



The Northern Trust Company
Economic Research Department
Positive Economic Commentary

"The economics of what is, rather than what you might like it to be."

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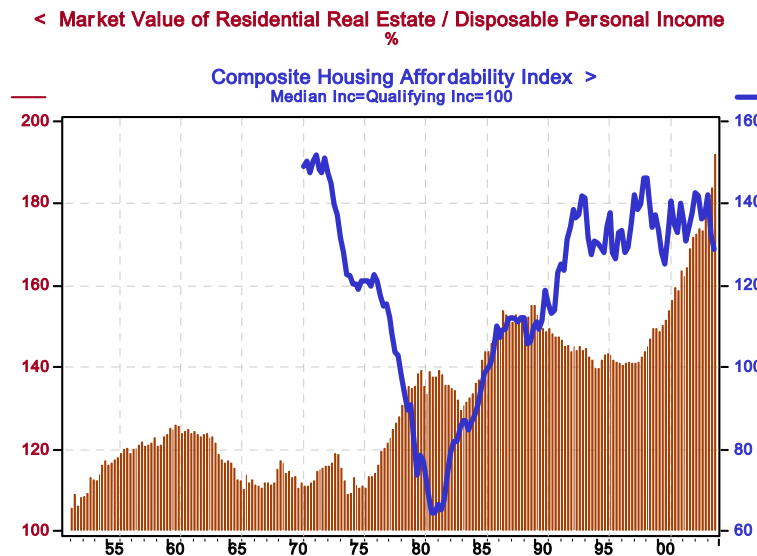
December 16, 2004

Flow-Of-Funds Stocking Stuffers

On December 9, the Fed released its flow-of-funds data updated through the third quarter of this year. Herewith are some "stocking stuffers" fashioned from these data.

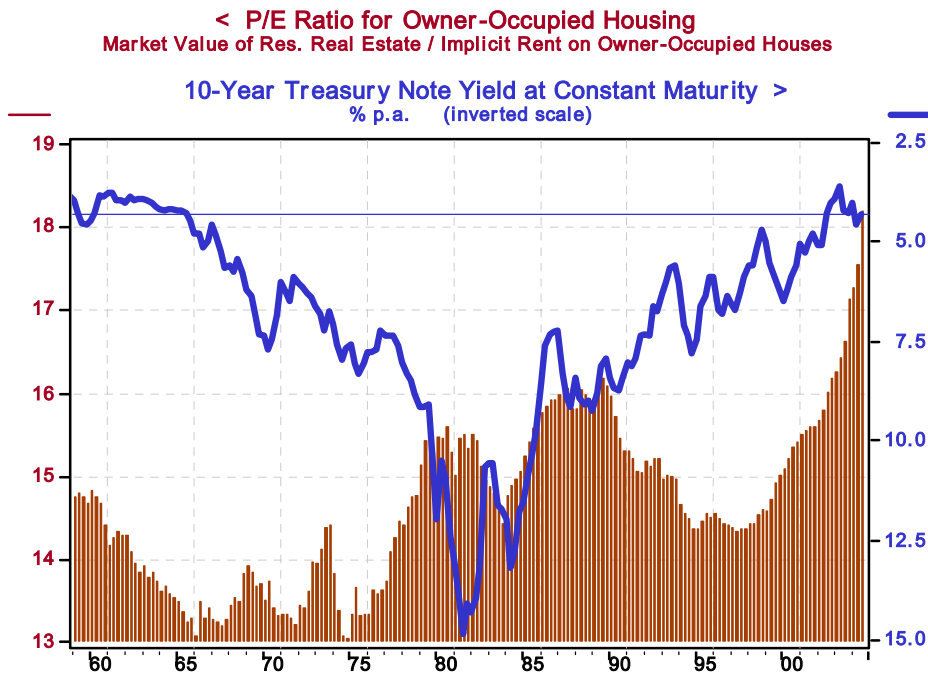
Relative to our after-tax income, the value of houses, and the ground under them, reached a new record high at 192% in the third quarter (see Chart 1). This escalation in home prices relative to household income finally appears to be having a negative effect on housing affordability. In the two quarters ended Q3:2004, the 30-year mortgage rate increased a minuscule net 29 basis points (based on quarterly averages of interest rates). But in that same period, an index of housing affordability declined by 9.44% (not annualized). Maybe this is why adjustable-rate interest-only mortgages are becoming so popular. Even with relatively low 30-year mortgage rates, many folks are not finding homes affordable given the sharp rise in the value of residential real estate. If the Fed keeps pushing up short-term interest rates, home-price bids might start to soften as housing gets less affordable even if financed with adjustable-rate interest-only mortgages.

Chart 1



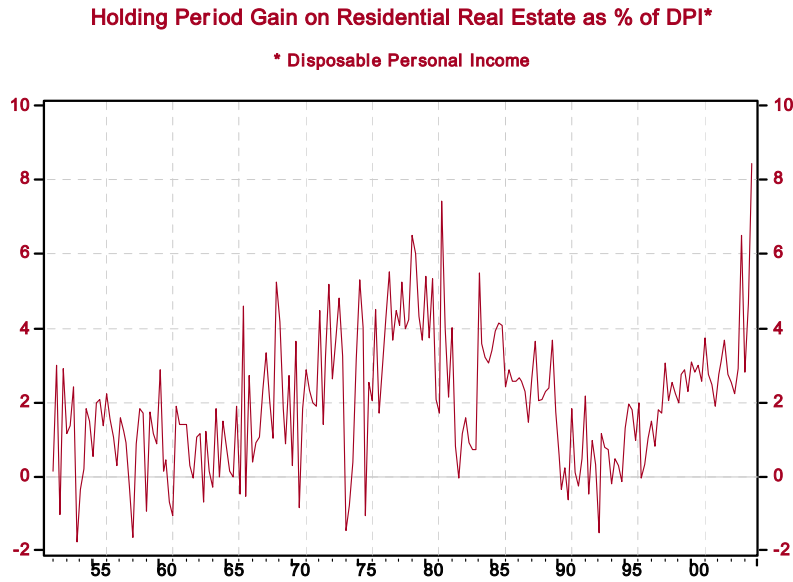
Back in the late 1990s, when the P/E ratios on corporate equities were climbing to the sky and some of us Chicken Littles were warning that the sky would be falling, we were told that "it's different this time." Currently, the P/E ratio on owner-occupied housing is also climbing to the sky, hitting a record high 18.2 in the third quarter. But the "it's-different-this-time" crowd will point out that a high P/E ratio on housing is to be expected because interest rates are low. But some of us Chicken Littles would point out that in 1965 the 10-year Treasury was trading around its third quarter average of 4.30 and the P/E ratio on housing was only 13.3 vs. today's 18.2 (see Chart 2). It very well may be different this time – much worse for housing when interest rates climb more.

Chart 2



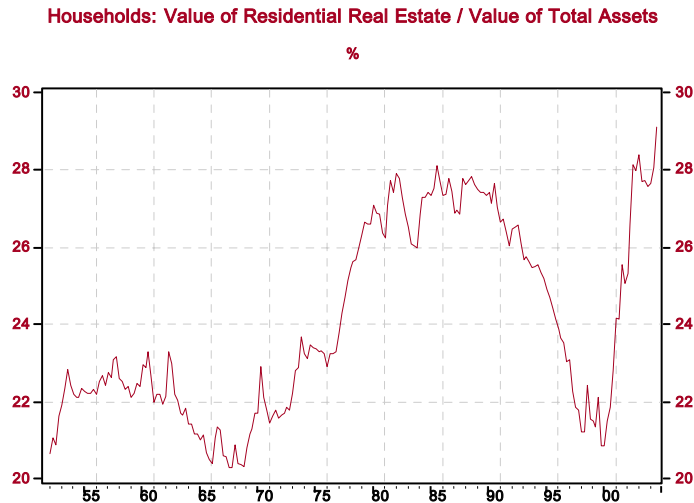
Housing was definitely an investment winner in the third quarter. The holding period gain on residential real estate, that is, the increase in value above and beyond any increase in the existing housing stock, was a record \$727.5 billion in the third quarter. This more than accounted for households' \$568.6 billion increase in third-quarter net worth. In fact, as shown in Chart 3, the holding period gain on residential real estate (non-annualized) was the highest percentage, 8.4%, of disposable personal income (annualized) in the post-WWII period.

Chart 3



Households continue to put a lot of their nest eggs in one basket – their houses. Chart 4 shows that residential real estate represents a record-high 29% of the value of total household assets. Sure hope it pays off for all of us rapidly-aging baby boomers. But as I said a number of commentaries ago, if it doesn't work out, we will become a nation of bed-and-breakfast proprietors, renting rooms to Chinese and Indian tourists.

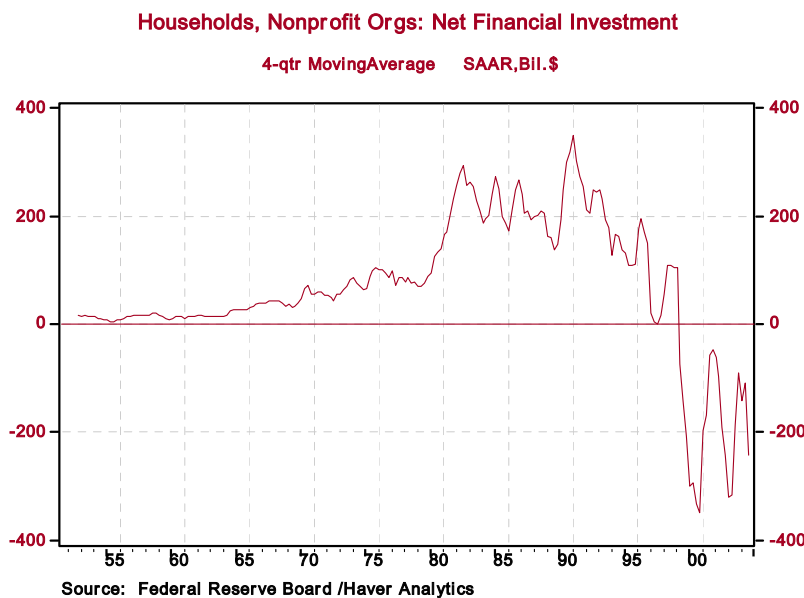
Chart 4



In recent years, households have joined with the government in being net demanders of funds from the rest of the economy – U.S. and global. That is, we now spend more than we

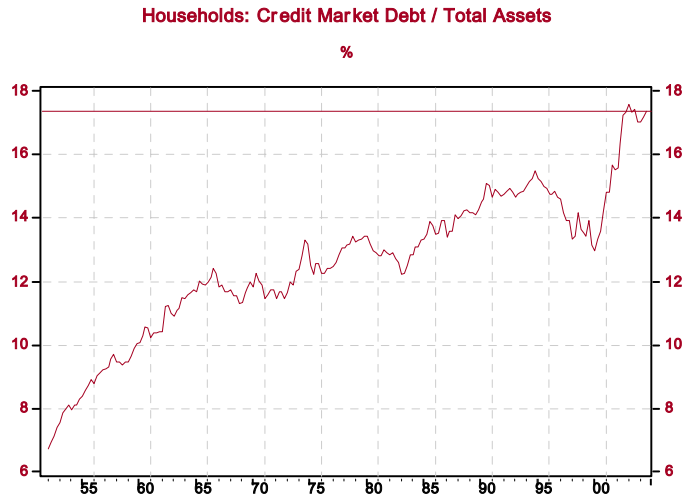
earn, making up the difference by borrowing or selling off some of our previous saving. In the flow-of-funds data for households, there is a line item, "net financial investment," which subtracts all household borrowing during a quarter from households' acquisition of financial assets -- such as deposits, stocks and bonds -- during that quarter. If net financial investment is positive, it means households are net suppliers of funds to the rest of the economy; if it is negative, it means households are net demanders of funds from the rest of the economy. As Chart 5 shows, throughout most of the post-WWII era, households have been net providers of funds. Starting in 1999, at the top of the stock market bubble, when households got the notion they could get rich enough on capital gains only, households became net demanders of funds. And they continue to be. In the four quarters ended Q3:2004, households' net demand for funds averaged about \$241 billion. How else were we going to pay for all of those SUVs, plasma TVs and McMansions? What is so remarkable about households being net demanders of funds now is that so many of them are baby boomers who have entered their prime saving years. One would think that as the retirement finish line is coming into view for these baby boomers, they would be stepping up their financial saving, having already bought their McMansions. I guess households are worried about inflation eroding the purchasing power of financial assets, so they are loading up on hard assets such as cars and houses -- perhaps leveraging up is a more accurate description.

Chart 5



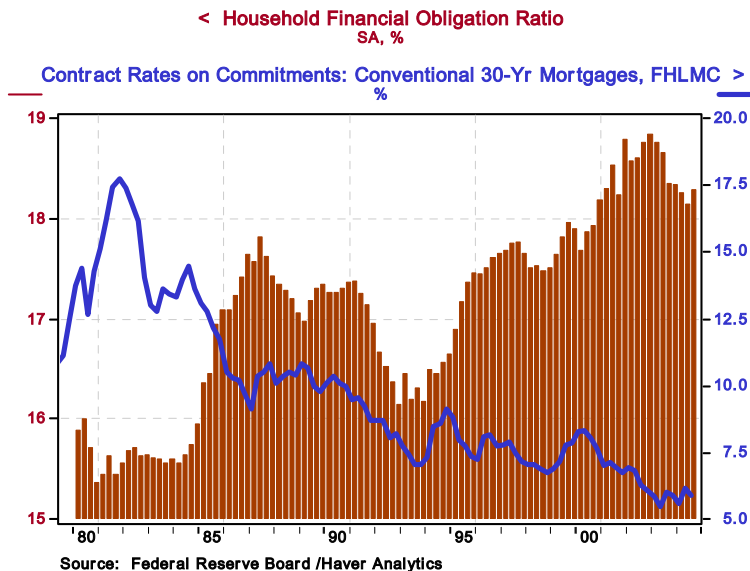
To see how much households have leveraged themselves, look at Chart 6. It shows that in the third quarter, household debt as a percent of the value of total household assets -- tangible as well as financial -- increased to 17.4%, just shy of the post-WWII high of 17.5% set back in the first quarter of 2003. Mind you, households' debt-to-asset ratio went up despite the fact that the value of their houses rose by a record amount.

Chart 6



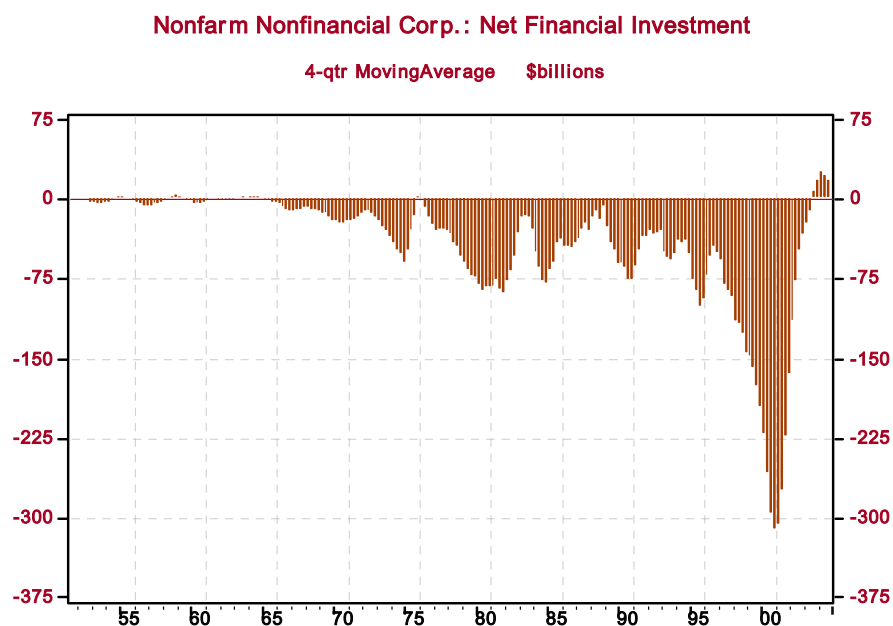
Before leaving the household sector, I want to show you one more household debt-related chart. The data are not from the flow-of-funds accounts but they still are from the Fed, so they must be true. Chart 7 shows what the Fed has called the "household financial obligation ratio." In addition to required principal and interest payments on household debt, the numerator of the financial obligation ratio includes payments of apartment rent, auto leases, homeowner's insurance and property taxes. The denominator of the ratio is after-tax household income. In the third quarter, the financial obligation ratio moved up to 18.31% -- not all that far below its record of 18.85%. What is so interesting about the behavior of the financial obligation ratio is that it has stayed at elevated levels in recent years despite the fact that interest rates have fallen to 45-year lows. The message of Charts 6 and 7 is that we have been "making it up on volume." That is, even though loan rates have been falling, we have managed to keep our monthly payments at high levels relative to our income by borrowing massive amounts.

Chart 7



Now let's turn to Corporate America. We have some role reversal here. As mentioned above, after decades of being net providers of funds to the rest of the economy, households have now become net demanders of funds. Curiously enough, after decades of being net demanders of funds, nonfinancial corporations have become net providers of funds to the economy. That is, corporations are not spending all of their after-tax after-dividend cash flow on capital equipment and inventories. Although the amount of funds nonfinancial corporations are providing to the economy is small – only \$20.3 billion on average in the four quarters ended Q3:2004 – as shown in Chart 8, any positive net financial investment by these corporations is very unusual. What makes it especially unusual is that the cost of capital – be it equity or debt capital – is so low now. This suggests that the expected return on capital in the U.S. might be unusually low now.

Chart 8



What are corporations doing with all of their free cash if they are not investing in their businesses? Chart 9 shows that one thing they are doing is returning earnings to stockholders by retiring equity. In the four quarters ended Q3:2004, nonfinancial corporations retired about \$130 billion of equity on average. Corporations retired massive amounts of equity in the second half of the 1990s. Chart 10, which shows nonfinancial corporation borrowing as a percent of internal funds (cash flow), suggests that a lot of the equity retirement in the "Roaring Nineties" was financed by debt. In contrast, the sharp drop in the ratio of borrowing-to-internal funds suggests that today's equity retirement is coming from internally-generated funds – not leveraging the corporation. In sum, while U.S. households' financial circumstances are deteriorating, U.S. corporations' are improving.

Chart 9

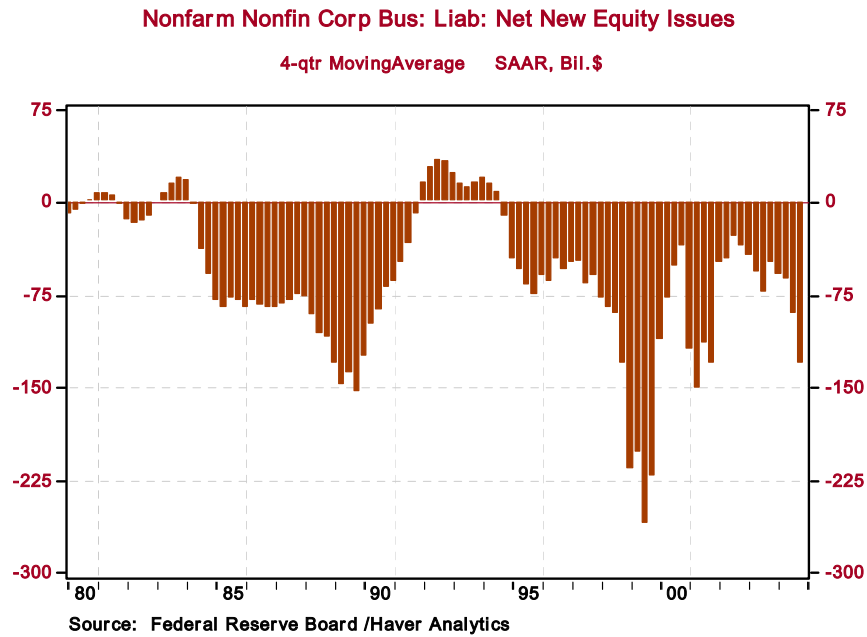
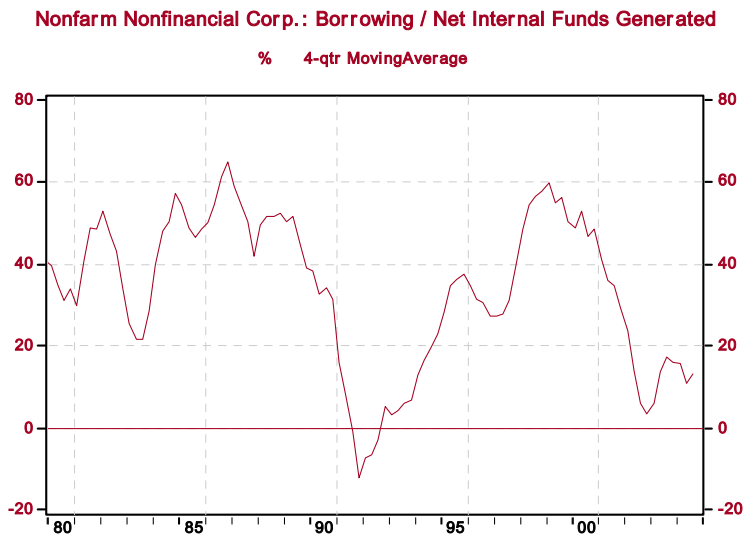


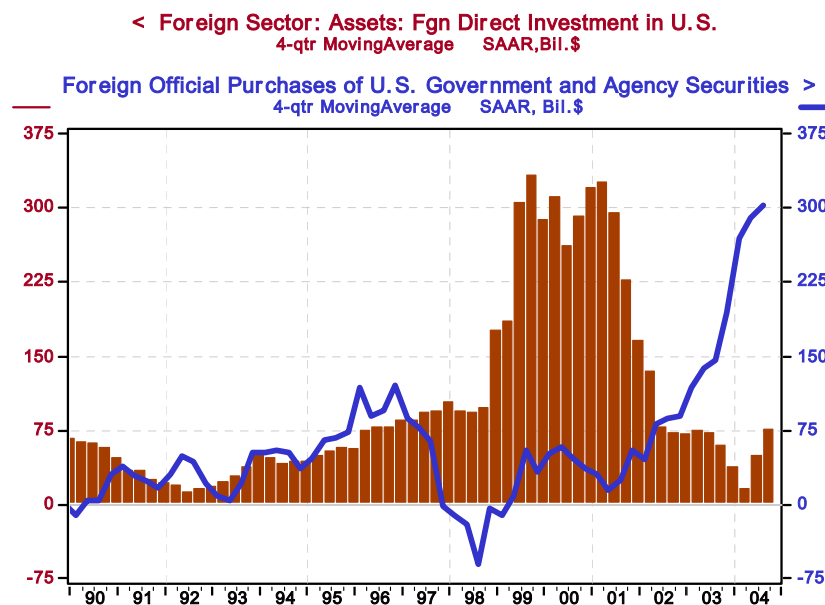
Chart 10



I want to finish with one more example of financial role reversal. Chart 11 shows two elements of the financing of our deficit with the rest of the world – foreign direct investment in the U.S. and the purchases of U.S. government and agency securities. In the late 1990s, there was a surge in foreign direct investment in the U.S. Foreign entities were building factories in the U.S. and buying up U.S. corporations. That was a genuine demonstration of

confidence in the American economy. All right, it was a mistake, but it still was a genuine vote of confidence. In recent years, foreign direct investment has been replaced with foreign official (foreign central bank) financing of our external deficit. This foreign central bank financing of our external deficit is not a vote of confidence in the American economy. Rather, it is a manifestation of Asian mercantilism. Japanese and Chinese policymakers are under the misconception that their economies must run trade surpluses in order to grow at a satisfactory rate. To help promote these trade surpluses, the Japanese and Chinese central banks have tried to keep their respective currencies from appreciating vs. the U.S. dollar by purchasing massive amounts of dollars in the market. These purchased dollars then get recycled into U.S. government and agency securities. These central banks pay for their purchased dollars with their own freshly “printed” currencies. So, the cost of their mercantilist actions is increased inflation in their economies. Ultimately, this rising inflation will induce these foreign central banks to cut back on their support of the dollar. So, enjoy the fact that the Japanese and Chinese are willing to send us cars and TV sets for our dollar-denominated IOUs while it lasts.

Chart 11



And enjoy these stocking stuffers over your Christmas and New Year’s holidays. To cheer you up over the holidays, I am going to take a couple of weeks off from writing these dreary commentaries. Aren’t you feeling cheery already?

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