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Financial Matters

**SPECIALIZING IN FINANCIAL MANAGEMENT AND INVESTMENT PLANNING
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Consumer Debt has Always Been the X Factor

Consumer debt has always been the X factor in making economic projections. Since consumer spending supports about two thirds of the economy, where the consumer gets his money is critical to forecasting.

An article in Fortune magazine pointed out that consumer use of debt would have to slow down and the nation would have to figure out a way to get itself out of hock. That appeared in March 1956...long before Starbucks credit cards and ATMs. Not much has changed!

The anti-debt crowd is quick to point out that this recovery will stall because the consumer has been living on borrowed money, credit cards are maxed out, or as Tennessee Ernie once sang "he owes his soul to the company store". Fortunately, our consumer will not have to "load 16 tons" of coal tomorrow to keep afloat.

Several factors have combined to support current levels of consumer debt. Lower interest rates have reduced the overall cost of borrowing. As our population ages and owns their homes longer, equity buildup and subsequent refinancing activities provide a ready source of capital to pay down short-term consumer debt.

Unlike the recession of 1990-91, core job loss has been relatively mild in the last few years. With employment stability comes confidence to incur debt-particularly as real wages rise, as has been the case. Granted, a consumer can borrow more, but the real issue focuses on the consumer's ratio of debt to income and the ability to repay.

For example, if the carrying cost of this debt were to rise, relative to income, such as would be the case with significant interest rate increases, the consumer would be forced to spend more of his income on carrying cost and debt reduction at the cost to the economy of a reduction of consumer spending. The same would be the case if unemployment struck deep or wages decreased...not likely to happen.

Installment debt dates back to the 1920s when General Motors first came up with the idea of extending credit to auto buyers. No longer did consumers have to save to buy furniture or a new refrigerator. They could buy and enjoy it now...and pay from income earned later. It materially advanced the living standards of our populace.

Consumer borrowing fell off during the Great Depression but accelerated after WWII when it was clear the Mark and Yen would not be our currency. But studies have shown that consumer debt reaches a certain point then tends to level off.

Jason Benderly, of Benderly Economics, studied the propensity to borrow and consume and concluded that over 56 years since 1946, consumer borrowing habits don't appear to have changed at all. His work concluded that the average maturity of consumer debt had been relatively stable at 3.5 years, meaning that roughly each year consumers borrow 10 cents for every dollar of after-tax income.

Barron's columnist Gene Epstein noted recently that another measure of debt burden—debt payments to disposable personal income—shows that consumer debt has not grown beyond historical norms. According to Federal Reserve figures as of the third quarter of 2001, the consumer was spending 7.7 cents out of each after-tax dollar to pay off their debts, a full penny lower than the peak of 8.7 cents in the first quarter of 1980.

He notes that since 1996 when the consumption boom really began, this ratio has grown by only 0.1 cents per year.

If you have any questions on your savings or spending strategies please give us a call at 732-224-9900.