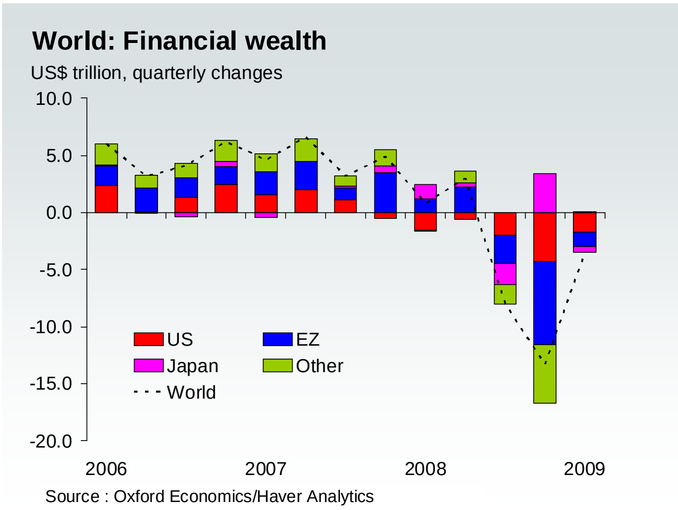
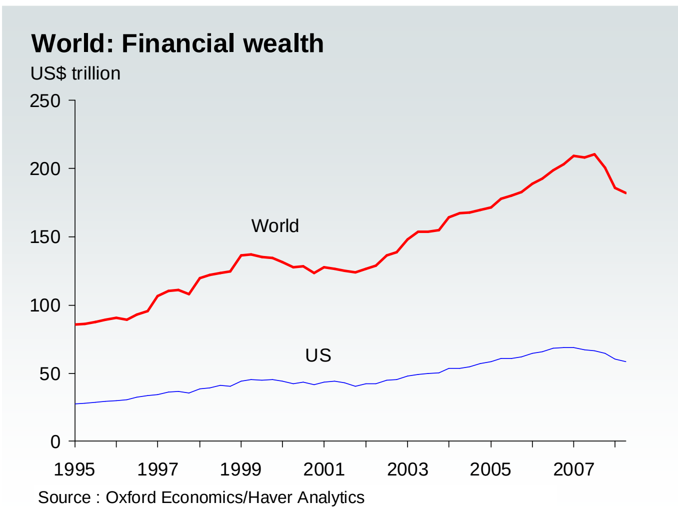
Slump in wealth to hinder global recovery prospects?

Since the credit crunch began in Q3 2007, there has been a dramatic slump in the prices of many financial assets. Global equity prices have dropped some 40-50% from their peaks in the major economies and by as much as 70% in some emerging markets. Many classes of other private sector securities have also seen sharp falls in value. Corporate bond spreads have exploded as defaults have soared, as have mortgage-backed securities (MBS). Currently, many classes of MBSs are trading at less than 10% of their par value, and even AAA-rated tranches are trading at as little of 25% of par.

This has led to a very substantial drop in global financial wealth. Oxford Economics estimates than total financial wealth has fallen some US$28 trillion, or 14% from its peak. In absolute terms, this has taken wealth back to the level prevailing in Q3 2006. These losses are somewhat larger, relatively speaking, than seen in the wake of the bursting of the dotcom bubble in 2000-02, and have taken place much more rapidly.

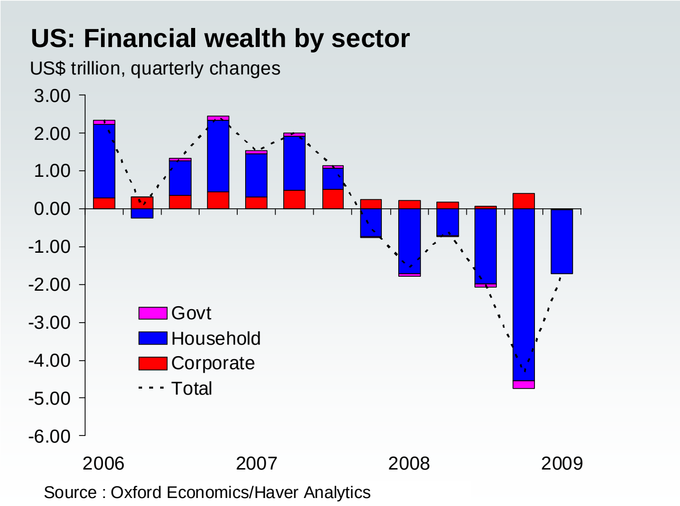


Initially, these wealth losses were centred in the US, where financial wealth has now declined for six successive quarters, by a total of US$8.1 trillion – equivalent to a 12% fall in total wealth. But substantial losses have also occurred in the Eurozone and in emerging markets. Wealth losses in both these areas have totalled around US$11 trillion, equivalent to closer to 20% of total financial wealth.

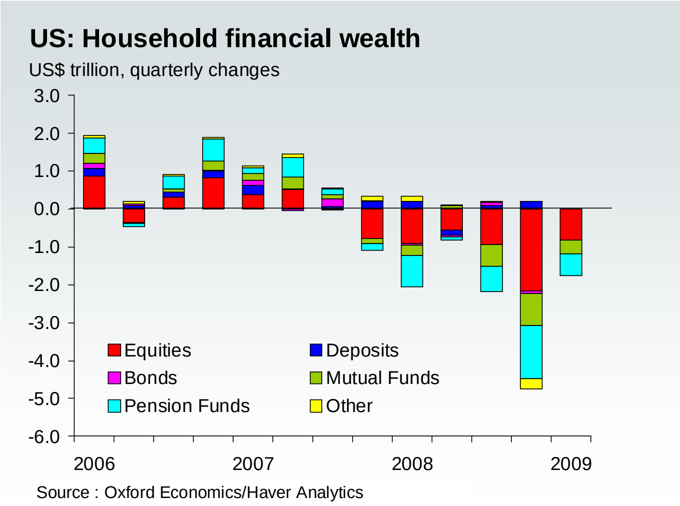


These losses in the Eurozone and emerging markets have been exaggerated in recent quarters by exchange rate effects as the US dollar has gained ground against the euro and many emerging market currencies, but even in local currency terms the losses have been very substantial indeed. Local currency wealth losses have also been significant in Japan, with wealth down 11%, but the appreciation of the yen against the dollar has seen the US$ value of Japanese financial wealth rise.

The wealth losses seen so far have been concentrated in the household sector. This is best seen by reference to the detailed data available for the US, where household financial wealth losses have reached US$11.4 trillion, while government sector wealth has been broadly flat and corporate sector wealth has actually risen slightly. The explanation for this lies in the very different pattern of asset holdings of the different sectors. Households hold a high share of their financial wealth in equities, both directly held and held via mutual funds and pension funds, while the government and corporate sectors hold far fewer equities and more cash and government bonds.



US government bonds have increased substantially in value as interest rates have fallen sharply, offsetting almost totally the losses on other private sector securities such as corporate bonds. As a result, the decline in US household financial wealth broken down by instrument shows a dominant role for equities. Falls in the value of directly-held corporate equities account for just under 50% of the drop in financial wealth, with the balance made up from the slump in value of shares held by mutual funds and pension funds and the slide in value of non-corporate equities.



Financial wealth losses on the scale seen so far raise the risk of significant negative wealth effects – especially on consumer spending. To some extent, these already appear to have materialised, with US consumer spending having weakened notably over the last year and the savings ratio rising. How much of this is a pure wealth effect and reflects consumers' attempts to rebuild the value of their assets and how much is simply precautionary saving in the face of rising unemployment is, however, unclear. Both factors are likely to be important.

Eurozone consumers have also pulled in their horns to a notable extent, with retail sales down 3% on the year in February. This has come despite a rather smaller rise in unemployment – at least in the 'core' Eurozone countries. This probably partly reflects the historically cautious behaviour of consumers in countries such as Germany, but also suggests a significant role for wealth effects.

In recent weeks, global equity markets have rallied, and given the scale of the preceding falls, there is a reasonable case to be made that further large falls may be avoided. This provides some scope for optimism about the likely persistence of wealth effects on consumers. No doubt consumers will continue to be scarred by their recent losses for a time, but the impact on spending should start to fade in due course.

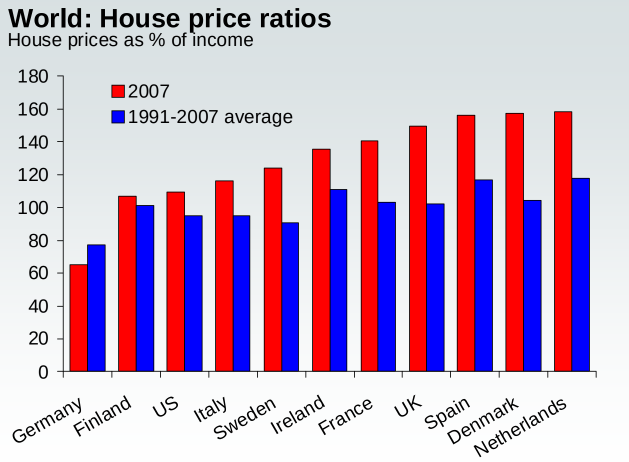
Table 1 – Household wealth

	Estimated fall in household wealth, % of GDP
UK	-92
Spain	-88
France	-69
Italy	-55
Germany	-37
US	-93

Source: Oxford Economics

But developments in financial wealth only represent part of the story, as households also hold significant non-financial assets, mostly in the form of housing. In the US, the financial and housing wealth of the household sector are broadly similar, but in the main European countries housing wealth is around 2-2.5 times the value of financial wealth. As a result, we estimate wealth losses from the recent fall in house prices at a combined US$15 trillion for the US and Europe – only a little below the estimated losses in financial wealth.

There is considerable variation across countries. US house prices have so far fallen some 30% from their peak, and UK prices around 20%. As a result, the total fall in value of financial and non-financial household wealth is estimated at just over 90% of GDP in both countries. In Spain, where house prices have also slumped and the initial level of household wealth was unusually high, the fall in the value of household wealth has been of a similar magnitude. In Germany, France and Italy, the much smaller declines in house prices seen so far mean that household wealth has dropped by a more limited 40-70% of GDP – so far.



Source : Oxford Economics/Haver Analytics

A significant concern for the medium term is that house price cycles tend to last much longer than those in financial assets – often a decade or more – due to the illiquid nature of housing as an asset. And with house prices having run up to significantly overvalued levels in recent years in many countries, there is an increased risk of price falls extending over several years, weighing on consumer spending.

If so, this will be a very different scenario to that seen in the wake of the dotcom crash, when a rally in house prices sparked by falling interest rates helped cushion the blow from falling equity markets, and equities then also recovered, generating a strong rise in overall household wealth from 2003-07. This time, there is a risk that while equity markets could stabilise and start to recover in 2009-10, this will not be enough to offset the continued drag from weak house prices. This could especially be the case in the Eurozone, where equities are less important than in the US, and where the housing market correction has so far lagged some way behind that in the US and the UK – but where prices have also risen rapidly in recent years and valuations in countries such as France, Spain and the Netherlands were as lofty prior to the credit crunch as those in the UK and somewhat more so than in the US.