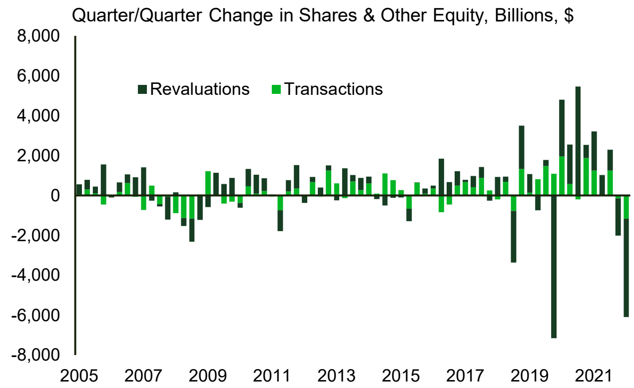
Offsetting some of these losses was growth in non-financial assets, which increased $1.4 trillion in the second quarter on top of the $1.6 trillion gain in the first quarter. Real estate accounted for 90 percent of the second-quarter growth, while purchases of consumer durable goods (such as cars, furniture, and electronics) were primarily responsible for the rest. As a side note, purchases of goods have never been a significant contributor to household wealth until 2020, when their quarterly growth contribution became more meaningful, averaging one-to-two tenths of a percentage point. This trend is reversing in 2022 as households continue to dial back on goods spending.

Chart 2: Sharp Drop in Stock Prices Eroded Wealth



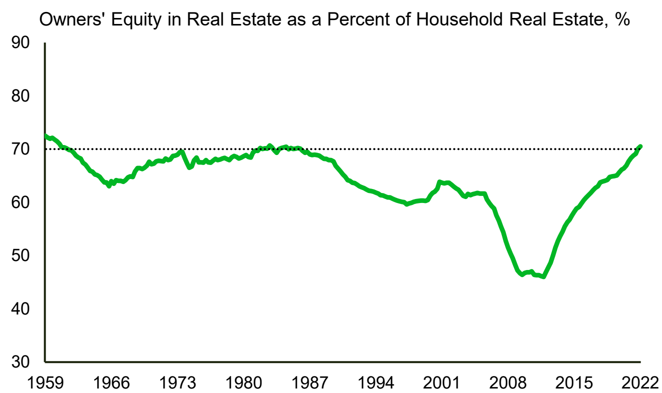
Source: Federal Reserve Board, TD Economics.

Chart 3: Households Sell $1.3 Trillion Worth of Stocks



Source: Federal Reserve Board, TD Economics.

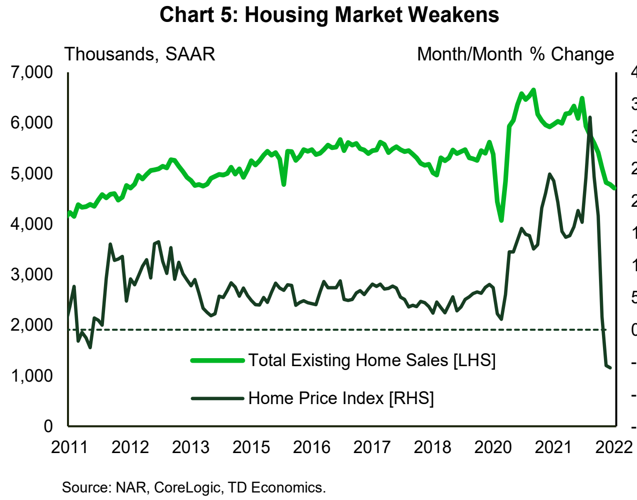
Chart 4: Higher Home Prices Propped Up Real Estate Equity



Source: Federal Reserve Board, TD Economics.

Meanwhile, the increase in real estate assets helped prop up overall household equity values, which reached 70 percent of total real estate assets – a level last seen in early 1980s (Chart 4). However, this is likely to represent the high watermark, as the housing market has since weakened on many levels: home prices have fallen 1.5 perecent since their all-time high reached in the second quarter, while the monthly average of existing home sales collapsed by 12 percent (Chart 5).

As the Federal Reserve continues to raise the policy rate, mortgage rates will remain elevated. As a result, the costs of buying a home will continue rising, further reducing housing activity and turning recent price deceleration into



Source: NAR, CoreLogic, TD Economics.

year-on-year price deflation of around eight percent by early 2023. The expected decline is far from the sub-prime crisis, when homes devalued by 30 percent, but it will have negative ramifications for economic growth through lower residential investment and consumer spending on home repairs, remodeling and household goods.

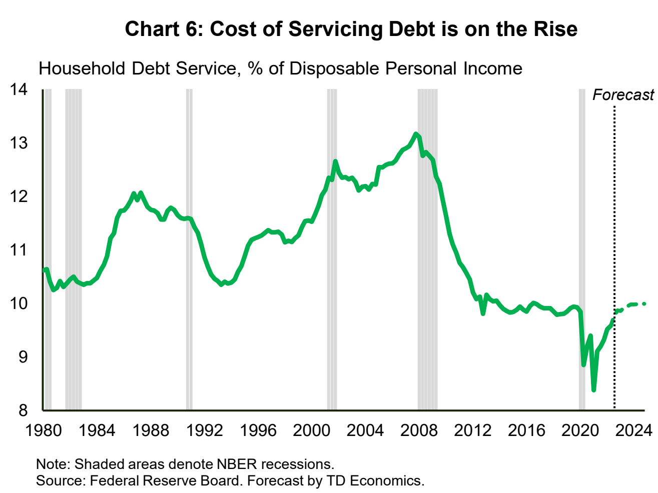
Growth in total real estate wealth will also depend on the extent of future household capital formation. At the early stage in the pandemic, the headship rate – the proportion of the U.S. adult population who form households – declined by almost two percentage points. Meanwhile, more recent data suggests that there has been a remarkable rebound in the headship rate. According to research conducted by the Fed, this rebound has been driven by the strong employment recovery and pandemic-driven adaptation in how and where people prefer to live.[1] However, going forward, housing demand will surely weaken as the impact of slower employment gains and weak U.S. population growth outweigh the boost underpinned by recent behavioral changes.

Surging Prices Lifted Debt

Rounding out the balance sheet, liabilities increased by $360 billion in the second quarter of 2022 due to higher mortgage borrowing and consumer credit. Mortgage debt accounted for 70 percent of the increase in liabilities as balances rose by $263 billion to $12.2 trillion, supported by house price growth. However, relative to the first quarter, the rate of borrowing slowed as aggressive monetary tightening pushed mortgage rates to levels not seen since 2002. As a result, mortgage debt servicing costs rose by two percent, making it more expensive to own a house.

Consumer credit growth also reflects increased borrowing due to higher inflation. Sharp increases in the prices for new and used vehicles primed auto loan volumes during 2021 and resulted in a $33 billion increase in auto loans in the second quarter of 2022. According to the Federal Reserve Bank of New York, the average auto loan origination grew by 36 percent since 2019 – equivalent to the pace of growth for an average new mortgage.[2] Higher inflation also played a significant role in an expansion in credit card balances, which grew by $46 billion – the highest since 1999. Acceleration in consumer spending on services, which is typically financed by credit cards, also played a significant role as consumers embraced some of their favorite pre-pandemic activities, such as travel.

The one category that remained weak was student debt. It declined by $1 billion in the second quarter, as lower enrollments and extended federal student loan forbearance continued to limit growth. Assuming that President Biden's cancellation of federal student loans clears legal hurdles, total educational debt is expected to shrink even more – by half a trillion dollars. This, in conjunction with additional measures aimed at lowering repayment burdens, may limit growth in aggregate debt over the next year, unless increased borrowing capacity boosts leverage in other areas (such as mortgages).



Note: Shaded areas denote NBER recessions.
Source: Federal Reserve Board. Forecast by TD Economics.

In the meantime, we expect that households will continue borrowing more, in part due to higher inflation, but at a more moderate rate than in the first half of 2022. Indeed, mortgage debt growth should turn negative next year as fewer sales reduce mortgage demand and lower home values reduce average new mortgage balances.

Taken together, household debt is set to reach $19.5 trillion by the end of the year - three percentage points above the historical average when measured as a share of aggregate personal disposable income. Combined with a higher cost of borrowing, debt servicing should be nine percent more expensive than last year and grow by an additional five percent in 2023. Should personal income growth remain below its historical trend, the share of income allocated to debt-servicing will likely return to the pre-pandemic level by mid-2023 (Chart 6).

Impact on Spending

With asset values declining and debt rising, household net worth is expected to continue to remain under pressure in the second half of 2022. This change in wealth no doubt has major implications for consumer spending. Other things equal, an increase in household wealth makes people more inclined to spend, while the opposite is true when wealth declines.

While it makes intuitive sense, it's hard is to quantify the extent to which consumer spending is affected for several reasons. First, consumers' wealth composition is not homogeneous and the magnitude of declines in equity vs. home prices may affect specific household's propensity to consume by different degrees. Second, the marginal propensity to consume out of financial wealth is significantly higher for households with low wealth or low income than for those with high wealth or high incomes.

Empirical evidence suggests that for each dollar of wealth increase, between three and five cents is spent soon after it is earned. Applying that same formula (albeit with a negative sign) on the losses sustained in the first half of 2022 and building in a rough approximation of the further hit to net wealth in the third quarter would translate into 1.0- to 1.5-percentage point drag to real consumer spending over a year. However, this may still understate the true impact as consumers' emotional reaction to losses appear to be more severe relative to an equivalent gain. This behavioral response is known as loss aversion. According to one study conducted by researchers at the De Nederlandsche Bank, there is a gap between positive and negative income changes, and it is wider for larger income shocks.[3] American households are tracking to lose more than three months' worth of disposable income, so applying the study's estimates for a larger income shock would suggest that negative wealth effect could be as high as two percentage point drag on real consumer spending.

This suggests that in today's environment of financial turbulence, consumer confidence will remain under pressure and weigh on spending in the coming months. That's no accident: in keeping broad financial conditions tight, the Fed tries to moderate demand to help bring inflation down toward its target. This may feel painful to consumers but to the Fed, the benefit of restoring consumers' purchasing power down the road outweighs the risk of them feeling queasy when looking at their investment statements today.

Endnotes

1. García, D., Paciorek A. The Remarkable Recent Rebound in Household Formation and the Prospects for Future Housing Demand. May 6, 2022. https://www.federalreserve.gov/econres/notes/feds-notes/the-remarkable-recent-rebound-in-household-formation-and-the-prospects-for-future-housing-demand-20220506.html

2. Quarterly Report on Household Debt and Credit (Q2 2022). Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2022Q2

3. Christelis, D., Georgarakos D., Jappelli T., Pistaferri L., and van Rooij, M. (2017), "Asymmetric Consumption Effects of Transitory Income Shocks," DNB Working Paper, No 551. https://www.dnb.nl/media/vkumkxmi/working-paper-no-551_tcm47-355601.pdf