COLUMBIA THREADNEEDLE INVESTMENTS

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THE STATE OF THE U.S. CONSUMER

Households are proving to be financially resilient during the COVID-19 pandemic, but does investing in consumer debt still make sense?

Prior to the pandemic and the related global economic shutdown, a prevalent theme in the U.S. market was the strength of the consumer, as unemployment was at historical lows and inflation remained benign. Following the financial crisis of 2008, tight lending conditions had forced U.S. consumers to clean up their balance sheets. Debt levels declined significantly, and low interest rates supported strong debt service ratios. Combined, these factors created a strong tailwind for investing in sectors tied to the consumer such as mortgage-backed securities (MBS) and asset-backed securities (ABS).

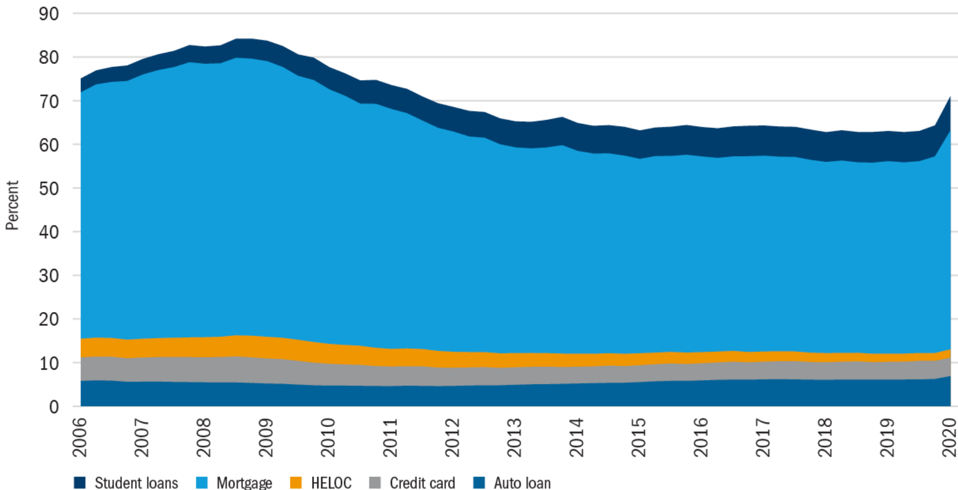
And then the pandemic hit.

Because of the rapid spread of COVID-19, unemployment skyrocketed and millions of people lost their jobs, mostly in the service sector. While much headway has been made since, over 10 million people remain unemployed — greater than the peak of the 2008 great financial crisis (GFC). Despite this very challenging dynamic, the consumer continues to be resilient, and securitized consumer-related investment sectors remain a good value.

Consumer balance sheets were healthy going into the crisis

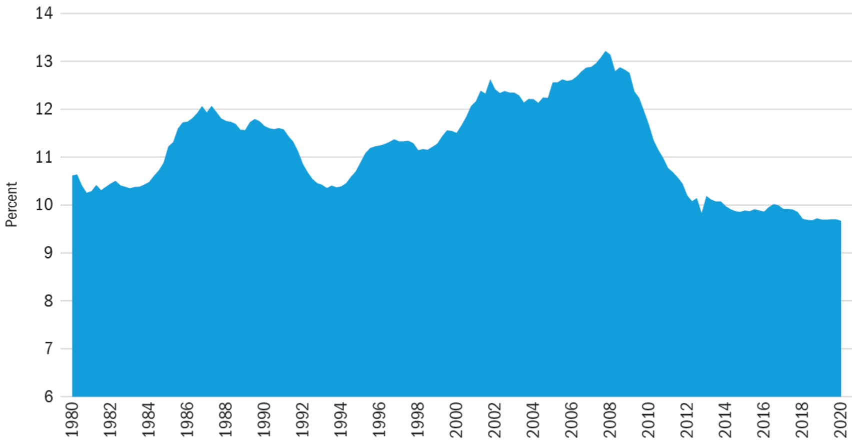
The primary risk in lending to consumers, and corporations for that matter, is the risk of rising delinquencies and defaults. In March 2020, that risk was considerably elevated. Memories of the GFC were quickly reignited, including its rise in foreclosures and falling property values tied to the subprime market. However, the GFC is different than the current crisis in many ways. Not only was the consumer in much better financial shape at the onset of the pandemic (Charts 1 and 2), but there was also a notable improvement in the quality of borrowers who had access to credit, as indicated by FICO score (Chart 3). Those with FICO scores below 650 declined, while those with scores above 650 increased.

Chart 1 — Consumer strength: Household debt-to-GDP levels were favorable heading into 2020



Source: Macrobond, Federal Reserve Board and Columbia Threadneedle Investments as of 06/30/20.

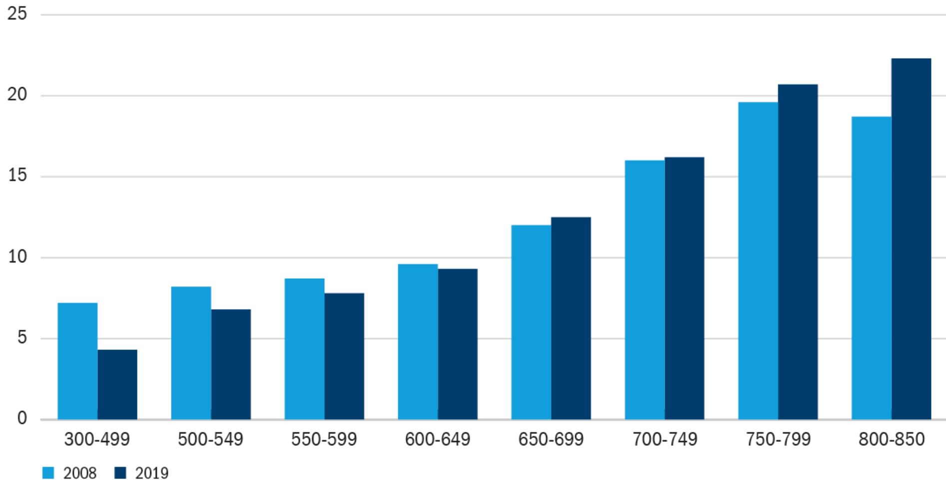
Chart 2 — Consumer strength: Debt-to-income levels were at 40-year lows heading into 2020



Source: Macrobond, Federal Reserve Board and Columbia Threadneedle Investments as of 03/31/20.

Chart 3 — Consumer strength: The quality of borrowers has improved since the GFC

Distribution of FICO scores

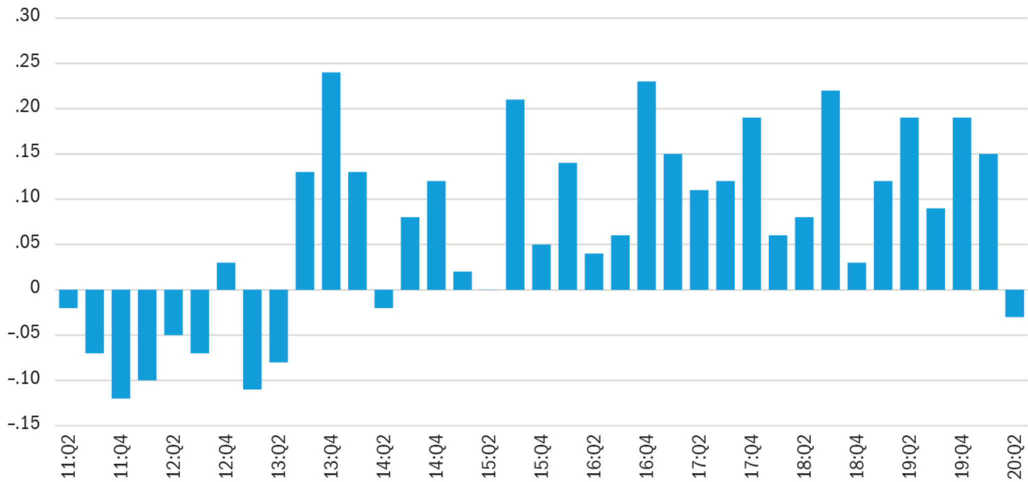


Source: FICO blog August 2020.

Also, consumers have been cautious, de-levering in the second quarter. Economic uncertainty combined with shelter-in-place mandates led to the first decline in household total debt since Q2 2014. Most notable was the decrease in credit card balances which, with nowhere for people to go and nothing to do, declined $76 billion in the second quarter.

Chart 4 — Consumers have been cautious about adding new debt

Quarter-over-quarter change in household debt ($trillions)



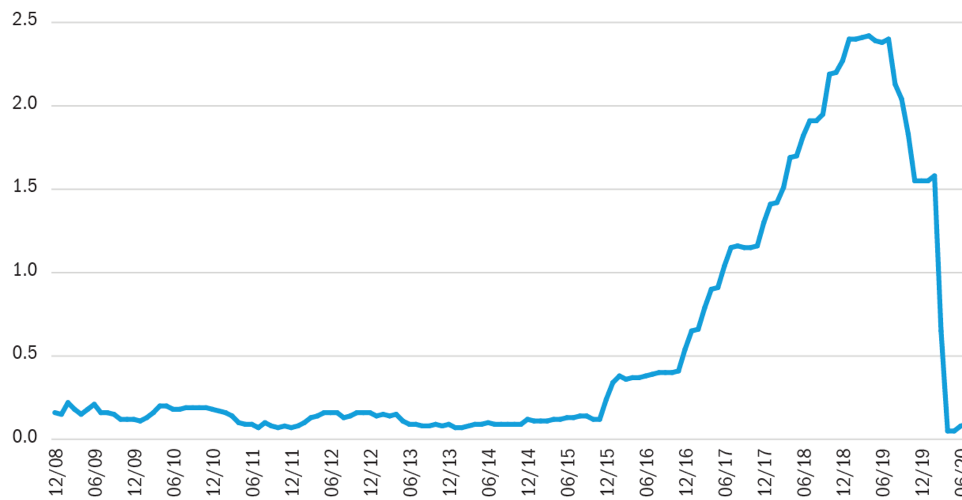
Source: NY Fed Consumer Panel/Equifax as of July 2020

Fiscal and central bank programs have offered support

Quick actions by the Federal Reserve (Fed) have also supported the consumer in the current crisis. With its 2008 playbook in hand, the Fed quickly stepped in, providing liquidity to the market: 0% interest rates, while committing Treasury and Agency MBS purchases to the tune of $80 billion and $40 billion a month, respectively. These actions have loosened financial conditions, allowing homeowners to refinance their mortgages at lower interest rates. They also provided a back-stop to the agency MBS market with their purchase volumes.

Chart 5 — Fed rate cuts have supported the consumer

Effective federal funds rate (%), monthly, not seasonally adjusted



Source: FRED, Federal Reserve Bank of St. Louis

The fiscal response has also been significant. Delinquencies and defaults have been held at bay as borrowers have taken advantage of forbearance plans and collected an additional unemployment benefit of $600 a week. However, this last benefit has expired and been replaced by a short-term $300 a week unemployment supplement funded through FEMA.

Delinquency and default signals are not flashing red

In its second quarter report, the New York Federal Reserve Bank reported that aggregate delinquency rates dropped markedly in the second quarter, reflecting increased uptake in forbearances (provided by both the CARES Act and voluntarily offered by lenders). In fact, during the second quarter, only 0.5% of current mortgage balances became delinquent, and roughly 24,000 individuals entered foreclosure, which is the lowest level since 1999.[1]

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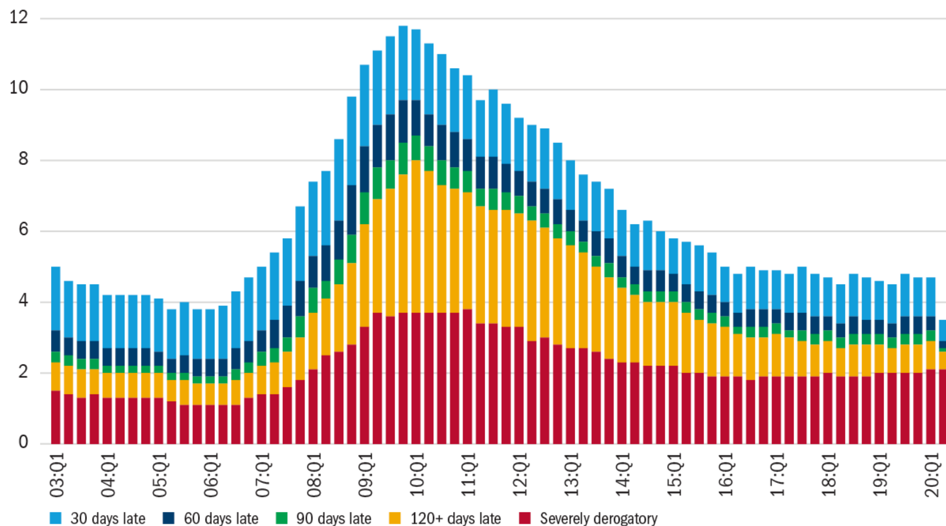
[1] Morgan Stanley

The improvement in delinquencies isn't unique to the mortgage sector. The share of student loans that transitioned to delinquency dropped markedly — most outstanding federal student loans are covered by the CARES Act administrative forbearance. And, while not specifically covered by the CARES Act, delinquencies in auto loans and cards also declined, reflecting the impact of government stimulus programs and possibly some voluntarily offered forbearance options for troubled borrowers.

Chart 6 — Delinquency rates for consumer debt dropped in the second quarter



Source: NY Fed Consumer Panel/Equifax as of July 2020

Where do we go from here?

At the end of July, we hit a fiscal cliff in terms of the programs that were implemented to support the U.S. consumer. Supplemental payroll programs are now less expansive, and the Payroll Protection Program in support of small businesses has expired. Congress hasn't decided on further support yet and the COVID-19 vaccine timeline is another unknown. That said, the Fed has said that it expects monetary policy to be accommodative for a long time as economies normalize. We've already seen a massive improvement in the employment picture, but there is still a substantial number of unemployed who will need to be brought back into the labor market. Housing activity is robust, with strong new and existing home sales, in stark contrast to the GFC. Given this macroeconomic environment, we remain positive in our consumer outlook. However, the ability to select from among specific sectors of the consumer debt universe is critical to controlling risk in portfolios.

While the pooled nature of structured credit products like non-agency MBS or ABS confers some degree of risk management (i.e., one loan going bad in a bundle of hundreds is unlikely to have a meaningful impact) a strategy of dynamically allocating to categories of structured products may be essential, especially if we begin to see weaker data within a particular segment.

Past performance does not guarantee future results.

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

The illustrations here are not intended to be representative of the performance of any particular investment. Such information has inherent limitations and may not be indicative of future results. It is important to keep in mind that no formula, model or tool can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them.

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