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THE HOUSEHOLD BALANCE SHEET

By Jody Lurie, CFA, Director, Corporate Credit Analyst

The low-rate environment has promoted borrowing from various corners of the market, including at the individual level. While certain types of borrowing have been muted in the post-recession era, others are expanding, a worrisome potential precursor of change in the credit cycle worth noting when considering the health of the US economy.

The Individual’s Balance Sheet

The consumer’s personal balance sheet in aggregate has achieved several records this year. First, total household net worth hit a record of $96.9 trillion, per the Fed’s Flow of Funds 3Q 2017 data. Secondly, the ratio of household liabilities to assets shrank in recent quarters to the lowest multiple since mid-2000, well below pre-recession levels. Finally, and contributing to the net worth, household real estate assets have reached an all-time high of $27 trillion, above the pre-recession high in 2006.

On the surface, the household is in better financial shape than pre-recession. The aggregate numbers, however, mask the difference in types of consumers, as high net worth households have reaped more benefit from the bull market than low net worth households. Although excesses of pre-recession housing market lending practices have been limited (in part thanks to regulatory oversight), other segments of consumer borrowing have seen increased leniency. Recent trends favoring consumption over saving highlight this shift. Savings levels have dipped to 2.4%, only slightly above the record pre-recession low of 1.9%. Although a portion of households will benefit from tax reform, it is too early to tell whether the multiplier effect will equate to healthier financial situations across a broader range of households.

How the Consumer Has Been Borrowing

Total debt at the household level peaked at $13.1 trillion in 4Q 2017, per the NY Fed. While home-buying related debt represented the lion’s share at 71% of the total, the composition of household debt has changed: home-buying related debt equated to 79% in 2Q 2010, but the growth in other types of lending outpaced that in the mortgage segment in recent years. Over the past year, both auto and student lending hit highs in terms of amount of debt outstanding and share of the household’s debt load. Credit card loans have yet to recover to, but are nearing, the 4Q 2008 peak.

The balance has shifted along with risk. Although we do not see the lending practices of each auto, student, or credit card loans by themselves causing notable disruption as part of the next downturn, the three segments taken together, as 26% of household debt outstanding, are likely to have a cascading effect on the broader credit markets.

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1 Federal Reserve’s Flow of Funds data include non-profits in the Household category, whereas NY Fed’s data do not

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It is hard to predict how or when an economic downturn will occur, but signs of elevated risk are surfacing as cracks in consumer’s balance sheet. When compounded with falling savings rates, spotty wage inflation, and high non-debt costs (e.g. healthcare), the consumer’s balance sheet may be stretched such that a downshift in the credit cycle or an economic downturn could translate to higher defaults and weaker recoveries. The three segments we outline below overlap in their customer base, as a consumer who may not have borrowed enough through auto or student loans, will supplement with credit card debt. A consumer who has student debt may also take on car payments, prioritizing the latter on the benefits a vehicle provides despite risks of not repaying the former.

**Auto Loan Trends:** We see the growth of the auto market as a symbol for this post-recession expansionary phase of the economy. Automakers emerged from the downturn (some through restructurings and others through aggressive debt repayment), and benefited from consumers’ replacement needs and a falling rate environment. While automakers may be better positioned now, the risk of the industry has shifted towards the lenders and consumers, who have continued to respond to the post-2010 momentum. The auto loan industry has become highly competitive as financial institutions compensate for meager growth in mortgage lending. In order to continue robust auto loan and lease generation volumes, standards became more lax.

As we commented in our **Auto Sector Review**, auto loans trends are showing some signs of softness. Delinquency rates are ticking up towards the highs of 2010, lending policies are being more accommodative towards borrowers via offering longer terms, and more borrowers are taking on auto loans with negative equity (i.e. being “upside-down” their investment). Because lease penetration rates have risen, per Manheim, as consumers roll out of one lease and into another, supply into the used car market has expanded to risk supply/demand imbalance, as noted by Edmunds. Further complicating the issue are vehicle repossessions, which are nearing an all-time high, per KAR Auctions and Bloomberg.

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**Student and Auto Loan Growth Have Far Exceeded Those of Other Consumer Loans Since 2010**

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**JODY LURIE, CFA  DIRECTOR, CORPORATE CREDIT ANALYST  JLURIE@JANNNEY.COM  215.685.6191**

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**Student Loan Trend:** Student loans have become more prevalent in the fabric of the education system: Pew Research Center cited two-thirds of college seniors having taken out student loans in 2011-2012, up from about half 23 years earlier. Per the Fed's 2016 survey of household economics, 37% of 18-29 year olds had student loan debt outstanding. Representing almost $1.5 trillion of consumer debt outstanding, as the largest segment of non-housing debt, the student loan market has received heightened scrutiny from regulators, politicians, and newswires in recent years, as longer-term higher education costs have risen along with default expectations.

The average amount borrowed is relatively low compared to the average mortgage at $37,172 in 2017, but consider that 44% of households do not have $400 to cover medical emergencies, per the Fed's 2016 survey. What's more, Brookings Institute guided that student borrowers with balances over $50,000 now account for “the majority of outstanding student debt owed to the government.” Per Brookings, “The increase in borrowing among graduate, parent, and high-balance undergraduate borrowers has many troubling similarities to the increase in borrowing at for-profit and public two-year community colleges that resulted in high rates of default.”

In a separate Brookings study, the think-tank projected a 38% default rate in student loans by 2023, based on 1996 and 2004 borrower trends, compared to the current rate of 11.5% for federal loans. Even the current rate is high by default standards, when considering that the overall consumer debt default rate (i.e. severely derogatory) is 1.9%. Similarly, the 90+ day delinquency rate for student loans is 11.0% vs 3.1% for all consumer loans and the 1.8% rate at the average US bank. A mitigating factor to these trends is the fact that over 90% of student loans are through federal programs, with default rates in the private loan sector (i.e. loans not guaranteed or subsidized by the government) much higher and skewing the average.

Admittedly, any challenges facing the student loan market would be slow-moving, given the lag between the start of student loans and the repayment period, as well as the lag between a missed payment and a classified default (270 days). Further, student loan borrowers have opportunities to delay default through deferral, forbearance, and income-based repayment plans. With the latter program, a borrower can pay an amount based on his/her income level that may be lower than the monthly loan payment, and the US government will forgive the remainder after 10-25 years. As of March 2017, 15% of 43 million borrowers were enrolled in such a program, up 33% from March 2016. The government intervention backstop promotes borrowing, though recent indications from the Dept of Education signaled that the student loan program has, in recent years, become more of a burden than a profit center for the federal government, potentially exacerbating the US government debt load issue and raising the question of how much of the theoretical government backstop exists.

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Philadelphia Fed President Harker noted in February 2018, “Both the sticker price of tuition and the discounted rate have risen faster than incomes over the past 20 years, putting pressure on households’ finances.” Further, “…in the decade leading up to 2015, the number of adults over 60 who took on student debt quadrupled, with roughly three-quarters of that being assumed on behalf of children or grandchildren…[D]ebt is being held by a substantial number of people living on fixed incomes, while the extended duration of their lives leaves them more likely to encounter increased care costs, making defaults a real threat.”

Credit Card Loan Trends: Trends in credit card loans caught the attention of banks, investors, and the Federal Reserve over the past year. For example, in its annual stress tests in June 2017, the Fed singled out credit card loans as a potential problem area, stating, “[Banks’] improvements in portfolios collateralized by real estate were partially offset by... a recent uptick in delinquency rates in credit card portfolios.” Banks responded to higher charge-off and delinquency rates in credit card loans through adding to loan loss provisions, though risks in the credit card industry compound when factoring in the high yield, unsecured nature of these loans.

Nonetheless, credit card delinquency rates remain below recession peaks and relatively unchanged over the past three years, despite balances and available credit each nearing the 2008 highs. The average individual household owns fewer cards, as guided by the Fed and CFPB, but has larger average balances predominantly because credit cards have become a preferred payment option to cash and cash-like alternatives. In the Fed’s 2016 survey of households, 46% of adults carry credit card debt.

Lending policies have become more lax since the recession, however. Whereas only 14% of the 30 million in new general purpose credit cards (i.e. Visa, American Express, Mastercard, and Discover) went to the lower-rated group of near-prime to subprime borrowers in 2009, the percentage ticked up to 20% of 50.5 million in 2015—and the CFPB noted a further rise since then. Average balances for lower rated consumers have accelerated at a faster rate than prime and above. Individuals are using credit cards as an easy loan alternative to meet rising medical costs, as noted by Kaiser Family Foundation. Similarly, small businesses supplement bank loans with credit card debt to finance operations, as guided by the

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Philadelphia Fed’s Credit Card Landscape Update. Credit card balances and limits ticked up to $834 billion and $3.5 trillion, respectively, or 9% and 28% between 1Q 2010 and 4Q 2017 compared to home equity lines of credit balances and limits, which both recorded double digit declines in that period.

### Areas of Opportunity and How to Position Against Risk

In our opinion, the companies that will likely fare better than others are the largest banks that have diversified portfolios of loans. Those firms with decreased exposure to consumer credit by way of large commercial & industrial loans and capital markets divisions will be able to absorb some of the shocks brought on by a weakening landscape in consumer credit. What’s more, many of these financial institutions have begun to address the risks through increasing reserves and rotating out of riskier ventures. Those firms with a greater degree of exposure include specialty lenders, servicers (as in the case of student loans), and smaller banks or those with more concentrated loan portfolios. These firms have latched onto the post-recession momentum in consumer loans, as mortgage lending is less robust than pre-recession. It is worthwhile to reconsider the bonds of financial firms with a greater degree of concentration in consumer lending.

In the auto space, the aftermarket and related sectors (e.g. specialty lenders, parts manufacturers, and rental companies) have the largest risks in our opinion. The biggest automakers (e.g. the “Big 3”), however, have been more vigilant since the recession. While a surplus of used vehicles may result in a slowing in production, and while a drop-off in auto loans would negatively affect captive finance subs, these companies have tightened their operations to more quickly respond to a shift in the economic cycle and have increased balance sheet cushion to do so.
Likewise, the housing market went through a cleanse post-recession. The heightened regulation and scrutiny of the space translated to higher-quality loans, thereby leading to reduced risk in mortgage-back securities compared to pre-recession. We couch our positive outlook on MBS with the uncertainty of interest rates this year. For example, a rise in long-term rates means elevated extension risk on these securities and a change from the trend of increased prepayments over the past 10 years.

Conclusion
Household debt is not as large a piece of GDP as it was right before the recession: The 76% pales in comparison to the 98% at the peak (1Q 2008). What’s more, households have benefited from positive economic trends in the post-recession years, and possibly tax reform most recently. Signs of wage inflation point to additional dollars in the average consumer’s pocket. A February 2018 McKinsey report noted that only 41% of US consumers surveyed feel financially insecure versus 43% in 2016 and 77% in the recession. Still, per Moody’s, “The effects of lending standards that have weakened since the post-crisis period will take a toll on the performance of most types of outstanding securitized consumer debt in 2018.” Nevertheless, as noted by Moody’s as well as in our recent note on the auto sector, some of the largest lenders of consumer credit have focused on improving loan quality and underwriting standards.

As we consider the risks in the credit markets more broadly, the question becomes: At what point do the open market conditions switch and what will be the trigger of such a change? Further, when the government’s own debt burden is growing, at what point will a bailout similar to that of the banks be unfeasible? The current profile of the average consumer is not as weak as right before the recession, but signs of increased appetite for leverage have emerged, which will add pressure to the lending landscape in the next downturn. Still, the size of the non-housing debt load is more manageable comparing now versus 10 years ago, translating to a less dramatic effect on the credit markets should sentiment towards risk turn negative.

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