OBSERVATION

TD Economics

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GOOSING U.S. ECONOMIC GROWTH THROUGH WEALTH EFFECTS

Highlights

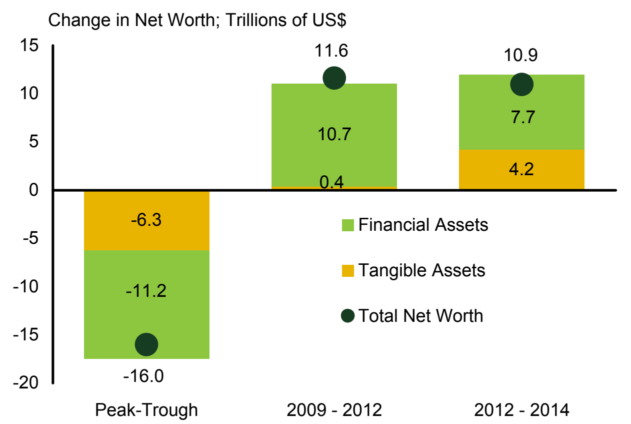
- The S&P500 index squeaked past record levels last week, before pulling back again. This prompted questions about the impact of wealth effects on economic growth.
- Wealth effects from home price gains are typically estimated to be larger than the trickle-down that flows from stock market appreciation. Financial wealth is not as broad reaching.
- But, wealth effects are not linear. Households respond differently to wealth gains that are recovering from past losses, as oppose to hitting new highs.
- We estimate real estate wealth will add roughly 0.2 percentage points to GDP growth this year, compared to 0.3 percentage points from the larger and more persistent stock market gains.
- Wealth effects offer a meaningful contribution, but take a back seat to the direct benefits from a growing real estate market in boosting investment and jobs.

Investors were buzzing when the S&P500 composite index began flirting with record levels. Likewise, clients started asking what it might mean for the economic outlook. This question is rooted in the notion of “wealth effects,” whereby a sustained rise in asset prices causes investors to feel more secure about their wealth and, consequently, spend more.

Benjamin Franklin was quite astute in saying that “the only thing you can be certain of is death and taxes.” Equity gains were not among the list, with good reason. On Friday, stock markets slipped on weak economic data and temporarily iced investor euphoria. Nevertheless, the question of economic impact is still relevant. From an economic perspective, the journey is more important than the destination. Wealth effects feed through with lags, particularly stock market gains due to inherent volatility.

In the past year, the S&P500 index has risen 12%. Even more impressive, it has more than doubled from the recession trough in March 2009. Meanwhile, total household assets have shot up by $16 trillion, recovering almost all of the loss sustained from the recession. But, if you don’t feel like daddy Warbucks, it’s because almost all of the recovery occurred within financial assets and there are lower odds that your household holds it. The most widely held asset is real estate, and its value remains in a $5 trillion hole since the peak in early 2006.

U.S. HOUSEHOLD NET WORTH



Source: Federal Reserve. Forecasts by TD Economics.

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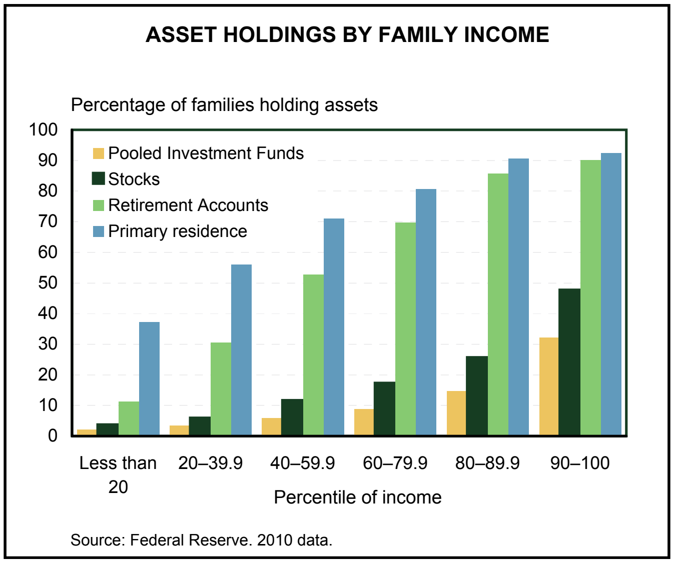


Real estate packs a bigger punch than stock wealth

Analysis of wealth effects reveals the economic impact from gains in home prices is consistently larger than the trickle-down that flows from stock market appreciation. Financial wealth is more concentrated in the hands of the affluent, and thus, does not have the broad reaching impact of real estate wealth. Federal Reserve data shows that nearly half of the families in the top 10 percentile of income hold equities directly, while 90% of them have retirement accounts, which would likely benefit from stock market gains. For families in the 40-60% income percentile, these figures are reduced to a mere 12% and 53%, respectively. As you go further down the income scale, the representation continues to shrink, eventually hitting negligible amounts among the lowest income group.

In contrast, when it comes to real estate assets, there is a more even distribution within the income spectrum of families. Returning to the highest income group, 90% own real estate. But, now compared to the middle-income group, the ownership rate is reduced to only 71% of families. At the very bottom end of the income distribution scale, you find that nearly 40% of families still hold real estate assets.

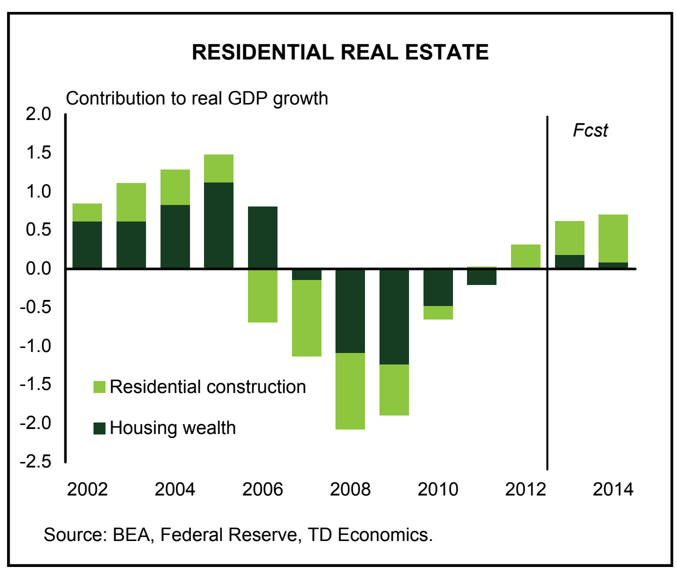
Estimates of wealth effects vary by asset category, but generally find that a dollar increase in real estate values eventually trickles down to a 3-7 cent boost in consumer spending, versus only 1-3 cents on the dollar for stock market gains. Thus, changes in housing wealth exert a bigger influence on the economy than stock appreciation. This is not just due to the asset being more widely held across the population. Financial innovation has also given households an ability to unlock the gains in their homes through mortgage equity withdrawal (MEW). One example is a home equity line of credit. However, MEW is currently negative, meaning that households are not reaching into their home equity to help fund purchases. Their income stream is the driver on this front. No surprise, given that even with the recent rise in home prices, 20% of mortgage holders are still underwater – where the value of the home is less than the mortgage owed.

This speaks to the non-linear relationship of wealth effect estimates. There is a growing understanding that households respond differently to wealth gains that are simply recovering from past losses, as opposed to gains that lift wealth to new highs. The former results in more muted wealth effects, suggesting the estimates cited above are likely at the lower end of the identified range. This would be true for both real estate and stock market appreciation, since the latter has only succeeded in clawing its way back to pre-recession highs.

Goosing economic growth

For this reason, we estimate that the 7.3% gain in home prices over the last year will equate to roughly 0.3 percentage points added to real consumer spending this year, or 0.2 percentage points to real GDP growth. Similarly, we estimate the larger gains in stock market wealth will add at most 0.3 percentage points to real GDP growth.

Although wealth effects offer a meaningful contribution, it comes second to the direct benefits generated from a growing real estate market in boosting investment and jobs. On this front, residential construction investment is expected to grow by 17% over the next year, directly contributing 0.4 percentage points to economic growth. But, this is just the



tip of the iceberg, because it's also expected to generate an additional 400,000 new jobs – roughly 20% of the total number created for 2013.

While wealth effects are not the primary driver of a recovery, they are a beneficial by-product of it. And, certainly the Federal Reserve has acknowledged it's importance to this economic cycle within various speeches and commentaries. As Bernanke noted in 2010, "…lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion." These wise words from the Chairman seem like an appropriate place to end this commentary.

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End Notes

1. http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html?hpid=topnews