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The Household Wealth Effect – From Wall Street to Main Street

Executive Summary

- American consumers have been remarkably resilient since 2019. One of the primary reasons is the tremendous rise in household net worth that has occurred over the last five years. In this piece, we focus on the concept of household net worth, its distribution across income cohorts, historical comparisons, and what it might mean for the future state of the U.S. consumer.
- A breakdown of the data by income quintiles shows a wealth concentration in the top 20% of U.S. households, who are much more likely to own stocks or a home and are less sensitive to rising interest rates.
- The primary impact of a rise in household net worth is on consumer confidence, as households feel more financially secure—a dynamic known as the "wealth effect." We are monitoring key risks that might cause the cycle to invert, including geopolitical uncertainty, the upcoming U.S. election, and the evolution of the labor market.
- We also see mitigating factors that would likely make any slowdown shallow, including the Fed's ability and willingness to ease monetary policy to preserve the health of the labor market, and strong household balance sheets.
- A shallow economic slowdown could create near-term market volatility. Despite the uncertainty in this environment, the foundations of the economy remain solid, productivity is expected to keep improving, and artificial intelligence (AI) and other technological breakthroughs are only in their nascent stages.
- We therefore reiterate the importance of staying invested through market volatility, and believe that a disciplined, diversified investment approach—one anchored in strategic asset allocation and augmented by tactical asset allocation nimbleness—is most prudent for helping investors to achieve their long-term financial goals.

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The U.S. consumer has been an exceptional driver of economic growth since 2020, defying expectations that household consumption would eventually succumb to higher interest rates and to the erosion of purchasing power. Since January 2021, personal consumption expenditures (which account for two-thirds of total Gross Domestic Product [GDP]) have grown at an 8.4% annualized rate, compared to a 3.9% annualized rate between 2010 and 2019. Even after adjusting for inflation, personal spending has risen 3.8% annualized since 2021, compared to 2.4% between 2010 and 2019.

There are several dynamics that have allowed U.S. households to better withstand inflationary pressures:

- Unusually large savings accumulated during the pandemic, which provided consumers with an important buffer to partially offset the sharp rise in prices of goods and services.
- A strong labor market that has supported robust income growth. We view continued employment growth as crucial to the health of the U.S. consumer going forward.
- A tremendous rise in household net worth, measured as the sum of financial and non-financial assets (homes, cars, stocks, bonds, cash, etc.) held by U.S.

households, net of all liabilities including mortgages and credit card debt. Federal Reserve (Fed) data shows that U.S. households, in aggregate, are 12% wealthier than they were two years ago, and 40% wealthier than they were at the end of 2019.

In this Focus*Point*, we delve into the concept of household net worth, how it is distributed across different income cohorts, how current levels compare to history, and what it all means for the future state of the U.S. consumer.

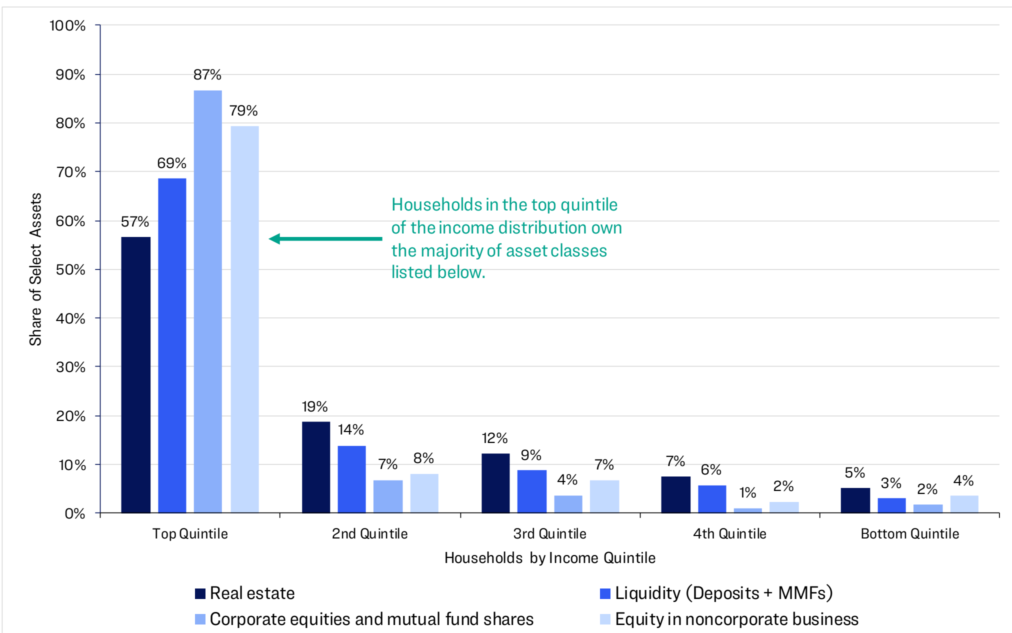
The distribution of household net worth

The solid increase in net worth since 2019 has been driven by strong price performance across several financial and non-financial assets, from equities to real estate, and including "liquid" assets (bank deposits and money market fund holdings) that were boosted by fiscal stimulus directly targeted at supporting household consumption during the pandemic. However, a breakdown of the data by income quintiles (Figure 1) shows that the majority of this positive impulse is likely to be concentrated in the top 20% of U.S. households, who are much more likely to own stocks or a home.

This has created a more bifurcated economy where higher-income households have benefitted from the sharp rise in financial (like stocks) and non-financial (like housing) asset prices. At the same time, these households have been less sensitive to higher interest rates as 70% of all outstanding mortgages originated at fixed rates lower than 5% (the average effective mortgage rate in the U.S. was still 3.9% as of Q2 2024). On the other hand, households with a smaller exposure to investment and residential holdings, and more reliance on debt with floating rates such as credit card and auto loans, have been more vulnerable. This is also evident in the distribution of "liquid" assets, which have grown by 5% for households in the bottom 60% of the income distribution and 13% for households in the top 20% of the income distribution since the end of 2019, after accounting for inflation.

FIGURE 1

Share of financial and non-financial assets owned by households, by income quintile.



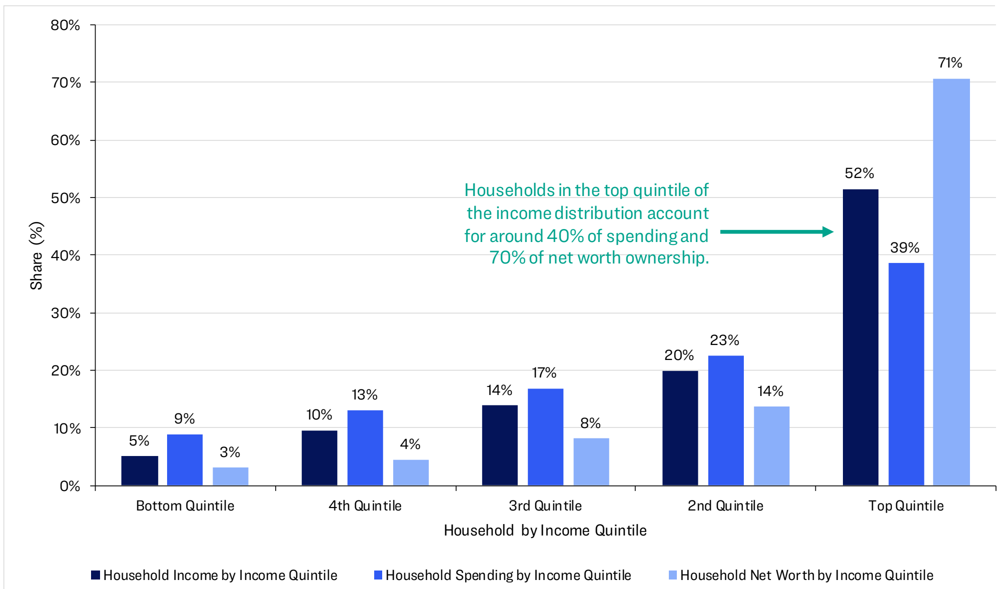
Source: Federal Reserve, TIAA Wealth Chief Investment Office. Data through 6/30/2024.

The wealth effect

Given that households in the top two quintiles of the income distribution control 85% of all household net worth in the U.S. and account for 62% of household consumption (Figure 2), a growing net worth that is now equal to more than 6 times total personal income (Figure 3) has increasingly become a key driver of household consumption over time. However, a historical comparison shows why this standalone metric holds little predictive power and is better characterized as a "coincident" economic indicator that reflects the performance of financial and non-financial assets owned by households over a certain timeframe. In fact, the 12% growth in net worth between Q2 2022 and Q2 2024 is similar to what occurred on average in the two years leading up to the four recessions that have occurred since 1988. Moreover, the elevated price inflation that has prevailed since 2021 has eroded more than half of this growth, so that inflation-adjusted net worth has grown by less than it did on average in past episodes (Figure 4).

FIGURE 2

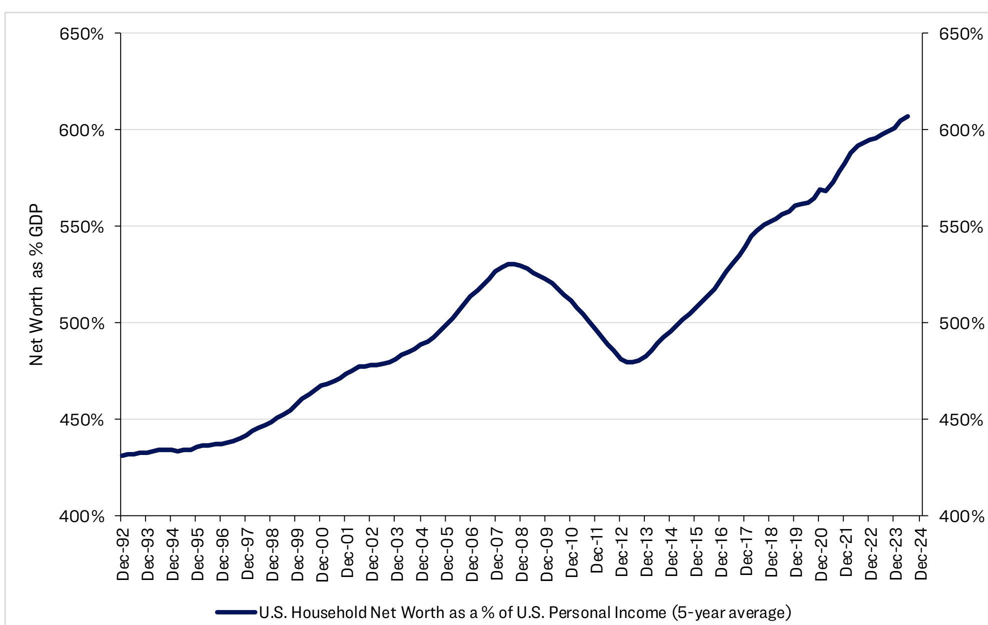
Households income, spending and net worth by income quintile.



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, TIAA Wealth Chief Investment Office. Data through 6/30/2024.

FIGURE 3

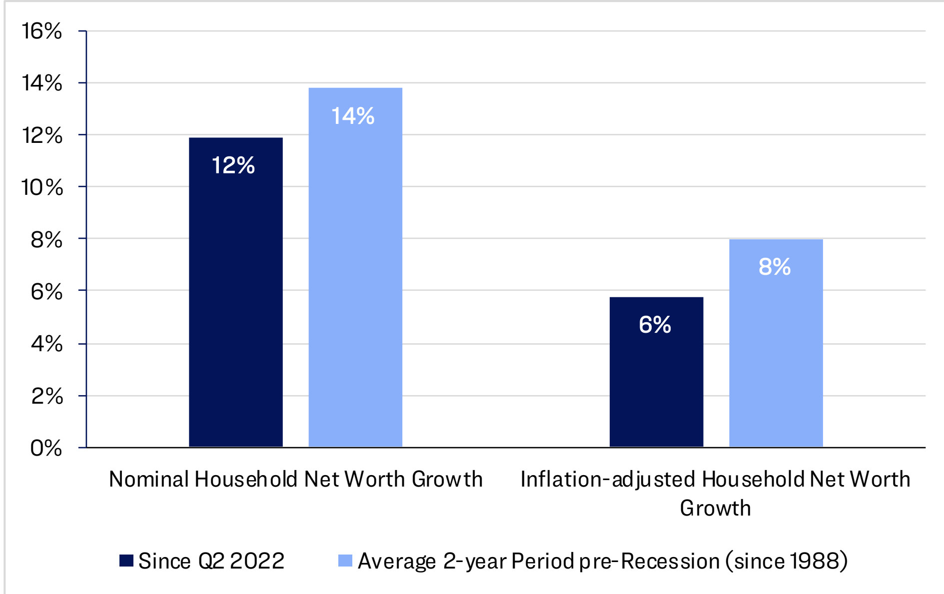
Net worth as a percentage of personal income.



Source: Bureau of Economic Analysis, Federal Reserve, TIAA Wealth Chief Investment Office. Data through 6/30/2024.

FIGURE 4

Nominal and inflation-adjusted household net worth: a historical comparison.



Source: Federal Reserve, TIAA Wealth Chief Investment Office. Data through 6/30/2024.

The primary impact of a rise in household net worth is on consumer confidence, as households feel more financially secure—a dynamic known as the "wealth effect." Higher asset prices lead to stronger confidence, which in turn drives robust consumption, surging corporate revenue and earnings, and therefore even higher asset prices, creating a virtuous cycle. Past experience demonstrates that this sequence can be interrupted by unexpected developments that reverse the self-reinforcing mechanism described above. From extreme events like the Great Financial Crisis (2007), the Dotcom bubble (2000) or the Covid pandemic (2020), to more textbook economic slowdowns (1990/'91), triggers that lead to lower asset prices can reverse the cycle. Reduced or stagnant net worth causes a drop in confidence, weaker consumption and corporate earnings, rising layoffs, and hence more market volatility.

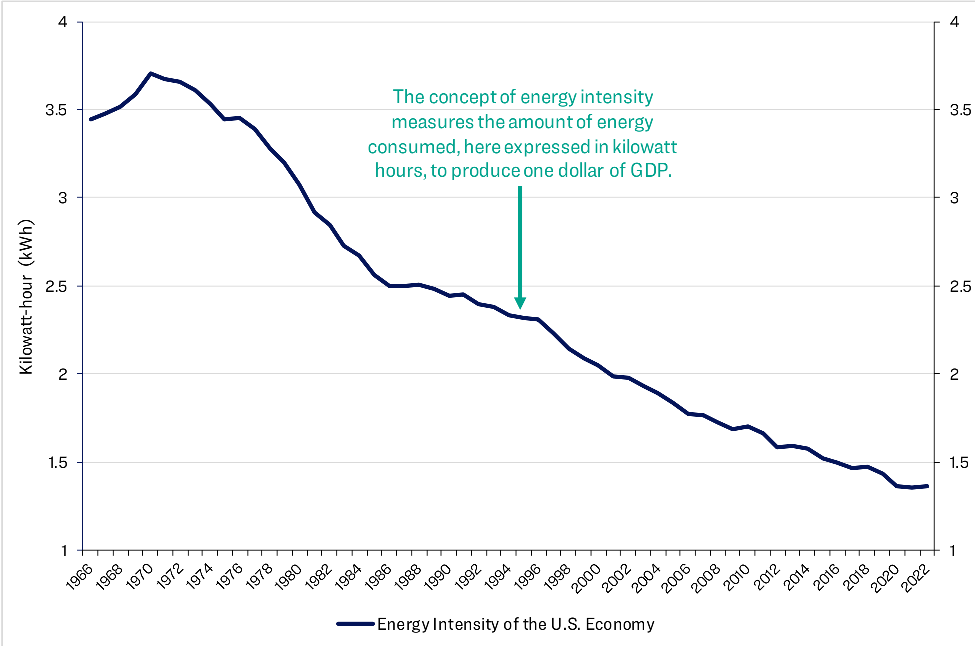
We therefore focus on monitoring those risks that could weaken the wealth effect in the current environment:

1. Geopolitics are top of mind given escalating tensions in the Middle East. The war between Israel and Hamas has already extended to Lebanon and Hezbollah, a key military proxy for Iran. If the conflict ever extends to Iran itself, global ramifications could become some significant. Iran produces around 3.2 million barrels of crude oil per day, or ~3% of global production. While member countries of the Organization of Petroleum Exporting Countries (OPEC) should have enough spare capacity to offset a partial or total loss of Iranian oil supply, a broadening conflict in the Middle East would very likely cause a sharp rise in oil prices, with direct ramifications to gasoline prices as well as consumer and business sentiment. This being said, the U.S. economy has progressively become less sensitive to changes in oil prices over the past two decades. The amount of energy consumed to produce one dollar of GDP, defined as energy intensity of the economy, has more than halved since the 1970s (Figure 5).

   When assessing the geopolitical landscape, a key and potentially much more disruptive risk is also represented by a Chinese invasion of Taiwan, where 60% of the world's semiconductors are produced. However, this event seems unlikely in the near-term.

FIGURE 5

Energy intensity of the U.S. Economy, measured as energy consumption per unit of GDP.



Source: U.S. Energy Information Administration, TIAA Wealth Chief Investment Office. Data through 3/31/2022.

2. As we discussed in our October issue of CIO Perspectives "Electionomics," the outcome of the upcoming U.S. election could alter the fundamental picture in a few different ways.

    - Former President Trump has been vocal about his plans to impose a 60% tariff on all Chinese goods imported into the U.S., and a 10% blanket tariff on all other imported goods. Escalating trade tensions could have far-reaching consequences, from higher market volatility to a spike in consumer prices, to lower corporate profit margins. Given the broad latitude at the President's disposal to enact trade tariffs without congressional approval, we are particularly attuned to this risk.

    - Both Republican and Democratic economic agendas, if enacted in their current proposed forms, could cause a material rise in the national debt, beyond what is already projected by the Congressional Budget Office. As we discussed here and here, the dominant role of U.S. capital markets globally reduces the risk of a debt crisis. However, the lack of fiscal discipline could eventually engender considerable interest rate and market volatility.

    - Vice President Harris is proposing a range of higher tax rates for higher-income individuals, corporations, and capital gains. Higher taxes would directly impact consumer and business sentiment, disposable income, and corporate earnings. Many provisions of the Tax Cuts and Jobs Act (TCJA) that lowered taxes for all households in 2017 are set to expire at the end of 2025, making it more likely that taxes could increase at least for higher-income individuals.

3. The labor market could continue to soften even in the absence of a specific catalyst, especially if restrictive rates continue to pressure small businesses and falling hiring intentions give way to rising layoffs. However, this has not happened so far, and there are several reasons to believe that any "garden-variety" economic slowdown—one not caused by an exogenous shock—would be relatively shallow:

    - The Fed's decision to cut the policy rate by 50 basis points (bps) in September underlines the committee's determination to protect the labor market. With the Fed Funds rate still elevated (4.75% - 5% range), the Fed has plenty of room to ease monetary policy in response to any further weakening of labor market conditions.

    - After recovering from the depths of the Covid pandemic, employment in the U.S. is just slightly above the long-term trend compared to the peaks in 2000 and 2007, when non-farm payrolls were 5 million jobs or more above trend (Figure 6). This implies that businesses are unlikely to view headcount as excessive, which should limit any job losses.

    - Household debt has fallen sharply as a percentage of GDP since 2008 (when it was ~100% of GDP), and it now stands at ~70%. In addition, households pay less than 10% of their disposable income to cover debt payments, down from almost 14% in 2008. In other words, it is less likely that U.S. consumers would have to drastically change spending habits to face mounting debt payments.

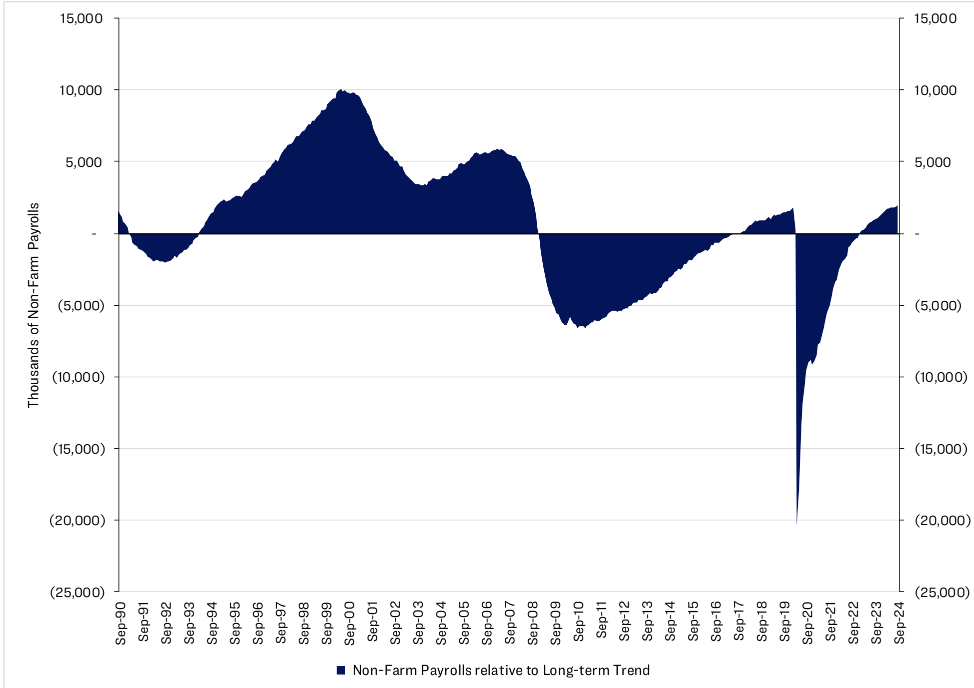
    - Banks are extremely well capitalized. The Fed runs a strict and comprehensive stress test every year to see how U.S. depository institutions would fare under a severely adverse scenario, and the results show a resilient banking system (with some vulnerabilities among small and regional banks). As a result, banks are well equipped to keep the credit tap for consumers open through a slowdown.

    - Finally, while the housing market was oversupplied and overleveraged in 2007, the opposite is true today. At the end of 2007, almost 3% of all homes in the U.S. were vacant, and there were almost 4 million homes on the market. Today, the vacancy rate is 0.9%, and the inventory of homes for sale is only 1.35 million units. Finally, the share of total outstanding mortgages that have adjustable rates and are therefore vulnerable to the sharp rise in interest rates since 2022 is less than 5%, down from more than 30% in 2006. All considered, we don't see the conditions for a material drop in home prices.

A shallow economic slowdown could create some market volatility, especially given that both equity valuations and credit spreads are more expensive than 90% of all historical observations going back almost 40 years. This could make financial assets relatively more vulnerable to a less supportive economic backdrop and impair the wealth effect, but not engender durable weakness, given the healthy fundamental backdrop described above.

FIGURE 6

Non-farm payrolls relative to the long-term trend.



Source: Bureau of Labor Statistics, TIAA Wealth Chief Investment Office. Data through 9/30/2024.

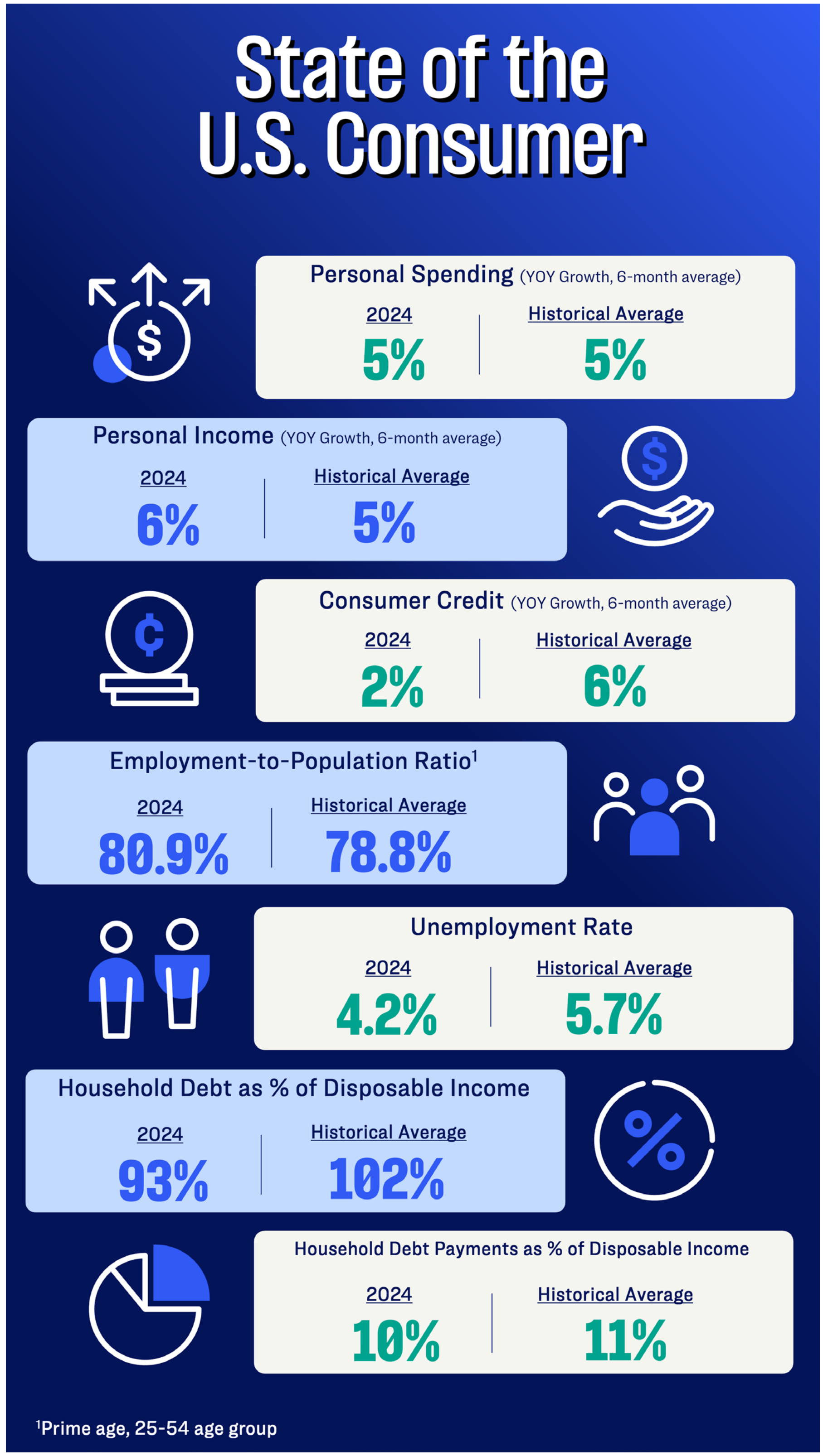
Conclusions

A resilient labor market and healthy U.S. household consumption, coupled with the Fed's proactiveness in normalizing monetary policy from restrictive levels, are driving the steady rise in asset prices, which is in turn boosting the wealth effect. We are monitoring key risks to this important dynamic given our view that consumers are ultimately reliant on the health of the labor market, with higher net worth functioning as a complement rather than a supplement to income growth. Geopolitics, the upcoming U.S. election, and the evolution of employment conditions are top of mind for us.

That said, in this environment where the foundations of the economy are solid, productivity (a key element of long-term economic growth) is expected to keep improving, and artificial intelligence and other technological breakthroughs are only in their nascent stages, we reiterate the importance of staying invested through market volatility. We recommend a disciplined and diversified strategic asset allocation approach focused on achieving long-term goals, as well as a prudent tactical allocation approach designed to provide nimbleness during periods of uncertainty and any changes to our baseline outlook.

FIGURE 7

Labor market conditions, even after softening over the past few months, remain more robust than historical averages, supporting income growth. At the same time, households have significantly reduced their indebtedness since 2007 and spend much less of their disposable income to service debt payments. The result is a more resilient U.S. consumer with the wherewithal to keep spending.



Source: Bureau of Economic Analysis, Federal Reserve, Bureau of Labor Statistics, Bloomberg, TIAA Wealth Chief Investment Office. Historical average data from 1/1/1988 – 8/31/2024.

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