MOODY'S
ANALYTICS

COMMENTARY
25 March, 2024

Author
Mark Zandi

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

U.S. Economic Outlook: Wealth Effects

The runup in stock prices and housing values since the pandemic is eye-popping, reflecting the strong economy and helping to power it. But prices may be too pricey and vulnerable to a significant correction. Asset prices would quickly swing from providing a tailwind to growth to potentially undermining it.

- The U.S. economy is doing well, helped by the big boost to investor and household wealth.
- But the pricey stock and housing markets may be vulnerable to correction.
- If the Fed does not begin to lower interest rates soon, investors could head for the door.
- A garden-variety correction in stock prices and a single-digit peak-to-trough decline in housing values would weigh on the economy but should not undermine it.
- Sustained double-digit price declines, however, could be too much for the economy to bear.

The U.S. economy is performing well. The economy's strong performance has helped propel stock prices and housing values higher. In turn, those high prices have lifted household wealth, consumer spending and the economy. But prices look pricey and vulnerable to a correction, particularly as long as the Fed maintains a tight monetary policy. While there are good reasons to think asset prices will hold more or less firm, there is a meaningful risk they will not. This risk poses a threat to the economy.

It is hard to quibble with how well the economy is doing. Real GDP expanded by a strong 2.5% last year and is set to increase by close to 2% annualized in the first quarter of this year. This is near the economy's estimated potential growth. Thus, businesses continue to create jobs at a rate sufficient to maintain unemployment below 4%, consistent with full employment.

The biggest surprise is just how many jobs the economy is creating. Payrolls are increasing by approximately 250,000 per month on average (abstracting from the vagaries of the data). This is almost double the pace Moody's Analytics had anticipated for the time when the economy reached full employment. This is because of surging foreign immigration. Immigration poses significant challenges to many communities, but the benefit is that it is lifting labor supply, allowing for stronger job and economic growth without fanning inflation. Indeed, inflation continues to moderate, and on a harmonized basis is already back to the Federal Reserve's inflation target.

Up, up and away

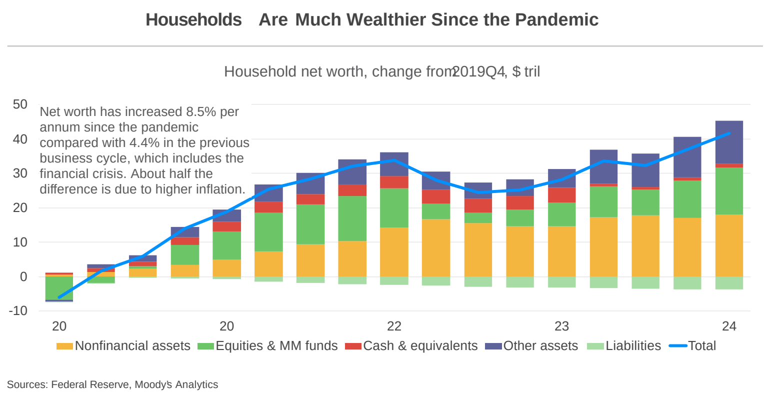
The resilient economy is the fundamental reason for the surge in stock prices. The Wilshire 5000, which measures the value of all U.S. publicly traded stocks, is up close to an astonishing 60% since the pandemic hit four years ago. Almost half this gain has come in the last six months as it became clear that the economy would not suffer the recession feared by many economists and investors, and inflation was receding enough to end Federal Reserve rate hikes. Indeed, the Fed is set to cut rates in the not-too-distant future.

Corporate bond spreads also have narrowed significantly. The difference between the yield on high-yield (below-investment-grade) corporate bonds and risk-free 10-year Treasury bonds is thin at just over 3 percentage points. The spread is the compensation bond investors receive for taking the risk that corporate borrowers will not make timely payments on their bonds. Since the high-yield market was established in the mid-1990s, the spread has been closer to 5 percentage points on average. There are few times in history that spreads have been as narrow.

House prices have also taken off. They are up almost 50% nationwide since the pandemic hit. Most of the runup was early on in the pandemic, when record-low mortgage rates and the shift to remote work juiced-up housing demand. But even since these tailwinds turned into headwinds with higher rates and a shift back to the office, prices have held up well and are still rising strongly in many parts of the country.

Wealth effect

The surge in asset prices has made many Americans much wealthier. Household net worth—the estimated difference between what households own and what they owe—has increased by more than $40 trillion since the pandemic.



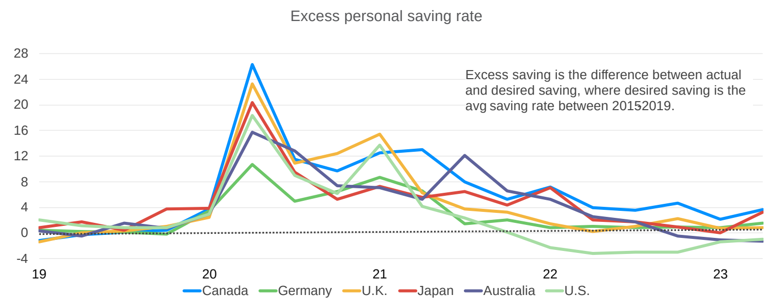
The average household has seen its net worth increase by nearly $325,000 in just four years. Almost half the increase is due to appreciating stock prices and the other half to higher house prices and increased homeowner equity. Household debt and other liabilities have also increased, but only modestly compared with the increase in households' asset holdings.

Of course, the after-inflation increase in net worth is not quite as impressive given the surge in inflation since the pandemic. And asset holdings are highly concentrated; two-thirds of households own their home, and no more than half own stocks of any consequence. Moreover, according to the Fed's Distributional Financial Accounts, households in the top decile of the wealth distribution hold nearly two-thirds of the nation's net worth.

Nonetheless, the massive increase in household wealth has been a powerful tailwind to consumer spending via the so-called wealth effect. Wealthier households are able and willing to spend more out of current income and save less. In typical times, we estimate the wealth effect to be approximately 3 cents. That is, every dollar increase in net worth powers a 3-cent increase in consumer spending. These are not typical times, and given how concentrated the increase in wealth has been, the effect may be smaller. But since the excess savings built up during the pandemic have gone mostly into easily accessible checking accounts, the wealth effect could be larger. Sticking with the 3-cent estimate, the wealth effect alone has added 0.35% to per annum real GDP growth over the past four years.

Surging household wealth and buoyant consumers distinguish the U.S. from most everywhere else in the world. Household stock holdings are meaningfully lower overseas, and asset prices have not risen as much. Surging net worth here at home and the wealth effect go a long way to explaining why American consumers have been willing to draw down the excess savings they accumulated in the pandemic, while consumers in other countries have not.

American Consumers Have Been Willing to Spend Excess Savings



Sources: Eurostat, ONS, Canada Statistics, BLS, Japan Statistics Bureau, Moodys Analytics

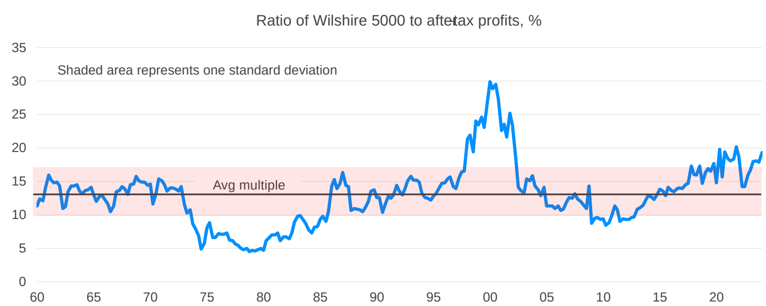
And this helps explain why the U.S. economy has outperformed nearly all others since the pandemic.

Prices are pricey

The wealth effect has been a boon to the U.S. economy, but it is also a vulnerability, since asset prices now look pricey and at increasing risk of a serious correction. This is especially so if the Fed does not soon follow through on the rising expectation that it will cut interest rates.

Stocks look richly overvalued by any measure. There are different measures of valuation, but particularly useful is the economy-wide price-to-earnings ratio, which is equal to the ratio of the Wilshire 5000 and corporate profits from the Bureau of Economic Analysis. As of last year's fourth quarter, the economy-wide PE ratio was close to 20 times, and it is sure to have risen significantly in the first quarter of this year given the massive stock market rally and despite what appears to be a solid increase in earnings.

Stock Market Is Richly Overvalued



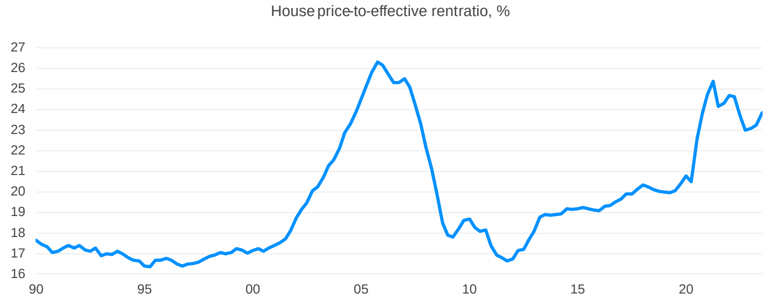
Sources: BEA, Moodys Analytics

This is far from the peak PE ratio of 30 times during the height of the internet stock bubble but is more than a standard deviation above the long-run average PE ratio of 13 times.

There are good reasons why the stock market's valuation should be high. Corporate profits jumped during the pandemic, and profit margins have never been higher, even after abstracting from the ups and downs in the business cycle. The market is also being driven primarily by the so-called magnificent seven technology stocks that are benefiting from the investor euphoria over the potential business opportunities created by artificial intelligence. Valuations for these companies have gone parabolic, while valuations for the rest of the market are high but pedestrian by comparison. These caveats notwithstanding, the market's valuation feels precarious.

House prices also appear stretched, as evidenced by the high house price-to-effective rent ratio.

Single -Family Housing Is Expensive



Sources: BEA, Moody's Analytics

The value of a home is ultimately tied to the future rent it will produce either if actually rented or implicitly if the owner lives in the home. The current PR ratio is close to 24 times. This is just below the record of 27 times hit during the housing bubble but well above its long-run average of 18 times. That valuations have remained so high given the doubling in mortgage rates since just prior to the pandemic is especially surprising.

Of course, the high valuations are supported in part by the unprecedented lack of housing supply. Most existing homeowners are effectively locked in to their homes with mortgages at interest rates near 3.5%. With new mortgage rates about double that, moving can result in a big increase in monthly payments particularly given the increase in house prices. So, homeowners are not moving, and there are few homes for sale. A severe shortfall of new housing supply since the collapse in homebuilding during the financial crisis is also keeping house prices and valuations up. The homeowner vacancy rate is hovering near a record low. For some semblance of normalcy to return to the housing market, something has to give—mortgage rates need to decline, incomes rise, and/or house prices cool considerably.

Waiting on the Fed

The most likely (our baseline) scenario is that stock prices and housing values go more-or-less sideways for a year—or two or three—and allow corporate earnings and rents to catch up and valuations to normalize at least partially. Critical to this relative optimism is the view that interest rates have peaked. It is testament to the fundamental strength of the stock and housing markets that prices held up so well in the face of the Fed's unprecedented interest rate hikes and the near tripling in 10-year Treasury yields and fixed mortgage rates in 2022. Indeed, aside from an outright recession, it is difficult to envisage a more rigorous test of the resilience of stock prices and housing values.

That said, the widespread expectation is that the Fed will soon begin to ease monetary policy. Like most investors, we expect three quarter-point rate cuts to the federal funds rate this year, the first occurring in June, and then approximately one 25-basis point cut each quarter until the funds rate settles into its long-run equilibrium. The funds rate will fall from 5.5% today to 3% by 2026. But if the Fed fails to begin cutting rates soon—for whatever reason—given the sky-high valuations, investors seem likely to run for the door, driving up long-term rates and pushing down stock prices and housing values.

A garden-variety correction in stock prices, say a decline of not much more than 10%, and a single-digit peak-to-trough decline in housing values would weigh on the economy but should not undermine it. After all, declines of this magnitude would only retrace part of the runup in prices since the pandemic. Moreover, judging by how well the financial system and economy are digesting the current slump in commercial real estate prices, which we estimate are down almost 15% since their peak nearly two years ago, a modest decline in stock prices and house prices should not kill the economic expansion. However, sustained price declines in the double digits would likely be too much for the economy to bear. And if prices continue to march quickly higher from here, stretching valuations even more, a darker scenario is more likely to unfold.