

ECONOMICS: US PERSPECTIVES—FEBRUARY 5, 2010

Historic Turn in Financial Balance of US Private Sector Limits Damage from Public Debt Binge

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The private sector financial balance moved into surplus in 2009, as households and companies saved more and invested less. In our view, the unprecedented shift in the balance of private sector saving and investment suggests that the US recovery is on a stronger footing for a sustainable recovery in early 2010.

With the US government swimming in a sea of red ink after enacting massive stimulus programs last year, fiscal sustainability is a hot topic on the economic agenda. Finances outside the public sector, however, have received much less attention, despite unprecedented changes in private saving and investment positions in recent months (**Display 1**).

While the government spent hundreds of billions of dollars to rescue the economy from recession, the US private sector was doing the opposite. Private saving by households and companies exceeded private investment in 2009 by an estimated \$325 billion (**Display 2**), marking one of the few years in postwar history when the balance shifted in favor of saving.

We believe this historic turn in the private sector financial balance indicates that the US recovery is on a much stronger footing than often perceived, especially since private investment has been one of the biggest catalysts for economic recoveries in the past. Increasing savings suggest that

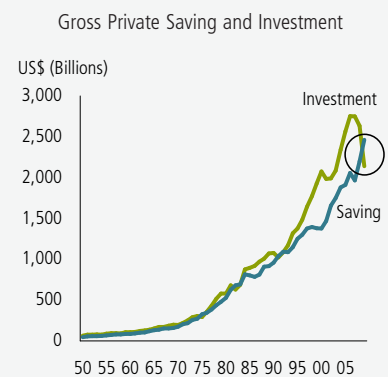
the private sector will have enough fuel to finance growth, outweigh the effects of any additional private sector de-leveraging and help offset the public debt burden, thereby keeping the US economy on course for a sustainable recovery.

Investment Drops, Saving Rises

Of course, the sharp turn in the ratio of private sector saving to investment is not all good news, as part of the recent change was driven by a large drop in investment spending. Investment on nonresidential and residential projects plummeted in 2009, and companies cut back quickly on inventories as well. Although this is a typical response to economic downturns, the scale of the investment and inventory cutback was larger than in previous recessions.

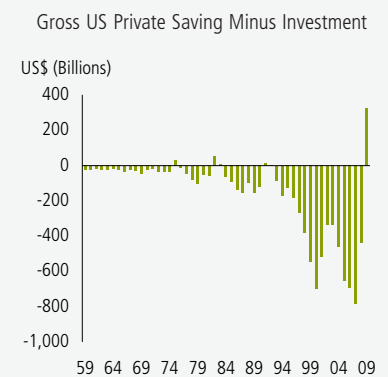
But the investment decline was not the only reason for the changing dynamics of private sector finances. During 2009, as private investment fell, there was a concurrent huge increase in private saving, which followed an equally large gain in

Display 1
Private Saving Exceeded Investment in Unprecedented Shift During 2009



Source: Bureau of Economic Analysis and Haver Analytics

Display 2
Financial Balance Increases to Record



Source: Bureau of Economic Analysis and Haver Analytics

2008. Households accounted for about half of the increase, as they attempted to rebuild cash and liquidity positions after the saving rate fell to a historic low of 1% to 2% of disposable income during the housing boom of 2005 to 2007. By the end of 2009, the personal saving rate had risen sharply to 4.6%, still somewhat below the average levels of the past decade (**Display 3**).

Firms Rebuild Liquidity Positions

Saving and liquidity positions have posted even more dramatic improvements in the corporate sector. Aggregate operating profits of US companies have climbed by an estimated 32%, or \$320 billion, since bottoming in the fourth quarter of 2008, according to the Bureau of Economic Analysis. Almost all of this increase in operating earnings has flowed into undistributed profits, which is a component of gross private savings.

The rebound in operating profits has been driven by the reversal of fortune in the financial sector, which was teetering on the brink of collapse just one year ago. However, away from the limelight shining on the financial sector, balance sheets of nonfinancial companies are also stronger than they have been in several decades, by nearly all measures used to gauge corporate liquidity. Indeed, at the end of 2009, the ratio of liquid assets to short-term liabilities of nonfinancial companies had reached its highest level since the early 1960s (**Display 4**).

These figures suggest that US nonfinancial companies have emerged from the recent recession stronger than after previous economic downturns. When the dust settled after the recessions of 1980 and 1990, the nonfinancial corporate sector was left with razor thin liquidity positions. Although their liquidity positions were

perhaps a bit better at the end of 2001 than following the recessions of the early 1980s and 1990s, many nonfinancial companies remained severely constrained in the early part of the last decade. Cost-cutting initiatives were kept in place well into the recovery following the 2001 recession, as companies were compelled to rebuild cash and liquidity positions while unwinding excessive capital spending programs of the 1990s.

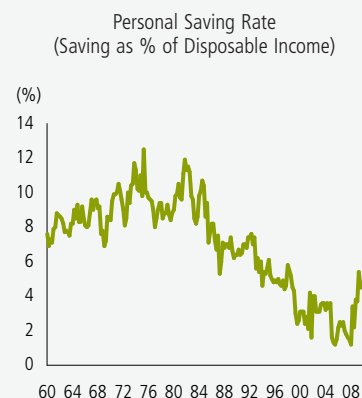
In our view, the current backdrop is completely different. Armed with strong-to-record liquidity positions, nonfinancial firms will not be bogged down with refinancing issues this year. Firms are also operating with historically low inventory positions and therefore do not face the physical or financial headwinds that characterized each of the past two downturns. The rebound in capital spending should therefore materialize sooner and perhaps with more strength than in recent economic recoveries.

Capital Spending Poised for Gains

Some signs of this rebound are already visible. Business spending on capital equipment and software rose at an annualized pace of 13.3% in the fourth quarter of 2009. In contrast, during the 2002 economic recovery, quarterly spending on capital equipment and software did not reach this level for seven quarters. Moreover, anecdotal reports that the technology spending cycle is rebounding, including comments made by Cisco's CEO John Chambers this week, suggest that our estimate of 10% growth in capital spending for 2010 may prove too low.

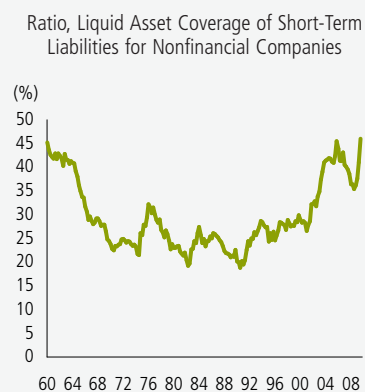
As the investment recovery accelerates, the excess saving balance in the US private sector will probably shrink, although we still expect it to remain positive this year. We're more concerned about the potential

Display 3
Household Saving Rose Sharply in 2009



Source: Bureau of Economic Analysis and Haver Analytics

Display 4
Nonfinancial Companies Have Record Liquidity Positions



Source: Federal Reserve Board and Haver Analytics

impact of tax increases on the private sector's excess saving balance, as the federal government considers measures to help reduce its budget deficit. When the debate on the 2011 federal budget heats up in the spring, we will be listening closely for signs of impending tax hikes, which could affect the ability of the private sector to continue supporting the broader economic recovery through next year. ■

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