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Economics Group

Interest Rate Weekly

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Is Consumer Credit a Concern with Rates on the Rise?

Consumer credit as a percent of disposable income is at an all-time high. With the Fed expected to continue hiking rates, readers may be concerned that an uptick in defaults could have an outsized impact in this cycle.

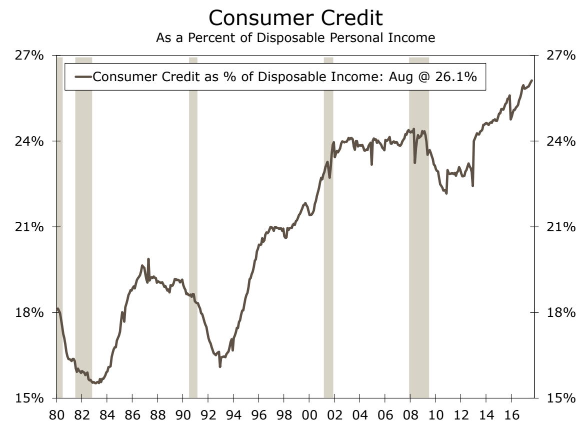
Dig a Little Deeper

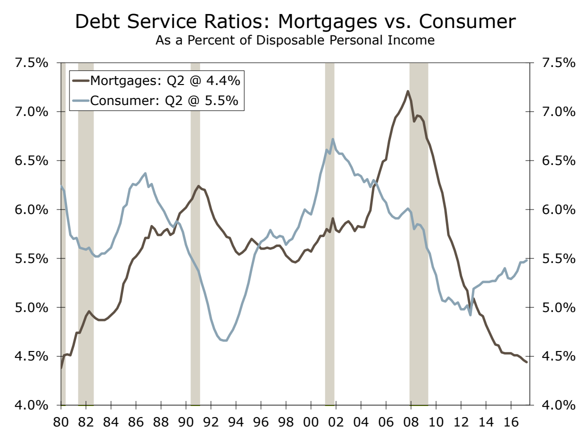
At first blush, the top graph may raise concerns among those who correctly notice that the outstanding amount of consumer credit is at an all-time high as a percent of personal income. This concern is perhaps more amplified against the backdrop of a Federal Reserve that is prepared to raise the fed funds rate in December and continue tightening policy through 2018. And although not all consumer credit is attached to a floating rate, delinquency rates may be expected to pick up as new credit becomes more expensive to pay back.

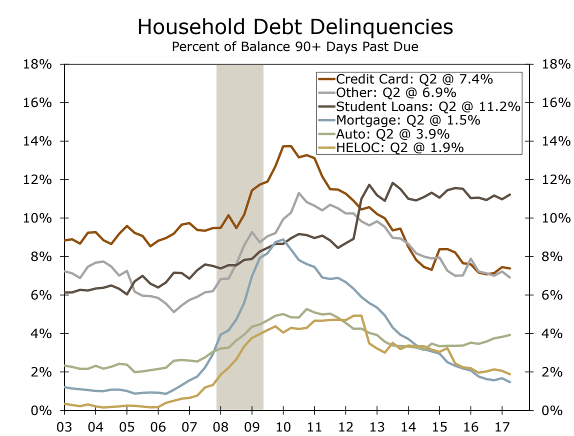
However, while the ratio in the top graph does has some interesting implications, it must first be acknowledged that this ratio includes a stock number (consumer credit) being divided by a flow number (disposable personal income). A stock refers to the value of a series at a point in time while a flow refers to the total value of the series over a period of time. Thus, stocks and flows are not easily comparable and therefore are not always useful in deriving conclusions.

Instead, we turn to the debt service ratio (middle chart), which compares the flow of consumer credit to the flow of disposable personal income over the same period. In this instance, the most recent data point is well below the all-time series high reached in late 2001. Despite the relatively subdued debt service ratio, the recent upward trend since 2013 is worth monitoring. The growing amount of auto and student loans being financed with credit is partially responsible for this trend as payments for these consumer debt categories continue to become due. Interestingly, the debt service ratio for mortgages has not seen an increase despite a modest rise in the federal funds rate. The fact that fixed-rate mortgages are much more common than adjustable-rates mortgages is perhaps partially responsible for the recent trend difference. Mortgage payments are consistent regardless of the interest rate environment, whereas credit card rates are largely floating.

Household debt delinquencies, largely, are still continuing their downward trend (bottom graph). The exceptions to this are student loans, which have been essentially flat since 2013, and auto loans, which have slowly climbed for 12 consecutive quarters. As we have stated in past pieces, we do not think the auto loan market poses a threat to household finances, as auto loans comprise just 9.2 percent of total household debt. Additionally, as the Federal Reserve continues to tighten policy we would not be surprised to see delinquency rates modestly tick up and loans with floating rates become marginally more difficult to pay back. However, if the Fed continues to raise rates in the 'slow and steady' manner in which they have over the past year, then a sharp uptick in consumer debt delinquencies will likely not occur, all else equal, as Fed policy would likely lag income gains.







Source: Federal Reserve, IHS Global Insight and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual			Forecast								
	2017				2018				2019			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.50
3 Month LIBOR	1.15	1.30	1.33	1.65	1.65	1.90	1.90	2.15	2.15	2.40	2.40	2.65
Prime Rate	4.00	4.25	4.25	4.50	4.50	4.75	4.75	5.00	5.00	5.25	5.25	5.50
Conventional Mortgage Rate	4.20	3.90	3.81	3.89	3.95	4.02	4.05	4.10	4.12	4.16	4.17	4.24
3 Month Bill	0.76	1.03	1.06	1.30	1.45	1.60	1.67	1.85	1.95	2.10	2.15	2.30
6 Month Bill	0.91	1.14	1.20	1.40	1.55	1.70	1.77	1.95	2.05	2.20	2.25	2.40
1 Year Bill	1.03	1.24	1.31	1.55	1.68	1.80	1.87	2.05	2.15	2.25	2.30	2.45
2 Year Note	1.27	1.38	1.47	1.72	1.83	1.93	2.00	2.15	2.23	2.33	2.38	2.50
5 Year Note	1.93	1.89	1.92	2.20	2.29	2.39	2.45	2.58	2.65	2.75	2.80	2.90
10 Year Note	2.40	2.31	2.33	2.49	2.57	2.66	2.71	2.78	2.82	2.88	2.91	3.00
30 Year Bond	3.02	2.84	2.86	3.19	3.29	3.41	3.49	3.58	3.62	3.68	3.71	3.80

Forecast as of: October 11, 2017

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2017	2018	2019
Change in Real Gross Domestic Product			
Wells Fargo	2.2	2.5	2.6
FOMC	2.2 to 2.5	2.0 to 2.3	1.7 to 2.1
Unemployment Rate			
Wells Fargo	4.3	4.0	3.8
FOMC	4.2 to 4.3	4.0 to 4.2	3.9 to 4.4
PCE Inflation			
Wells Fargo	1.5	1.6	2.0
FOMC	1.5 to 1.6	1.8 to 2.0	2.0 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.4	1.8	1.9
FOMC	1.5 to 1.6	1.8 to 2.0	2.0 to 2.0

Forecast as of: October 11, 2017

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: September 20, 2017

Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities

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