RBC Financial Group

Financial Industry *Monitoring Service*

In-depth analysis of developments in the Canadian and U.S. financial services industries

A closer look at the liquidity of U.S.households

March 2006

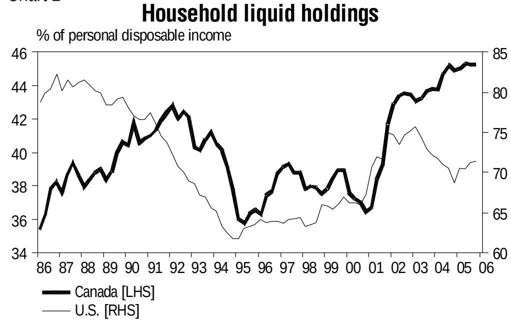
Introduction

While it's true that wealthier households hold the bulk of liquid assets, this does not imply that they are the ones with the largest buffers against shocks. To gauge credit quality, what must be considered are liquidity levels *relative* to debt, and by this measure, with the exception of the very highest income cohort, it is the very lowest income cohort maintaining the largest liquidity buffer.

North American households shifted their risk appetite and began ramping up liquidity since 2001 (chart 1). In the U.S., balances held in cash, time and saving deposits, and money market funds currently sit at almost 75% of personal disposable income. An even more convincing trend has been seen in Canada where the purest forms of liquidity have been setting records. However, such a measure says nothing about who is holding the liquidity. To get this type of data, we turn to the newly released 2004 Survey of Consumer Finances. Published only once every three years, this survey offers a much richer picture of the financial condition of households. Such data is also available in Canada, but is released on a far less timely basis and we'll have to wait until next year for the first update since 1999. Given the similarities between the two markets, however, coupled with the more substantial liquidity build-up in Canada, it may not be unreasonable to infer that similar conclusions hold true north of the border as well.

Chart 1

Household liquid holdings



Note: Due to data limitations, time deposits are included in the U.S., but excluded in Canada
Source: Bank of Canada, IFIC, Statistics Canada,Federal Reserve Board, RBC Economics

This type of analysis can be used in two key ways. The first is as a source of data for risk managers. By breaking out asset and liability positions by income cohort, it's possible to get a closer look at the tails of the distribution, where there tend to be greater sensitivities. The second is as a source for wealth managers, as it can help pinpoint where the greatest opportunities lie.

Smaller income, bigger buffer

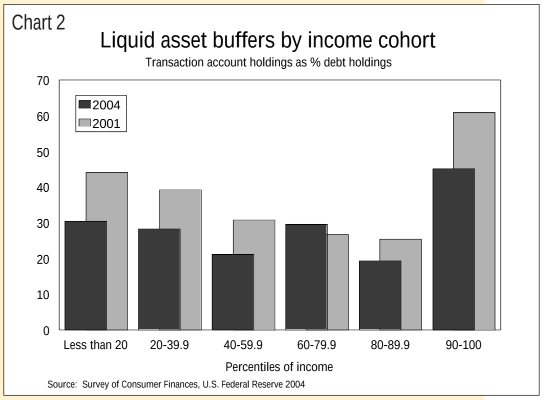
From the perspective of risk managers, it is key to zone in on the lowest income cohort, which as a share of total households comprises 20% of the population. It is in this income bracket that one would expect liquidity constraints to be the greatest, and as such this would leave households susceptible to shocks to employment or interest rates. Indeed, this cohort holds the smallest absolute level of liquidity. However, simply looking at absolute holdings does not provide a comprehensive picture. What's important to credit quality is not how much liquidity is on hand, but rather how much there is relative to the amount of debt outstanding.

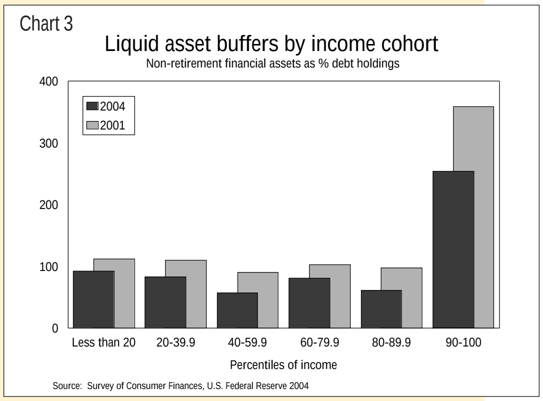
Charts 2 and 3 look at the size of liquid asset buffers by income cohort, using both a narrow definition of liquidity and a broader definition, relative to outstanding debt levels using the latest survey data. The results are rather interesting, and challenge some of the more bearish, and often exaggerated, views on the consumer sector. According to the data, with the exception of the top 10% of earners, the lowest income cohort has the largest balance of liquid holdings relative to their level of debt. This observation holds both using the narrow measure of liquidity and the wider definition, which includes stocks, bonds, and mutual funds. Therefore, from a shock perspective, the cohort that at

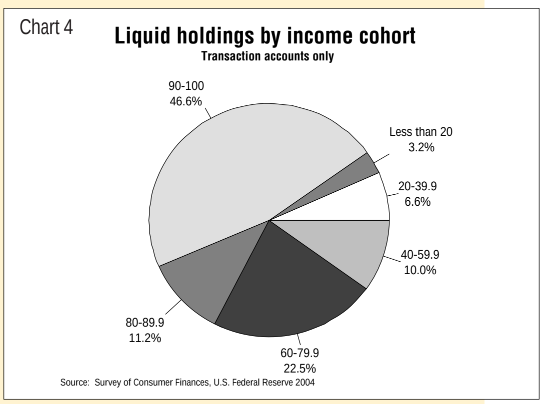
Derek Holt
Assistant Chief Economist
(416) 974-6192
mailto: derek.holt@rbc.com

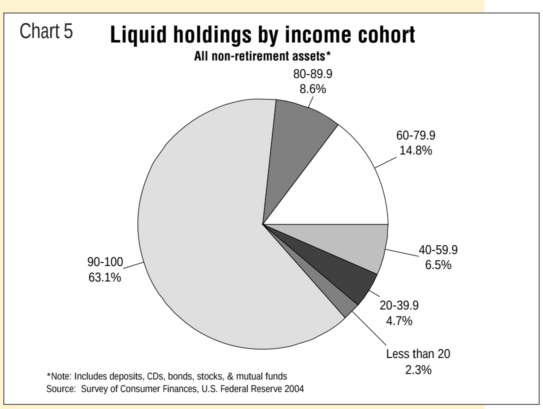
Ivana Rupcic
Economist
(416) 974-6525
mailto: ivana.rupcic@rbc.com

first pass appears to be most at risk, is one of the best positioned to handle a surprise to their credit picture.









The preference of a high liquidity ratio among the lowest income bracket is likely driven by a larger liquidity constraint; less wealthy households tend to have fewer reserves to draw upon in the event of a shock and often exhibit higher risk aversion. Comparing the latest survey results to those released in 2001, there has been a comprehensive decline in the liquidity ratio, as consumers took advantage of very low interest rates and growing net worth to purchase homes, vehicles, and other goods. This caused debt levels to increase. Despite the declines in liquidity in 2004, buffers across income cohorts remain relatively large and, coupled with moderating debt growth, rising incomes and only modest further rate increases expected, point to quite healthy consumer conditions, as further elaborated upon in our updated 2006 version of the Seven Myths of Household Finances (*click here*). Moreover, throughout 2005, liquid holdings trended up (chart 1, again).

Bigger income, bigger balances

From the perspective of wealth managers, it is key to know who is holding the liquidity, and in what form it is being held. Charts 4 and 5 provide the answer. Using data broken out by income cohort and the means data provided by the survey, it is possible to calculate the dollar volume of liquid holdings by income cohort. Chart 4 looks strictly at transaction accounts, while chart 5 looks at a broader measure of liquidity. The results are hardly surprising. The top 10% of earners in the U.S., which typically are the wealthiest residents, hold by far the bulk of liquid balances. This observation is underscored when the wider measure of liquidity is considered, which includes stocks, bonds, and mutual funds. As the income cohorts get progressively smaller and smaller, so too does the total share of liquid holdings. The very lowest income cohort, who comprises 20% of total households, holds less than 5% of total liquid holdings by either measure.

This type of breakdown allows wealth managers to easily pinpoint where their greatest opportunities lie in terms of which income cohorts are most at risk of earning negative real after-tax returns, and who might be willing to consider alternative asset classes. If this money is reallocated, it would likely lead to slower, perhaps even negative, growth in deposits and money market holdings, which would also be a consideration for the banking sector.

How much liquidity is there?

To get a sense of the magnitude of excess liquidity in the U.S., we consider the impact of consumers bringing liquidity ratios relative to today's debt holdings back down to the pre-run-up ratios that existed at the end of 2000. If this were the case, the amount of cash released would total around $495 billion. We are expecting that this liquidity will be gradually redeployed over the coming year, with a portion of the funds transferred to other investments, such as equities, in search of higher returns and coincident with a rising risk tolerance. Alternatively, this liquidity could be redeployed to single handedly boost consumer spending by an additional 5.7% above 2005 levels, or it could be used to absorb a 5.7 percentage point rise in the debt service burden, though such a shock would be very unlikely.