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**ECONOMICS:** US PERSPECTIVES—JUNE 11, 2010

# US Private Sector Continues to Boost Liquidity and Repair Balance Sheets

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Households continue to reduce debt and rebuild liquidity positions, while US nonfinancial companies are flush with cash to pursue growth opportunities. We believe the improvement in private sector finances will help support the recovery and lead to a sustainable economic growth cycle.

The Federal Reserve flow of funds data for the first quarter was a bit of a mixed bag for the private nonfinancial sector. Households continued to reduce outstanding debt while boosting net worth. Meanwhile, outstanding debt levels of nonfinancial corporations rose slightly, but were exceeded by rising liquid asset positions, allowing companies to increase their coverage of short-term liabilities to the highest ratio since the mid-1950s.

On balance, stronger liquidity positions and balance sheets in both households and nonfinancial businesses are important signs that the rehabilitation of the US private sector is in full swing. In our view, these improvements indicate that the US recovery is on a much firmer footing than often perceived, with the resilience to weather a more challenging economic and financial environment.

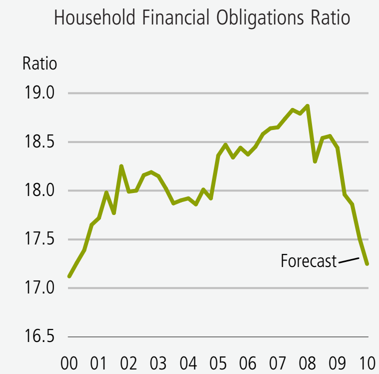
## Household Debt Falls

During the first quarter, the household sector reduced its debt by $330 billion annualized, extending a trend that started in the middle of 2008. Before then, household debt had never contracted in any quarter during the postwar period. Yet now, household debt has fallen for six straight quarters—and seven of the last eight, according to the Federal Reserve.

The impact on US household finances has been dramatic. Over the past two years, liabilities fell by about $600 billion, greatly alleviating the household debt burden and reducing servicing costs. Based on the sharp drop in debt and lower interest rates, we estimate that the household financial obligations ratio (HFO) fell 0.2 or 0.3 percentage points in the first quarter to about 17.25%, the lowest since early 2000 **(Display 1)**. This ratio measures the amount of disposable income needed to meet payments on loans, leases, property and insurance, and is an important gauge of household financial health.

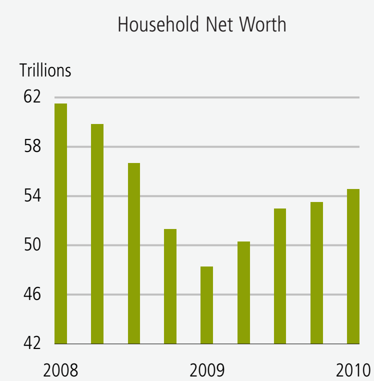
When the HFO peaked two years earlier at 18.9% in the first quarter of 2008, this relatively high level of leverage within the household sector was a catalyst for the economic and financial crisis. Although we expect additional household deleveraging in the coming months, the sharp drop in

Display 1
Record Pace of Household Deleveraging




Source: Federal Reserve Board and Haver Analytics

Display 2
Modest Rebound in Household Wealth




Source: Federal Reserve Board and Haver Analytics the HFO over the past two years indicates that personal finances are in somewhat better balance, and consumers may have a bit more cash available to support a sustained recovery in consumer spending.

Mortgage debt has accounted for most of the drop in household liabilities to date. In the first quarter, mortgage debt declined by another $389.8 billion annualized, the largest quarterly fall on record. This reflects the slowdown in home buying and lower transaction prices, as well as the impact of banks writing off loans on homes that have gone through the foreclosure process. It could take up to a year or more before a foreclosed home actually shows up in the flow of funds data, according to Federal Reserve officials.

Meanwhile, household financial assets increased by over $1 trillion in the first quarter, prompting a similar gain in personal wealth. At the end of the first quarter, household financial net worth reached $54.6 trillion, up $6.3 trillion in the past year **(Display 2, previous page)**. The rebound in financial assets helped boost the ratio of household coverage of total liabilities slightly to 2.29, up from 2.22 in the fourth quarter **(Display 3)**.

Most likely, much of the first-quarter gain in financial assets will be reversed in the second quarter, given the recent setback in equity prices. But we think the impact of a decline in wealth on consumer spending may not be substantial for two reasons. First, losses may prove temporary if confidence in the economic recovery improves and financial markets turn up again. Second, recent losses are unfolding against gradually improving income gains tied to more jobs, longer hours and higher wages, unlike in 2008 when markets collapsed amid a broader economic slump.

Although the liquid asset coverage of total liabilities remains low in historical perspective, the first-quarter ratio was still the best since early 2008. It's also impressive that households have managed to rebuild liquidity, when income growth has been relatively weak to date. Clearly, government spending programs have helped, even as labor markets remain weak, but we expect the recovery to bring more jobs and income gains and generate further liquidity improvements.

## Companies Are Flush with Cash

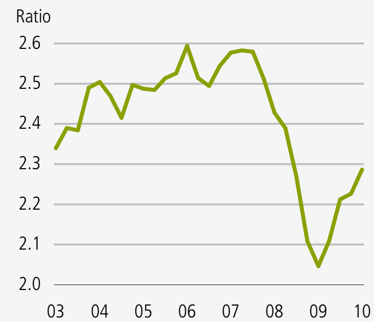
In the corporate sector, nonfinancial firms are adding cash to their holdings. After bolstering liquidity positions to a record at the end of 2009, total liquid assets rose further by $22 billion to a new high of $1.841 trillion. Over the past year, liquid assets have risen by 26%, or $381 billion. By the end of the first quarter, the ratio of liquid assets to short-term liabilities rose to 51.2%, from 50.4% in the fourth quarter of 2009. Both figures represent the highest coverage of short-term liabilities since 1956 **(Display 4)**.

These figures indicate that private businesses are flush with cash and in a strong position to support the recovery through increased investment and hiring. Indeed, investment plans of nonfinancial firms are running a little over $1 trillion, according to GDP data compiled by the Bureau of Economic Analysis. This means US companies have about $800 billion more in their coffers than their current spending plans **(Display 5)**, in stark contrast with previous economic recoveries. At the end of the last three downturns, nonfinancial companies barely had enough liquid assets to cover investment spending or were in a slight deficit.

In our view, US nonfinancial companies will not be held hostage to tight bank lending or difficulties on capital markets, because strong financial positions provide the means to internally fund any increase in capital spending or other expansion plans. Despite the recent market turbulence, we believe strong corporate liquidity and improving household finances increase the odds of a sustained US economic recovery and will help prevent a "double dip" recession from developing. ■

Display 3
### Household Liquidity Is Improving

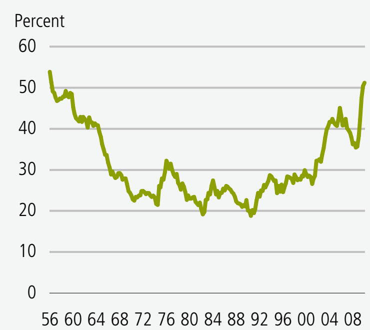
Household Liquid Asset Coverage of Total Liabilities




Source: Federal Reserve Board and Haver Analytics

Display 4
### Companies Enjoy Strongest Liquidity Position Since Mid-1950s

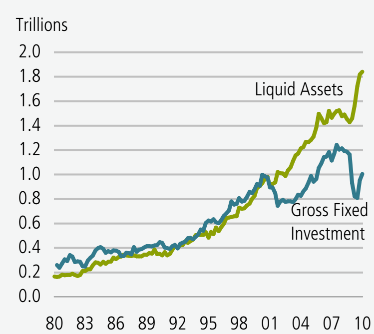
Liquid Asset Coverage of Short-Term Liabilities for Nonfinancial Corporations




Source: Federal Reserve Board and Haver Analytics

Display 5
### Ample Liquid Assets for Investment Drive

Nonfinancial Companies Holding of Liquid Assets vs. Gross Fixed Investment




Source: Federal Reserve Board and Haver Analytics

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