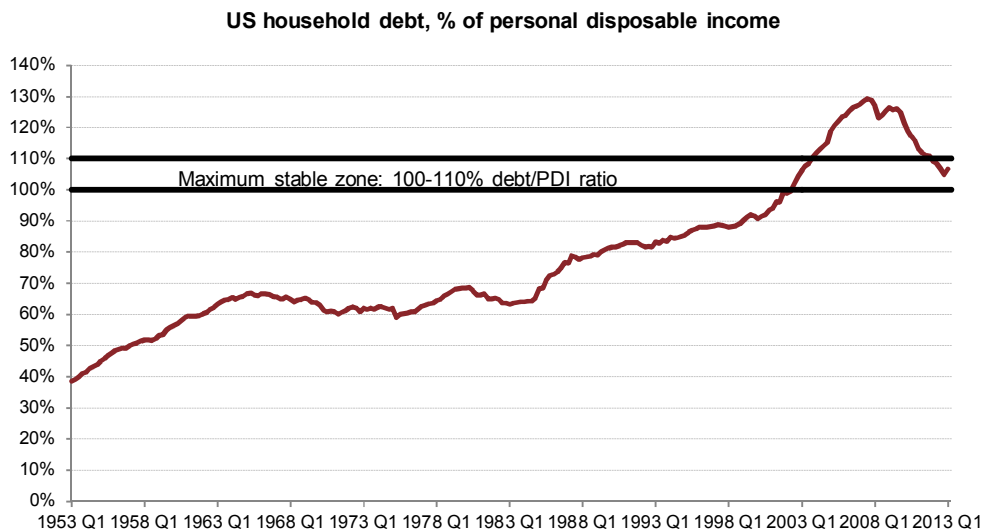


Financial Accounts show US pause will be brief

- **Household debt/PDI ratio rose slightly in Q1**
- **Deleveraging will continue but at slower pace**
- **Corporate liquidity at historically high levels is good for equities**

Earlier this month the Federal Reserve published the Financial Accounts of the United States – formerly known as the Flow of Funds – for the first quarter of 2013. As ever, the Financial Accounts are a veritable cornucopia of data, and it is sometimes difficult to know exactly which parts of it to focus on. However, two developments stand out from last quarter's numbers. The first is the financial situation of households – debt and net worth; the second is corporate liquidity.

On the household side, the debt/PDI (personal disposable income) ratio rose in Q1 2013, from 105% to 107%. This was the first rise since Q4 2008. However, the household debt/PDI ratio for Q4 2012 was revised down slightly. Historical data for US homeowners' financial obligations ratio (FOR, ie, amortisation and interest payments) shows that US households could sustain an FOR of around 15% of disposable income. By 2005, the FOR had risen above 18%, triggering the housing market crash. The debt/PDI ratio peaked somewhat later at just below 130%. The implication is that if households' FOR needed to come down from 18% to (at least) 15% *at normal interest rates*, then the debt/PDI ratio also needed to come down by one-sixth to be sustainable. This means somewhere in the 100-110% region. Bearing in mind that current ultra-low interest rates for the moment make a somewhat higher debt bearable, the latest debt/PDI ratio is good news in that it is within this maximum sustainable ratio; and also because the slightly higher debt confirms that households feel sufficiently confident of the future to be ready to take on some more debt.

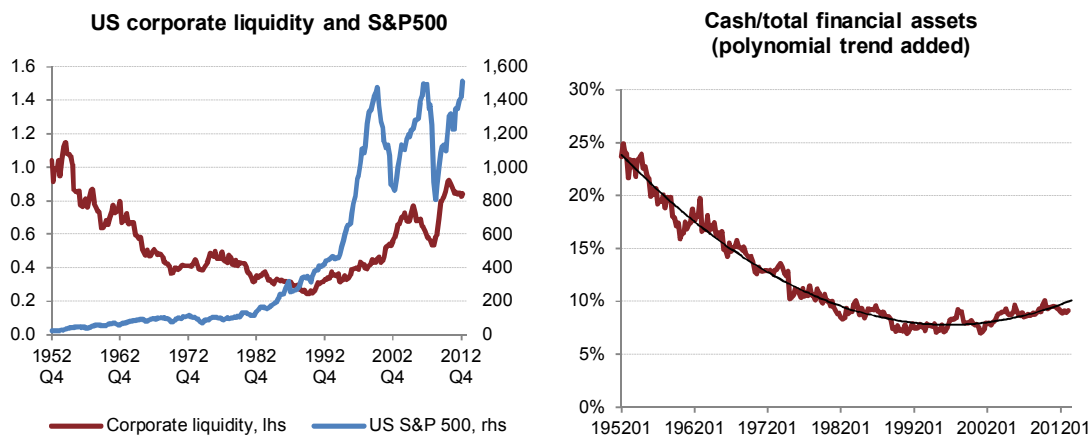


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However, this is not yet true for mortgage debt, which fell for a 20th consecutive quarter. In fact, household equity in housing continued to rise in the quarter, reaching 97% of total mortgage debt, up from a low of 60% in Q1 2009. While net equity in housing at close to 100% of mortgage debt sounds satisfying, it is actually still low by historic standards – as recently as 2005 it was 150% and the 60-year average is close to 200%. Hence, although households are now prepared to take on short-term debt, the likelihood is that the overall deleveraging process will continue – the more so once interest rates begin to rise, as they eventually will. But, crucially, with much or even most of the immediately necessary deleveraging done, the pace is likely to be slower in the future, leaving scope for increased household consumption as well. Moreover, household net wealth rose for a third consecutive quarter, edging up by 3 trillion dollars of which 2 trillion (unsurprisingly) was in financial assets, further boosting households' balance sheet.

One of the peculiarities of the Federal Reserve is that – in spite of otherwise excellent statistics – it does not publish a monthly breakdown of deposits by holder, nor sufficient data to enable us to calculate the credit counterparts of broad money. For this, we are therefore reliant on the Financial Accounts. The latest data for corporate liquidity show a sideways move over the past six quarters, but, with liquidity (defined as bank deposits and other short-term financial assets relative to bank borrowing) at levels not seen since the late 1950s. A different measure with a broader denominator – cash relative to total financial assets – is also moving sideways at levels that are high by the standards of the past 30 years and is still from a somewhat longer perspective trending upwards.



The importance of the corporate liquidity is that companies generally do not like to hold large amounts of cash for a longer period of time. If they do so, it will eventually translate into one form of expenditure or other, be it capital expenditure, dividends, share buy-backs or mergers & acquisitions. All of these tend to be good for the economy and good news for asset prices.

Some other data published over the last month or two – eg, the manufacturing ISM, factory orders and foreign trade – point to a slowdown in US activity in the current quarter. However, the Financial Accounts

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data, although relating to the first quarter, have a longer lead and are more positive. They imply that the slowdown will be of short duration; and that the recovery should gain strength again by late summer and in the autumn. As it happens there will be a major revision of current and historical US GDP data introduced from the first release for Q2, which could throw the numbers. However, the trend should hopefully not change, nor, more importantly, the healthy outlook.

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