THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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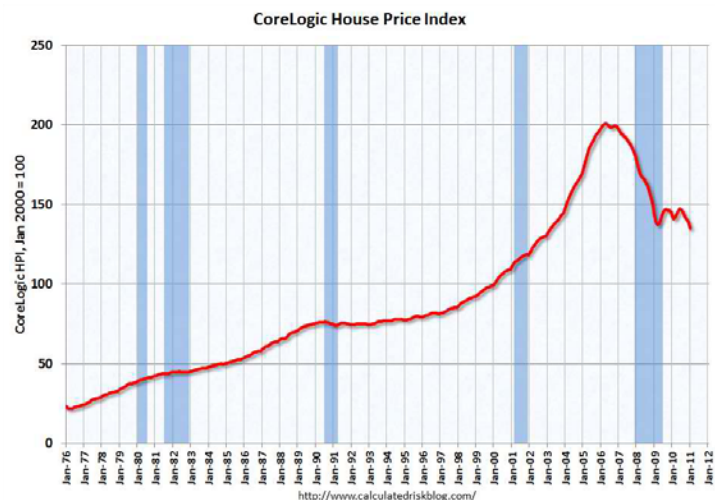
Expansion to Slow But Not Falter – Fed's Reflation Policy Working

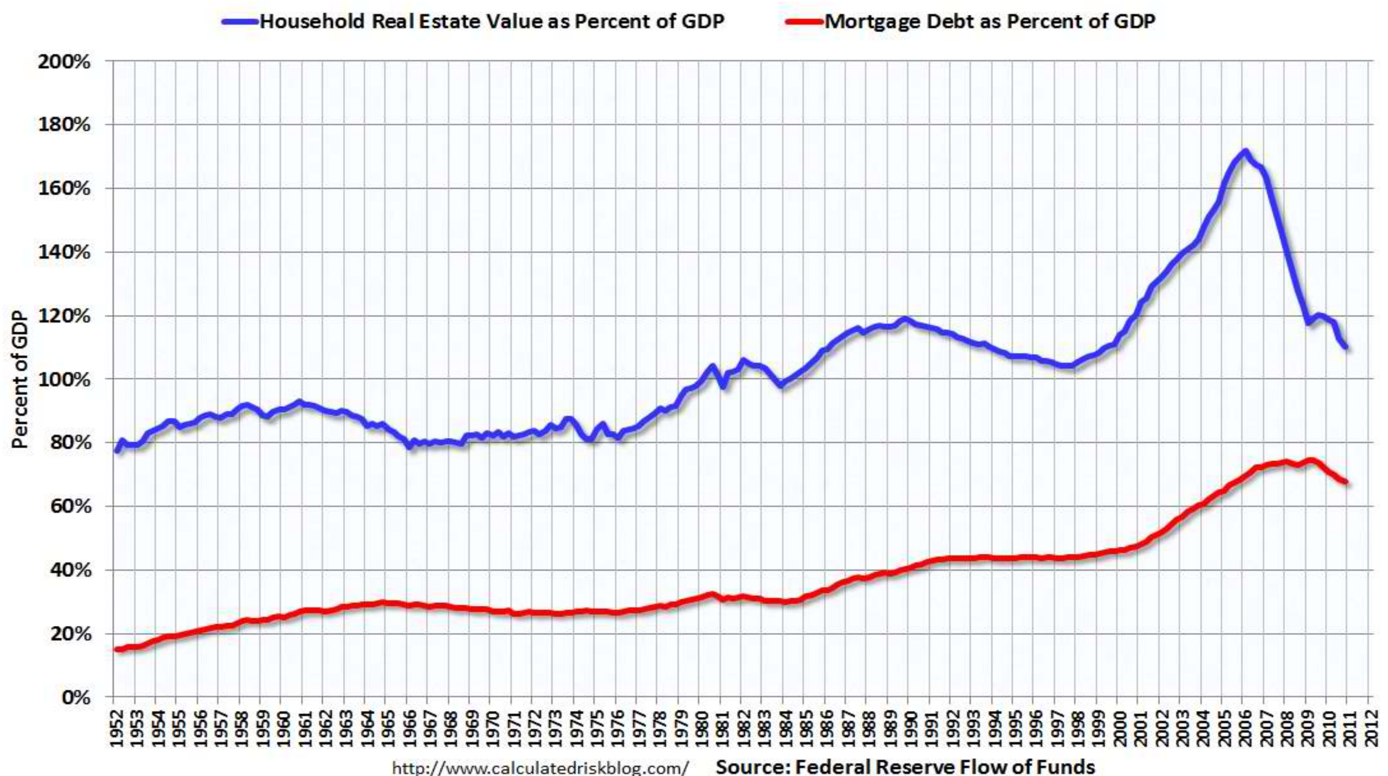
- Inflation expectations for one year from now, a component of the University of Michigan's consumer confidence survey, jumped to 4.6% in March from 3.4% previously. We think this will prove excessive, but believe it has implications for consumer behavior. The last time surveyed inflation expectations were this high, in the summer of 2008, oil and gasoline prices were surging (the survey peaked at just over 5% before subsequently collapsing as the global financial crisis and great recession gained momentum). Year to date, gas prices have already risen over 15%, which is feeding into higher inflation expectations. A recent Gallup poll shows that Americans expect gas prices to rise to $4.36 a gallon this year, with over a quarter of those surveyed expecting prices to exceed $5. However, there is little evidence of wage growth — the key transmission mechanism for higher sustained price appreciation — with unemployment still near 9%. In this environment, attempts by businesses to pass along higher production costs from commodity price spikes only reduce consumer spending power, acting as a tax on consumption. Indeed, Gallup notes: "it seems reasonable that consumers and businesses will change their behavior accordingly — with consumers reducing their use of gas, spending less in general, and downscaling where they buy, while businesses anticipate revenue declines, also spend less, and limit their hiring."
- If oil and gas prices stay near current levels, Credit Suisse estimates that a $55–75 billion 'tax' would be imposed on households this year, reducing consumers' disposable personal income by about half a percentage point. Fortunately, the compromise job stimulus/tax cut extension deal reached late last year — which temporarily lowers Social Security payroll taxes — provides households with an additional $112 billion to absorb the hit to their pocketbooks. We think this helps explain why retail sales continue to grow, even excluding gasoline sales, and purchasing manager surveys suggest ongoing economic expansion (which currently imply more than 3.5% annualized GDP growth). However, if oil prices continue to rise, we expect economic growth to progressively slow, at around $145 per barrel, they could threaten recession. Currently, our best guess is that oil remains above $90 per barrel but below $120. We think this allows the S&P 500 to hold above support between 1250 and 1275 and the global equity bull market to continue, albeit at a slower pace. Regarding Japan, while it is early to draw well-informed conclusions, we see the Bank of Japan's aggressive increase in asset purchases financed by balance sheet expansion as appropriate and indicative of their determination to respond swiftly to the crisis.
- One way oil is having a direct impact on US growth is through widening trade deficits, which subtract from GDP. Last week the government reported January's trade deficit widened $6.1 billion to $46.3 billion (when oil prices were still around $90). Given the subsequent rise in oil prices, we expect that continued trade deficit deterioration in the first quarter will be a drag on economic growth.
- Along with oil, home prices are starting to weigh more on consumption and growth, in our view. CoreLogic's national house price index for January declined 2.5% to a new post-bubble low and is nearly 33% below its peak (see chart on right). CoreLogic also reported last week that "11.1 million, or 23.1 percent, of all residential properties with a mortgage were in negative equity at the



end of the fourth quarter of 2010, up from 10.8 million, or 22.5 percent, in the third quarter." In terms of dollar value, this translates to $751 billion (up from $744 billion) of negative equity. We think home prices are still likely to decline another 5% to 10% this year, with corresponding increases in negative equity (and incidents of foreclosure).

- The Federal Reserve's comprehensive Flow of Funds report for the fourth quarter of 2010, released last Wednesday, provides an aggregate view of US home equity. The value of household real estate fell $260 billion to $16.4 trillion, down $6.3 trillion from its peak. This has reduced households' home equity to 38.5% from 60% before the housing crash. Moreover, as Calculated Risk notes, "something less than one-third of households have no mortgage debt. So the approximately 50+ million households with mortgages have far less than 38.5% equity — and 11.1 million households have negative equity." This dynamic is illustrated in our Weekly Chart, courtesy of Calculated Risk, which shows household real estate and mortgage values as a percentage of GDP. Although mortgage debt declined by $55 billion in the fourth quarter, it is still 'only' down half a trillion from its peak (mostly through default) compared to the $6.3 trillion loss in real estate value. This implies further household 'deleveraging,' particularly in a rising mortgage interest rate environment.
- Thankfully, since 2009 the ongoing decline in real estate value has been more than offset by the rising stock market (and to lesser extent, the bond market). Household net worth reached a $56.8 trillion post-bubble high in the fourth quarter, up from its $48.7 trillion low in the first quarter of 2009, but is still substantially below its second-quarter 2007 peak of $65.7 trillion. We think the rise in household net worth from its lows has helped boost consumer confidence and spending, but we think asset price increases over the last two years have in part been fueled by low interest rates and the Fed's quantitative easing. We believe further increases in household net worth will continue when policy accommodation is removed, but at a slower pace, more in line with economic and earnings growth.

The Weekly Chart: More household deleveraging to go



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