Special Commentary — May 9, 2024

Like There's No Tomorrow: Unpacking Consumer Credit

Summary

The recent run-up in revolving debt combined with the much higher financing costs raises doubts about the ability of credit to continue to make up for the shortfall between modest real income growth and aspirational spending. Is there a way to feel better about the consumer credit situation?

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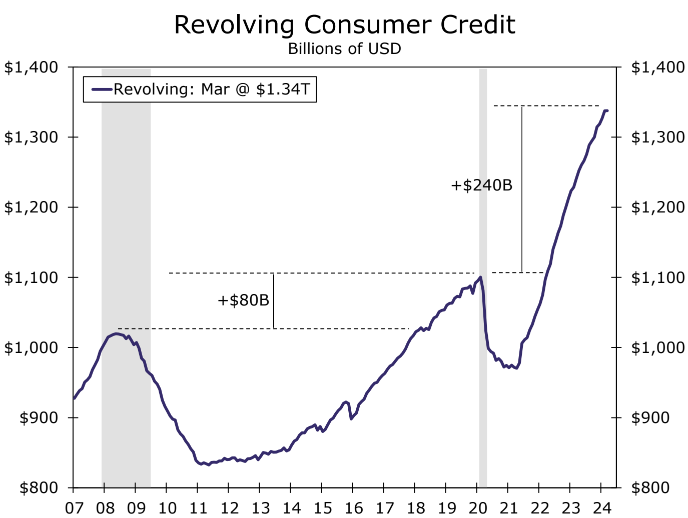


Source: Federal Reserve Board and Wells Fargo Economics

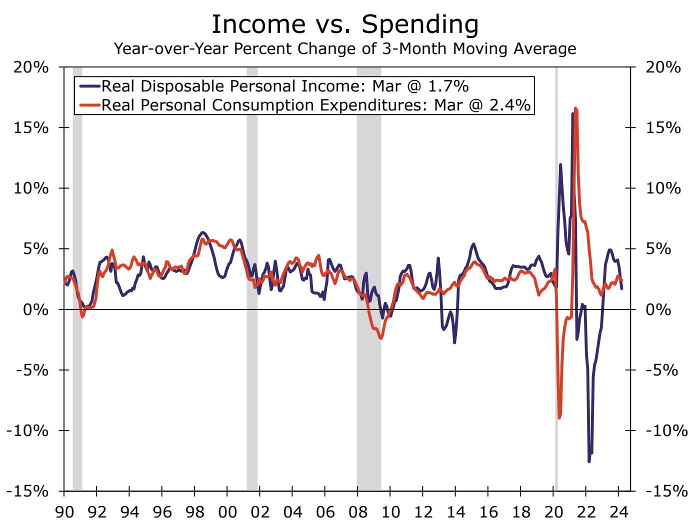
How Long Can Consumers Brush Off Higher Rates?

The economic story of the year so far is how hopes for lower interest rates have been dashed by a disruption in the trend decline in inflation. The gravity-defying power of consumer spending deserves a hearty share of the blame. Unbroken by the highest cost for consumer credit in decades, it is difficult to look at spending today and find indications of a consumer that is chastened by higher financing costs. But with pandemic-era savings now fully depleted, bridging the gap between aspirational spending and comparatively modest real income growth, consumers are running out of options. This report unpacks the latest data on consumer credit with a skeptical eye on the ability for consumers to keep borrowing.

Spending and Income, the Broken Relationship

On an inflation-adjusted basis, consumer spending tracked reasonably well with disposable income growth in the 20 years leading up to the pandemic. In overly simplistic terms, more income meant more spending. Things got turned upside down over the past four years (Figure 1). Beginning during the quarantine and early pandemic years the linkage between these series broke down. Initially income soared amid generous fiscal stimulus programs as spending was cut way back. Then inflation generally outpaced income growth as real disposable income cratered, yet spending roared ahead facilitated by stashed cash and easy access to relatively cheap credit.

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

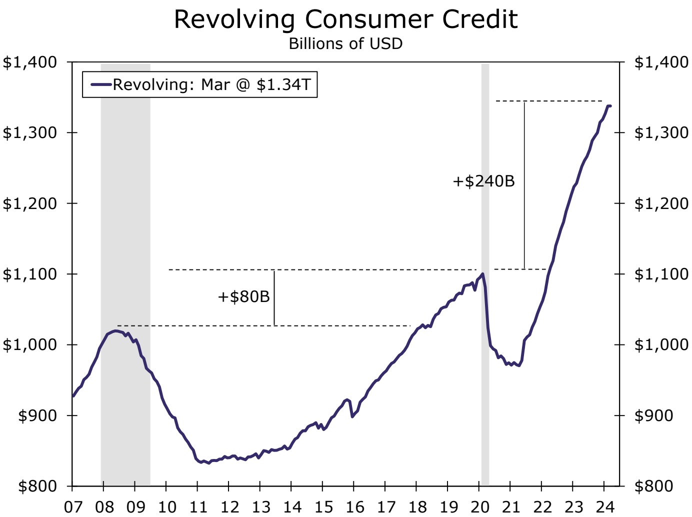
More recently, real disposable income resumed growth but has lost momentum. Remarkably, through the past few years, consumer spending has continued to expand at a steady rate. The sustained staying power of the consumer has perennially exceeded expectations in recent years and has made a mockery of the historical relationship between income and spending. What explains this apparent ability to defy gravity?

We Take All Major Credit Cards

When the paycheck alone cannot provide the necessary funds, consumers still have options. For starters, they can rely on savings previously stashed away at an earlier date, or they can also set aside a smaller amount of each paycheck redirecting a larger share of income to spending. Both of these dynamics results in a lower saving rate and have helped float the consumer this cycle. Another way to overcome insufficient funds is to reach for the credit card; also something households have been doing in this cycle to a pronounced degree.

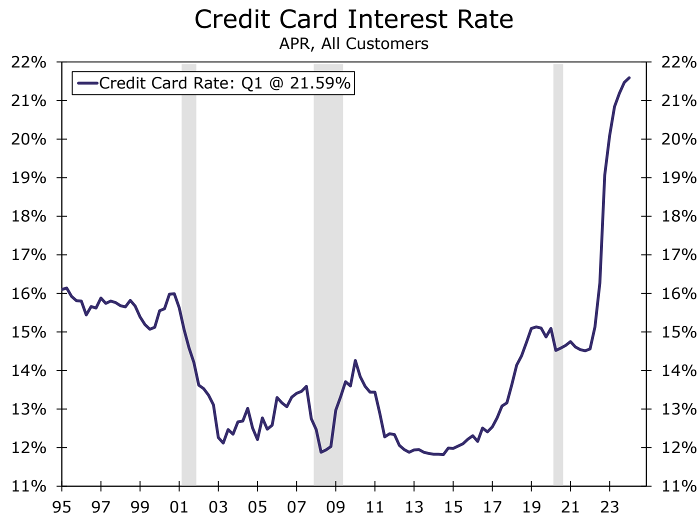
In looking at revolving credit, the category that is primarily comprised of credit card debt, we find the take-up rate of borrowers in this cycle is stunning (Figure 2). Take for example the fact that from the peak prior to the financial crisis in 2008 until the peak prior to the pandemic in 2020, revolving credit rose $80 billion. Contrast that with the roughly $240 billion increase from the pre-pandemic peak through March 2024. Credit card debt has grown three times as fast over just the past four years as it did during the almost 12-year stretch in the prior credit cycle.

Figure 2



Source: Federal Reserve Board and Wells Fargo Economics

Figure 3



Source: Federal Reserve Board and Wells Fargo Economics

Access to credit for consumers is less readily available today than it was just a year or so ago. After loosening standards in 2021 and 2022, banks have been tightening lending standards on credit cards more recently. Meanwhile, banks' willingness to lend is lower now than it was at the height of the recessions of the early 1990s or early 2000s. Only the financial crisis and the pandemic were worse.

It is not only tough to find credit, but the cost of credit for consumers has not been higher at any point in the past 30 years. From the mid-1990s until the start of the current Fed tightening cycle, credit card interest rates never climbed above 17%. Today the APR for all borrowers is north of 21% (Figure 3).

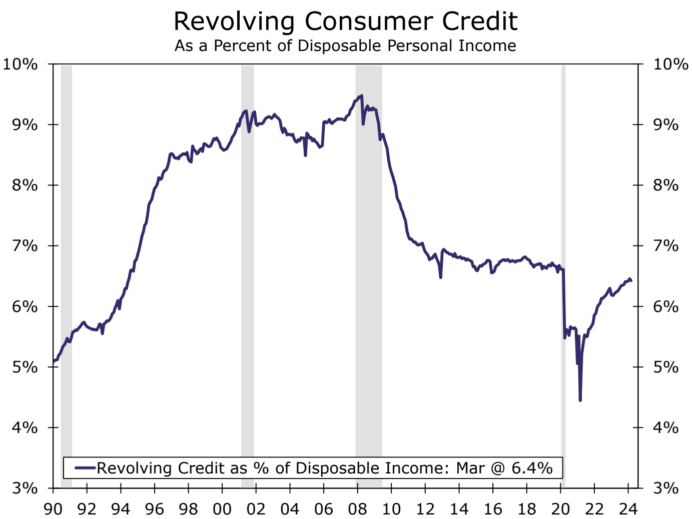
Taken together, the run-up in revolving debt combined with the much higher financing costs raise doubts about the ability of credit to continue to make up for the shortfall between modest real income growth and aspirational spending. Is there a way to feel better about the consumer credit situation?

Ability to Pay: Debt in the Context of Rising Income

The consumer credit situation is less dire when considered in the context of high inflation experienced over the past few years. Revolving credit data are reported nominally, and since it is impossible to attribute revolving balances to specific periods of purchase, we are unable to accurately adjust the data for price changes. But inflation is certainly a factor in higher revolving balances. Consider that while revolving credit sits about 22% above its pre-pandemic February 2020 peak, the PCE deflator is up about 17%. A better way to contextualize debt burdens, however, is in the context of income.

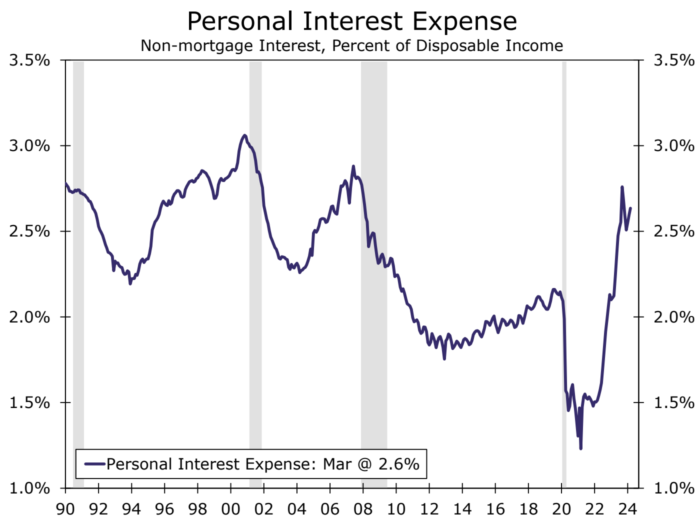
The fact that the labor market is as tight as it has been in recent years has allowed income to grow very quickly and outpace inflation on trend. In Figure 4 we plot revolving credit as a share of disposable personal income over time. At 6.5% through March, this ratio is undoubtedly on the rise and up markedly from what was a 30-year low earlier in this cycle. Still, thanks to robust income growth, this metric is lower today than at any point in the 25-year stretch that preceded the pandemic.

Figure 4



Source: Federal Reserve Board, U.S. Department of Commerce and Wells Fargo Economics

Figure 5



Source: U.S. Department of Commerce and Wells Fargo Economics

So by this measure that factors in strong income growth, revolving credit does not look quite as scary as it does on a level basis. But what about elevated interest rates? Even if the pile of debt looks manageable relative to income, at what point do interest rates make the cost of carrying this debt unsustainable? This is an important consideration to policymakers on the FOMC who are well aware of the lagged effects of monetary policy. Turns out we may be closer to the breaking point than the robust consumer spending in the first quarter might otherwise suggest.

In Figure 5, we plot personal interest expense also as a share of disposable income. Note that this is not only the interest paid to credit card providers but also the interest expense accrued on all other non-mortgage lines of credit including those for autos, boats, RVs and student loans. This measure too has risen from multi-decade lows reached in 2021. The key distinction is that the 2.6% share that interest payments eat up today represents the biggest share of income since the height of the financial crisis in 2008.

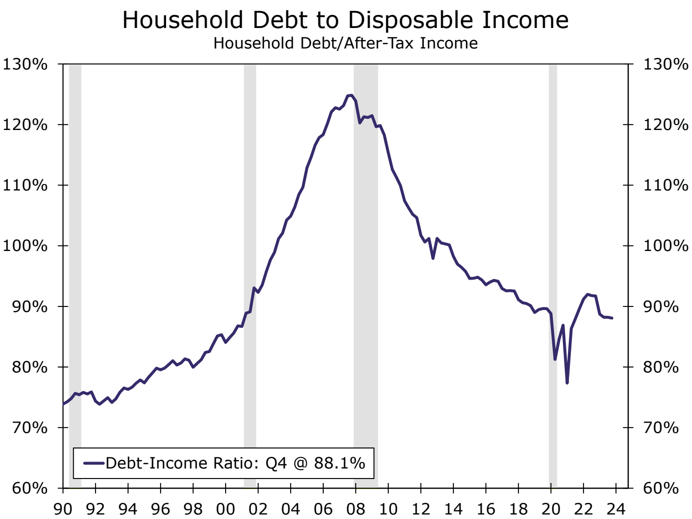
Signs of Struggle

Be wary of reassurances from those bearing charts of broad household debt-to-income measures or financing costs, like that shown in Figure 6. The fact that aggregate household debt remains near the low end of a 15-year range says more about mortgages, which comprise a 70% share of household debt, much of which has a fixed rate structure and therefore are unimpacted by Fed rate hikes, than it does about households serviceability burdens.

So are there any indications that households are struggling with debt today? The share of debt that is delinquent is the best way to gauge household stress. The delinquency rate on all household debt stands at just 1.7% as of the fourth quarter, which is below pre-pandemic levels and just a stone's throw away from the all-time low of 1.4% hit in late 2022. But here too a sound mortgage portfolio is impacting the data as delinquency trends differ across loan-products (Figure 7). Delinquency rates remain near the low end of the range for the past decade for mortgages and student loans. Yet if we look at delinquency rates for auto loans and credit cards we find that both measures are as high as they have been since 2011 when they were coming down from financial crisis era highs.

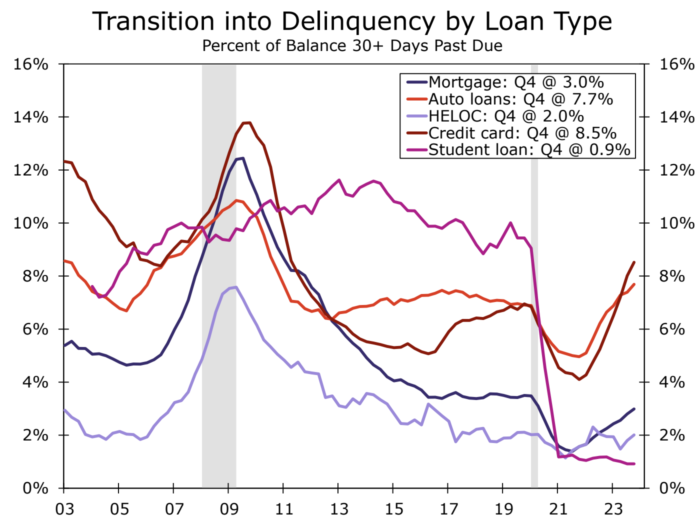
The increased transition into delinquency on credit card and autos loans is clearly not a favorable development and suggests continued reliance on credit cards will grow more challenging. But when we think of it from the broad macro perspective, the notable offset from mortgages cannot be ignored as it offers a bit more cushion for delinquencies to rise elsewhere without a credit crunch in the broad household sector.

Figure 6



Source: Federal Reserve System and Wells Fargo Economics

Figure 7



Source: New York Fed Consumer Credit Panel, Equifax and Wells Fargo Economics

Consumers keep spending, and they're pulling out all the stops to do so. Credit reliance has been a key factor in helping support the consumer this cycle, but with the smallest increase in revolving credit since April 2021 in March, this source of purchasing power may be fading. Interest rates are perched at 30-year highs leading to serviceability challenges as delinquencies are ticking higher. While we're not yet worried of a full-blown credit crunch in the household sector, the recent run-up in credit card borrowing doesn't look sustainable. It's no wonder households are growing a bit more choosy in spending behavior.

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