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Economic Outlook

Wealth Enhancement and Storage

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The desire to enhance and store wealth has been present ever since income rose above subsistence levels. In ancient times, prior to the creation of symbolic financial claims on wealth, wealth storage was, quite literally, the storage of intrinsically valuable articles in temples, pyramids, or other such formidable structures. Even today in Tibet, which was long a theocracy, a major repository of wealth can be seen in religious statues of solid gold resting in temples.

The enhancement and storage of wealth by individuals—as opposed to kings or religious organizations—grew rapidly after the Middle Ages. Italian and Dutch traders amassed great fortunes in the fifteenth and sixteenth centuries. After the Industrial Revolution, large fortunes were accumulated in England. The accumulation of great wealth always brought with it problems of enhancement and storage. Enhancement often meant moving into businesses unrelated to those that first created the wealth for an individual or family. When the desire for wealth enhancement (as opposed to wealth storage) grew too intense, fortunes were sometimes lost. Striking the right balance has defined successful wealth management.

The dangerous stage for many wealth managers arises when the prospects for wealth enhancement (as opposed to storage) seem to become overwhelmingly attractive. Bubbles arise, be they tied to the price of tulips, tech stocks, or Miami condos. A bubble occurs when investors believe that purchasing a particular means of storing wealth will yield such strong returns that a substantial rise in living standards will be possible much sooner—and for many more people—than previously imagined. Journalist Samuel Crowther's 1929 interview with General Motors financial executive John J. Raskob, published in *Ladies' Home Journal* under the title "Everybody Ought to Be Rich," comes to mind. It cited an expected annual return on stocks of 24 percent.[1] Contemporary examples abound in print and on television about how to grow rich in real estate. Some people do. Many do not.

The prevalence of postbubble regrets notwithstanding, there is substantial evidence that the United States enjoyed a remarkably strong period of wealth creation during the 1990s. That experience convinced many households that wealth enhancement did not require saving out of disposable income, as evidenced by a substantial drop in the personal savings rate from a long-term average of around 8 percent of disposable income between 1960 and 1990 to just 2 percent by 2000. Thereafter, by 2004, a credit boom, which enabled households to convert rapid gains on home values into cash, was associated with a drop in the measured savings rate virtually to zero.

A major question surrounding the outlook for the U.S. economy, in terms of the length and depth of the current recession, concerns the pace at which Americans will restrict spending relative to (falling) income, first to arrest the drop in accumulated wealth and subsequently to restore wealth.

Old-Fashioned Wealth Management

In nineteenth-century England, wealth management, at least viewed retrospectively a century and a half later, was relatively simple. As England

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industrialized, the middle class, which built the factories and railways and conducted England's growing global trade, accumulated wealth and stored it in British consuls. Consuls were long-term bonds issued by the British government, and their yield varied roughly between 5 percent at the start of the nineteenth century and 2.5 percent at the end. The long-term drop in yields on consuls was largely associated with a century of relative peace after the British victory at Waterloo in 1815. The absence of war meant the absence of wartime finance and inflation.

There were minor wars and accompanying oscillations of yields on consuls throughout the century. A primary day-to-day preoccupation of British investors was the price of consuls. Soames Forsyte, the main character in John Galsworthy's *Forsyte Saga*, personified the attitude of the British wealthy middle class—as opposed to the upper class, whose wealth was based on ownership of land. Soames's dinnertime conversation with his uncles about wealth management, as opposed to the running of businesses, centered mainly on the price of consuls, since they were the primary vehicle of wealth storage for England's middle class during the nineteenth century. Prices fell and yields rose upon the prospect of war, as in the cases of the Boer War in 1899 and World War I in 1914. The onset of peace and the prospect of easier government finances usually produced a rally in consul prices. Throughout such cycles, the underlying presumption remained that the way to enhance wealth was to live well within one's income so that asset holdings could grow. The rich grew richer if their spending grew more slowly than their income from wealth. The same was true for the not-so-rich.

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Britain's new wealthy in the latter half of the nineteenth century had generally worked hard in business, accumulated wealth, and meant to maintain it or enhance it in perpetuity for themselves and their heirs. One wanted to accumulate enough assets so that the yield on those assets would pay for a handsome lifestyle without cutting into capital, the stock of wealth that yielded the income on which to live. A person described as having "£100,000 a year" was a person with assets the income from which amounted to £100,000 a year. At 3 percent, that meant holdings of consuls and other assets worth over £3.3 million—a substantial fortune—in the hundreds of millions of dollars in today's world.

There were, of course, other assets available to British investors, some with considerably higher rates of return and more risk. Inflation was low and stable in the nineteenth century and drifted downward toward the end of the century, thereby enabling the nominal yield on consuls to fall as purchasing power remained steady.

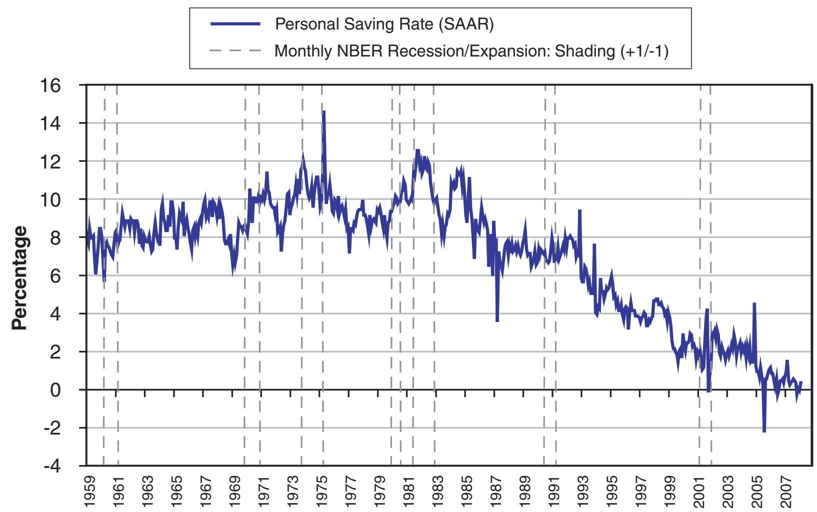
Underlying Realities

Long-term real yields between 3 and 3.5 percent on low-risk assets like claims on stable governments constitute a sort of a norm in the world of wealth storage and enhancement. Jeremy Siegel reports that between 1802 and 1997, the real return on long-term government bonds averaged about 3.5 percent. Between 1871 and 1997, that real return had dropped to 2.8 percent, partly reflecting the downward drift in returns during the nineteenth century.[2] Underlying a long-term real return of about 3 percent on low-risk assets is the return on investment in real and human capital. Those willing to forgo current consumption in order to accumulate assets on average earn real returns of 3–4 percent for low-risk investments and higher rates for high-risk investments. Stocks are more volatile than government bonds and therefore riskier. Over that same long period from 1802 to 1997, the average real return on stocks was 7 percent, or roughly twice the average real return on bonds. The standard deviation of returns on stocks is roughly twice that on bonds, so that risk-adjusted real returns on stocks and bonds over long periods of time are roughly equal.

The postwar American experience with wealth accumulation and storage has been more complex than the British experience in the nineteenth century. The array of assets—means for wealth storage and enhancement—available to American households, especially since the 1960s, is far greater. Beyond that, inflation has been more volatile than was typical in nineteenth-century Britain because the gold standard no longer operates as an anchor on prices. The postwar period in America has seen more substantial demands on the government in the form of broadly expanded social programs begun first in the 1930s and expanded dramatically in the 1960s under Lyndon Johnson's "Great Society."

The 1967 "guns and butter" budget resulting from Johnson's simultaneous pursuit of the Great Society and the Vietnam War created more than a decade of higher inflation that persisted until 1980, when the new Federal Reserve chairman, Paul Volcker, took drastic steps to bring inflation back down. The subsequent two-and-a-half decades of falling inflation, at least until 2000, broadly coincided with higher and less volatile economic growth and enhanced returns on assets. As we struggle with the collapse of the housing bubble and recession in 2008, however, American households may be coming to terms with a more difficult environment for wealth accumulation and wealth storage.

FIGURE 1
PERSONAL SAVINGS RATE
JANUARY 1959–FEBRUARY 2008



SOURCE: Bureau of Economic Analysis, U.S. Department of Commerce.

American Wealth Expansion

Between 1960 and 2007, the real net worth of American households compounded at an average annual rate of 3.68 percent per year. That figure includes the appreciation of stocks, bonds, and real estate over the period. From 1990 to 2000, the average growth rate of real net worth for American households was 5.3 percent per year. For the growth rate of real net worth of households in the world's largest economy to have persisted for a decade at a level nearly 44 percent above its average rate during the forty-seven years from 1960 to 2007 was nothing short of extraordinary. During that period, a steady rise of house prices coupled with an extraordinary rise, particularly later in the decade, of stock prices combined to increase the growth rate of wealth of American households at an unprecedented rate.

That unusually rapid pace of wealth accumulation was accompanied by a substantial drop in savings rates by American households as well as by rapid innovation in American financial markets (see figure 1). From 1990 to 2000—the period of most rapid American wealth accumulation—the measured savings rate out of disposable income fell to 2 percent from its long-run average of 8 percent. With real returns on investments rising at twice the normal rate—certainly twice the rate enjoyed by British households in the nineteenth century—American behavior adjusted to what was perceived as a new reality. Disposable income could be virtually all consumed while wealth accumulation took care of itself through investments in the stock market and, later on, in housing. A generation of American heads of households has grown up under the impression that wealth accumulation can be left to the natural appreciation of stocks or houses.

The notion of autonomous wealth creation through the stock market suffered a severe blow in 2000, when the tech bubble burst and the broader stock market fell sharply from the highs achieved after nearly two decades of steady growth crowned by a surge of tech stocks. Between late 2000 and late 2002, the broad stock market, measured by the S&P 500 Index, fell by nearly 50 percent. Still, the savings rate remained low and subsequently fell to zero after 2004 as the housing boom took hold.

It may be that the search for an alternative vehicle for wealth accumulation, coupled with the remarkably easy credit conditions that emerged in the wake of the stock market crash, pushed American households into investments in housing as an alternative vehicle of wealth accumulation. There was plenty of help from the American tax code, which favors housing with full deductibility of interest on mortgages and favorable tax treatment of capital gains on residential real estate. Beyond that, the innovative mortgage sector had, by 2003, begun to expand radically the amount of leverage available for households wishing to purchase real estate. By 2005, the need for down payments, income documentation, and even timely mortgage payments had been largely eliminated, so that home buyers became accustomed to the notion of purchasing real estate with no money down and no need to make interest payments on a timely basis. With all this help from the credit sector—and because a strong predilection existed that there ought to be an investment that yields at least 20 percent a year—house prices, particularly in markets like Los Angeles, Miami, Las Vegas, New York, and other major metropolitan areas, soared at annual rates of 20–40 percent per year.

American Wealth Contraction

Despite the surge of house prices in major metropolitan areas, and the extraordinarily easy credit conditions that enhanced it, American households have been unable to recapture the extraordinary pace of wealth accumulation enjoyed during the 1990s. Between 2000 and 2007, the real net worth of American households rose at 2.29 percent per year—less than half the 5.3 percent annual growth rate of wealth during the 1990s, despite a concentration of double-digit house price gains in major metropolitan areas.

The current situation facing American households intent on accumulating wealth in order to sustain spending of 100 percent of disposable income is difficult. The front page of the March 26, 2008, *Wall Street Journal* reminded investors that stocks had not offered much help over the last decade, pointing out that the S&P 500 had risen only about 1.3 percent a year after dividends and inflation were factored into returns. For the last eight of those years, the number is even more discouraging—*negative* 1.4 percent a year. Currently, the S&P 500 is oscillating at levels between 11 and 18 percent below its October 9, 2007, record close. Just as stocks are flirting in bear market territory, house prices are dropping according to the Case-Shiller Price Index at a rate of 11 percent a year with the prospect of a drop from peak to trough now over 25 percent. With the prices of two major assets—stocks and housing—both falling at double-digit rates, American households are turning from strategies of wealth enhancement to wealth preservation and risk avoidance.

The least risky asset, three-month U.S. Treasury bills, has been yielding between 0.6 percent and 1.3 percent over the past month. Adjusted for inflation, this is a negative return of about 3 percent per year. Those willing to invest their money in bank certificates of deposit for six months to a year (a little riskier and a little less liquid than Treasury bills) can earn about 3.5 percent in nominal terms—not quite enough to compensate for the annual CPI inflation rate of 4 percent over the past year.

A Long Recession

The difficult experience of American households with wealth accumulation and wealth storage, especially over the past year, has profound implications for spending behavior. The presumption that emerged during the decade ending in 2000, when real net worth was rising at a rate well above 5 percent a year and saving seemed unnecessary, will have to be reexamined.

Even a modest effort by U.S. households to increase savings could cut U.S. growth substantially. Just 2 percent of U.S. disposable income is $200 billion. If U.S. households attempt to boost the savings rate from the current zero level to 2 percent, the drag on GDP would be about 1.5 percentage points. That drag, coupled with the equal drag from deleveraging in the U.S. financial sector (allowing for some overlap between the two impediments to growth) could cut U.S. growth by 3 percentage points over the coming year. Even after that retrenchment, American households would still have a traditionally measured savings rate of only about 2 percent of disposable income.

The Fed's measures in March of this year to avoid a credit meltdown that would have resulted from the collapse of Bear Stearns and perhaps other investment banks has helped to calm credit markets. But the U.S. economic crisis resulting from a collapse of the housing bubble and falling stock prices that combine to hammer U.S. household balance sheets is just beginning. Even the Federal Reserve has acknowledged that U.S. growth will probably be negative during the first half of 2008. The Fed's outlook still looks for a rebound in the second half of the year. While tax rebate checks may boost growth slightly in the third quarter, the persistent drag from wealth losses as house prices and stocks fall and households begin saving again—coupled with bank deleveraging—will undercut the Fed's forecast for a sustainable growth rebound. Instead, a prolonged U.S. recession looks like the more probable outcome.

Notes

1. Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw Hill, 1998), 3.
2. Ibid., 15.