Consumer Watch U.S.

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Where Houses Lead, Will US Consumers Follow?

Benjamin Tal and Avery Shenfeld

Homebuilding isn't a large enough sector to bring the US economy to its knees on its own, but would be if household spending is destined to follow the housing market's dramatic cooling. All else equal, the loss of home equity wealth extraction would seem to doom consumer spending to recession. But all else is not equal, as newfound labour income gains look to ease some of the real estate pain, and mitigate the consumer plunge.

The End of Homemade Money

A housing slump is no longer a forecast. It's a reality. The American real estate market is slowing — maybe too rapidly. All recent housing numbers were well below expectations and forward-looking indicators such as housing permits and inventories are deteriorating at a pace not seen in decades (Chart 1). Mortgage applications are also declining rapidly, and with some $1.2 trillion in adjustable rate loans expected to adjust to higher rates in the coming 12 months, substantial damage is still in the pipelines. It's hard to see how, in such an environment, house prices will continue to rise. In fact, it's more likely that in the coming year, they will fall.

And as rapidly as real estate markets cool, Americans' ability to extract spending power from home equity will dry up (Chart 2). That's not trivial as a macro force. During the year ending March 2006, American

Chart 1
It Doesn't Look Good

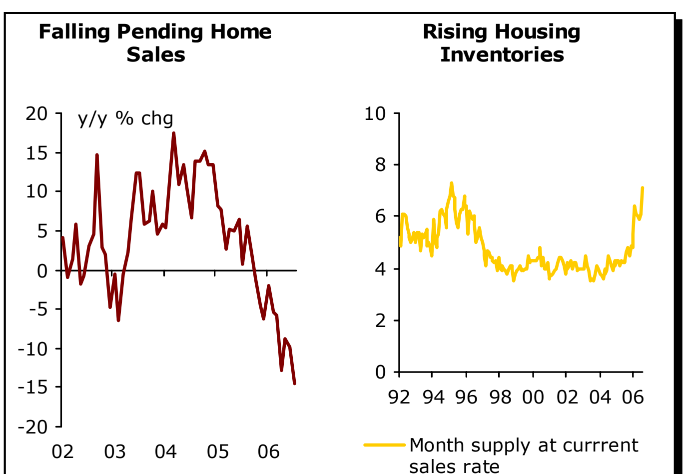
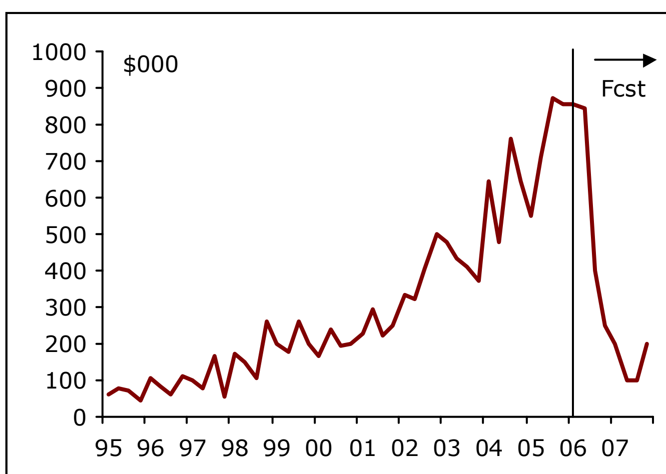
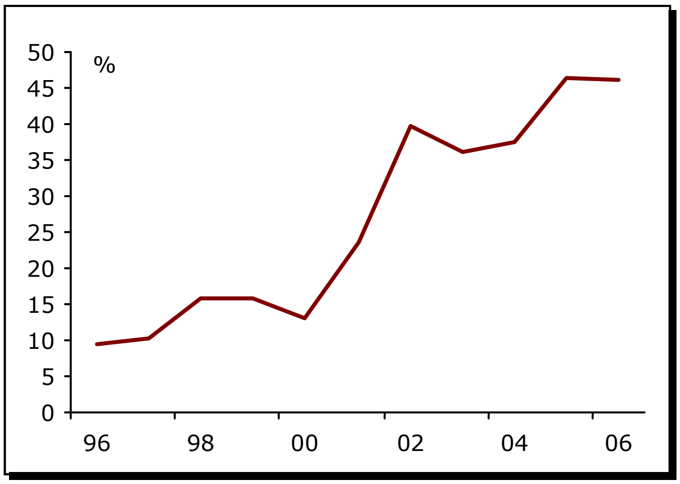


Chart 2
Home Equity Extraction Will Soon Return To Normal



households extracted a record high $825 billion from the value of their houses. Using Fed estimates, roughly $250 billion of that sum went directly to consumption—accounting for almost one-half of the growth in consumer spending during that period (Chart 3).

Chart 3
Contribution of Home Equity Extraction To Growth in Consumer Spending



But there's a reason why Americans became so dependent on debt to finance their shopping habits in this expansion. Until recently, labor income, historically the more sustainable underpinning for consumption, has been abysmal, seeing its share of GDP falling to the lowest level in more than 15 years (Chart 4). With consumers potentially stripped of

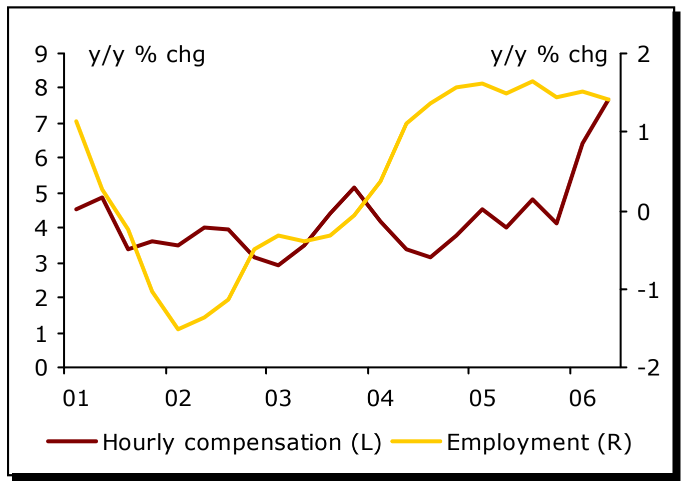
Chart 4
Labor Income as a Share of GDP

such a large chunk of cash, no wonder the market is getting nervous about the recessionary potential of the current housing slowdown.

Wage Growth Boosting Cash Flow

After such a long drought, it's difficult to remember that wage growth, not debt against home equity, is the usual way for Americans to finance consumption. And now, old fashioned wage and salary payments are on the rise, with higher per hour payments more than offsetting a deceleration in hiring (Chart 5).

Chart 5
Higher Wages



That hasn't been fully picked up in the Employment Cost Index, which tracks wages and benefits for a fixed mix of occupations—missing improvements in the mix of jobs—and which excludes some compensation components such as stock options. The more comprehensive hourly non-farm business compensation, taken from the *Quarterly Productivity and Cost* report, is now rising by an impressive 7.7% on a year-over-year basis, the highest rate in more than six years.

A one-percentage-point gain in average wages generates as much total income as no less than 1.6 million new jobs. As a result, despite more moderate gains in the number of workers on non-farm payrolls, total labour compensation is now rising at a healthy 8.5% year-on-year (Chart 6).

Chart 6
Labour Income on The Rise

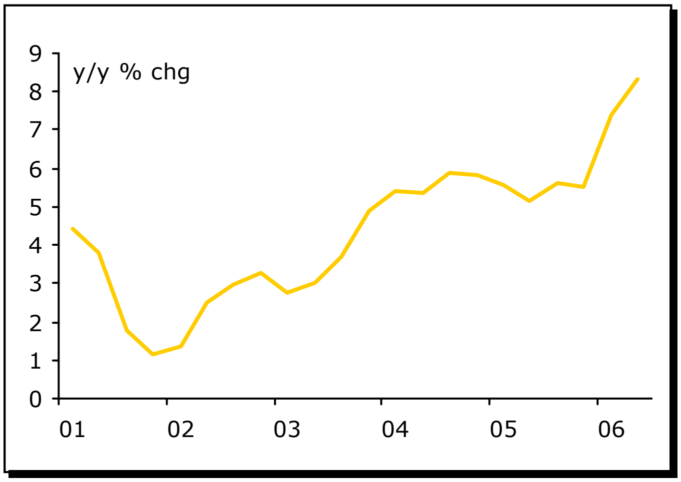
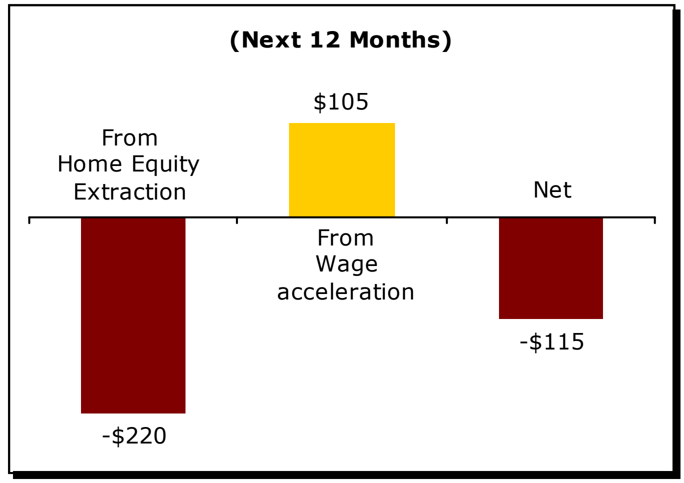


Chart 7
Impact on Nominal Consumption, $Bn

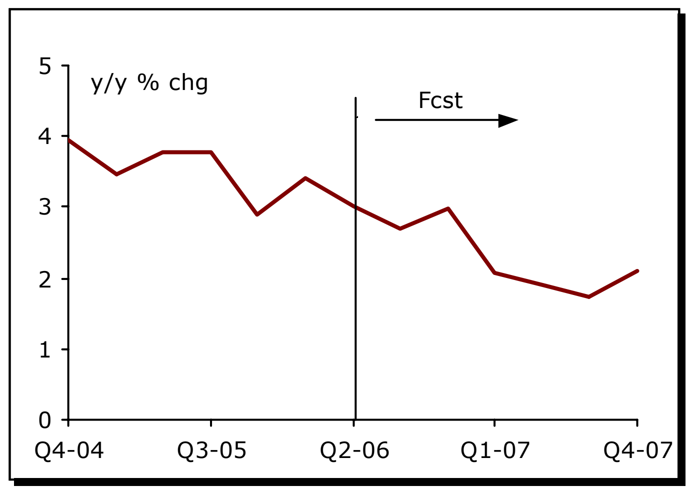


Chances are that workers will retain that improved bargaining position in the coming year, despite the slowdown in net hiring. Wages invariably lag changes in employment as it takes considerable time for the momentum from the job market to affect wage trends, with a lag of roughly a year. US employment started its recovery in 2004 but only recently have real wages started to accelerate in any meaningful way. And given the historically low share of the total GDP pie going to workers, there's room for that redistribution to continue.

Wage Growth vs. Home Equity Extraction

Ultimately, for American consumers, it comes down to the trade-off between the extra cash from accelerating wage growth, and the absence of new cash from home equity. Assuming that the level of home equity extraction will return to its long-term average relatively quickly, and applying the historic average propensity to consume from such transactions, we project that in the coming year, declining home equity draws will pare growth in consumer spending by $220 billion over the next year. Average growth in real disposable income is now roughly one percentage point above the average pace seen in the past 12 months, and given the lag structure of the employment/wage relationship, it's likely that this pace will persist in the coming year, adding $105 billion to the pace of consumer spending.

Chart 8
Real Consumption



The net result is that over the next 12 months, growth in consumer spending will be $115 billion less than otherwise (Chart 7). That translates into roughly one-fifth of the 6.4% growth in nominal consumption (3% in real terms) over the past four quarters (Chart 8). A slowdown yes, but that impact is a far cry from anything remotely resembling a consumer-led recession.