July 29, 2019

Economics Group

Special Commentary

Tim Quinlan, Senior Economist
tim.quinlan@wellsfargo.com • (704) 410-3283
Shannon Seery, Economic Analyst
shannon.seery@wellsfargo.com • (704) 410-1681

Rate Cuts & Consumers: Will the Medicine Take?

Typically, a rate cut from the Federal Reserve reduces financing costs for consumers, thus freeing up cash flows which can then be a tailwind for spending. In this cycle however, the expansion in household debt has not occurred in variable rate categories—adjustable-rate mortgages or credit card spending—which would see the greatest benefit. Instead, the growth in household debt has been entirely in two categories: student and auto loans (Figures 1 & 2), where rates are typically fixed and do not move in lockstep with the fed funds rate.

It is widely expected that the Federal Open Market Committee (FOMC) will cut the federal funds rate at the conclusion of this week's policy meeting. There are a number of different ways it could approach policy, which makes this one of the most anticipated meetings in recent memory.[1] Whatever the Fed decides, it has been steering expectations in the direction of more accommodative policy. Lower rates will still be helpful to some households, but due to the composition of household debt growth in this cycle, we should not expect as much of a boost to household finances from a rate cut compared to prior cycles.

Lower rates may not provide a large boost to household finances.

Figure 1

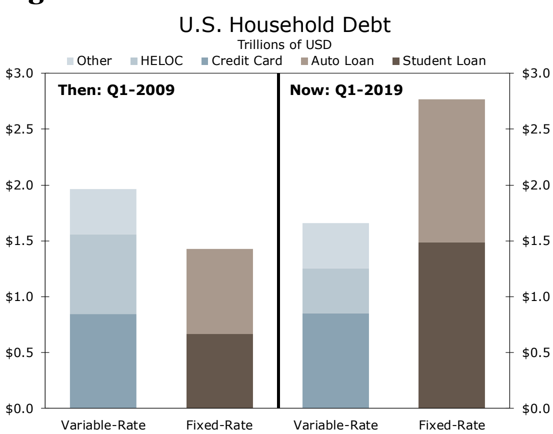
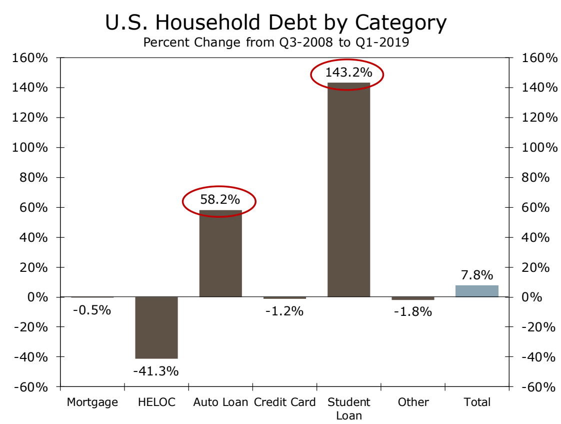


Figure 2



Source: Federal Reserve Bank of New York and Wells Fargo Securities

The point of this report is to gauge the impact on consumer spending of a lower rate environment, but it bears noting that the consumer is already on pretty solid footing. Personal consumption expenditures (PCE) rose a solid 4.3% annualized in the second quarter, the fastest pace since Q4-2017. Household debt is rising, but as a share of disposable income and as a share of the economy, it remains well-below levels seen prior to the financial crisis. Household debt service and financial obligation ratios also remain near historically low levels, suggesting the debt burdens of households appear to be largely manageable. There appears to be no glaring need at present for easier monetary policies to boost consumer spending.

[1] **Please see our recent report, "A Flashlight for the FOMC Blackout Period" (July 22, 2019) for additional commentary regarding possible outcomes for the July FOMC meeting.**

Mortgages: ARMs Need a Leg Up

In prior economic cycles, a drop in the fed funds rate quickly translated into lower payments on mortgages and credit card debt. But because homeowners are financing their purchases differently and consumers have been less apt to reach for the plastic in this cycle, there may be less of an immediate boost for consumer finances from rate cuts.

The majority of mortgages have a fixed rate, which will not be impacted by a rate cut.

To be clear, consumers with an adjustable-rate mortgage may be in store for some relief as lower rates equate to lower interest payments. Still, the economic benefits to the housing sector from rate cuts will likely be muted compared to prior cycles. Most homebuyers today are opting for fixed-rate mortgages—adjustable-rate mortgages account for only about 5% of total mortgages outstanding today, compared to roughly 30% of mortgages prior to the last recession (Figure 3). Moreover, mortgage rates in general tend to track more closely with the yield on the 10-year Treasury than the fed funds rate (Figure 4), which limits the direct effect the Fed can have on mortgage financing costs. So while some homebuyers with adjustable-rate mortgages have benefitted from the recent decline in the 10-year yield, the majority of borrowers who today have a fixed-rate mortgage will not see a change in their monthly payment from lower rates.

Another factor to consider here is that high mortgage rates are not the primary obstacle to home purchasing; that role goes to the low supply of affordable homes. Rate cuts will not address that issue. So while lower rates may ease the mortgage burden of some households, we do not see a lower rate environment engendering a surge in demand for new home purchases. Furthermore, while mortgage debt still accounts for a majority of total household debt, it is down both in total amount outstanding and as a share of total household debt throughout this cycle.

Figure 3

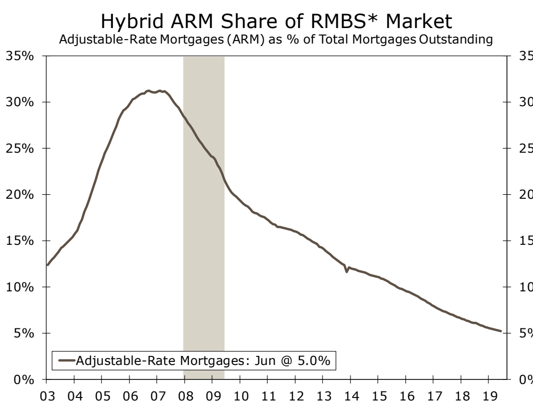
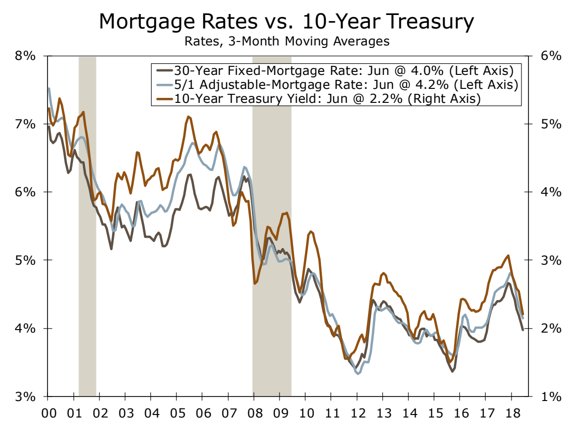


Figure 4



Source: CPR & CDR Technologies, Bloomberg LP and Wells Fargo Securities

Credit Cards: Category is Smaller than in the Prior Cycle

In terms of credit card bills, lower rates would be welcome news. The average annual percentage rate (APR) now stands at its highest level since 2001 (Figure 5). Lower rates would likely free up some cash flow for consumers, as banks traditionally alter their prime rate, or the rate they charge the most credit-worthy consumers to borrow funds, in response to fluctuations in the federal funds rate. Some consumers who carry credit card debt could therefore expect to see a lower APR on their upcoming statements, if the Fed moves forward with a rate cut this week.

Rate cuts help credit card debt, but consumers have been less apt to reach for their plastic.

Something to keep in mind here is that credit card debt has not fueled spending in this cycle as in the prior cycle. In fact, overall credit card debt is slightly lower today than it was at its height in 2008. As a share of household debt, credit card debt has fallen to 6.2% as of the first quarter of 2019 from 6.8% in 2008. For households with credit card debt, rate cuts help, but the data suggest households are reaching for their credit card a lot less than they did a decade ago.

Figure 5

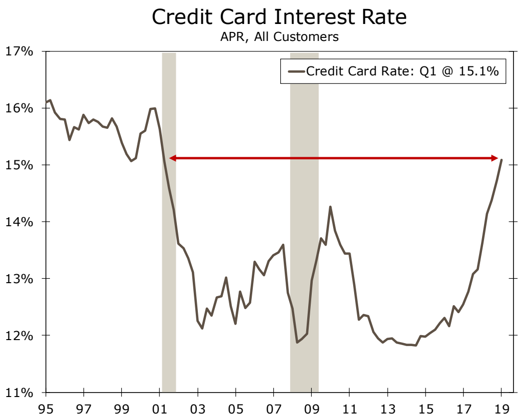
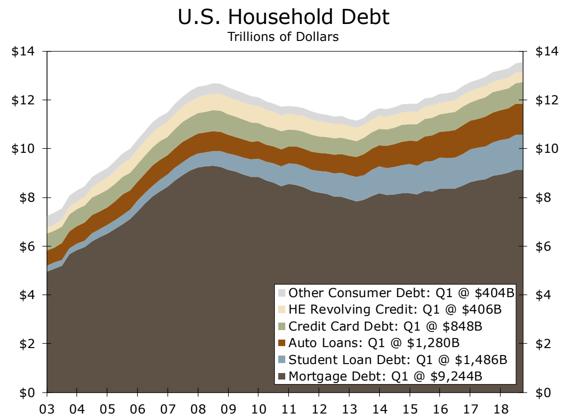


Figure 6



Source: Federal Reserve Board, Federal Reserve Bank of New York and Wells Fargo Securities

Student Loans: The $1.5 Trillion Question

As recently as 2009, student loans were the smallest category of consumer debt. Things have changed dramatically since then. As the U.S. economy shed almost nine million jobs during the recession and employees pared back hiring, a lot of displaced workers either went back to finish college or sought out advanced degrees to deepen their skill sets. That shift back to school combined with the rising cost of tuition culminated in a more than doubling of student loan debt (143.2% increase) since Q3-2008. At $1.5 trillion, student loan debt has gone from the smallest category of household debt 10 years ago to the 2nd largest (after mortgages) today (Figure 6). Further, student loans are the largest category of debt for those aged 18 to 29 years of age.

Student & auto loans typically have a fixed rate, limiting any benefit from rate cuts.

Because student loans are typically set at a fixed rate, there is limited scope for a Fed rate cut to meaningfully decrease costs for these borrowers. That can be discouraging for those holding large college bills, and the squeeze has been more acute among younger borrowers.

Auto Loans: The Priority Payment

Auto loan debt is the only other category that has grown as a share of total household debt over the past decade (reference Figure 2). Not only are total auto loans outstanding more than half again as large as they were in 2008 (up 58.2% to $1.3 trillion), they also represents a record share of total household debt at 9.4%.

For households struggling to make ends meet, the reality sets in that you can't drive your house to work. An analysis by TransUnion found that of those consumers who have a bankcard, auto loan and a mortgage, those households are far more likely to default first on a mortgage than on any of the other two trade types, rather than miss a car payment[2]. Auto loans are also typically fixed-rate loans, which means that even for cash-strapped consumers who are most likely to make the car payment a priority, a rate cut brings no relief.

Conclusion

As the Fed guides interest rates lower in the second half of 2019 two things stand out to us as different from prior cycles. The first is that with the unemployment rate near an all-time low and consumer spending growing at a brisk 4.3% pace in the second quarter, it is not altogether clear that easier money is what is most needed at the moment for the consumer. The second point and the thrust of this special report is that student and auto loans have driven all of the growth in household debt in this cycle. Because these categories tend to have a fixed interest rate, lower rates will have very little effect on these categories, though it will provide some wiggle room for the shrinking share of households with adjustable-rate mortgages and credit card debt.

[2] **"Payment Hierarch Analysis: A Study of Changes in Consumer Payment Prioritization from 2007-2011", TransUnion White Paper, Komos, Reardon, Wise and Becker, 2012.**

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

WELLS FARGO SECURITIES