



**PARTY LIKE IT'S 1989:
THE DISPOSABLE-INCOME SQUEEZE AND THE TWO ECONOMIES**

Conditions are developing that could trigger another “recession that no one sees coming.” A disposable-income squeeze, like the one that caused the 1990-1991 recession, is taking shape again, this time around household budget items such as property taxes, insurance, energy, health care and tuition. These items are rising in price as salaries remain stagnant, hardly a classic inflationary spiral. Troubles in household budgets are starting to alter the consumers’ financial standing and could ultimately shift the direction of the economy. Cautious observers would do well to subject news of a growing economy to a critical eye.

Squeeze Redux

In the course of our reading, we recently happened upon an essay that struck us as curiously aligned with events and actions we were noticing elsewhere. We decided to quote it at length:

Beginning last year, evidence began mounting that simultaneous and substantial increases in tuition costs, property taxes, health care costs, auto insurance and adjustable rate

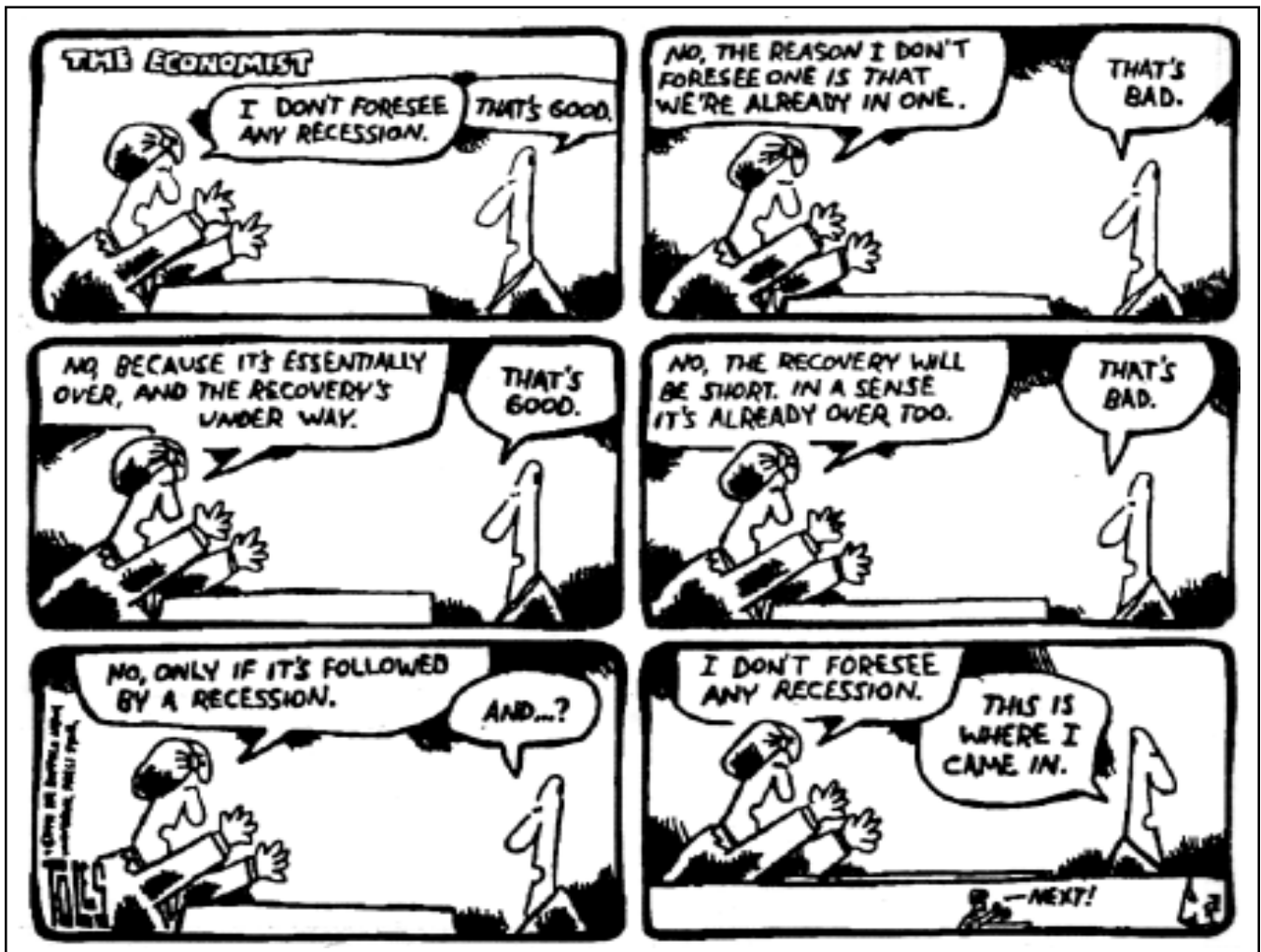
mortgages [were squeezing] consumer disposable income (net income after taxes)... Also, substantial increases in credit card debt and expanded use of home equity loans suggested that consumers were digging deeper just to stay even.... These seemingly unrelated signals, when joined together, indicated that an unusual type of spending squeeze was developing.... While these signals were appearing, traditional economic indicators—*e.g.*, unemployment rates, plant

utilization, GNP—indicated a still vibrant and growing economy. In fact, these indicators led 48 out of 50 blue chip economists to forecast that inflation, not an economic slowdown, would be the critical issue facing the economy in 1989.

Until the very end, a reader could be forgiven for assuming that the extended quote—taken from our 1989 *Briefing* entitled “Disposable Income Squeeze” (IF 1029, 7/28/89)—was talking about today. Those 1989 observations preceded the infamous “recession

from their companies in record numbers in the five years from 1989 to 1994.

Observations from current reading suggest that such a set of financial and economic circumstances is once again taking shape, including the fact that economists are once more forecasting more growth and inflation as far as the eye can see. For a brief moment, we considered re-dating the earlier report and sending it again to see what responses it might inspire. But we thought the better of it and decided, instead, that a closer look at the specifics of today’s developing disposable-income squeeze would be more enlightening, not to mention more precise.



that experts missed,” with the economists’ official dating committee finally acknowledging the beginning of a recession after it had already ended. Despite the experts’ weak observation skills, the real recession had real effects, especially on workers who were purged

It’s All Good

With unemployment hovering under 5 percent, real estate price increases breaking a 25-year record last year, credit-card charge-offs at their lowest level

since 2000, and consumer spending clipping along at double and even triple the inflationary rate, the economy, to the casual observer in the first half of this year, seemed strong and gave every indication of getting stronger. “I don’t think anyone remembers a time when there was so much money around for art,” exclaimed Charles Moffett, co-chairman of Sotheby’s Impressionist and Modern Art Department. “It’s a classic case of demand outstripping supply.... [The buyers] have so much [money] that the amount something costs is secondary – their concern is just getting the art.” (*Newsweek*, 9/12/05; *Art Newspaper*, 9/05)



The speculator’s mindset has infected the real estate market in Florida, with condominiums and new homes changing hands several times before construction has even started. As of mid-September, the mergers and acquisition (M&A) market had completed deals valued at more than \$7.16 billion, well ahead of last year’s pace, which led to a record-setting total of \$8.3 billion. Meanwhile, private equity funds have more than \$100 billion ready to deploy, and venture capitalists (VCs) raised more money in the first half of this year

than they did in all of 2003. In the second quarter of this year alone, VCs raised \$6.1 billion, a record for any quarter in history. (*Women’s Wear Daily*, 9/19/05; *International Herald Tribune*, 9/23/05)

Consumer spending, because of its apparent resilience right through the last recession, has enlivened M&A activity in the retail sector, and as in the art market, value seems to take a back seat. For instance, when Texas Pacific Group/Warburg Pincus LLC bought Neiman Marcus, the upscale department store based in Texas, the \$100 per share offer included a 35 percent premium. So much money chasing returns has helped the bottom line of companies such as Lehman Brothers, which in September reported a quarterly earnings increase of 74 percent, only to be outdone the next week by Goldman Sachs, which revealed an 87 percent jump in quarterly earnings. (*Women’s Wear Daily*, 9/19/05; *Market Watch*, 9/14/05 and 9/20/05)

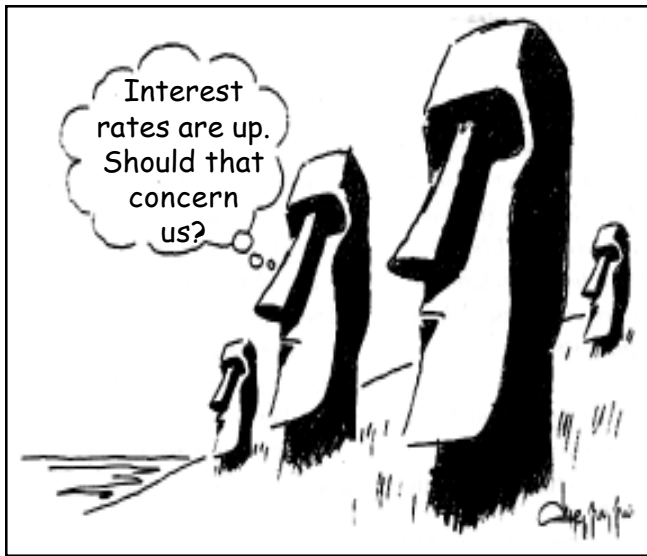
Much of the economic good news comes from the upper tier of the “two economies” that we have identified in earlier *Briefings*. But public discourse often seems to suggest that the good news is applicable across the economy. Two indicators capture the range and scope of the positive perspectives embedded in some experts’ discussions of the economy.

- ◆ Banks selling bad debt – uncollected car loans, credit card balances and other consumer loans, excluding mortgages – have watched prices increase 10 percent in the past 12 months. (*U.S. Banker*, 9/05)

- ◆ For the first time in American history, the country has more than 1 million owner-occupied homes with values in excess of \$1 million. The 2004 number of million-dollar homes reached 1,034,386, up from 595,441 such homes just 3 years earlier. (*BusinessWeek Online*, 9/27/05)

These two facts reveal the way in which an illusory optimism is affecting perspectives, one hinting that new bankruptcy laws and a growing economy can remake bad loans into something more valuable and the other suggesting that new-home prices will further inspire a “wealth effect” to continue stimulating the economy. But does money chasing art mean a booming economy or a peak in that economy? Do large accumulations of capital in investment categories suggest economic growth or the beginning of bargain hunting on the downside?

We have noticed several events that encourage caution when interpreting current economic statistics.



Feel the Squeeze

Consumers are facing budget cuts that do not bode well for their economic standing. In essence, current economic realities are putting pressure on several categories of the household budget.

◆ In 2003, incomes of Americans totaled \$263 billion, lower in real dollars than in 1999. The five-year period ending in 2004 was the first half-decade in American history in which median household incomes failed to increase. Real earnings for workers with a college degree fell for four years straight ending in 2004. For that period, the median pay for full-time male workers actually declined 2 percent, but those workers managed to keep their overall income steady by working more hours. (*International Herald Tribune*, 8/31/05; *Business Week*, 9/12/05; *New York Times*, 8/29/05)

◆ Last year, property-tax collections nationwide increased by 24 percent. (*AARP Bulletin*, 9/05)

◆ In the 2004-2005 school year, tuition and fees at public institutions of higher education rose 10.4 percent. That followed a 14.1 percent increase the prior year, while the current year is adding another 7.3 percent. (*Chronicle of Higher Education*, 9/9/05)

◆ In September, gasoline prices nationwide surpassed the all-time high set in 1981 (\$2.95 in constant dollars). (*Business Week*, 9/12/05)

◆ Over the past five years, employers have raised workers' annual contributions for family health coverage by an average of 68 percent. (*Business Week*, 9/26/05)

◆ In the first quarter of this year, drug prices rose 3.3 percent, compared with a general inflation rate of roughly 1 percent for the same time period. (*CNN Money*, 8/16/05)

◆ The Bush administration has announced that Medicare premiums will increase next year by 13 percent, after a 17 percent increase this year. (*New York Times*, 9/17/05)



These pressures are rising just as new bankruptcy laws take effect. The new legal constraints on the consumers' ability to shed burdensome loans could slow consumer spending, as consumers carry their debts farther into the future, and also slow borrowing, as consumers become more cautious in their acceptance of debt.

This squeeze on household budgets has started to affect consumers' financial health. For instance, seventy-seven million Americans—40 percent of U.S. adults—are having trouble paying medical bills or have assumed debt to cover medical costs. This type of financial pressure is putting household budgets at risk. For example, the U.S. Commerce Department reported that in July the savings rate of Americans dropped to 0.6 percent, which the Department said was the lowest since the Great Depression. But then the Department revised that number downward to a negative 1.1 percent. Meanwhile, the Federal Reserve reported that by its measurements the U.S. savings rate had turned negative, registering a minus 1.8 percent.

(*Christian Science Monitor*, 8/3/05; *Investor's Business Daily*, 9/22/05 and 9/29/05)

Negative savings suggest an accelerating borrow-to-spend practice, which for American consumers has reached new territory, with unknown consequences. In the second quarter, the percentage of credit-card accounts 30 days in arrears climbed to 4.81 percent, the highest figure since the American Bankers' Association started collecting such data, in 1973. More ominously, consumers last year extracted equity from their houses equal to 5 percent of gross national product (GNP), roughly \$550 billion, by far the most ever. At the same time, a Bear Stearns study revealed that 65 percent of borrowers with option-adjustable-rate mortgages have been paying less than the monthly interest due, and they have been doing so "for several months." This tactic adds debt to the mortgage principal – in essence, a *de facto* home-equity loan – and subjects the borrower to the possibility that he or she could owe more on the home than the home is worth – that is, in loan jargon, the account could turn "upside down." This past year, the number of home foreclosures with defaulters holding upside-down loans increased 17 percent. (*Associated Press*, 9/28/05; *New York Times*, 8/29/05; *BusinessWeek Online*, 9/28/05; *International Herald Tribune*, 8/31/05; *Dallas Morning News*, 8/24/05)

Extended borrowing has brought many consumers to limits they have not experienced in the past several years. In response, they have started to take actions to balance their household budgets, and those actions are starting to affect the economy.

◆ In August, more than half (58 percent) of American consumers reported that they had cut back on discretionary spending because of rising gas prices. (*Investor's Business Daily*, 9/22/05)

◆ In July, new-home prices fell 4 percent from a year earlier, the fourth straight month of declines, retrenching new-home prices to their December 2003 level. In August, new-home sales tumbled 9.9 percent. (*Christian Science Monitor*, 8/25/05; *Associated Press*, 9/27/05)

◆ In August, U.S. leading economic indicators fell 0.2 percent, and July's indicators were revised from a 0.1 percent increase to a 0.1 percent decrease. (*Reuters*, 9/22/05)

As we have noted in a recent *Special Briefing*, the long-term effects of Hurricane Katrina have yet to be fully realized. Negative economic news was part of the pre-Katrina reality, but the psychological effects of that disaster turned the already bad news into worse news in the post-Katrina environment. And consumers felt it. In September, "consumer confidence," as measured by the Conference Board, plummeted from 105.5 in August to 86.6 in September, the largest one-month drop in 15 years and the number's lowest level in 2 years. Meanwhile, the University of Michigan's "consumer sentiment index" fell from 89.1 in August to 76.9 in September, pushing that number below its value in the aftermath of September 11, 2001. In addition, the *Investor's Business Daily/TIPP* "economic optimism index" declined 19 percent in September, reaching an all-time low of 41.2. (*Reuters*, 9/27/05; *Investor's Business Daily*, 9/19/05 and 9/28/05; *Boston Globe*, 9/17/05; see also "'They're Trying to Wash Us Away': Psychic Shock and the Aftermath of Hurricane Katrina," **Special Briefing**, 9/23/05)

The pressures that consumers are experiencing are signals of an economic turn very similar to the ones we first identified in 1989. While the recession that followed the 1989 *Briefing* was relatively mild, the stealth nature of its appearance – because traditional economic indicators had pointed experts in a different direction – undid many business plans, altered portfolio returns and ultimately cost one political party its control of the White House.



Two Economies

In our recent *Briefing* on the “double-take economy,” we noted that the upside of the business cycle may have crested. At that point, we were watching some statistics that were intimating the possibility of an economic slowdown: same-store sales figures languishing for many retailers, Wal-Mart missing its quarterly estimates, overall consumer sales registering smaller increases, and new-home inventories rising. We were also monitoring some changes that represented portents of a disposable-income squeeze: banks feeling pressure from the Federal Reserve and increasing the monthly amount due on credit-card debt; interest rates on adjustable-rate mortgages rising; and higher copayments and premiums on employee health-care plans (see “The Double-Take Economy: Secular Changes Make Cyclical Numbers Look Strange,” **IF 2619**, 9/2/05).

The “two economies” we have identified over the past 18 months have triggered different types of

statistics for different segments of the economy, and that spread of impact has confused those who watch one set of signs to the exclusion of another. Much of what has been positive in the economy for the past two months has occurred in the upper reaches of the economic strata (e.g., art sales, M&A, corporate earnings), and much of what has been negative in the economy in that time period has affected the middle and lower reaches of the economic strata (e.g., outsourcing of jobs, credit stresses) (see “Two Images of the Economy...and Then There’s Reality: Crazy Season, Anomalies and Secular Economic Changes,” **IF 2504**, 2/27/04).

The disposable-income squeeze outlined in this *Briefing* threatens to make the two-economy distinction moot by triggering a slowdown that will affect the whole economy. Some experts may be looking at statistics that suggest a big-growth economy with inflation, preferring to “party like it’s 1989.” More cautious observers, however, might want to look closer at the economic risks involved with the consumer’s new disposable-income squeeze.

