Agincourt Capital Management, LLC

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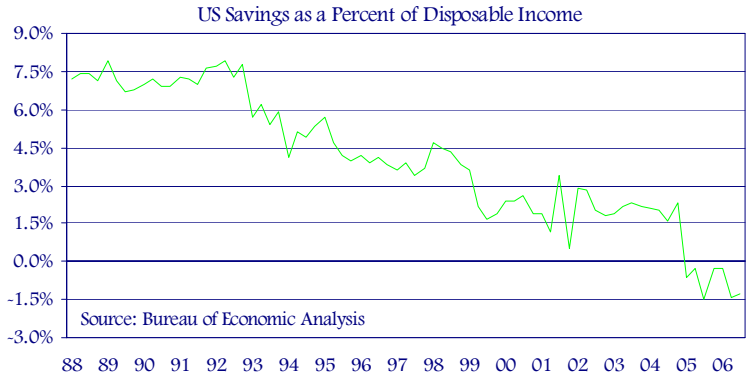
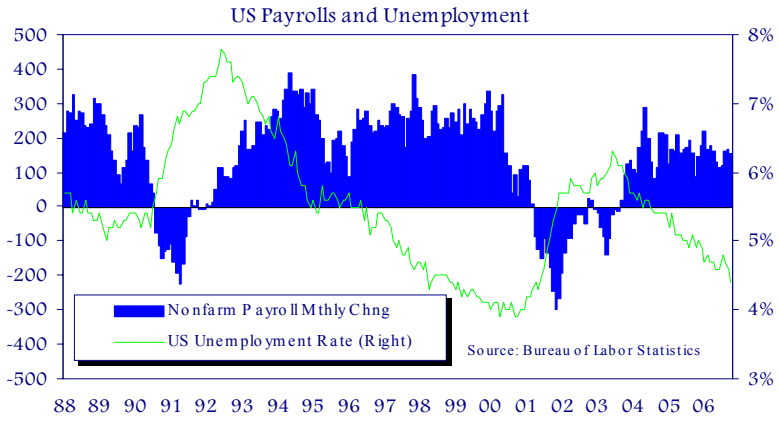
Investment Update

What are we to make of the fact that the US savings rate is, judging by conventional measures, below zero? How can that be? Are Americans taking money out of savings, or—even worse—going deeply into debt just to buy things? Has the famous American consumer culture gone too far? Or is there some other part of the equation that we're missing?

The first step in this inquiry is to define our terms. First of all, what exactly do we mean by "savings?" Formally, savings is defined as "disposable personal income less personal consumption expenditures" and is calculated by the Bureau of Economic Analysis. To make the measure more meaningful, we typically express the savings "rate" as a percentage of personal disposable income. The top chart on this page shows how this savings rate has eroded over the past twenty years or so, from the late-80's when the average American saved approximately 7.5% of their disposable income, to the low single-digits in the early part of this decade, to less than zero over the past two years.





Obviously, the savings rate cannot stay below zero indefinitely. An individual can only spend more than is earned for so long before borrowings must be paid back. But similar arguments were used to justify savings rates that fell below 5%, and then below 2%—namely, that savings rates were being held down by transitory factors, and that the rate would have to turn back up. Yet it still hasn't happened.

Perhaps the most confusing element is that we wouldn't expect the savings rate to fall in the environment we've had over the past couple of decades. Traditionally, the motivation to spend rather than save comes from a combination of poor returns from savings and high inflation; that is, if prices of goods and services are soaring, you're better off buying now rather than waiting, especially if your expected returns from savings and investments are poor. Yet over the past twenty years inflation has fallen dramatically and investment returns have ranged from pretty good to outstanding. Real, inflation-adjusted interest rates were negative for long periods in the 70's and early 80's, when we'd expect to see low savings, but the savings rate during this period ranged between 8% and 12%. Conversely, the savings rate fell through the second half of the 1990's, despite the fact that savers could have earned extraordinarily high returns in the US stock market.

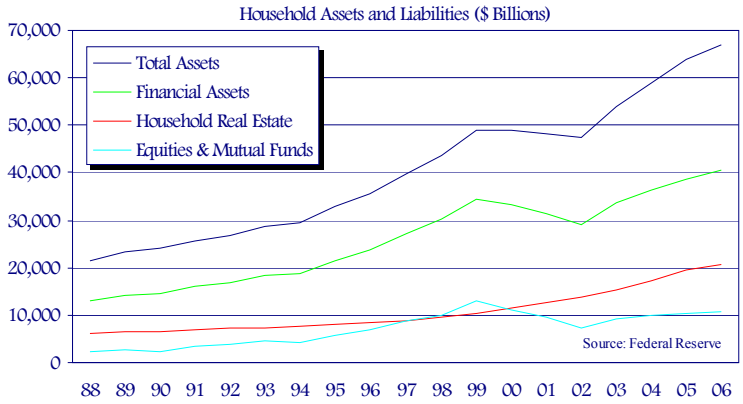
So, there must be something else going on, either within the psyche of the US consumer, or in the way we measure savings. We'll look at a few alternatives.

Some economists would argue that the single most important measure of the health of a country's economy is its unemployment rate. When people have jobs, and are reasonably confident that they'll be employed in the future, the fewer problems the economy is likely to encounter. For purposes of our discussion, a low unemployment rate and a healthy outlook for jobs translates to a higher propensity to spend; there's less need for savings as a financial backstop if you're not afraid of losing your job. As the second chart shows, the US labor market is healthy, adding jobs at a rate of 165,000 per month (well above the 125,000 rate at which unemployment neither rises or falls) since 2004. As a result, the unemployment rate has fallen to 4.4%, within ½ percent of the lows of the past 35 years. Now, note the relationship between rising unemployment and the savings rate—from the first chart, we can compare how the rate of savings flattened out during the two most recent periods of rising unemployment, and only began to fall again when jobs were being added at a healthy clip. When it comes to the choice between spending or saving, consumers seem to be well-attuned to the labor market.

Of course, there's more to the story than just the labor market—the reason consumers spend rather than save also reflects the confidence they have in financial assets (not measured in the "savings" calculations) such as retirement funds and benefits, insurance, and government-sponsored programs like Social Security and Medicare. In addition, the acceleration in productivity over the past decade is likely to have boosted households' expectations of future earnings, as surveys of future productivity remain high.

There are additional problems with the measurement of savings, and no shortage of articles addressing these shortcomings. One key problem is that savings, as calculated by the BEA, is a residual calculation—it is what's left over after calculating both the income and spending components—and any errors in calculating these individual components therefore show up in the savings figure. Because this savings result is, by definition, smaller than either of the other two main components, any inaccuracies in their calculations are magnified in the residual.

There is also the issue of what is defined as personal disposable income. While wages and salaries, proprietors' income, rental income and dividends and interest are included, other important sources of personal wealth are excluded. The biggest items that go uncounted include the appreciation of real estate and capital gains (both realized and unrealized) on personal investments. In the current environment, realized capital gains would add back a whopping 5% to the savings rate; it should be kept in mind, however that this figure is volatile and in other periods would have made a far smaller impact.



In addition, when consumers buy durable goods (e.g., automobiles, furniture, etc.) the entire cost is recorded as current period consumption, even if the item is paid for over time, "front loading" the consumption calculation. Recent studies indicate that adding back the cost of durable goods purchases (less the current period's depreciation of these items) boosts the US savings rate by approximately 2%. Similarly, the money spent on home improvements is included in consumption, even though this type of spending has a strong "investment" component. Recent home improvement spending, less depreciation, would add an additional 1% or so to the savings rate if it were removed from personal consumption.

These adjustments don't really change the fact that the US savings rate has been on the decline for two decades, they only soften the trajectory of that decline. But adjusting these numbers does boost the current savings rate above zero and helps to make sense of what seems to be a nonsensical data series—namely, that an entire economy's consumer base is spending more that they are bringing home in income.

After all adjustments, the most compelling reason for a decline in the savings rate is something we touched on earlier: namely, that there are other important sources of wealth that aren't captured in the analysis of income and consumption—the financial and real assets held by households.

It's no coincidence that the drop in savings rates began after the stock market re-established itself in the mid-80's. From 1982 to 1999, the stock market, as measured by the S&P 500 returned 18.5% on an annualized basis. So, even though the share of income put into savings was decreasing, the money that was saved was performing handsomely.

While the collapse of the dot-com bubble (and the collateral damage to the rest of the US stock market) wiped out trillions of dollars of wealth, the US housing market continued to plug along. In fact, as the chart on this page shows, even though the total value of equity holdings is still not back to its 1999 peak, the accumulated wealth in the housing market has doubled over this same period.

From both a psychological and real wealth standpoint, the appreciation of home prices in the US has had a profound impact on the savings rate by lowering the need (real or imagined) for individuals to set money aside. The important question going forward will be to what extent we should expect to see savings rates move up if home prices actually fall in the coming months, and how will that play out with personal consumption?

Studies have shown consumers' savings and spending decisions are much more sensitive to changes in housing wealth than financial wealth—primarily because housing wealth is far more evenly distributed across the wealth spectrum than financial wealth, which is tilted towards the richest Americans. To the extent that we may be entering a period of real depreciation of home prices, we may just see, for the first time in recent memory, a genuine increase in the level of savings.

Short-term, the net effect on the economy is likely to be a slower growth rate driven by an easing of consumer spending, which may be already underway. Longer-term, a greater savings rate can only strengthen the consumer for the inevitable next recession, though that event still appears to be years away.