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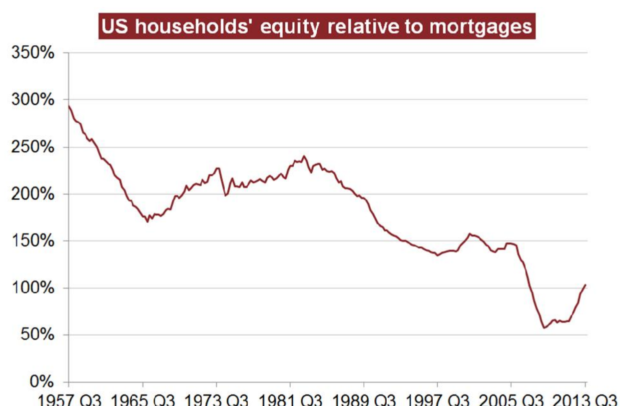
Good US news => earlier QE taper

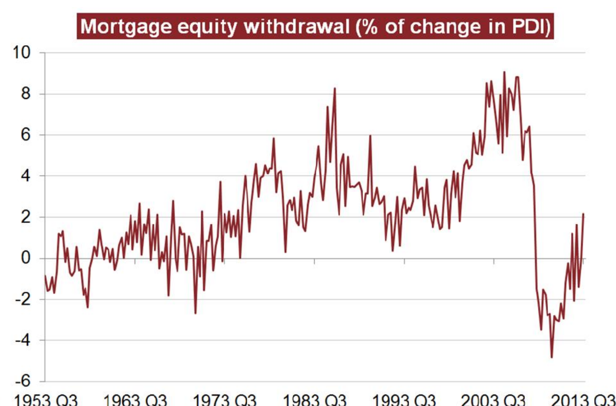
- **Recent strong US data has increased the likelihood of a December or January QE taper**
- **Modest mortgage equity withdrawal is supporting household spending**
- **Rising corporate liquidity should underpin equity prices**

Recent US data has been strong enough to shift expectations of a change in Fed policy – ie, announcing and beginning the taper of quantitative easing – to January or even to next week's meeting. That is probably justified, although two points warrant keeping in mind. The first is that US inflation remains well below trend, a point stressed this week by Jim Bullard, President of the St Louis Fed. Although he supports an early taper, Mr Bullard was clear that there will be a long period between this move and any increase in the fed funds rate. This stance is in tune with that of the incoming Fed Chairman, Dr Yellen. The second is that not all data is as strong as it seems. The Q3 GDP number was boosted by a substantial inventory build-up (which contributed 1.7 percentage points to overall 3.6% growth); while the housing market, strong November new home sales data notwithstanding, is trending gently upwards instead of surging (see also *The modest strength of US housing*, Comment 5th December 2013).

The positive picture of the US economy is reinforced by the Financial Flows data published 9th December. One of the interesting developments in the third quarter was that US household debt increased – but by less than disposable income, so that the debt/PDI ratio eased to an 11-year low of 104.1%

Another encouraging trend is the continued modest increase in mortgage equity withdrawal (MEW). In 1957, US households' equity in their houses was three times the value of their mortgages. (To put it another way, the outstanding value of mortgages was about one-quarter of the total value of housing.) As recently as 1989, it was twice as much. But, by Q1 2009, the value of the mortgages was close to twice the equity. As house prices rose, American households used their homes as banks, taking out further mortgages on the increased value to finance their spending. In the run-up to the Great Recession, mortgage equity withdrawal on a number of occasions exceeded 8% of the quarterly rise in personal disposable income, peaking at 9.1% in Q4 2004.





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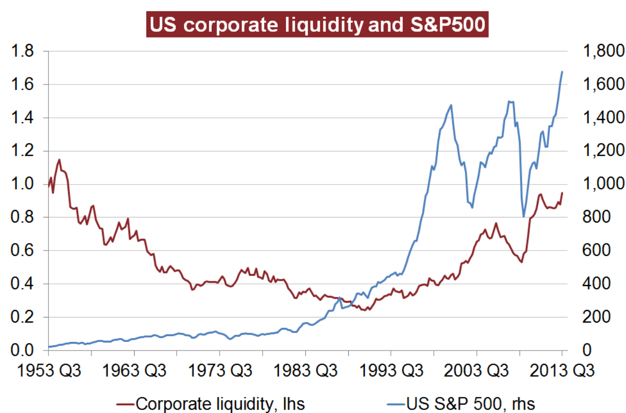
Although MEW reached similar levels in the early 1980s housing boom, that was only for two quarters (Q1 and Q4 1985). In the early 2000s, by contrast, MEW exceeded 7% of the change in personal disposable income for eleven of the 15 quarters from Q4 2002 to Q2 2006, providing a substantial support to household consumption over the period. Unsurprisingly, this method of financing spending eroded the share of homeowners' equity in housing. By 2005, the ratio between equity and mortgages had fallen to 1.5:1; that is to say, the value of mortgages was about 60% of the total value of housing. By Q2 2009, slumping house prices had brought the ratio down to less than 0.6:1 (ie, mortgages substantially exceeded equity).

By dint of furious deleveraging – household debt fell in absolute terms from Q2 2008 to Q1 2012 and again in Q3 2012 and Q1 2013 – and thanks to rising house prices, US households have brought back the equity/mortgage rate to just over 1:1. This has enabled some renewed MEW in recent quarters, although at 2% of the change in PDI, it is more reminiscent of the 1960s and 1970s than of the 1980s, 1990s and 2000s. That is not surprising. Although some of the erosion in homeowners' equity has been reversed, there just isn't enough equity to support large-scale withdrawal. Moreover, following the late 2000s housing bust, it is unlikely that banks are happy to lend against increased house prices to the same extent as they did pre-crisis. Nevertheless, this adds to rising household incomes and allows for private consumption to continue to expand at the reasonable, if unspectacular 1½-2% rate we have seen in recent quarters.

As usual, the Financial Flows data is full of valuable and interesting information. One series that should be highlighted is the surge in corporate liquidity (defined as non-financial companies' cash and bank deposits relative to bank loans). This has a reasonable – though not perfect – relationship with equity prices. The latest data puts corporate liquidity at a 57-year high of 0.96, implying further support for US share prices.



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